Connecting communities in the North East with a better financial future

Newcastle Building Society

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Annual Report and Accounts 2016

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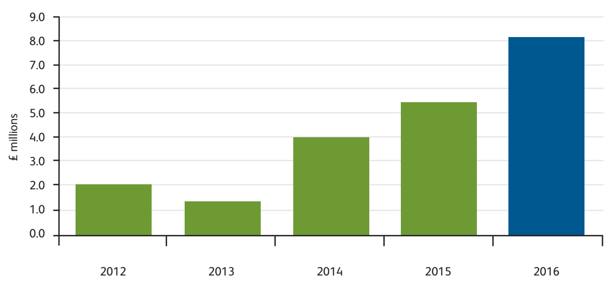

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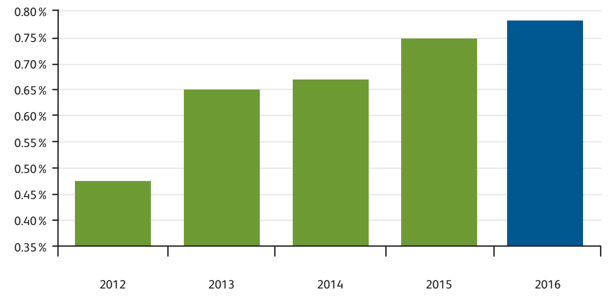

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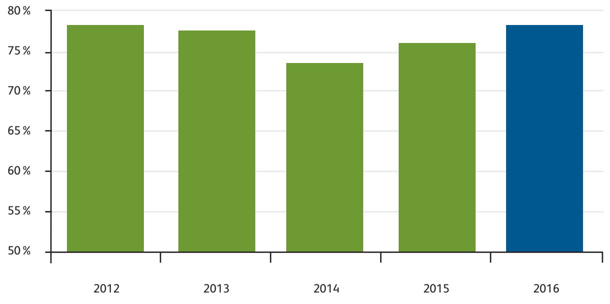

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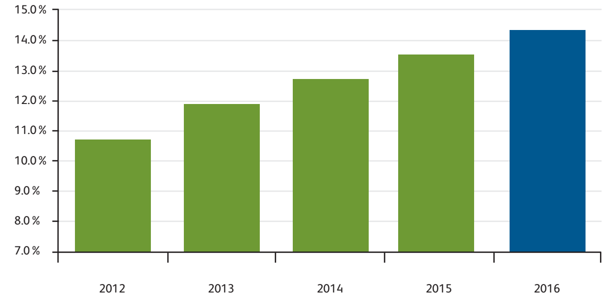

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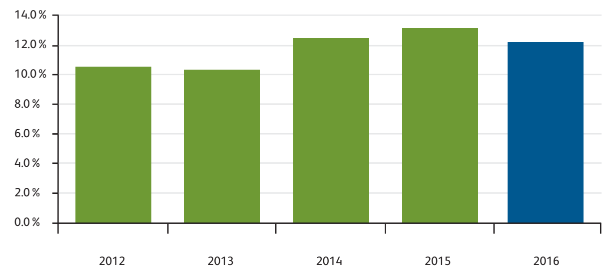

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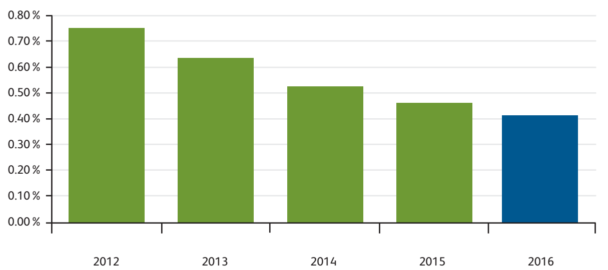

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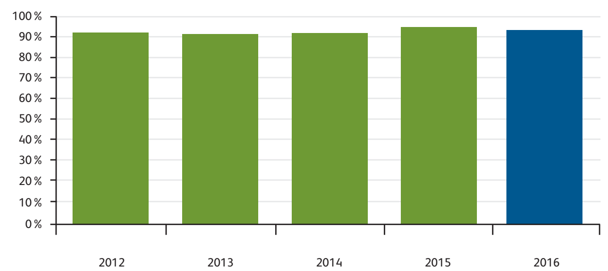


Chairman's Statement

Phil Moorhouse
Chairman

We began 2016 with a positive announcement of a £10m investment in improving services for Members and clients across our network. This was underpinned by the creation of 100 new jobs in the North East. This recruitment drive was just one of a number of key milestones that were successfully delivered as part of an organisation wide commitment to delivering excellent service and growth.

Our financial performance continued to progress and saw an increase in our profit before tax to £8.1m. It was pleasing to see our overall capital and liquidity ratios maintained at robust levels of 18.7% and 17.4%, respectively. A strong and sustainable commercial performance is a required foundation for the Society's future and 2016 continued the good progress in this area. We were pleased to deliver a record year in mortgage lending for the Society, see continued growth in our outsourcing subsidiary, Newcastle Strategic Solutions Limited, and continue to provide financial advice throughout the network.

Economy

Despite the uncertainties that exist following the decision to exit the EU, the UK economy proved relatively resilient through 2016. GDP continued the trend of positive growth although slowing as 2016 progressed. This is predicted to slow further in 2017, with continued economic uncertainty. During the year the Bank of England cut base rate from 0.5% to 0.25%. Across the mortgage market as a whole, the trend has been towards a more restrained level of activity, reflecting a number of factors; regulatory and tax changes impacting buy to let; affordability and stamp duty affecting higher end properties; and first time buyers and home movers facing similar affordability pressures, although various government schemes have helped bolster first time buyers.

With inflation and borrowing costs expected to rise in 2017, we remain cautious about the stability of the housing market. Historically low interest rates have presented no less a challenging environment for savers in 2016. But despite an interest rate environment which has been on the side of borrowers since 2009, and a monetary policy designed to encourage spending, consumers have been building up their cash savings, and are likely to continue to do so, largely due to the uncertain outlook.

Members

As part of our investment programme, we are committed to maintaining a comprehensive network of branches across the North East in the right format and right locations to grow the Society's membership. We know that in a range of areas, particularly financial planning advice and mortgage advice, Members value our personal approach and the opportunity for face-to-face interaction. This is something we will continue to offer.

In 2016 we relocated and revamped two new branches – Newcastle's Hood Street branch relocated to become a city centre Financial Advice Centre branch in New Bridge Street, Gateshead branch moved to Trinity Square, and we closed Low Fell branch. Due to falling usage at Wallsend and Heaton, these branches were also closed, with customers welcomed to an upgraded North Shields branch and the new city centre facilities. A new, mini branch in Yarm library was launched in October as part of a successful partnership with Stockton Borough Council. It has received recognition for its innovative approach and community focus from customers and national observers alike.

Fulfilling our commitment to providing service via the channels our customers choose, we also made some changes to our online service offering. A new look, easy-to-use website with mobile functionality, and improved online account set up and servicing for savings customers, alongside a webchat facility and online appointment booking for those seeking to mortgage or remortgage a property, were all introduced or improved.

A number of "best buy" savings and mortgage products were launched by the Society throughout 2016 and our mortgage business enjoyed record residential lending figures. Our mortgage proposition has been further improved with a comprehensive range of products designed to meet a variety of circumstances, including self-employed, self-build, buy to let and help to buy products. We continued with our commitment to helping first time buyers get a foot on the housing ladder, and similarly to those who are seeking to remortgage in order to move home, or just to improve their mortgage deal.

On the savings front, we provided a number of Member loyalty products and we saw the very successful launch of the Newcastle Building Society Community Saver account. The Community Saver account has the benefit of generating an income for the sole use of community projects across our branch network. The Society was thrilled to win the prestigious Heart of the Community accolade at the North East Business awards for Tyneside and Northumberland, recognising both our significant fund raising contributions and our successful financial education programme within schools, which has seen us engage with over 2,000 primary school children to date.

Newcastle Strategic Solutions Limited

Our subsidiary providing online savings management outsourcing for third party financial institutions enjoyed another year of strong growth. We are making significant investments in our structure for the future. Significant recruitment activity through 2016 has strengthened the Solutions management team, we have improved operational efficiency, and successfully delivered a record performance for the value of savings balances under administration, creating a significant profit stream that is used within the Member business. Newcastle Strategic Solutions was shortlisted for FSTech Outsourcing Partnership of the Year Award and has a strong pipeline of new client launches for 2017 and beyond.

Our Staff

The Society has more than 1,000 staff across its branches, support functions and subsidiaries, making it a significant employer for the region. We continue to offer great opportunities for development and progression internally, with around one third of all appointments this year filled by internal candidates.

Over the course of the year, our Aspire Leadership course was attended by 231 staff and the Society continued to invest in supporting colleague development. Our first Ocademy financial adviser trainees successfully graduated and a new Service Academy was introduced to facilitate a seamless introduction to client servicing teams for new Solutions customer service advisers. Following the introduction of our volunteering policy whereby staff are supported by two days of paid volunteering per year, more than 100 staff have been out and about in our local communities this year.

Our Board

We are pleased to welcome Damian Thompson to the Society's Board, taking up the newly created role of Customer Director. This role is central to our focus on Members and customers. Damian joined us from a building society background and with 25 years' experience in financial services, bringing a wealth of expertise in understanding customers to evolve product distribution and service capabilities in order to keep pace with changing needs. He will be focused on growing our Member organisation, connecting with Members in the North East and beyond, and ensuring Members continue to have a powerful voice across our organisation.

Overview

During 2016 the Society has continued to grow and maximise its impact across a range of key areas. Its financial position has continued to strengthen, as underlined by the growth in profit and capital. Investment across the organisation will continue into 2017 as the Society seeks to consolidate its role as a key building society and employer - within and for the region. Facing anticipated economic challenges and increasingly competitive markets, the Society will continue to take a prudent approach, but remains cautiously optimistic around its potential growth and will seek to further enhance performance across its business areas.

Finally, it is important to acknowledge the continued support we receive from our staff. The dedication they show in helping us deliver our strategy can be seen in the achievements made in 2016. This commitment is critical in helping us realise our ambitions and the support and enthusiasm of our staff is very much appreciated by the Board.

Phil Moorhouse
Chairman
23 February 2017

Chief Executive's Review

Andrew Haigh
Chief Executive

The Society has made good progress in 2016, despite what has been a challenging and unpredictable external environment. At the start of the year we set out an ambitious agenda including substantial investment to improve our service to customers through digital, branches and mortgage intermediaries and the creation of over 100 new jobs across the North East region.

It is very pleasing to report that we achieved the goals we announced at the beginning of the year, while also adapting to the changing regulatory agenda and unforeseen events, both in the wider world and closer to home too.

A few of the highlights include: opening new customer facilities at our Head Office, Gateshead and Yarm branches; launching the Advice Centre concept in Newcastle City Centre; delivering good and timely outcomes to some significant regulatory projects such as the Deposit Guarantee Scheme Directive and FCA cash savings study; achieving our goal of creating 100 jobs; development workshops for our staff; launching the Newcastle Building Society Community Fund and Community Saver accounts; continued growth in Newcastle Strategic Solutions; a new website; an expanded and enhanced recruitment team and a brilliant effort in supporting local communities through our volunteering scheme.

Of course financial performance is also important and across 2016 we have improved profitability, maintained strong capital and liquidity ratios and achieved record low arrears figures.

Financial Performance

Profit before tax improved to £8.1m for the year ended 31 December 2016 compared to £5.4m for 2015, an increase of 50%. Operating profit before impairment charges and the Financial Services Compensation Scheme (FSCS) Levy was maintained at £11.9m with a higher contribution from the Solutions business being used to fund investment into the Group both in infrastructure and also increased investment in staff as we build our capability to grow. Net interest margin improved from 0.75% to 0.77% reflecting increased levels of residential mortgage lending although the mortgage market continued to be very competitive with mortgage rates at historically low levels.

The profitability of our Solutions business improved reflecting the impact of the 4 contracts launched in 2015 as they continued to grow and build scale. The Solutions business provides a diversified income stream, based on core competencies within the building society business. All of the profits from this business are ploughed back into the Society and support increased investment in services for Members as well as providing capital to support and grow the business.

In 2016 we invested significantly in IT systems and supporting processes, particularly around combatting cybercrime, enhancing resilience, reflecting the latest regulatory developments and improving functionality. All of this is essential to further enhance our market leading Solutions business proposition and also benefits the Society's wider business and service to customers. The pipeline for the Solutions business continues to be very strong particularly for 2017 implementation.

There was a reduction in impairment charges from £4.6m to £3.2m reflecting the ongoing reduction in the legacy commercial portfolio and the FSCS levy also decreased from £1.9m to £0.6m due to a pleasing reduction in the amount of the levy imposed on retail deposit takers by the FSCS.

The Society's capital ratios continue to improve with Common Equity Tier 1 ratio improving from 13.6% to 14.3% and Tier 1 capital ratio increasing from 15.3% to 15.8%. The Group overall capital ratio (Solvency ratio) remained at 18.7% as strong profitability offset amortisation of Tier 2 capital in the run up to maturity dates in 2017 and 2019. The leverage ratio (on a transitional basis) reduced from 5.3% to 5.2% reflecting a larger balance sheet size, but remains comfortably in excess of minimum requirements.

Despite the mortgage market being extremely competitive in 2016 we achieved a significant uplift in lending reflecting the investment we have made in distribution, our mortgage product range and online systems capability for brokers. Gross residential mortgage lending was up 46% from £340m to £496m and net lending increased from £10m to £195m reflecting the higher level of lending and greater retention of existing mortgage customers. We also have a strong mortgage pipeline going into 2017.

The percentage of mortgage loans in arrears of 3 months or more, across our whole mortgage portfolio based on the number of loans, reduced again from 0.49% to 0.42%; lower than the industry average with 2016 seeing a record low since we began tracking 3 months arrears. Possession cases also continued at very low levels reflecting the excellent credit quality of the Society's residential lending.

Our liquidity at the end of the year was 17.4%, excluding encumbered assets, down slightly compared to the level at the end of 2015 of 17.7% but well above our minimum operating requirements. Against the liquidity coverage ratio, the new European measure introduced in 2015, the Society's ratio was 202% against a minimum required level of 90% (from 1 January 2017). This significant headroom reflects the quality of the Society's liquidity with the majority of it invested in AAA/AA rated assets, in the UK.

Supporting our Members

Our mortgage borrowers have seen mortgage rates at record lows this year following the base rate cut announced by the Bank of England in August. As well as continuing to offer a great range of products for customers we have expanded our range to include new products tailored for customers who are either self-employed or require a larger loan size.

Our first time buyer lending was successful in 2016 with consistent good value products up to 95% Loan to Value (LTV) for those customers taking their first step onto the property ladder. We extended our support for first time buyers with the launch of Help to Buy mortgage products. Our buy to let and self-build mortgage products have also been well received by brokers and customers and have contributed to strong lending volumes in 2016.

Our 'Home Saver' savings products have been popular and we are now seeing customers buying their home who have been saving through the Government's Help to Buy scheme and the Society's First Home Saver account, taking advantage of the bonuses available on both accounts.

A high point of 2016 has been the successful launch of our Community Saver accounts where we have already attracted over £200m of balances from customers who want to combine a good savings rate with helping to support their local communities. More details of this exciting new initiative are given in the Community Support Round-up Report.

Our financial advice subsidiary, Newcastle Financial Advisers Limited, gives customers financial advice regardless of how much they have to invest. We know our customers really value this face-to-face service as this area of the business scores very highly in customer satisfaction (97% for 2016), and experiences high levels of repeat business. We have made further investment into our financial advice proposition this year with the launch of two new advice centres in our branches in the heart of Newcastle.

Over the last 12 months we have engaged with our Members through 'Meet the Chief Executive' roadshows, branch events, our customer panel, and most importantly responding to the feedback our Members give us. I really value the direct feedback I receive through the roadshow events as a measure of where we are doing well and where we need to develop or improve.

At several of our 'Meet the Chief Executive' roadshows I have had questions around security of customer data. Criminals are becoming increasingly sophisticated in their tactics to access and use information held online and it's a challenge faced by every organisation to ensure that confidential customer information is protected.

The Society was pleased to be awarded the Cyber Essentials Plus Standard of assurance in 2016. Cyber Essentials is a UK government-backed cyber security certification scheme that sets out how to meet a good cyber security baseline, and provides an independent endorsement of the high cyber security standards we employ across the business.

We remain mindful that this is a threat that continues to evolve and we therefore plan to maintain our ongoing investment in developing our defences and keeping a strong focus on this key area.

Supporting our Staff

We are conscious of our responsibilities as a leading employer in the region. We continually search for ways to make the Society an even better place to work and help people achieve their potential.

We have continued our investment into the recruitment and development of staff across the business. Alongside the introduction of an online recruitment management platform, we have introduced a framework of behaviours to help us achieve our vision, our goals and to underline and support our customer focused culture, including a new customer promise.

We have continued to invest in our 'Ocademy' programme, working with our partner, Openwork, to develop new advisers for Newcastle Financial Advisers Limited. The first candidates graduated this year, with excellent results, and our second cohort have already started the next programme. Our Aspire development programme, our newly launched service academies and our well established relationships with local universities all reflect the investment we are making in our people.

In line with our promised commitment at the start of the year, we reached and exceeded our target of creating 100 new jobs in the region in 2016, supporting our growth plans for 2017 and beyond and we expect to grow our workforce further in the year ahead.

It is pleasing to note that as well as increasing the number of new staff at the Society we have also maintained the tradition of building long term career relationships. While we have just passed the 1,000 employee mark, we are also proud of the fact that nearly one quarter of our staff have 10 years' service or more. This is a remarkable sign of commitment and a wealth of experience within the Society.

Summary

I am very pleased with the Society's performance in 2016 which I believe balances the need for a robust financial performance with investing in the products and services we provide for customers both now and for the longer term.

I would like to thank our staff for their exceptional contribution in 2016. We have had a challenging year and whether it has been dealing with the myriad of new regulations, input into projects to grow and develop our business or helping customers navigate financial uncertainties, the flexibility, professionalism and commitment of everyone across the Society has been impressive.

We look forward to the future knowing that we will be true to our purpose of Connecting Communities in the North East with a better financial future, encouraging people to save and plan their finances and helping people to own their own home. During what may be uncertain times, our Members and customers can rely on their local building society.

Andrew Haigh
Chief Executive
23 February 2017

Strategic Report

The Directors present their Strategic Report on the Group for the year ended 31 December 2016.

Purpose and Strategy

Newcastle Building Society is the largest building society based in the North East of England.

In recent years the Society has successfully followed a strategy which has seen improvement in areas of our services and financial strength. These improvements have been made by focusing on key stakeholders, our Members, Staff, Communities, and Solutions customers.

In 2016 we reviewed our strategy to ensure our focus was on our purpose as a building society. Although financial strength underpins any successful business, we do not exist to make record profits, we exist to make a real positive difference to the communities in which we operate.

The Society's purpose is:-

"Connecting communities in the North East with a better financial future".

We aim to do this through:-

- Encouraging people to save and plan their finances;
- Helping people own their home;
- Being a great place to work, where people can realise their potential;
- Helping our communities make positive changes; and
- Helping our clients and partners succeed through our excellent products and services.

At our core, we remain a straightforward saving, lending and advice business putting Members at the heart of what we do. As well as providing mortgage and savings accounts to our Members, we also provide a number of other related services, including regulated financial advice for investments through our subsidiary Newcastle Financial Advisers Limited; an Appointed Representative of Openwork LLP. We also provide insurance products including home and contents insurance through our partner Legal & General Group PLC.

Newcastle Strategic Solutions Limited is a business to business subsidiary which plays a key role in the Society's financial model. Our IT subsidiary, serves all elements of the Group and also extends those services to business to business clients. In both cases we will continue to develop the quality and efficiency of our capability – underpinning the group with excellent IT services and securing our market position as the leading provider of outsourced savings management services.

The Solutions business operates on a commercial basis, to make a profit, and the profits from this business generate capital enabling the Society to invest in the services it provides and grow our lending.

Key Performance Indicators

Key Performance Indicators (KPI) are an important way of monitoring achievement of short-term objectives and progress against the strategic plan and are reported to the Board on a monthly basis.

Senior management consider a wide range of financial and non-financial metrics to assess the performance and future direction of both the Group and Society. Financial metrics include both measures defined or specified by the Group's applicable financial reporting frameworks (primarily International Financial Reporting Standards and the Building Societies (Accounts and Related Provisions)), such as profit before tax, and non-specified measures, such as net interest margin, cost to income ratio, and operating profit before impairment provisions and FSCS levy.

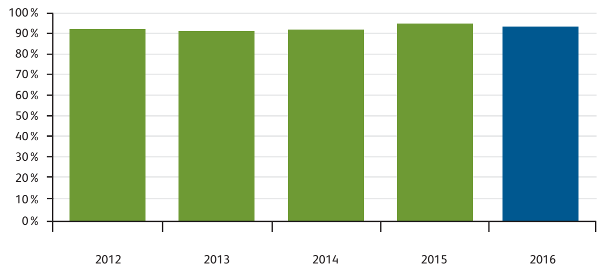
Those financial measures not specified by the Group's financial reporting frameworks are alternative performance measures (APMs) with further detail provided in the financial KPIs and analysis section.

CUSTOMERS	2016	2015
Customer satisfaction	93%	95%
Complaints handling % achievement within service level	99%	99%
Telephones - % achievement of all service levels	90%	86%
Servicing - % achievement of all service levels	98%	97%
PEOPLE		
Staff turnover	12.2%	13.2%
FINANCIAL - PROFITABILITY		
Profit before tax	£8.1m	£5.4m
Net interest margin	0.77%	0.75%
Cost to income ratio	78%	76%
Solutions profit before tax	£9.4m	£7.0m
NFAL profit before tax	£1.1m	£1.2m
FINANCIAL - BALANCE SHEET		
Common Equity Tier 1 ratio	14.3%	13.6%
Leverage ratio	5.2%	5.3%
Liquidity as a percentage of shares, deposits and liabilities	24.9%	24.3%
Liquidity as a percentage of shares, deposits and liabilities, excluding encumbered assets	17.4%	17.7%
Liquidity coverage ratio	202%	230%
Gross residential lending	£496m	£340m
Net residential lending	£195m	£10m
3 months or more arrears for total mortgage portfolio, by number	0.42%	0.49%
3 months or more arrears for total mortgage portfolio, by balance	0.24%	0.39%

Customers

The current KPI designed to reflect how well the Society is meeting Members' needs is the customer satisfaction survey which shows the proportion of our customers who say that they are pleased with the service they receive. The customer satisfaction survey showed overall satisfaction of 93% in 2016, continuing the preceding years' trend of achieving or exceeding our target of 90%.

Overall Customer Satisfaction Percentage



The 2016 survey highlighted improvements in many aspects of the service offered by the Society including increases in scores for our friendliness and helpfulness of staff in branch and over the phone, a higher net promoter score, which measures the loyalty of our customer relationship and a net easy score, which measures how easy customers find it to interact with us.

In addition the overall satisfaction within the financial advice subsidiary, Newcastle Financial Advisers Limited (NFAL), was 97% (2015: 99%), a major testament to the quality and value NFAL customers receive from the face-to-face financial planning service offered.

Other customer KPI metrics include the timeliness of response following customer feedback on those occasions our service is not as good as we would want it to be, and customer service levels in our call and servicing centres. These metrics were above target across 2016.

The Society continued to improve the mechanisms that customers have to engage with the Society in 2016 as part of a £10m investment programme. There has been further investment in telephone and digital offerings and improvements to our branch network demonstrating the Society's commitment to enhancing and expanding the service we give to customers.

We were delighted to open two Advice Centres in Newcastle and two new branches, one in Gateshead and the other in Yarm. The branch in Yarm is an innovative new strategic partnership with Stockton Borough Council which has enabled the Society to re-establish our presence on Yarm High Street and offer traditional building society services and financial advice within a redeveloped library facility.

The Society launched a new look website making it easier to find out about our products and services and features helpful guides, tools and videos. Webchat was also launched during 2016 providing an alternative and responsive customer service option for our customers. Further details of what the Society has been doing for Members and customers are included in the Chief Executive's Review on pages 6 and 7.

People

The Society needs to have the right people, in the right jobs, with the right skills appropriately supported to achieve both personal and organisational potential.

In 2016 we developed and delivered key initiatives which included the establishment of an in-house recruitment team supported by an e-recruitment platform, development and implementation of a behavioural framework and the introduction of job evaluation resulting in a clearly defined grading structure. Our people strategy focuses on providing an immediate, on-going and long term framework for engaging, developing and managing our people.

Our people strategy is about creating an inspiring place for people to work and achieve their full potential whilst delivering the Society's ambitions, with key objectives as follows:-

- Developing high quality leadership and management;
- Developing individual and collective performance;
- Attracting, recruiting and retaining talent; and
- Developing staff communications and engagement.

The Society places a great deal of emphasis on engaging its staff in the ongoing development of its business and delivering its purpose and strategy. The valued views of staff are regularly gathered through focus groups and interactive corporate updates delivered by the Chief Executive and senior management team. The Society listens very carefully to this feedback, which is used to shape aspects of how we improve as an employer. The Society is also committed to promoting a common understanding of the more specific drivers of its financial performance. Bi-annual update sessions, typically coinciding with the Society's half-year and year-end results, are delivered by senior management to explain the Society's position and direction with emphasis given to key financial and economic influences.

Many of our staff volunteer to help local charities and groups through participating in a huge variety of activities and events. Further details are given in the Community Support Round-up Report on page 15.

As the first building society to achieve Investors in People (IIP) status in 1992 the Society has a long and consistent track record of investing in the development and learning of its staff. Our forward looking HR strategy seeks to deliver worthwhile careers to people in the North East of England and ensuring the Society is a great place to work. Further details regarding our training programmes including the Aspire Development Programme, Service Academy and Ocademy are given in the Chief Executive's Review on page 6.

An annual pay review for all staff takes place on 1 April and the Group operates a discretionary Corporate Bonus Scheme for all staff based on performance as measured by the delivery of KPIs linked to the Group's strategic objectives. The 2016 Corporate Bonus Scheme will pay all eligible staff an amount equal to 3.0% (2015: 3.0%) of salary. Unite has negotiating rights on behalf of all staff up to and including senior management level and in 2016 a pay award of 2.0% was given.

Strategic Report (continued)

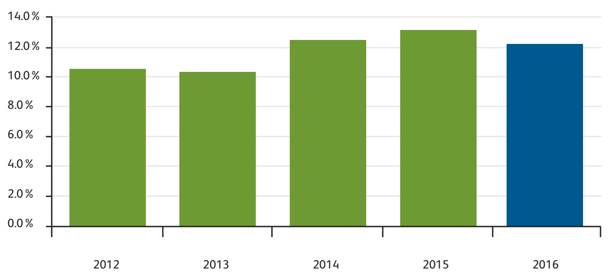
The Society operates an Equal Opportunities Policy. It is the intention of the Society that no applicant or employee receives less favourable treatment on the grounds of disability, sex, transgender status, sexual orientation, marital status, civil partnership status, race, ethnic origin, colour, age,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

The Board also has an approved diversity policy. The gender diversity for the Society's staff at 31 December 2016 is as follows:

	Female		Male	
	2016	2015	2016	2015
Directors	18%	27%	82%	73%
Senior Managers	25%	25%	75%	75%
Managers	51%	55%	49%	45%
Employees	63%	62%	37%	38%
Overall	**60%**	**61%**	**40%**	**39%**

The Board views the staff turnover KPI as an important reflection of the success of the people agenda. The Group staff turnover rate decreased slightly to 12.2% in 2016 from 13.2% in 2015, this is below the KPI target and should be considered against a background of improving economic conditions having influenced the jobs market.

Percentage Staff Turnover



The Society has a Health and Safety Committee that supports and assists the Society in developing safe systems of work. The purpose of the Committee is to provide a forum for representative staff to discuss specific issues to help ensure that the Society has taken all reasonable and practicable steps to maintain a safe and healthy working environment.

The Committee reviews the overall operation of the Society's Health and Safety Policy, including the content of employee health and safety training and discusses health and safety performance, problems and future priorities.

Financial KPIs and Analysis

Profitability

Profitability is one of the key performance measures the Board monitors closely. The Society seeks to make sufficient profit in order to invest in and grow the business for the benefit of its current and future Members. A Building Society must be profitable to demonstrate it has a long term sustainable business model and show financial strength to savers, borrowers, regulators and business partners.

GROUP INCOME STATEMENT	2016 £m	2015 £m
Net interest income	27.1	27.1
Other income and charges	27.5	23.0
Total income	**54.6**	**50.1**
Administrative expenses	(40.3)	(36.1)
Depreciation	(2.4)	(2.1)
Operating profit before impairment charges and provisions	**11.9**	**11.9**
Impairment charges	(3.2)	(4.6)
Provision for FSCS	(0.6)	(1.9)
Profit for the year before taxation	**8.1**	**5.4**

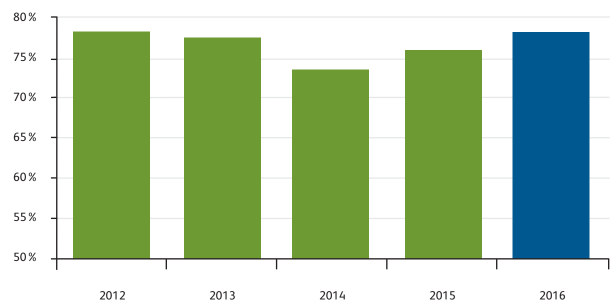
Profit before tax increased by £2.7m to £8.1m in 2016 from £5.4m in 2015 due to a fall in mortgage impairment losses and the Financial Services Compensation Levy. Other income increased by £4.4m, mainly due to an increase in Solutions income but was offset by administration expenses increasing by £4.2m.

Operating profit before impairments and provisions was unchanged at £11.9m in 2016 (2015: £11.9m). Underlying operating profit continued to be influenced by investment in staff and infrastructure that began in 2015. Operating profit before impairment provisions and the FSCS levy is considered an important reflection of the operating strength of the Group's core business (including Solutions) in advance of one-off, exceptional, or other items of income and expense that fall out of management's direct control.

The Board considers the cost to income ratio to be an important measure of financial progress against internal targets and the return achieved on investment in the business. The cost to income ratio rose by 2% from 76% in 2015 to 78% in 2016, due to increased administration costs reflecting the investment in infrastructure and people for both the Solutions business and to enhance services to Members.

The cost to income ratio reflects costs deemed to be under the control of management (administrative expenses plus depreciation as disclosed in the Income Statements on page 38) divided by total operating income, as similarly presented. Management assess the ratio as a measure of operating efficiency.

Cost to Income Ratio



Net interest margin

Net interest margin is a relative measure of the Group's net interest income (as disclosed in the Income Statements on page 38) - the difference between interest received on assets and interest paid on liabilities – divided by the Group's average total assets during the year.

The Group's net interest margin increased to 0.77% in 2016 from 0.75% in 2015 as the Society continued to manage the margin with a view to the long term future by balancing the risks and rewards from residential lending while offering consistent value to savers. Whilst interest margin was negatively impacted by the 25bp cut in base rate and very competitive mortgage rates this was offset by increased net lending and lower retail savings rates.

Net Interest Margin

Other income and charges

Net other income in total across the Group increased by 19% to £27.4m in 2016 from £23.0m in 2015 due mainly to a significant increase in Solutions income linked to the growth in the four new savings management contracts launched in 2015. Diversification through the Solutions business is a key element of the Society's strategy, with the current client base and the healthy pipeline of savings management contracts providing further growth in the business in 2017 and beyond.

The other income and fees for the Member business were £0.8m lower in 2015 due to one off income gains recognised in 2015 of £0.6m and reduced mortgage fees reflecting the success of fees free products. The divisional performance of the Member and Solutions businesses are shown in Note 8 on page 50.

Administrative expenses and depreciation

Administrative expenses and depreciation (together "management expenses") increased to £42.7m in 2016 from £38.2m in 2015, reflecting the Society's strategy of investing in infrastructure, people and processes to support expected growth in the business. Staff costs increased by £2.8m in 2016 compared to the prior year. The increase is mostly associated with supporting the growing Solutions business but many areas of the Member business have seen new posts created as the Society develops to meet the challenges and opportunities of a modern, forward looking building society. There were 118 new roles created and 359 appointments during 2016, further details can be found in note 6 on page 48.

Non staff costs increased by £1.4m in 2016 compared to the prior year. The depreciation charge in 2016 increased by £0.3m due to increased capital expenditure.

In 2015 we reported the Society's commitment to significant capital investment in our branch network and technology platforms. In 2016 we continued this with our branch refurbishment programme and investment in computer and telephone networks. Investment is key in both areas, through improvements the Society aims to ensure our branches offer Members a modern, welcoming and inviting environment in which to do business with us.

The Society recognises that information technology is a cornerstone of any business and investment ensures our technology platform is at a leading level to provide security of its data and enhance resilience.

The ratio of management expenses to mean total assets increased to 1.21% in 2016 compared to 1.06% in 2015. Although a traditional method of measuring cost management for building societies, the Board considers the management expense ratio to be less reflective of the Group's business model in that the Solutions business income stream requires minimal assets to support it. The management expenses ratio excluding the Solutions business was 0.85% for 2016 compared to 0.77% in 2015 reflecting significant levels of investment in staff and infrastructure during the year.

Impairment charges

The impairment charge for loans and advances to customers has fallen overall to £3.0m in 2016 from £4.6m in 2015, (excluding provision charges for suspended interest), which represents the fifth consecutive year of reduction in charges. The Society has been successful in its strategy to de-risk the commercial portfolio by winding down the loan book and increasing provisions against what remains on the balance sheet.

IMPAIRMENT CHARGES BY AREA	2016 £m	2015 £m
Commercial	2.5	4.5
Residential (1)/ Other	0.7	0.1
Provisions charge for the year	3.2	4.6
Interest added to provisions (2)	(0.2)	-
Total charge recognised	**3.0**	**4.6**

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

From 1 January 2018 the Group's recognition of impairment losses will be calculated under IFRS 9 'Financial Instruments' as the reporting standard replaces the current provisioning requirements of IAS39. Note 11 on page 53 and Note 29 on page 67 contain further details.

Provisions for liabilities and charges

The 2016 charge of £0.6m recognised in the Income Statement relates to the Financial Services Compensation Scheme (FSCS) levy (2015: £1.9m). The fall in the charge reflects a lower overall expected levy for interest charges and no capital shortfall charge in respect of 2016.

Taxation

The Group shows an effective corporation tax rate of 24.7% in 2016 or £2.0m. 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. Corporation tax rate changes announced in 2016 were substantively enacted by the end of 2016 and therefore the impact of these tax rate reductions on the deferred tax asset have been written off in 2016. The Society and Group have not paid any corporation tax since 2007 due to the taxable losses available.

Other Taxes paid by the Society are summarised in the table below:

TAXATION	2016 £m	2015 £m
Employers' National Insurance	2.1	1.9
Value Added Tax	1.6	1.8
Total	**3.7**	**3.7**

Strategic Report (continued)

Balance Sheet

Liquid assets

The Society has continued to maintain a level of high quality liquid assets throughout 2016. All of the Society's liquid assets are placed with AAA rated UK Institutions with the exception of Gilts and deposits with the Bank of England which carry the UK Sovereign rating of AA+.

ASSET CLASS	2016 %	2015 %
Cash in hand and balances with the Bank of England	36.2	34.4
Gilts	13.3	9.4
Residential mortgage backed securities	28.2	30.9
Covered bonds	21.9	23.0
Other	0.4	2.3
	100.0	100.0

The Society also has access to the Bank of England liquidity schemes and has pre-positioned mortgage collateral and asset backed securities that provide funding as part of business as usual and contingency funding plans.

The Society liquid assets increased slightly during the year with the statutory liquidity percentage reported at 31 December 2016 being 24.9% compared to 24.3% in 2015. Excluding encumbered collateral balances liquidity was 17.4% compared to 17.7% at the previous year end – well in excess of the Society's minimum operating level.

The Liquidity Coverage Ratio (LCR) measures unencumbered high quality liquid assets as a percentage of net cash outflows over a 30 day stress period. The LCR as at 31 December 2016 was 202%, comfortably in excess of the minimum regulatory limit set by the PRA of 90% from 1 January 2017.

Loans and advances to customers

Loans and advances to customers increased by £79m overall in 2016 as shown in the table below, which highlights the Society's strategy to grow prime residential mortgage business whilst winding down legacy portfolios.

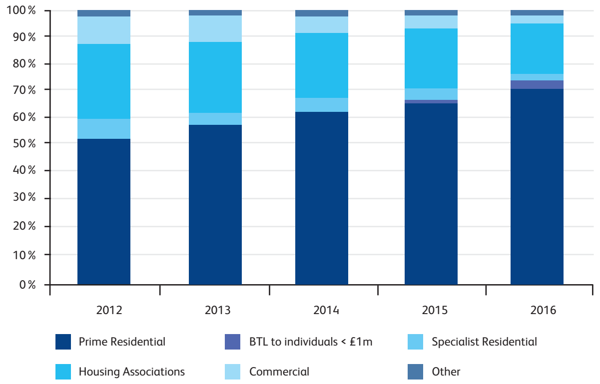
LOAN PORTFOLIOS	2016 £m	2016 LTV%	2015 £m	2015 LTV%
Prime Residential	1,796	53.9	1,667	53.8
Retail BTL <£1m	79	67.5	22	66.4
Specialist Residential	68	59.5	72	62.5
Housing Associations	521	64.2	561	70.6
Commercial	81	100.5	135	97.4
Other	31	63.3	40	71.9
	2,576		2,497	
Provisions	(12)		(18)	
	2,564	**58.1**	**2,479**	**60.6**

The £79m increase in gross mortgage balances before provisions includes £116m fall in legacy books and a £195m increase in prime residential balances which includes £57m of net lending on buy to let properties.

The Society re-entered the residential buy to let market in 2015, a strategic decision to strengthen our overall mortgage proposition as the buy to let market represents around 20% of the overall UK mortgage market. Our buy to let proposition is focused on individuals looking to borrow on up to 3 properties, with a maximum loan size of £0.5m on an individual property, and loan to value of 75%. The Society does not lend to professional buy to let investors.

The Group's lending is all secured with a first charge registered against the collateral property. Residential loans are shown at indexed loan to value using the quarterly regional Halifax House Price Indices, all other loans are shown without indexing. Further information on security loan to value is provided in Note 29.

Mortgage book profile



Mortgage Credit Quality

Arrears

The Society has KPI measures for mortgage arrears of 3 months or more (excluding possessions) for both number and value of loans. Although primarily a measure of the quality of the existing mortgage books, the Society also uses its arrears management functions to influence future lending with "lessons learned" fed back into lending policy.

ARREARS PERFORMANCE 3 months or more arrears	By number of loans 2016 %	By number of loans 2015 %	By balance 2016 %	By balance 2015 %
Residential	0.41	0.47	0.32	0.36
Commercial Investment	-	1.53	-	2.07
Housing Association	-	-	-	-
Other	0.94	0.92	0.36	0.51
Total	**0.42**	**0.49**	**0.24**	**0.39**

The overall level of mortgage arrears experienced has fallen once again in 2016, the fifth consecutive year for total arrears by number of loans, continuing well below Council of Mortgage Lenders reported averages and at a record low for the Society. Overall by number of loans arrears are down by 7bp to 0.42%, by balance down by 15bp to 0.24%. The residential loan book has reduced arrears compared to previous year across both measures reflecting the excellent credit quality of the book. There were no commercial loans in arrears at the year end.

Forbearance

The Society will work closely with any homeowner experiencing difficulties, offering help and advice on all aspects of the situation. Forbearance cases and options granted are monitored by the Society's Retail Credit Committee with the levels of concessions granted not considered to be material for the size of the overall book.

The Society grants forbearance to commercial borrowers on a case by case basis however the size of the remaining book and low levels of arrears mean little forbearance was granted in 2016. Note 29 on page 74 contains further details of commercial forbearance cases.

Law of Property Act Receiverships and Possessions

The Society continued to experience a low level of possessions on residential loans and Law of Property Act receiver appointments.

At the end of 2016 the Society had 5 possession properties in relation to owner occupied loans, 1 buy to let possession property and there was 1 exposure being managed by a Law of Property Act receiver.

Funding

The Society manages its funding levels, mix and duration carefully to ensure it has the required resources in place to meet its liquidity and lending targets. The Society is predominantly funded through retail savings with wholesale funding used to diversify funding sources. Retail savings balances increased by £30m during 2016 to £2.7bn. Wholesale exposures increased during the year by £90m. This increase in wholesale balances has resulted in the percentage of wholesale balances to total share and deposit liabilities increasing from 10.29% in 2015 to 13.66% in 2016. The Group's mortgage loans remain wholly funded by retail savings balances.

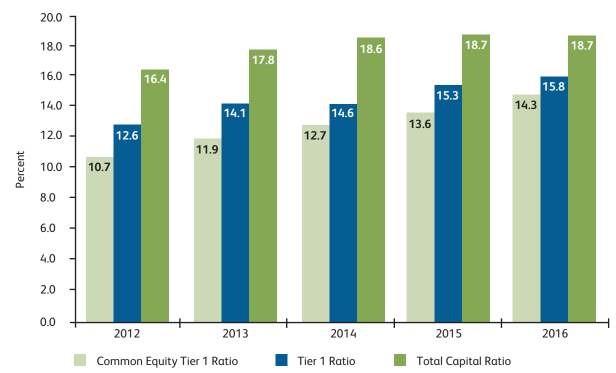
Capital

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

CAPITAL	2016 £m	2015 £m
Tier 1 Capital		
Common Equity Tier 1 Capital	169.8	161.8
Additional Tier 1	18.0	21.0
	187.8	182.8
Tier 2 Capital		
Tier 2 Capital	30.3	37.3
Collective Impairment Allowance	3.3	2.3
	33.6	39.6
Total Capital	**221.4**	222.4
Risk Weighted Assets		
Liquid Assets	54.6	59.3
Loans and Advances to Customers	999.4	998.2
Other Assets	34.2	33.2
Off Balance Sheet	21.2	27.2
Operational Risk	76.8	73.4
	1,186.2	1,191.3
Capital Ratios	**%**	**%**
Common Equity Tier 1 Ratio	14.3	13.6
Tier 1 Ratio	15.8	15.3
Total Capital Ratio	18.7	18.7
Leverage Ratio	5.2	5.3

The Group complied with Individual Capital Guidance plus planning buffers, as notified by the Prudential Regulation Authority, throughout 2016. The total capital ratio was 18.7% (2015: 18.7%) which does not in itself reflect the improvement in the quality of the Society's capital base. Tier 1, and more importantly Common Equity Tier 1, offers the greatest protection to Member's funds in the unlikely event of unforeseen financial stress. The Common Equity Tier 1 ratio has increased to 14.3% in 2016 from 13.6% in 2015 reflecting the Group's improved profitability, through 2016.

Capital Ratios



The leverage ratio is a simplified capital strength ratio measuring qualifying tier 1 capital against on and off balance sheet assets. The Board monitors the leverage ratio on a monthly basis and as at 31 December 2016 the figure was 5.2% (2015: 5.3%). This is, and has remained throughout 2016, well in excess of the proposed target.

Further details on the Group's capital position including the transitional impact of Basel III is given in the Pillar III disclosures to be published on the Society's website at the same time as these accounts.

Principle risks and uncertainties

The principle risks and uncertainties faced by the Group are set out in the Risk Management Report on pages 31 to 34.

Outlook

The programme of investment announced in January 2016 will continue with improvements to our branch network, IT infrastructure and most importantly further investment in our people.

Global macroeconomic and political factors may continue to impact on the UK economy but the UK is proving to be remarkably resilient following the Brexit vote. It is likely that low interest rates will continue for the year ahead but at some stage interest rates will have to rise to combat the spectre of inflation, which the Bank of England is tasked at maintaining at 2.0%. While disposable incomes may come under pressure if CPI moves ahead of wage inflation and interest rates start to rise, we are not too concerned about the impact on mortgage lending. All lenders, including ourselves, have been doing affordability assessments based on a higher interest rate environment for several years.

While there remains significant uncertainty on the horizon the Society will focus on what it does best; providing great products and services to our customers and Members, connecting then to a better financial future.

On behalf of the Board
Angela Russell
Deputy Chief Executive & Finance Director
23 February 2017

Newcastle Building Society Community Fund
at the Community Foundation

Grants make our communities even better...

Supporting our communities is core to what we do and in June we committed to a long-term programme of support in the North East and across our branch network.

Following the launch of the Newcastle Building Society Community Fund in association with the Community Foundation Tyne & Wear and Northumberland, Members can now nominate local community groups, causes, and charities for grants of up to £3,000. North East projects have already started to benefit from grants awarded in 2016.

New grants will be made available throughout the year, with nominations for worthy causes always welcomed. If you would like to nominate a cause local to you and to our branch network, please see our website: **newcastle.co.uk/community** or visit your local branch.

Our first grants

We committed to a total of £18,000 in two grant phases in 2016. The first projects received their grants towards the end of the year. This is the story so far on where some of the money has been spent.

Daisy Chain Project

Daisy Chain provides day care and short term respite to families with children on the autism spectrum across the Tees Valley area.

Some children with autism can't cope with being inside, and bad weather can make playing outside difficult.

Daisy Chain was nominated for consideration by Patricia Chambers, a customer of the Society's Middlesbrough branch, for a grant of £3,000 to help build a permanent canopy which will enable children to play outside all year round.

The canopy will provide flexibility in terms of the number and range of activities on offer, and will be especially beneficial to toddlers who aren't yet big enough to use all the play equipment in place.

MS Research & Relief Fund

Nominated by our customer, Catherine Gilroy, a £1,500 grant is helping to establish a weekly support group for multiple sclerosis carers in Morpeth.

The group will enable carers to meet people in similar situations to themselves, share their experiences, access useful new information and find support where they need it, all free of charge.

Nathan's Needs

Seven year old Nathan Main from Ashington suffers from severe cerebral palsy, leaving him unable to sit up, walk or talk.

Customer, Tracey Main Walsh set up Nathan's Needs to fundraise to make essential adaptations to the family home and provide Nathan with specialist equipment and essential aids to help with communication and mobility.

A grant of £1,135 has helped purchase a wheelchair attachment and specialist EyeGaze software to advance Nathan's learning and communication when he's out and about.

Henry Dancer Days

A grant of £1,500 is extending a special storytelling project which helps young cancer patients during their treatment at the Great North Children's Hospital.

The storytelling sessions help provide a welcome distraction for children undergoing cancer treatment, giving parents and carers a little time and space for themselves.

This project was nominated by Jane Nattrass, a customer at our Morpeth branch whose son Henry passed away at the age of 12 due to bone cancer. Jane said:

"The hospital had seen the direct benefits of the project and wanted us to put on more sessions, which this generous funding will enable us to do - it's really worth its weight in gold and allows us to give more back to young patients from across our native North East."

Whickham Hermitage Community Garden

Customer John Gibbon nominated the Whickham Hermitage Community Garden, a walled garden on the outskirts of Gateshead, for a grant to help build a permanent marquee over its outdoor seating area.

The garden is a hub for a range of community activities, meaning the canopy will be used by a variety of local residents and visitors to the garden. The £1,865 grant will play a part in benefiting many in this local community.

You can read more and see video stories about these grant project stories on our website Newcastle.co.uk/community.

Supporting through volunteering

Staff have supported 20 different causes across our branch network as part of their two-day work volunteering allocation for 2016.

From excavating archaeological digs, to careers mentoring in schools, they have been out and about making a difference across our region. When cancer charity FACT's shop in Gateshead suffered flood damage, staff from across the business swooped in at short notice to help repair the damage and to allow the store to quickly re-open.

Teams from across the business supported Newcastle's West End Food Bank's food collection, storage and distribution, on a number of occasions, helping ensure those who need it can receive assistance.

In Teesside colleagues volunteered to help deliver the Northern Children's Book Festival Gala Day at Middlesbrough Central Library and MIMA. Just a few of the many examples across the Society -making a positive difference to our communities is something we are proud to contribute to.

£2m Landmark contribution

We were thrilled when our fund raising contribution to the Sir Bobby Robson Foundation tipped the £2m mark earlier this year.

The Sir Bobby Robson Foundation funds projects within the Newcastle upon Tyne Hospitals NHS Foundation Trust, benefiting cancer patients from across the Society's heartland area and contributing to the global fight against the disease.

North East business awards 2016 necc

At the 'heart' of our community

We were thrilled to win the prestigious Heart of the Community accolade at the 2016 North East Business awards for Tyneside and Northumberland.

Percy Hedley Foundation
Achievement for All

Percy Hedley Foundation

Percy Hedley Foundation was our corporate charity for the past two years and over that time our staff have raised in excess of £20,000 for this important North East facility.

One of the largest regional charities supporting disabled people, Percy Hedley Foundation provides a wide range of high quality, specialist and personalised care and education support to over 1,000 families each year.

Financial Education Programme

Our ongoing Financial Education Programme receives heart-warming feedback from teachers and parents about the benefits and enjoyment it brings to the children involved.

Over the six week schools programme, branch colleagues are actively involved in guiding the groups of children and helping them develop their ideas. Winning groups from each school then present their ideas to a panel of judges, which includes our Chief Executive. This year's Boardroom Charity Challenge final was won by Gateshead's Lingey House Primary School. They scooped the £1,000 prize, going on to work with Gateshead College to create an inspiring community fashion show and raise a significant amount for Marie Curie.

Our Directors

Andrew Haigh
Chief Executive

Andrew became the Society's Chief Executive in May 2015 having joined the Board as Chief Operating Officer in January 2014.

He has a track record in transforming and developing businesses, with more than 30 years' business experience and over 20 years in the mutual sector. He has held leadership roles as both an Executive and a Non-Executive Director. As the former Chief Executive of Engage Mutual Assurance, he led the organisation for over 10 years, through a period of sustained growth and innovation. Andrew gained his strong customer focus through his early career in marketing and customer service roles with British Airways, Barclays and National & Provincial Building Society. An advocate of mutuality, he was previously Chairman of Mutuo, an independent organisation that promotes the development of new and existing mutuals to Government. Andrew recently joined the Board of the Community Foundation serving Tyne & Wear and Northumberland.

Angela Russell
Deputy Chief Executive & Finance Director

Deputy Chief Executive and Finance Director Angela is a Fellow of the Institute of Chartered Accountants and a Certified Public Accountant with 28 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 many years' experience in finance roles within the building society sector, including her current role as Finance Director for Newcastle Building Society, which she has held since 2010. Angela is also Deputy Chief Executive for the Society. Prior to joining the building society sector Angela spent 12 years at PricewaterhouseCoopers LLP. Angela is a Trustee of Percy Hedley Foundation.

Patrick Ferguson
Strategy, Planning & Risk Director

Strategy, Planning and Risk Director Patrick joined the Society's Board in February 2014; before this he was the Society's Group Risk Executive for almost four years.

He has extensive experience in risk management, including conduct risk and regulatory compliance, in addition to financial reporting, planning, and budgeting. He has 17 years' experience in the building society sector and has held the posts of Finance Director, General Manager, Finance and Head of Strategy and Planning. He qualified as a chartered accountant with PricewaterhouseCoopers LLP.

Damian Thompson
Customer Director

Damian joined the Board as Customer Director in August 2016.

He brings extensive experience in customer insight and retention and has previously held senior customer-related roles, including Head of Retail and, latterly, Head of Distribution for a leading building society. Damian's skills encompass strategic leadership to evolve and develop our product, distribution and service capabilities to keep pace with our customers' changing needs. He has spent more than 25 years serving and understanding customers, and has particular expertise in developing performance through behaviours to deliver exceptional customer experience.

David Buffham
Non-Executive Director and Senior Independent Director

Non-Executive Director and Senior Independent Director, David has spent most of his career at the Bank of England. He held a wide variety of banking and other roles, including 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 Group Risk Committee and also as a member of the Nominations and Remuneration Committees. He is a Director of Newcastle Systems Management Limited. He is an experienced Non-Executive Director and is a Director of Zytronic PLC, William Leech (Investments) Limited and The William Leech Foundation Limited.

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 Audit, Group Risk and Nominations Committees and is Chairman of the Remuneration Committee.

Phil Moorhouse
Chairman

Phil has been the Society's Chairman since the 2013 AGM. He is a Fellow of the Chartered Association of Certified Accountants.

He is the Chair of Newcastle Systems Management Limited and a Director of Newcastle Strategic Solutions Limited. 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 was Vice Chairman of Cumbria Partnership NHS foundation trust for four years. He is currently chair of Molins PLC and also sits on the Board of North Group. Phil brings 37 years of business experience to the Society's Board. His skills and expertise were recognised recently when he was awarded 'North East Non-Executive of the Year 2015' at the North East Business Executive of the Year Awards.

Ron McCormick
Deputy Chairman

Ron 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 had more than seven years' experience with Guardian Royal Exchange, as well as seven with KPMG, both in the UK and abroad. He is the Society's Deputy Chairman and is also a member of the Society's Audit and Group Risk Committees and is Chair of Newcastle Strategic Solutions Limited. He also works as a senior adviser to businesses within a range of sectors. He is Director of Threshfield Quarry Development Trust Limited.

Richard Bottomley OBE
Non-Executive Director

Richard joined the Board in 2014 as a Non-Executive Director and he is also Chair of the Audit Committee.

He is a Fellow of the Institute of Chartered Accountants and in 2010 was awarded an Order of the British Empire for services to the Accountancy Profession and Business in the North East. He was Managing Partner at KPMG for 12 years prior to his retirement in 2008, and is a past President of the North East Chamber of Commerce. In a professional career spanning over 30 years he gained experience in corporate finance, strategic planning and was the Lead Audit Partner on some of the region's largest companies. Richard is Chairman of Greggs PLC Retirement Benefits Scheme, TL Dallas Group and Skillsbridge.

Karen Ingham
Non-Executive Director

Karen has an extensive customer services background within the consumer sector and is extremely people and customer focused.

She is currently Customer Service Director at Virgin Media and has previously held roles in other organisations as Head of Service and HR Director. Karen started her career with 18 years in Financial Services at the Co-operative Bank. She is a Director of Newcastle Strategic Solutions Limited, a member of Newcastle Building Society's Remuneration Committee, and a trustee of the Virgin Media Pension Scheme. Karen also plays an active role within the North East Chamber of Commerce and is a member of techUK.

Ian Ward
Non-Executive Director

Ian has extensive experience in financial services and was Chief Executive of Leeds Building Society for 16 years until his retirement in 2011.

He is Vice-Chairman and Senior Independent Director of the Charter Court Financial Services Group of Companies, which includes Charter Savings Bank where he also chairs the Risk Committee, and sits on the Audit and Remunerations/Nominations Committees. Ian is a Non-Executive Director of Harrogate & District NHS Foundation Trust and is its Senior Independent Director and a member of its Audit and Finance Committees. He has been a Non-Executive Director of Newcastle Building Society since 2013 and is a member of the Group Risk Committee and a Director of Newcastle Systems Management Limited.

Directors' Report

The Directors present their Annual Report and Accounts and Annual Business Statement for the year ended 31 December 2016, which they consider to be fair, balanced and understandable, providing Members with the information necessary to assess the Group's position and performance, business model and strategy.

Objectives and Activities

It is the intention of the Directors that the Society will continue to remain an independent regional building society. The Society's purpose and strategy are set out on page 8 of the Strategic Report.

Business Review and Future Developments

The Chief Executive's Review and Strategic Report on page 8 set out the business activities and business performance in the year against our strategic objectives, as well as likely future developments. The Strategic Report also outlines the Group's key performance indicators (KPI's), which include customer, people and financial KPI's, details of the Group's customer focus and people agenda, financial analysis, mortgage credit quality and capital position.

The Annual Business Statement on page 77 and the Credit Risk section of Note 29 on page 72 contain respectively the ratios and arrears disclosures required by the Building Societies Act 1986.

The Board has assessed the viability of the Group by reviewing medium and long term plans over a detailed 5 year horizon 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. This horizon is considered appropriate through alignment to the Group's usual forecasting and management reporting allowing robust and continuous assessment of the Group's expected position and principal risks over the time-frame. Active risk management is undertaken to mitigate the Group's principal risks as detailed.

The outcome of this review is that the Directors are satisfied that the Society and the Group have adequate resources to continue in business and meet their liabilities as they fall due throughout the period of assessment. Accordingly the financial statements of the Society and the Group have been prepared on a going concern basis with no material uncertainties that the going concern basis of accounting is appropriate.

Risk Management, Principal Risks and Uncertainties

The Risk Management Report on page 31 sets out the principal risks and uncertainties faced by the Group together with the risk management framework and risk governance structure. The Risk Management Report also details how the Group mitigates the specific key risks to which it is exposed, which are credit, conduct, liquidity, interest rate, pension fund obligation, operational, capital and Brexit risks. In addition, Note 29 to the accounts on page 67 sets out the metrics associated with the key risks including sensitivity analysis and exposure levels.

Mortgage arrears

As at 31 December 2016 there were 24 cases (2015: 19) where payments were 12 months or more in arrears. The capital balances of these loans were £1.3m (2015: £0.9m). The total amount of arrears on these loans was £0.2m (2015: £0.2m).

Political and charitable gifts

Charitable donations: The Society is pleased to be able to give back to its heartland communities, through volunteering, charitable donations, and staff fundraising. Through a variety of savings accounts, including the Newcastle Community Saver and the Sir Bobby Robson Foundation Saver, a total of £619,800 was donated to charitable causes, including the Newcastle Building Society Community Foundation and the Sir Bobby Robson Foundation. The Percy Hedley Foundation was our corporate charity for 2015-2016, and our staff undertook a variety of fundraising activities over this time, raising in excess of £20,000 for this important local cause. Staff increased their commitment to volunteering in 2016, making an important contribution of their time, skills and enthusiasm to a variety of different causes across our heartland.

Further details on the Society's charitable giving during 2016 can be found in the Community Support Round-up on pages 14 and 15.

Supplier Payment Policy

The Group follows an internal policy that payment will be made within 30 days from receipt of an invoice and endeavours to meet individual suppliers' payment terms which may be set at shorter timescales. At 31 December 2016, the number of creditor days was 27 (2015: 26 days).

Directors

As at 31 December 2016, the members of the Board, who have served at any time during the year and continue to act as Directors, are as follows:

Richard Bottomley, David Buffham, Patrick Ferguson*, Andrew Haigh*, Karen Ingham, Ron McCormick, Phil Moorhouse, John Morris, Angela Russell*, Damian Thompson*(joined the board on 22 August 2016) and Ian Ward.

At the Annual General Meeting (AGM), to be held on 26 April 2017, all of the current Directors will offer themselves up for either election or re-election, with the exception of Ron McCormick who will be retiring at the conclusion of the meeting.

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

*Executive Directors

All Directors are Members of the Society. Please see the Remuneration Committee Report on page 27 for further information.

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. Each of the Directors, whose names and functions are listed in the Our Directors section on pages 16 and 17 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.

Corporate Governance

The Society's statement on corporate governance can be found in the Report of the Directors on Corporate Governance on pages 20 to 24.

Statement of Directors' Responsibilities

The following statement, which should be read in conjunction with the statement of auditors' responsibilities on page 37, 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:

- Keeps 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
Phil Moorhouse
Chairman
23 February 2017

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 (FRC) in September 2014 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. The Code applies to accounting periods beginning on or after 1st October 2014, and, therefore, the Society has regard to the Code within the 2016 Annual Report and Accounts.

A working party operates to ensure that on an ongoing basis the corporate governance procedures and processes within the Society are appropriately aligned with the Code, including when updates or revised guidance are published. Limited amendments were made to the 2014 Code during 2016 and are first applicable for the Society with regard to the 2017 Annual Report and Accounts. These amendments were particular to the make-up of Audit Committees with the Society's Audit Committee members already meeting the expanded requirement to have, as a whole, competence relevant to the Society's operating sector.

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 16 and 17. In carrying out its role, the Board aims to ensure that excellent service is delivered to its Members and customers. The Board has responsibilities for contributing to and supporting the values of the Group set by management, and believes that the interests of all stakeholders can be best served by remaining a strong and forward looking mutual building society.

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. The Nominations Committee (NomCo) carries out a review of the independence of Non-Executive Directors as set out on page 21.

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.

Phil Moorhouse was appointed Chairman of the Society on 24th April 2013, and Ron McCormick appointed Deputy Chairman on 1st January 2011. David Buffham was appointed to the role of Senior Independent Director on 1st January 2016. The Deputy Chairman and Senior Independent Director provide a sounding board for the Chairman and where necessary serve as an intermediary for the other Directors.

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 2016 the Board comprised of seven Non-Executive Directors and four Executive Directors.

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

Matters Reserved to the Board

The Board's Terms of Reference are reviewed on a regular basis and were last agreed by the Board in April 2016. A schedule is maintained of matters reserved to the Board which includes the following:-

- **Strategy and Management –** determining the overall strategy of the Group including approval of the Corporate Strategy, with the responsibility for its implementation delegated to the Executive team; monitoring operational and financial performance in pursuit of the strategy; overseeing and approving the Society's recovery options and resolution pack; monitoring any recovery plan and approving appropriate management actions; and approving budgets, forecasts and major capital expenditure.
- **Culture –** overseeing the culture and values of the Society.
- **Structure, Capital and Liquidity –** approval of the Society's Internal Liquidity Adequacy Assessment Process (ILAAP); approval of the Society's Internal Capital Adequacy Assessment Process (ICAAP); approval of changes to the Group's corporate structure; and approval of any programme for the issuance of long-term debt or capital.
- **Financial Reporting and Internal Controls –** approval of preliminary announcements, half year and final annual results; approval of the Annual Report and Accounts including the Strategic Report, Risk Management Report, Report of the Directors on Corporate Governance, and the Remuneration Committee Report; approval of the Pillar 3 disclosures; ratification of the Going Concern and Business Viability review following review and approval by the Audit Committee; approval of any significant changes in accounting policies or practice, based on the recommendations of the Audit Committee; and ensuring an adequate internal control environment is in existence. The Board delegates oversight of internal controls to the Audit Committee.
- **Risk Management and Regulatory –** ensuring an adequate risk management framework is in place. This includes approval of risk appetite, oversight of risk governance, reviewing the top risks, ensuring the strategy and risk appetite are consistent, and approving the ICAAP. The Board delegates oversight of risk management to the Group Risk Committee, as well as oversight of compliance with regulations (including by the Prudential Regulation Authority and the Financial Conduct Authority).
- **Strengthening Accountability in Banking –** ensuring that the Society meets its obligations under the Senior Managers Regime (SMR), including: reviewing at least annually the SMR Policy; maintaining a responsibilities map for all prescribed responsibilities and ensuring all prescribed responsibilities have been allocated; and leading the development of the Society's culture.
- **Board Membership and Senior Management Issues –** approval of changes to the structure, size and composition of the Board, following recommendations from NomCo; ensuring that adequate succession planning for the Board and senior management is in place following recommendations from NomCo; and approving and overseeing appointments to the boards of subsidiary companies.
- **Appointment and/or re-appointment or removal of the external auditor** to be put to Members for approval, following a recommendation from the Audit Committee.
- **Remuneration –** agreeing the remuneration policy for the Directors and other Senior Executives, following recommendations from the Remuneration Committee.
- **Delegation of Authority –** ratifying the terms of reference for Board Committees and Subsidiary Companies; and receiving minutes and/or reports from the chair of the Board Committees and Subsidiary Companies.
- **Corporate Governance Matters –** ensuring that a formal evaluation of the effectiveness of the Board is undertaken on an annual basis and considering whether an external assessment using outside consultants as a facilitator is undertaken every three years; determining the independence of Directors; reviewing the Group's overall corporate governance arrangements; and agreeing the Directors' Conflicts of Interest Policy and other relevant policies.

Board Changes and Elections/Re-elections

It is recognised that changes need to be made to the Board from time to time and in 2016 Damian Thompson joined the Society as Customer Director and strengthens the Society's focus around engaging and providing excellent service to customers.

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 offer themselves for either election or re-election at the Society's AGM, with the exception of Ron McCormick who will be retiring at the conclusion of the meeting. The biographies of all of the Directors are detailed on pages 16 and 17.

Management Information

The Chairman is responsible for ensuring that the Directors receive accurate, timely and clear information. Board members receive meeting packs each month except in August when there is not a Board meeting. They also receive details concerning Management Information each month by way of email. A rolling Board agenda is tabled at each meeting to ensure that all key areas are covered appropriately during the year. Sufficient time is set aside to ensure that constructive discussion and challenge can take place.

All Directors have access to independent professional advice, if required, and also access to the services of the Group Secretary.

Board Effectiveness

In last year's Annual Report and Accounts, reference was made to the fact that the Board had decided to carry out an externally facilitated review of its effectiveness during 2016. Praesta LLP carried out this work, with the findings presented at the September 2016 Board meeting. Later in the year, in December 2016, the Board carried out the annual internal review of its effectiveness based upon an assessment of the first two principles of Leadership and Effectiveness set out within the UK Corporate Governance Code issued in September 2014, together with the Financial Reporting Council's guidance on board effectiveness published in March 2011. Overall the board concluded it was effective.

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, with further details provided below. The Chairman of each Committee reports to the Board at its subsequent 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 improvement 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. All concluded satisfactorily.

Information concerning attendances at the meetings is detailed on page 24. Terms of Reference for the Audit Committee, Group Risk Committee, Remuneration Committee and NomCo are included on the Society's website (http://www.newcastle.co.uk) and are subject to annual review.

Audit Committee

Details of the Audit Committee are contained in the Audit Committee Report on page 25. Through the work of the Audit Committee and the Internal Audit department during 2016, the Directors have carried out a review of the Group's risk management and internal control systems, covering all material controls, including financial, operational and compliance controls.

Remuneration Committee

Details of the Remuneration Committee are contained in the Remuneration Committee Report on page 27.

Group Risk Committee

Details of the Group Risk Committee are contained in the Risk Management Report on page 31.

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 carried out in December 2016.

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, diversity and experience; and
- To oversee the Board's succession plan.

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

Members of NomCo are Phil Moorhouse (Committee Chairman), David Buffham and John Morris.

NomCo operates to a rolling agenda to ensure it discharges its full responsibilities. It normally meets a minimum of twice a year and in 2016 it met on two occasions.

NomCo is supported by the Chief Executive and the Human Resources Director 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 advisers are normally utilised to ensure there is a robust list of suitable candidates with which to fill a vacancy. During the year the Society utilised the services of independent recruitment specialists Norman Broadbent in the appointment of the Customer Director.

Whenever a new Director is appointed, the Financial Conduct Authority and Prudential Regulation Authority have the right, for certain key roles, to carry out formal Significant Influence Function (SIF) interviews in order that the director becomes an Approved Person.

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.

Diversity of the Board

The Board recognises and embraces the benefits of having a diverse Board which utilises a range of factors including skills, industry experience, background, race, gender and the other qualities of its Directors. Giving specific regard to gender ratios, there were two female directors on the Board throughout 2016.

Report of the Directors on Corporate Governance (continued)

It is important to note that all Board appointments are made on the basis of individual competence, skills and expertise measured against identified objective criteria. Appointment is therefore based on merit and the Board has not set any measurable objectives for diversity although the position will be kept under review.

Re-election to the Board

It has been agreed previously by the Board that all Directors, as appropriate, should be required to seek election or re-election at each AGM, the forthcoming one to be held on 26 April 2017.

Non-Executive Directors are usually expected to serve more than one three year term, subject to satisfactory performance evaluations and re-election by Members. Only in exceptional circumstances will Non-Executive Directors be able to seek re-election when they have served nine years on the Board. NomCo has in place a risk based succession plan which is reviewed at each meeting as part of the standard 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, against the criteria set out in the Code. This does not include the Chairman, Phil Moorhouse who was appointed Chairman of the Society on 24 April 2013, and at the time of appointment was considered to be independent by the Board (the Code states that the Chairman should, on appointment, meet the independence criteria, but thereafter the test of independence is not appropriate in relation to the Chairman). The last review was carried out by NomCo in December 2016 where it was confirmed that the independence requirements in terms of character and judgement were met; this was subsequently agreed by the Board in January 2017.

In January 2015, one of the Non-Executive Directors, Ian Ward, was appointed as a director of a number of companies within the Charter Court Group, including Charter Court Financial Services Limited. He has previously advised the Board of the existence of this relationship, and under the Conflicts of Interest Policy has undertaken to advise the Board if any actual conflict arises.

The Society recognises that it is good corporate governance to have a Senior Independent Director. David Buffham was appointed to this role on 1 January 2016 and it is intended that, subject to re-election, he continues in this role.

During 2016, the Chairman met separately with the Non-Executive Directors regularly, without the Executive Directors present, in addition to regular telephone contact 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 conducted the appraisals of the Chief Executive and Non-Executive Directors, the Chief Executive conducted the appraisals of the Executive Directors, whilst the Senior Independent Director led the appraisal of the Chairman.

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.

NomCo 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 NomCo discharges its duties in this area effectively, a Board skills matrix and a training menu for Non-Executive Directors are in place.

Newcastle Strategic Solutions Limited (NSSL)

NSSL Board Members are:

Ron McCormick (NSSL Chairman), Phil Moorhouse, Karen Ingham, Phil Grand (Managing Director NSSL) and Andrew Ward (Finance Director NSSL).

The main responsibilities of NSSL, as delegated by the Society's main Board, are as follows:-

- To oversee the strategic direction of NSSL ensuring this is consistent with the Society's agreed corporate strategy;
- To evaluate and monitor the financial and operational performance of NSSL against pre-determined objectives, which includes assessing performance in terms of contract contribution, profitability, efficiencies, risk and compliance, and development of the savings management proposition;
- To ensure that appropriate mechanisms are in place to inform the Society's Board about the performance of NSSL and any key issues identified;
- To ensure that NSSL complies with all relevant legislation and the appropriate regulations relating to its activities;
- To establish and review a risk appetite statement for NSSL;
- To ensure that an annual review of service resilience is conducted and that there is ongoing development to enhance resilience;
- To approve the NSSL budget on an annual basis (prior to inclusion in the Group budget which is approved by the Society's Board);
- To approve the NSSL statutory accounts;
- To consider and act upon the findings of any external/internal audits or reviews; and
- To ensure that a formal evaluation of the effectiveness of the NSSL Board is undertaken on an annual basis. The last review was undertaken in December 2016 where it was concluded the NSSL Board was effective.

Further details of the activities of NSSL are given on page 11 of the Strategic Report.

Newcastle Systems Management Limited (NSML)

NSML Board Members are:

Phil Moorhouse (NSML Chairman), David Buffham, Ian Ward, Steve Watchman (Managing Director NSML) and Andrew Ward (Finance Director NSML).

The main responsibilities of NSML, as delegated by the Society's main Board, are as follows:-

- To oversee the strategic direction of Information Technology, Property Management and associated services and to ensure this is consistent with the Society's agreed corporate strategy for ongoing development and improvement of these propositions;
- To evaluate and monitor the performance of NSML against the objectives set, which includes assessing performance in terms of service delivery, contribution and effective management of risk and compliance;
- To monitor developments in the area of cyber risk mitigation to ensure the Group and Society are protected and resilience is enhanced on an ongoing basis;
- To ensure that appropriate mechanisms are in place to inform the Society's Board about the performance of NSML and any key issues identified;
- To ensure that NSML complies with all relevant legislation and the appropriate regulations relating to NSML activities;
- To establish and review a risk appetite statement for NSML;
- To ensure that an annual review of service resilience is conducted;
- To approve the NSML budget on an annual basis (prior to inclusion in the Group budget which is approved by the Society's Board);
- To approve the NSML statutory accounts;
- To consider and act upon the findings of any external/internal audits or reviews; and
- To ensure that a formal evaluation of the effectiveness of the NSML Board is undertaken on an annual basis. The last review was undertaken in October 2016 where it was concluded the NSML Board was effective.

Newcastle Financial Advisers Limited (NFAL) (formerly Newcastle Financial Services Limited, with the name changed in October 2016)

NFAL Board Members are:

Angela Russell (NFAL Chairman), Stuart Dodson (Managing Director NFAL) and Damian Thompson (the Society's Customer Director). The Society's Chairman, Phil Moorhouse, also attends NFAL Board meetings on a regular basis in an advisory capacity.

The NFAL Board also uses external consultants to provide challenge and advice to the Board. At least once a year directors from Openwork Limited attend an NFAL Board meeting to provide a financial and market update; NFAL is an appointed representative of Openwork Limited.

The main responsibilities of NFAL, as delegated by the Society's main Board, are as follows:-

- To oversee the strategic direction of NFAL ensuring this is consistent with the Society's agreed corporate strategy;
- To evaluate and monitor the performance of NFAL against the objectives set, which includes assessing performance in terms of sales quality, customer satisfaction and outcomes, complaints, risk and compliance oversight (including consideration of the aspects that are specifically the responsibility of Openwork Limited) and profitability;
- To ensure that appropriate mechanisms are in place to inform the Society's Board about the performance of NFAL and any key issues identified;
- To review and approve the bonus scheme for NFAL ensuring that quality and customer outcomes are central to performance assessment;
- To review, at least annually, the reputational and consumer risks associated with NFAL and the controls in place in respect of this risk. The review will be presented to the NFAL Board in the first instance and ratified by the Society's Group Risk Committee;
- To ensure that NFAL complies with all relevant legislation and the appropriate regulations relating to NFAL activities;
- To approve the NFAL budget on an annual basis (prior to inclusion in the Group budget which is approved by the Society's Board);
- To approve the NFAL statutory accounts;
- To receive the minutes of strategic partner governance meetings and to be made aware of any changes to the framework for managing relationships with strategic partners;
- To consider and act upon the findings of any external/internal audits or reviews; and
- To ensure that a formal evaluation of the effectiveness of the NFAL Board is undertaken on an annual basis. The last review was undertaken in November 2016 where it was concluded the NFAL Board was effective.

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 Members are encouraged, as owners of the business, to use their vote and we try to make this process as easy as possible, including the ability to vote online and by post. We also try to make the AGM as engaging as possible and encourage Members to attend.

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.

We also conduct satisfaction surveys with intermediaries that introduce mortgage business to the Society. The information which is collected is used from these sources to help to develop and improve our offering.

Special Members' seminars are held on a regular basis and are designed to provide customers with useful information to help them understand and make sense of what is becoming an increasingly complex and 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. Periodically we also hold 'Meet the Chief Executive' events for Members which provide an opportunity for Senior Management, including Members of the Board, to engage with and listen to customer feedback. We also keep in touch with Members via our Priority Register Service and on-line newsletter.

Through our community and charity support activities we are able to engage with both our Members and the communities we serve. Following the launch of the Newcastle Building Society Community Fund at the Community Foundation, we have provided a range of financial grants to North East community projects nominated by our Members. We intend that this financial support for our heartland communities will continue to grow in scope and scale.

We have also helped to raise money for local, worthy causes, and delivered a continuing financial education programme to local primary schools, in addition to providing careers skills support and guidance in senior schools.

We work hard to make a difference and improve the well being of people who live within our heartland. Our colleagues are similarly encouraged to support our communities by volunteering their time and skills, and we are pleased to see the enthusiasm and commitment with which they have responded since we introduced a new volunteering policy in 2015. Further details of Member and Community Engagement are given in the Community Support Round-up on pages 14 and 15.

Report of the Directors on Corporate Governance (continued)

Board and Board Committee Membership Attendance Record

The table below sets out the number of meetings attended by Directors during 2016 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	NSSL	NSML	NFAL
Phil Moorhouse	12 (12)	-	-	-	2 (2)	6 (6)	3 (4)	4 (5)*
Ron McCormick	11 (12)	2 (4)	6 (7)	-	-	4 (6)	-	-
Richard Bottomley	11 (12)	4 (4)	-	-	-	-	-	-
David Buffham	12 (12)	-	7 (7)	3 (3)	2 (2)	-	4 (4)	-
Patrick Ferguson	12 (12)	-	-	-	-	-	-	-
Andrew Haigh	12 (12)	-	-	-	-	-	-	-
Karen Ingham	12 (12)	-	-	3 (3)	-	5 (6)	-	-
John Morris	12 (12)	4 (4)	7 (7)	3 (3)	2 (2)	-	-	-
Angela Russell	12 (12)	-	-	-	-	-	-	5 (5)
Damian Thompson	4 (4)	-	-	-	-	-	-	2 (2)
Ian Ward	12 (12)	-	7 (7)	-	-	-	4 (4)	-

*attended in an advisory capacity.

Annual General Meeting (AGM)

The AGM 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 30p to The Newcastle Building Society Community Fund at the Community Foundation.

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
Phil Moorhouse
23 February 2017

Audit Committee Report

Audit Committee

Members of Audit Committee at 31 December 2016 were:
Richard Bottomley (Committee Chair), Ron McCormick and John Morris.

The Audit Committee's extensive experience and qualifications are detailed on pages 16 and 17 of the Annual Report and Accounts. The Committee's combined financial sector experience and competence is considerable and wide-ranging with specific relevance to the Group's core building society activities. At least one member of the Committee meets the requirements of the UK corporate governance code to have significant recent, relevant financial experience. The Committee members were selected for appointment by recommendation of the Nomination Committee in consultation with the Audit Committee Chairman.

Directors' remuneration, including the members of the Audit Committee, is detailed within the Remuneration Committee Report on page 27 of the Annual Report and Accounts. The Report on Corporate Governance on pages 20 to 24 also sets out the process for review of effectiveness of Board sub-committees including the Audit Committee. The 2016 review concluded that the Committee is operating effectively.

Committee meetings:
The Committee meets at least four times each year coinciding with key dates in the Group's financial reporting calendar following a rolling schedule of items for discussion, agreed and reviewed on an ongoing basis. Meetings are attended by Audit Committee members with other regular attendees at meetings including the Chief Executive, Deputy Chief Executive and Finance Director, Strategy Planning and Risk Director, Internal Audit Executive and a representative of the External Auditors, PricewaterhouseCoopers LLP (PwC), as well as other management, as the Committee feels is appropriate and necessary. For details of Committee meeting attendance see page 24 of the Annual Report and Accounts.

At least once a year the Audit Committee invites the External Auditors and Internal Auditors to meet the Committee without senior management present, to discuss matters relating to their remit. In addition, as well as a formal annual meeting, the Audit Committee has an opportunity to meet with the External Auditors at each Audit Committee meeting, without senior management present. These meetings cover matters relating to its remit and any issues arising from audits, including matters required to be discussed by relevant law or regulations.

Key roles and responsibilities as delegated by the Board:
The main function of the Audit Committee is to assist the Board in fulfilling its oversight responsibilities, specifically the ongoing review, monitoring and assessment of:

Financial reporting:
The Audit Committee's primary role regarding financial reporting is to monitor the integrity of the Annual Report and Accounts of the Group including the interim and annual reports, and any other formal announcements relating to the Group's financial performance.

This responsibility is discharged through:

- review of interim announcements and the Annual Report and Accounts, their clarity, completeness and compliance with relevant accounting standards and other regulatory and legal requirements;
- reporting to the board on the consistency and appropriateness of critical accounting policies and any changes thereto, taking into account the views of the external auditor;
- review and challenge of significant financial reporting judgements, estimates and the actions and judgements of management;
- advice to the board on whether the Annual Report and Accounts, taken as a whole are fair, balanced and understandable and provide the information necessary for Members to assess the performance, strategy and business model of the Group;
- review of any correspondence from regulators in relation to financial reporting;
- review of the going concern and business viability assessment produced by the Deputy Chief Executive and Finance Director on a six monthly basis;
- evaluation of the risks to the quality and effectiveness of the financial reporting process, especially in light of the External Auditor's communications with the Audit Committee; and
- review and monitor management's responsiveness to the External Auditor's findings and recommendations.

The main areas of financial reporting significance considered by the Audit Committee in 2016 were as follows:

- **Commercial and residential loan impairment provisions:** This is inherently an area of accounting estimate and judgement. The Society's commercial loan impairment provisions are agreed by the Society's Provisioning Committee and then reported to the Audit Committee. The Audit Committee reviews the level of provisioning through detailed discussion with management on the key judgements and estimates made including triggers for and methodology behind impairment calculations. The Committee also considers the models used for production of residential provisions although the resulting provisions are small relative to commercial provisions. The impact of forbearance in the mortgage portfolios has been considered and appropriate disclosures made in the Annual Report and Accounts.

  The Committee is satisfied with the assumptions adopted and models used to calculate provisions over the residential and commercial mortgage books. The Committee has also maintained oversight of the Group's IFRS 9 project, effective from 1 January 2018 with significant changes to the Group's established provisioning models, methods and management judgements required to comply with the incoming accounting standard.
- **Going Concern:** Preparing the Annual Report and Accounts under the Going Concern assumption requires the Board and Audit Committee to be satisfied about the long term viability of the Group's business operations, business planning, business management and risk management. Long term liquidity, capital and funding budgets and forecasts alongside capital, cash flow and business viability considerations are assessed formally at the half year and year-end to coincide with the approval of the interim and Annual Report and Accounts. A balanced consideration of positive and negative plan aspects is considered with supporting narrative provided by the Deputy Chief Executive and Finance Director.

  The Audit Committee concluded that the adoption of the Going Concern basis to prepare the accounts is appropriate.
- **Provisions for other liabilities and charges:** The Audit Committee reviews and challenges the estimates and assumptions made by management when calculating provisions at the end of the reporting year. The Committee was satisfied with provisions in relation to potential consumer redress and the Financial Services Compensation Scheme Levy.
- **Hedge accounting:** The Audit Committee is appraised of the Group's derivative and hedge accounting position and strategy and also agrees the accounting policy for hedging, including disclosures in the Annual Report and Accounts. The Committee has concluded satisfactorily in this area.
- **Taxation:** Recovery of deferred tax assets is the main area of focus of the Committee in relation to taxation and this is considered in conjunction with the review and approval of the Going Concern and Business Viability Review. The Committee was satisfied that deferred tax assets are recoverable. The Audit Committee reviewed the Group Tax Risk Policy which sets out compliance with relevant jurisdictional legislation, identifying areas of tax risk for appropriate focus and managing the overall Group tax risk.
- **Pension:** Consideration of the assumptions and disclosures relating to the defined benefit pension scheme with advice provided by independent actuary; First Actuarial.
- The Committee considers matters raised by the External Auditors and the Committee concluded there were no adjustments proposed that were material to the Annual Report and Accounts.

Audit Committee Report (continued)

Having undertaken the above responsibilities and considerations throughout the Group's 2016 financial year the Audit Committee recommended to the Board that approval be given to the audited Annual Report and Accounts and Summary Financial Statements as at 31 December 2016.

Effectiveness of the internal control and risk management systems, including internal financial control

The Audit Committee works closely with the Group Risk Committee to ensure that management and staff take appropriate responsibility for departmental, business unit and subsidiary risk mitigation and internal control. The Audit Committee also reviews Internal Audit and management reports on the effectiveness of systems for internal control and risk management across the Group.

Further details of risk management activities are given in the Risk Management report on page 31 of the Annual Report and Accounts.

The Audit Committee is responsible for:

- review of 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;
- review of the Group's procedures for detecting fraud and whistle blowing and ensuring that arrangements are in place by which employees 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; and
- reporting to the Board on significant findings concerning risk management, internal control, financial reporting and other aspects of relevance.

The Group's Internal Audit department forms a core component of the Group's risk management and internal control process.

During the year the Audit Committee, through the Internal Audit department and from other management reports, reviewed the scope and effectiveness of the Group's internal controls. Specific areas of focus in 2016 included reviewing the controls in operation for; lending, savings, information technology and cyber security, treasury, finance, risk management, regulatory compliance and reporting, and key projects. The Internal Audit department utilised KPMG LLP and Deloitte LLP where necessary for co-sourced internal audits to provide specialist expert input and promote knowledge transfer to the Internal Audit department.

The Internal Audit department reflects the Audit Committee's primary available resource however the Committee retain the authority to obtain outside legal or independent professional advice as it sees fit. Reports from the Strategy Planning and Risk Director, Internal Audit, External Auditors and senior management provide input on key risks, uncertainties and controls direct to the Audit Committee.

Internal Audit

The Audit Committee is responsible for monitoring and reviewing the effectiveness of the Group's Internal Audit function in the context of the Group's risk management system, ensuring that professional standards are applied, resource is adequate in terms of number, skills, knowledge, and standing within the Group to execute its responsibilities in an independent and objective manner. A formal review of the qualification and effectiveness of Internal Audit is undertaken by the Committee annually and most recently in July 2016.

The Committee approves and reviews the Internal Audit work programme and results and ensures the Internal Audit department maintains sufficient access to the Board, management and the books and records of the Society and its subsidiaries. This oversight allows the Audit Committee to monitor and assess the role and effectiveness of the Internal Audit function in the overall context of the Group's internal control framework, ensure appropriate management responsiveness to audit findings and recommendations given and promote open communication between the Group's Risk, Compliance, Finance, Internal Audit and External Audit functions.

External audit:

The Audit Committee is responsible for overseeing the Group's relationship with the External Auditors; PricewaterhouseCoopers LLP (PwC). This role extends to:

- appointment, reappointment, removal and assessment of independence, objectivity and effectiveness of the External Auditors;
- approval of terms and remuneration in respect of audit services provided;
- annual approval of the Society policy on the use of the External Auditors for non-audit work; and
- consideration of audit quality including reports by the Audit Quality Review Team.

The Audit Committee assesses annually the qualification, expertise and resources of the External Auditors seeking reassurance that the auditors and their staff have no family, financial, employment, investment or business relationship with the Society that is considered to impact their independence. The External Auditors communicate their formal independence annually and appraise the Audit Committee of policies, processes and monitoring in place for maintaining their independence.

Prior to an External Audit engagement the Audit Committee discuss the nature and scope of the audit. They review findings of the auditors' work and assess the effectiveness of the audit process. This assessment reviews whether the auditor has met the agreed audit plan, considers the robustness and perceptiveness of the auditors in responding to questions from the Audit Committee and obtaining feedback about the conduct of the audit from key people involved.

The Audit Committee ensures that non-audit services provided by the External Auditors will not adversely impact the independence and objectivity of the audit firm in performing their duties. A formal Society policy on use of the External Auditors for non-audit work is reviewed annually encompassing pre-approved, low risk non-audit services alongside permitted and prohibited services requiring Audit Committee approval.

During 2016 the External Auditors were engaged to provide payroll services in relation to the Society's Gibraltar branch, data audit services, pensions advice in relation to the 2016 triennial valuation, and conduct risk workshops, by virtue of their expertise across these areas. All work was carried out by PwC partners and staff that had no connection to the external audit team. The fees paid to the External Audit firm for audit and non-audit services are set out in Note 5 to the Report and Accounts.

PwC have been external auditors to the Group since 1994. A formal external audit tender process was undertaken in 2013 which followed a rigorous assessment process including the appointment of an audit selection panel comprising the Chairman of Audit Committee, the Society's Chairman, the Deputy Chief Executive and Finance Director, the Group Financial Controller, the Chief Executive and one other Member of the Audit Committee. Following submission of detailed proposals and a series of presentations a recommendation was made to Audit Committee and the Board to retain PwC as external auditors. The recommendation was made in light of a challenging and robust external audit and satisfaction with previous audits undertaken. The next formal external audit tender process is expected to be conducted in advance of the 2020 audit cycle, in line with the mandatory rotation of the audit's senior partner, Gary Shaw (the partner since 2015), at the end of the 2019 audit.

On behalf of the Board
Richard Bottomley
Chairman of the Audit Committee
23 February 2017

Remuneration Committee Report

Introduction

This report details the Society's approach to pay for the period 1 January to 31 December 2016. It sets out the remuneration policy and remuneration details for the Executive and Non-Executive Directors of the Society and how it applies the principles of the UK Corporate Governance Code relating to remuneration, the Regulators' Remuneration Code and the disclosure requirements arising under the EU Capital Requirements Directive IV (CRD IV). The report is split into three main areas; the Statement by the Chairman of the Remuneration Committee, the Report on Remuneration and the Directors' Remuneration Policy.

i) Statement by the Chairman of the Remuneration Committee

The Remuneration Committee operates within the Terms of Reference (TOR) agreed by the Board. The TOR are reviewed annually and were last reviewed on 29 November 2016. The effectiveness of the committee is also reviewed on an annual basis and was last reviewed, and found effective, on 29 November 2016.

The main objectives of the committee are summarised as follows:

- To ensure a formal and transparent procedure is in place for developing policy on Executive remuneration and for fixing the remuneration packages of individual Directors;
- To design an Executive remuneration policy that promotes the long term success of the Society;
- To ensure compliance with the Regulators' Remuneration Code through at least annual review;
- To determine and agree with the Board the framework for Executive and senior management remuneration and conditions of employment;
- Approval of the Society's Remuneration Policy Statement, Remuneration Committee Reports in the Group's Annual Report and Accounts and Summary Financial Statements, and the remuneration sections of the Society's Pillar III disclosure;
- To consider and make recommendations to the Board on the general framework of staff bonus schemes;
- To consider and make recommendations to the Board on fees paid to Non-Executive Directors; and
- To consider and make recommendations made by the Chief Executive to the Board on fees paid to Non-Executive Directors.

The Board believes remuneration should be sufficient to attract, retain and motivate senior managers to continue to run the Society successfully, whilst avoiding paying more than is necessary for this purpose. The Remuneration Policy, therefore, focuses on rewarding our most senior Executives in line with the achievement of our goals set out in the annual strategic plan whilst continuing to provide value for money for our Members.

Composition of the Committee

The Committee comprises solely of Non-Executive Directors who have no personal financial interest in the recommendations. The Chairman of the Committee is John Morris, the other members are David Buffham and Karen Ingham (appointed 25 January 2016). The Chairman and Chief Executive (except for items relating to his own remuneration) also attend meetings but are not members of the Committee. The HR Director acts as Secretary to the Committee. No use of external remuneration consultants was made by the Committee during the year.

During the year the Committee met three times and activities included:

- Overseeing compliance of the Society's approach to remuneration against the requirements of the Regulators' Remuneration Code;
- Considering and agreeing pay and benefits for Executive Directors, senior managers and the Chairman, as well as overseeing remuneration matters across the Society and its subsidiaries;
- Reviewing the performance for the financial year and approving the resulting level of Corporate Bonus to be paid based on achievement of the Corporate Key Performance Indicators; and
- Consideration of the disclosure requirements for the Remuneration Report including Pillar 3 disclosures.

There were no substantial changes relating to Directors' remuneration made during the year and the Society's Remuneration Policy does not include significant performance related variable remuneration. The Society has adopted a simple remuneration structure which is appropriate to its business and is efficient and cost effective in promoting its long term strategy. Transparent salary, other benefits and pension contributions are supplemented by a modest and straight-forward Corporate Bonus Scheme that promotes continued involvement in the Society's ongoing success through cumulative performance targets without over-emphasising reward based on short term results.

ii) Report on Remuneration

The total remuneration received by Executive Directors is shown on page 28. The information has been audited and shows remuneration for the years ended 31 December 2015 and 31 December 2016 as required under the Building Society (Accounts and Related Provisions) Regulations 1998. There is a requirement under Para 14 of the Society's Rules to have deposits to the value of not less than £1,000 in a Society share account in order to qualify as a Director. This means all Directors are Members of the Society. There are no requirements for a Director to own shares in the Society's subsidiary companies.

The Chief Executive is the Society's most highly paid employee and no employee earns more than any Executive Director. The 17.6% increase in the total remuneration of Mr A S Haigh mainly reflects his promotion to the position of Chief Executive Officer in April 2015. The underlying increase in his total remuneration amounted to 1.4%. The average percentage change through 2016 in respect of employees of the Group taken as a whole was 2.6%.

For details of other non-Society Board positions held by the Society's Executive Director team see the Annual Business Statement on page 77 of the Annual Report and Accounts. None of the current Executive Directors retained any remuneration as a result of their non-Society positions.

Remuneration Committee Report (continued)

Directors' Emoluments (Audited)

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

	Year	Salary or fees	Other benefits	Annual bonus (Note 1)	Pension contributions to defined contribution scheme (Notes 2 and 3)	Total contractual benefits
Executive Directors		£000	£000	£000	£000	£000
AS Haigh - Note 2, 4	**2016**	**269**	**37**	**8**	**-**	**314**
	2015	227	32	8	-	267
AM Russell - Note 3	**2016**	**186**	**15**	**6**	**12**	**219**
	2015	183	10	6	16	215
P Ferguson	**2016**	**135**	**10**	**4**	**12**	**161**
	2015	132	10	4	12	158
D Thompson (Appointed 22 August 2016)	**2016**	**58**	**7**	**-**	**5**	**70**
	2015	-	-	-	-	-
JH Willens (Retired 30 April 2015)	**2016**	**-**	**-**	**-**	**-**	**-**
	2015	261	34	-	-	295
Total for Executive Directors	**2016**	**648**	**69**	**18**	**29**	**764**
	2015	803	86	18	28	935
Non-Executive Directors						
PJ Moorhouse	**2016**	**66**	**-**	**-**	**-**	**66**
	2015	65	-	-	-	65
R Bottomley OBE	**2016**	**39**	**2**	**-**	**-**	**41**
	2015	37	1	-	-	38
D Buffham	**2016**	**50**	**-**	**-**	**-**	**50**
	2015	47	-	-	-	47
K Ingham	**2016**	**37**	**-**	**-**	**-**	**37**
	2015	29	-	-	-	29
RD Mayland (Retired 24 February 2015)	**2016**	**-**	**-**	**-**	**-**	**-**
	2015	6	-	-	-	6
RJ McCormick	**2016**	**53**	**1**	**-**	**-**	**54**
	2015	52	2	-	-	54
J Morris	**2016**	**49**	**2**	**-**	**-**	**51**
	2015	43	2	-	-	45
CRR Vine-Lott (Retired 31 December 2015)	**2016**	**-**	**-**	**-**	**-**	**-**
	2015	43	3	-	-	46
IW Ward	**2016**	**43**	**1**	**-**	**-**	**44**
	2015	42	1	-	-	43
Total for Non-Executive Directors	**2016**	**337**	**6**	**-**	**-**	**343**
	2015	364	9	-	-	373
Total for all Directors	**2016**	**985**	**75**	**18**	**29**	**1,107**
	2015	1,167	95	18	28	1,308

Notes:

1. The Society's Executive Directors participate in the Group's annual Corporate Bonus Scheme. The annual corporate bonus is determined based on achievement of the current year's corporate KPIs. There is no consequent deferral of the bonus payment or vested element.
2. Mr AS Haigh has elected to take his pension contribution amounting to £24,208 as a cash payment. He is liable for his own tax and national insurance contributions on this payment.
3. Mrs A M Russell has elected to take a proportion of her pension contribution amounting to £5,141 as salary.
4. Mr AS Haigh was appointed as Chief Executive in May 2015.

iii) Directors' Remuneration Policy

The Society's Remuneration Policy is designed to provide competitive remuneration packages that attract, retain and reward our senior team, to deliver business objectives in support of the Society's strategy whilst providing value for Members. The Society's Remuneration Policy does not include significant performance-related variable remuneration.

The Society operates a Corporate Bonus scheme that is simple, modest and fair and applies to everyone across the Society. Basic remuneration potential (salary, other benefits and pensions) is not pre-determined against targeted Society performance, and is periodically reassessed by the Remuneration Committee with regard to actual Society performance.

With regard to Director pay rises, Directors normally receive the same percentage increase as the Society's wider employee base (2016: 2.0%), unless there is a change in their responsibilities.

In implementing the Policy, the following key principles are observed:

- The Policy is clearly linked to the Society's business strategy, objectives and values;
- Policy, process and practice are consistent with and promote effective risk management, whilst creating an acceptable relationship between risk and reward;
- Basic pay and total remuneration is set at a competitive level to attract and retain the appropriate calibre of people;
- The approach to pay satisfies regulatory requirements and good Corporate Governance practice;
- Remuneration arrangements are transparent, consistent and fair, reflecting individual responsibilities and performance; and
- Remuneration arrangements are straightforward to understand, communicate and administer.

There have been no significant changes made to the Society's Remuneration Policy, or application, since its implementation in April 2015.

Remuneration for Executive Directors

The table below shows the elements of remuneration for both existing and new Executive Directors and the way they operate.

How elements support our strategy	Operation	Maximum potential value	Performance conditions and assessment
Basic Salary Supports the recruitment and retention of Executive Directors, reflecting their individual roles, skills and contribution.	Basic salary reflects the size of the role and responsibilities, individual performance (assessed annually) and the skills and experience of the individual. In setting appropriate salary levels, the Committee takes into account data for similar roles in comparable organisations. The Society aims to position Executive Directors competitively within the reference group.	Increases to base salary are determined annually by the Committee taking into account: • Individual performance; • The scope of the role; • Pay levels of comparable organisations; and • Pay increases elsewhere in the group.	None applicable however individual performance is taken into account when considering base increases.
Pension Supports recruitment and retention of Executive Directors at a cost that can be controlled by the Society.	Generally the Society contributes to a defined contribution pension scheme for the Executive Directors. The contribution can instead be paid in cash (which is excluded from bonus calculations) if the Executive Director is likely to be affected by the limits for tax approved pension saving.	9% of basic salary.	None applicable.
Benefits • To attract and retain Executive Directors; and • Provides a competitive level of benefits to assist Executive Directors to carry out their roles effectively.	A number of benefits are provided to Executive Directors, including car or car allowance, private medical insurance, life insurance, relocation allowance and permanent health insurance. The Committee reviews benefits and from time to time may make changes, for example to reflect market practice or the needs of the business.	The Society bears the cost of providing benefits which may vary from year to year.	None applicable.
Short Term Incentive Scheme • Supports attraction and retention of Executive Directors; • Supports the development of a high performance culture; and • Rewards performance within the context of achieving corporate goals and objectives as set out in the corporate strategy.	Performance measures and targets are set on an annual basis and are measured over the financial year. Payment is made in cash, after performance has been assessed. Payment is made at the discretion of the Committee.	The Committee determines the maximum incentive. A corporate bonus payment has been awarded of 3.0% of base salary in relation to 2016 performance.	The performance measures considered by the Committee in respect of the Corporate Scheme are delivery of the Corporate KPIs which include: • Group profit, capital and liquidity targets; • Quality measures around service, complaints and customer satisfaction; • Targets for savings and mortgage business; and • Other KPIs covering people, Solutions business and delivery of major projects. The measures are assessed by the Committee. (Further information on KPI performance can be found on page 8 of the Strategic Report.)

Notes to the table

As noted above, the Committee has complete discretion to make payment under the Corporate Bonus Scheme and also has discretion to amend or remove the Scheme where necessary to ensure the arrangements continue to meet the Committee's overriding remuneration principles.

Remuneration of Non-Executive Directors

The table below set outs the elements of Non-Executive Directors' remuneration and the policy on how each element is determined.

Element	Approach
Basic Fees	Reviewed annually based on time commitment and responsibility required by Board and Board Committee meetings. Review takes into account fees paid by comparable financial services organisations. Fees set by the Remuneration Committee.
Additional Fees	Additional fees are payable for additional responsibilities such as Committee chairmanship or membership.
Other items	Non-Executive Directors are not eligible to participate in any form of performance pay and do not receive pensions or other benefits in kind.

The Remuneration Committee also determines the Chairman's fee.

Remuneration Committee Report (continued)

Directors' service agreements and notice periods

Executive Directors are employed on service agreements which can be terminated by either the Society or the Director giving 6 months notice.

Non-Executive Directors do not have service agreements. Non-Executive Directors are appointed for an initial three year term. They will generally be expected to serve more than one three year term.

Documents may be served on any of the Society's current Directors at: "Newcastle Building Society" c/o Addleshaw Goddard LLP (Ref. GAB), Milton Gate, 60 Chiswell Street, London EC1Y 4AG.

All of the Society's Directors volunteer for annual re-election.

Policy on termination pay

The Committee aims to treat departing Executive Directors fairly, taking into account the circumstances of their departure, but is always careful to ensure that the interests of Members are considered and that there are no rewards for failure.

Executive Directors are entitled to be paid their basic salary and contractual benefits (including pension contributions) during their notice period. The Society has the discretion to pay these as a lump sum in lieu of notice.

The rules of the Corporate Bonus Scheme set out the treatment for an individual who cease to be an employee or Director of the Society.

Consideration of remuneration for individuals elsewhere in the Society

The Committee is responsible for setting the remuneration of the Executive Directors and approves the policy for senior managers who have material impact on the Society's risk profile (Code Staff). In addition, the Committee reviews recommendations from the Chief Executive for approval on the remuneration of other executives. When setting salary increases for Executive Directors, the Committee considers the level of salary increases across the Society and Group. All employees of the Society receive a basic salary and benefits consistent with market practice, and are eligible to participate in the Society's Corporate Bonus Scheme and pension arrangements.

Consideration of Member views

The Committee does not consult with the Society's Members on its Executive Remuneration Policy but takes into account feedback given by Members. The Committee has for a number of years, invited Members to vote on the annual remuneration report, and Members have always voted in favour. In 2014, the Society voluntarily elected to adopt some of the changes to remuneration reporting that apply to UK listed companies and one of the factors that the Committee took into consideration was the opportunity to give Members a chance to vote on the Society's Remuneration Policy. Members voted and gave their support (89.35% voted to approve the policy with 18,145 votes for, 2,163 against and 539 withheld) to the policy in April 2015 which took immediate effect. In accordance with the Code, the policy will be put forward for vote again in 2018. Member approval was given to the 31 December 2015 Directors' Remuneration Report (91.09% approval with 16,393 votes for, 1,604 against and 353 withheld) in April 2016.

Summary of the Remuneration of Code Staff

A summary of the remuneration of Code Staff during 2016 and the business areas in which they operate is shown below.

Category	Typical Functions	Year	Number in Category During the Year	Fixed Remuneration £000	Variable Remuneration (Note 1) £000	Total Remuneration £000
Executive Directors	CEO, Finance Director & Deputy CEO, Strategy Planning & Risk Director, Customer Director	**2016**	**4**	**746**	**18**	**764**
		2015	4	917	18	935
Other Executives	Sales & Marketing (Note 2), Treasury, Information Technology, Operations, Human Resources, Commercial Services, Business Assurance	**2016**	**6**	**500**	**13**	**513**
		2015	8	787	21	808
Control Functions	Compliance, Underwriting	**2016**	**2**	**128**	**2**	**130**
		2015	2	117	3	120
Total		**2016**	**12**	**1,374**	**33**	**1,407**
		2015	14	1,821	42	1,863

Notes:

1. Variable remuneration reflects participation in the Group's annual Corporate Bonus Scheme.
2. The Group has revised its interpretation of code staff and two roles in sales and marketing were removed from that classification throughout 2016.

There was no deferred remuneration during 2016. As the Society's Remuneration Policy does not include significant performance related variable remuneration, no formal ratio between fixed and variable remuneration is relevant.

John Morris
Chairman of the Remuneration Committee
23 February 2017

Risk Management Report

Overview

The Society's risk management framework is designed to enable the Society to proactively identify and manage risks to support the achievement of the Society's objectives.

It includes monitoring and controlling the significant risks to which the Society is exposed to ensure the security and resilience of the Society. The Society's ability to identify, measure, monitor, report and control risks is key to delivering sustainable and resilient business performance, including fair outcomes for Members and customers.

Risk Governance

The Board is ultimately responsible for ensuring that adequate systems of risk management are in place, and that the Society's strategy, risk appetite, and risk management are consistent. To assist the Board a Group Risk Committee (GRC) oversees the management of risk across the Group (see below).

The GRC is supported by an independent Group Risk department that is responsible for ensuring that appropriate risk management is used. This includes the provision of reports on risks, and risk management for the GRC and its sub-committees. The Strategy Planning and Risk Director provides formal updates on risk management to the Board, in relation to the Group, at least quarterly.

Risk Framework

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 GRC and supporting sub-committees together with oversight of the first line by the Group Risk department. The third line of defence is provided by Internal Audit and the Audit Committee, which are responsible for reviewing the effectiveness of the first and second lines of defence.

The risk framework includes the use of Board approved risk appetite statements covering profitability in a stressed scenario, capital, liquidity, operational risk, credit risk, interest rate risk, the fair treatment of customers and conduct risk, and IT risk. They set out key limits and escalation triggers. The risk appetite statements, together with the risk position, are reported to the Board quarterly, and formally approved annually.

The risk framework makes use of stress testing and scenario testing. Stress tests consider the potential outcomes for portfolios and for the Society in the event of stressed scenarios incorporating, for example, falling house prices and rising unemployment. Scenario tests consider the outcome in the event of a particular risk or event occurring, and are used to help evaluate the controls, and assess the adequacy of the Society's incident management and business continuity plans.

Group Risk Committee

The GRC oversees the Society's risk management and governance framework, and oversees the Society's overall risk profile. The Committee meets at least six times a year and more frequently when required.

Members of the GRC throughout the year, all of whom were Non-Executive Directors, were David Buffham (Committee Chairman), Ron McCormick, John Morris, and Ian Ward.

The duties of GRC include:

- 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;
- Oversight of the risk sub-committees (see below);
- Review and assessment of the adequacy of risk management information to monitor and control risks;
- Approval of risk management of new initiatives and projects, and in particular the risks those initiatives and projects expose the Group to;
- Consideration and approval of the top risks for the Society and Group including low likelihood, high impact risks; and
- Approval of stress testing and scenario testing.

During 2016 the Committee met seven times and in particular considered the following matters:

- Review of the risk appetites for prudential, and conduct risk;
- Review of the Group's Risk Management Strategy;
- Oversight of the annual stress testing report including low likelihood high impact risks;
- Review and ratification of key risk policies covering lending, treasury, and operational risk;
- Review and approval of the Society's compliance plan;
- Review of compliance with the Buildings Society Sourcebook limits; and
- Review of the Society's risk framework, including a review of the Society's conduct risk framework.

The GRC is supported by five Executive committees, as follows:

The Retail Credit Committee (RCC) is responsible for credit risk across the Group arising from the retail mortgage portfolio including lending policy, underwriting, limit setting and monitoring, forbearance, possessions, affordability, scorecard effectiveness and efficiency, and residential stress testing. During 2016 RCC met monthly.

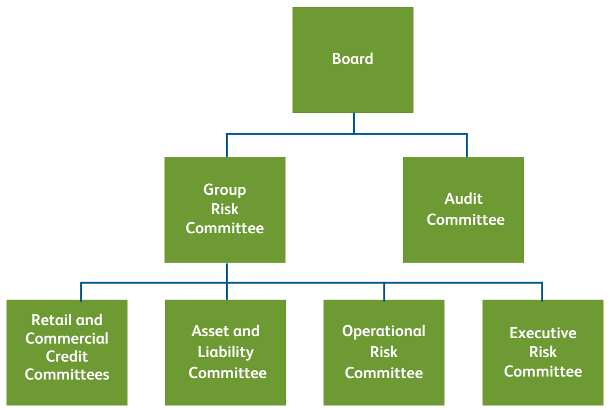
The Commercial Credit Committee (CCC) is responsible for credit risk across the Group's non-retail mortgage portfolio including loan strategy, limit monitoring, risk indicators and stress factors, annual reviews and breach reports, loan renegotiations and restructures, monitoring risk trends on the portfolio, and stress testing. During 2016 CCC met once every two months.

The Operational Risk Committee (ORC) is responsible for operational risks arising across the Group, including operational risk policy, risk event trends, actions on significant risk events, project risks, business continuity policy, and scenario testing. During 2016 ORC met monthly.

The Executive Risk Committee (ERC) is responsible for "overlap" risks, i.e. risks that go across business areas, and in particular for conduct risks, and overall stress testing. It is responsible for approving compliance policy, monitoring compliance with policies, conduct risk indicators, business continuity policy, and overall stress testing. During 2016 ERC met monthly.

The Assets and Liabilities Committee (ALCO) is responsible for all aspects of treasury risk management including liquidity risk, interest rate risk, counterparty credit risk, and balance sheet management. During 2016 ALCO met monthly.

Risk Governance Structure



Risk Management Report (continued)

Risk and Impact	Mitigation	Change	Commentary
Credit Risk The primary credit risks relate to commercial, residential, and investment (see below).			
Residential Retail borrowers do not repay the Society and the Society's collateral is insufficient to meet the debt obligations. The risk is sensitive to unemployment rates, house prices, and interest rates. For example, if a borrowing customer loses their job they may be unable to meet their repayments. If the Society takes possession of the property it may not realise enough on subsequent sale to repay the loan balance. In a recession when unemployment rises and house prices can fall the risk is greater.	Loans are underwritten individually based on affordability, credit score and history, acceptable collateral (including loan to value), and the Society's lending criteria. The Society does not undertake sub-prime or self-certification lending. The Society's lending policy is subject to review at least annually. The residential book is subject to monthly reporting in relation to its credit risk characteristics (including loan to value, loan to income, arrears, early delinquencies, and arrears arising from cohorts of lending). The Society's risk appetite is expressed in terms of losses arising in a stressed scenario, and stress testing is used to ensure that the portfolio is within the Society's risk appetite.	←	The Society has increased its lending to retail borrowers in 2016, including BTL lending to individuals, and has a strategy to continue to do so. The Society's risk to residential lending has increased as the overall book has increased. Indexed LTV has reduced due to house price rises and capital repayments. Loans 3 months or more in arrears are at historically very low levels. The retail book remains within the Society's risk appetite. Actual losses on the residential book remain very low at less than £0.1m p/a.
Commercial Commercial borrowers do not repay the Society and the Society's collateral is insufficient to meet the debt obligations. The risk is sensitive to economic conditions that can impact the viability of tenants and commercial real estate values. For example, if a commercial borrower has a property where the tenant is lost they may be unable to meet repayments. If the Society takes possession of the property it may not realise enough on subsequent sale to repay the loan balance. In a recession when more tenants may fail and commercial property values can fall the risk is greater.	The commercial loan book is being actively managed down. Commercial loans over £500k are subject to annual reviews reporting to the Commercial Credit Committee (CCC). Higher risk loans are subject to quarterly review. Concentration risk to single names and to sectors is monitored. In the event of a breach a report is provided to the CCC. Borrower and tenant watchlists are maintained by the credit risk team, and are reviewed monthly. Watchlists for borrowers and tenants are updated on a real time basis. Sector reviews are completed regularly. Where appropriate the Society uses property experts to provide it with options analyses. Stress testing is used to determine the risk associated with the portfolio and with individual loans within it.	↓	The Society withdrew from new commercial lending in 2008. Lending balances on commercial property have fallen by £54m (40%) in 2016, and now represent 3% of the mortgage book. The Society's exposure to single name risk has also materially reduced. Loans to registered social landlords (RSL) are subject to the same controls as commercial loans. However, the risk of default in relation to an RSL loan is extremely low with no history of default within the portfolio. The assessment of risks has fallen significantly based on stress test losses and number of cases on watchlists.
Investment/Liquidity Credit Wholesale counterparties the Society lends to default, or the value of the investment falls and the Society is obliged to crystallise that fall in value. This risk arises in relation to the treasury investments made by the Group in order to meet liquidity requirements. The risk is sensitive to market volatility and credit spreads (both general credit spreads and name specific credit spreads). For example, if the Society invests in Residential Mortgage Backed Securities, and subsequently the market value of that falls, the Society may have to sell the assets at a loss. The risk is higher when there is greater market volatility.	Investments are subject to a GRC approved policy, which sets out what instruments, countries, and counterparties investments can be made in, and sets limits on exposures to instruments, countries, and counterparties. Investments are monitored and reported to management daily, and reported to the Assets and Liabilities Committee (ALCO) on a monthly basis, including compliance with the policy. The credit default swap rates for the Society's counterparties are monitored, and alerts raised if certain criteria are met in relation to those spreads. The mark to market value of the Society's investments in gilts, residential mortgage backed securities, and covered bonds are monitored daily and reported to ALCO monthly.	←	The Society's overall risk exposure has remained constant. Overall liquidity is at similar levels and the proportion of liquid assets held with highly rated counterparties has been maintained.

Risk and Impact	Mitigation	Change	Commentary
Conduct Risk Conduct risk is the risk of customer detriment arising from the Society's activities. Examples include products that do not perform as customers expected them to, or products being sold to customers for whom they are not suitable. Conduct risk and operational risk (see below) are closely aligned where the operational risk results in customer detriment (e.g. a failure to protect customer data is an operational risk which may result in customer detriment). For example, if the Society provides a mortgage product to a customer where the information the customer needed to make an informed decision was absent, and the product does not meet the customer's needs.	Conduct risk is wide-ranging, and the key mitigants are:- The Society maintains a risk appetite statement relating to customer outcomes and measures performance relative to that statement monthly, reporting to the Executive Risk Committee (ERC) with oversight from the GRC. All new products are approved by a Mortgage and Savings Committee, which includes consideration of an assessment of risks to customer outcomes. The Society maintains a Treating Customer Fairly dashboard, which looks at evidence supporting good customer outcomes (or suggesting poor outcomes) and this is reviewed quarterly and reported to the Board. The Society maintains an annual Compliance Plan, which is risk based, reporting to ERC with oversight from the GRC. (See also Operational Risk).	←	The Society has a simple product range covering mortgages, savings, insurance, and financial advice via Newcastle Financial Advisers Limited (an Appointed Representative of Openwork).
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. For example, if there are exceptionally high withdrawals at a time when there is illiquidity in financial markets preventing the Society from selling its liquid assets, then it may have to sell assets at a discount to obtain liquid assets.	Liquidity is subject to a GRC approved Policy, which sets out limits in relation to liquidity. Liquidity is monitored and reported to management daily, and reported to the Assets and Liabilities Committee (ALCO) on a monthly basis, including compliance with the policy. Cash flow forecasts are used to forecast liquidity, and ensure compliance with the limits in the future. Wherever appropriate the Group ensures it takes any necessary steps to ensure it has access to Bank of England schemes designed to support financial institutions. Stress tests are used to ensure that liquidity risk is within the risk appetite.	←	Overall liquidity risk is unchanged.
Interest Rate Risk Interest rate risk is the risk that the value of the Society's net assets or net interest income falls as a result of a change in interest rates. Basis risk is the risk that net interest income falls because of a change in the relationship between two market rates. For example, the Society has assets which earn interest based on the LIBOR rate, and liabilities where the rate is set by the Society. For example, if LIBOR falls at a time when base rate and savings rate do not, then the Society's assets realise lower income, but the costs remain unchanged.	Interest rate risk is subject to a GRC approved policy. Interest rate risk and basis risk are subject to policy limits. They are monitored and reported to ALCO monthly, including compliance with policy. The Society uses interest rate swaps to manage interest rate risk. Derivatives are only used, in accordance with the Building Societies Act 1986, to mitigate risks arising from interest rates or indices. Forecasts are used to assess future compliance with limits and determine the need for management action. Stress tests are used to assess the Society's exposure to interest rate and basis risk.	←	The Society's policy in relation to interest rate risk has not changed in the year nor has the overall interest rate risk to which the Society is exposed. Note 29 gives details of the derivative financial instruments held at 31 December 2016, together with the impact of a rate shock of 1% and 2%.

Risk Management Report (continued)

Risk and Impact	Mitigation	Change	Commentary
Pension Fund 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 fund obligation 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. For example, if yields on gilts fall then the value of liabilities rises, resulting in a larger deficit. If the value of shares falls then the value of the pensions fund assets falls and the deficit rises.	The pension fund is overseen by the Trustees of the Scheme, within an agreed Investment Strategy. Reports prepared by the Scheme's independent actuary are reviewed by the Trustees quarterly and, if appropriate, management action is taken. The Group performs stress testing on the pension scheme liabilities and assets at least annually. The Board received quarterly updates on the Society's Pension Scheme including mitigation strategies.	↓	The pension fund deficit on an IAS 19 basis improved to a surplus of £2.6m at 31 December 2016 compared to a deficit of £1.7m at the end of 2015. The reduction in the deficit is due to payments into the scheme of £1.7m in 2016 and a strong rally in equity markets at the end of the 2016 financial year. The pension scheme has rebalanced its investment strategy in favour of investments that better match the liabilities of the scheme (Liability Driven Investment) and has also diversified its investments to reduce overall risk (via Diversified Growth Funds). However the scheme is still exposed to significant market volatility particularly in long term gilt rates.
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. Operational risk covers examples such as a fire or accident, fraud or theft, or, for example, a failure of IT systems resulting in customers being unable to log in.	Operational risk is subject to a GRC approved policy, which covers the framework for operational risk, including the measurement and management of risk, operational risk appetite, use of scenario testing for operational risk, 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. Key risks and controls are identified for all areas of the business. 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. Corporate Insurance policies are negotiated with regard to the key risks within the Group requiring greater mitigation.	↑	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. The Society implemented several projects and recruited additional specialist risk staff in 2015 to further enhance its resilience and combat risks from cybercrime. The value of savings balances managed by the Solutions business and the level of income increased significantly during 2016 (see segmental analysis in Note 8).
Capital Risk Capital risk is the risk that the Society is or becomes inadequately capitalised to address the risks to which it is exposed.	The Society updates its ICAAP on an annual basis. Capital adequacy is monitored on a monthly basis by the Board and the 5 year capital plan has been updated on a regular basis between ICAAP reviews against the background of changing economic circumstances and updated budgets and forecasts. The Group maintains its capital at a level in excess of its Individual Capital Guidance. The Group publishes further information about risk exposures in its Pillar 3 disclosures, available on the Society's website (www.newcastle.co.uk).	↓	The Society's Common Equity Tier 1 ratio has improved to 14.3% from 13.6%.
Brexit Risk Brexit risk is the risk that Brexit results in adverse outcomes for the Group. Brexit results in uncertainty to the regulatory environment, and economic environment.	Brexit is monitored via the Group's existing framework. The Group does not trade outside the UK and Gibraltar, and does not rely on EU employees. As such the impact of Brexit is limited.	↑	The regulatory environment is largely dependent on the EU regulations, including the ability of EU firms to passport permissions into the UK. Some of our savings management clients passport their EU permissions into the UK. The UK economic outcomes will depend on Brexit, and the uncertainty may result in lower growth in the UK. This may impact the risks highlighted above.

David Buffham
Chairman of the Group Risk Committee
23 February 2017

Independent Auditors' Report to the Members of Newcastle Building Society

Report on the Annual Accounts

Our opinion

In our opinion, Newcastle Building Society's group annual accounts and Society annual accounts (the "annual accounts"):

- give a true and fair view of the state of the group's and of the Society's affairs as at 31 December 2016 and of the group's and the Society's profit and cash flows for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards ("IFRSs") as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Building Societies Act 1986 and, as regards the group annual accounts, Article 4 of the IAS Regulation.

What we have audited

The annual accounts, included within the Annual Report and Accounts (the "Annual Report"), comprise:

- the Group and Society Balance Sheets as at 31 December 2016;
- the Group and Society Income Statements and Statements of Comprehensive Income for the year then ended;
- the Group and Society Cash Flow Statements for the year then ended;
- the Group and Society Statement of Movement in Members' Interests for the year then ended; and
- the notes to the annual accounts, which include a summary of significant accounting policies and other explanatory information.

Certain required disclosures have been presented elsewhere in the Annual Report, rather than in the notes to the annual accounts. These are cross-referenced from the annual accounts and are identified as audited.

The financial reporting framework that has been applied in the preparation of the annual accounts is applicable law and IFRSs as adopted by the European Union.

Our audit approach

Overview

Materiality:

- Overall group materiality: £1,240,000 which represents 0.5% of Net assets.

Audit Scope:

- We conducted all of our audit work from Newcastle upon Tyne using one team.
- Audit procedures were performed over all material account balances and financial information in the Society due to its significance to the group's financial performance and position.
- Audit procedures were performed over specific account balances and financial information in four other group undertakings that materially contributed to group's financial performance and/or position.

Areas of focus:

- Allowances for losses on loans and advances secured on commercial property/land.
- Valuation of the equity release loan portfolio.
- Valuation of derivative financial instruments and application of hedge accounting.

The scope of our audit and our areas of focus

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) ("ISAs (UK & Ireland)").

We designed our audit by determining materiality and assessing the risks of material misstatement in the annual accounts. In particular, we looked at where the directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain.

As in all of our audits we also addressed the risk of management override of internal controls, including evaluating whether there was evidence of bias by the directors that represented a risk of material misstatement due to fraud, and the risk of fraud in revenue recognition.

The risks of material misstatement that had the greatest effect on our audit, including the allocation of our resources and effort, are identified as "areas of focus" below. We have also set out how we tailored our audit to address these specific areas in order to provide an opinion on the annual accounts as a whole, and any comments we make on the results of our procedures should be read in this context. This is not a complete list of all risks identified by our audit.

Area of focus

Allowances for losses on loans and advances secured on commercial property/land

See note 1 to the annual accounts for the directors' disclosures of the related accounting policies, judgements and estimates and notes 11 and 29 for detailed disclosures.

The Society has recognised an impairment charge on loans and advances to customers secured on commercial property/land of £3.2m (2015: £4.6m) in the year. This leaves a balance of £82.1m (excluding provision) on the balance sheet. There is a specific provision of £7.0m (2015: £15.0m) and a collective provision of £2.6m (2015: £2.0m). Whilst the Society has had success in its strategy of winding down this loan book over recent years, the portfolio remains significant in the context of the results of the group in the current and previous years.

Significant judgement needs to be applied by the directors to estimate the potential loss on loans where an impairment event has occurred. Judgement is required in respect of identifying an impairment trigger event on loans and, once identified as impaired, the estimate of loss on a loan is calculated by use of models to discount the future cash flows expected to be received on the loan. This calculation is impacted by a number of assumptions which we focussed on, including, but not limited to:

- The value of the underlying security;
- Likelihood of re-letting where part/all of property remains vacant or tenancy agreements contain break clauses which pre-date the loan's maturity; and
- The exit strategy of the Society and, where this pre-dates the contractual maturity of the loan, the feasibility of delivering this strategy.

We also paid particular attention to the director's assumptions in assessing the timing and value of future cash flows, as this is subject to significant estimation uncertainty and as a result there is an increased risk that impairment allowances may be materially understated.

How our audit addressed the area of focus

We evaluated and challenged the directors' future cash flow forecasts for loans where specific impairment allowances had been recognised, and the process by which they were drawn up. We tested the significant inputs in the models to underlying evidence, for example agreeing property values to valuations provided by external third parties and other details to tenancy agreements. For properties which were sold post year end, we agreed cash proceeds to amounts used in the models.

Where the directors had obtained and relied upon third party property valuations, we obtained and read copies of these reports to check that the valuations were consistent with those applied in the directors' cash flow models, and found no exceptions. We also independently assessed the competency of the external third party property valuers contracted by the group to undertake these valuations as well as their independence and objectivity. We did not identify any issues with the quality of the valuations undertaken, with the organisations involved, or with the validity of other evidence provided.

Our work on the cash flow forecasts also involved assessing the reasonableness of the assumptions used (as described above) to derive the expected future cash flows. We also undertook sensitivity analyses to assess the changes required in those assumptions to result in material misstatement of the allowances, and the likelihood of such changes arising individually and in aggregate. The results of our work lead us to conclude that no reasonably possible changes in assumptions resulted in material changes to provisions recognised, and hence the assumptions used by the directors were reasonable.

We evaluated the outcome of commercial loans redeemed in the year by comparing these to management's previously expected outcome to ascertain whether losses realised were consistent with previously recorded provision allowances. No significant variances were noted during this testing, which provides us with further evidence over the directors' ability to estimate future cash flows accurately.

The appropriateness of the collective provision of £2.6m was assessed through utilising the evidence we had obtained from the procedures outlined above against the impairment criteria defined in accounting standards. We did not identify any material error in the collective provision based on the evidence obtained from those procedures.

In evaluating the completeness of specific impairment provision allowances on commercial loans and the appropriateness of the collective provision, we:

- Re-performed a sample of controls relied upon by the directors to address accurate capture of arrears information, including testing over the allocation of cash receipts from borrowers to the correct loan accounts and recalculation of arrears for a sample of borrowers;

- Obtained "watch lists" representing borrowers being closely monitored by the Commercial Credit Committee and minutes of the committee's meetings to identify any loans of higher risk and investigated the past performance of these loans to assess if an impairment event had occurred and the likelihood of loss in the event of default: and
- Identified specific commercial loans which had not been assessed by the directors as impaired but in our view represented a heightened risk of potential impairment, including loans with significant balances outstanding at the balance sheet date, with high Loan to Values ("LTVs") and loans in arrears or where forbearance had been granted and again investigated the past performance of these loans to assess whether an impairment event had occurred and the likelihood of loss in the event of default.

Following completion of the above procedures, we did not identify any errors in the capturing and recording of arrears information and we did not identify any loans recorded on the watch lists or identified as higher risk through use of our own selection criteria for which we considered there to be evidence of a need for a specific provision.

Areas of focus

Valuation of equity release portfolio

See note 1 to the annual accounts for the directors' disclosures of the related accounting policies, judgements and estimates and note 11 for detailed disclosures.

The Society has legacy equity release loans with a total value of £201.3m (2015: £208.7m). The of these loans is judgemental, and is based on a number of assumptions.

The Society has £162.5m of 'standard' equity release products, where the return to the Society is unknown, as it is based on the future loan value at the point of redemption which is not a fixed point in time given that redemption occurs on the death of the borrower or them entering long-term care. In addition there are £38.7m of fixed reversion products, where the repayment amount to the Society is fixed, but there is significant judgement around the time of the redemption.

As a result of the above factors there is a significant amount of judgement applied by the directors in valuing the equity release portfolios. For the standard equity release loans these judgements are based on identifying a trigger event on loans, and once identified as impaired, the estimate of loss on a loan is calculated by comparing the expected loan balance at maturity (i.e. death of the borrower) with the expected value of the property on maturity. We have focused our work on the assumptions made by management which underpin the estimated loan and property valuations at the date of redemption.

The fixed reversion loans are held at amortised cost based on an actuarial valuation, to establish the expected current value of the future cashflows on this portfolio. This calculation is impacted by a number of assumptions which we focussed on, including, but not limited to:

- The value of the underlying security;
- Mortality and long term care rates;
- Early redemption rates; and
- The discount rate.

How our audit addressed the area of focus

Where the directors have relied upon HPI movements to forecast expected property values we have tested the controls which management operate to ensure that HPIs are entered and calculated correctly by the system. We have also reviewed the reasonableness of the HPI assumptions used by management, and note that management use an industry standard valuation method, appropriately disaggregated by region.

We evaluated the completeness of management's listing of accounts which are at risk, i.e. those where the current value of the property is below the current outstanding loan balance, and have identified no further balances which we consider to be at risk for which there is not a provision.

We have obtained the actuarial valuation of the fixed reversion loan portfolio, and considered the key assumptions made. We have challenged management and employed the use of experts on the appropriateness of key assumptions such as the mortality rates, assumptions for long term care, and early redemptions.

We obtained the data inputs for the actuarial model and have reperformed the calculation of the model to assess the accuracy and reliability of the actuarial report. We also independently assessed the competency of the external third party actuaries contracted by the group to undertake these valuations as well as their independence and objectivity. We did not identify any issues with the quality of the valuations undertaken, with the organisations involved, or with the validity of other evidence provided.

Following completion of the above procedures, we did not identify any issues with the assumptions on which the valuation of the equity release portfolios rely, and have identified no need for further specific provisions.

Areas of focus

Valuation of derivative financial instruments and application of hedge accounting

See note 1 to the annual accounts for the directors' disclosures of the related accounting policies and note 29 for detailed disclosures.

The Society's operations expose the group to significant interest rate risk, as a result of a mismatch between fixed and floating cash inflows and outflows.

The directors have sought to mitigate the risk of future movements in market interest rates affecting the group's profitability through the use of a number of derivative financial instruments, mainly in the form of interest rate swaps. The group has designated a number of these derivatives as accounting hedges, in accordance with accounting standards to reduce the effect of future movements in interest rates on the amounts recorded in the financial statements.

The group has a significant number of derivative instruments and uses valuation systems, and in some instances, valuations provided by counterparties, to determine the fair value of each instrument at the balance sheet date. The group also uses systems, and in some cases bespoke cash flow models, to assess hedge effectiveness for the accounting hedges as required by accounting standards.

We focused on this area as there are a large number of instruments that require valuations, and these require judgement. The process of recording the valuations in the accounting records requires manual input and the criteria for achieving hedge accounting are onerous and complex, both of which increase the risk of error in application.

In particular we focused on:

- the interest yield curves and discount rates applied in the Society's valuation systems and/or counterparty valuations; and
- the Society's hedge documentation and calculation spreadsheets used to calculate ineffectiveness in hedge relationships.

How our audit addressed the area of focus

We agreed fair values for each derivative financial instrument by management to the values recorded in the annual accounts.

We obtained a sample of derivative contracts and undertook independent valuations for these instruments at the balance sheet date using our own models. Within our models we used externally available sources for interest yield curves and discount rates for the group, in arriving at our own independent estimates of fair value.

We compared our independently determined fair values to those calculated by management for the same instruments (whether through the use of valuation systems or those provided by counterparties) to evaluate any differences arising. In performing this comparison we calculated tolerable thresholds for valuation differences which took into account the complexity of the instrument being valued. We noted no significant differences outside of those tolerable thresholds.

We obtained and read the group's hedging documentation to evaluate whether this documentation was compliant with the accounting requirements for applying hedge accounting and found no issues.

We also obtained and re-performed the hedge effectiveness calculations undertaken by management in assessing the effectiveness of the group's hedge relationships. In performing this work we also recalculated the ineffectiveness recorded in the income statement within the 'Gains less losses on financial instruments and hedge accounting" line. In performance of these procedures we noted no differences to the effectiveness as calculated by the directors and recorded in the accounts.

How we tailored the audit scope

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the annual accounts as a whole, taking into account the geographic structure of the group, the accounting processes and controls, and the industry in which the group operates.

Substantially all of the group's activities are in the United Kingdom and it reports its operating results along two business lines, being the Member business and the Solutions business (refer to note 8 of the annual accounts).

The group has a number of subsidiaries, but the majority of the Member business and a significant proportion of the Solutions business is undertaken by, and recorded within, the accounting records of the Society.

The Solutions business is in the process of being carved out from the Society with all new and a proportion of extant contracts being recognised in the Solutions business but some older contracts still remaining within the Society. As a result we have carried out testing over external revenue streams, as well as payroll and other associated costs in this entity in the current year. Significant activity in other group entities include:

- The provision of financial advice to customers, reported as a Member business activity, undertaken by a subsidiary undertaking of the Society, Newcastle Financial Advisers Limited ("NFAL"); and
- The provision of managed IT services to other group companies, as well as managing a small number of external contracts, undertaken by a subsidiary undertaking of the Society, Newcastle Systems Management Limited ("NSML").

Certain group assets reside in other entities, including material leasehold land and buildings held within a subsidiary undertaking, Newcastle Portland House Limited ("NPHL"). The accounting records and functions for both business lines, which encompass the Society and its subsidiary undertakings, are all located at the Society's principal office in Newcastle upon Tyne, with the consolidation of the group annual accounts performed centrally from this location.

Accordingly, due to majority of the 'Member business' and the 'Solutions' business being conducted by the Society, and the financial significance of this to the group annual accounts, we performed an audit of all material account balances for the Society, together with the assessment of management's going concern assumption.

We also determined it necessary to perform specific audit procedures over account balances and other financial information in certain subsidiary undertakings where such entities significantly contributed to the amount recorded in the group annual accounts. As a result, we performed audit procedures on Leasehold land and buildings recorded in NPHL and revenue recorded in NSSL. No specific audit procedures were deemed necessary on the account balances and other financial information in NSML, as the entity did not contribute materially to the group's financial performance or position.

Taken together, our audit procedures on the Society and its subsidiary undertakings provided us with sufficient audit evidence as a basis for our opinion on the group annual accounts as a whole.

Materiality

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating the effect of misstatements, both individually and on the annual accounts as a whole.

Based on our professional judgement, we determined materiality for the annual accounts as a whole as follows:

Overall Group materiality	£1,240,000 (2015: £1,240,000).
How we determined it	0.5% of net assets
Rationale for benchmark applied	We believe that net assets is the most appropriate benchmark to use for the Society and Group, whose strategy is not one of profit maximisation. Regulatory capital is a key benchmark for management and regulators and hence we continue to use net assets, a GAAP enshrined proxy to regulatory capital, as our benchmark.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £62,000 (2015: £62,000) as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

Other required reporting

Consistency of other information and compliance with applicable legal requirements

Opinions on other matters prescribed by the Buildings 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 Strategic Report and the Directors' Report for the financial year for which the annual accounts are prepared is consistent with the accounting records and the annual 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.

Propriety of accounting records and information and explanations received

Under the Building Societies Act 1986 we are required to report to you if, in our opinion:

- proper accounting records have not been kept by the Society; or
- the Society annual 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.

We have no exceptions to report arising from this responsibility.

Responsibilities for the Annual Accounts and the audit

Our responsibilities and those of the Directors

As explained more fully in the Statement of Director's Responsibilities set out on page 19, the directors are responsible for the preparation of the annual accounts and for being satisfied that they give a true and fair view.

Our responsibility is to audit and express an opinion on the annual accounts in accordance with applicable law and International Standards on Auditing (UK & Ireland) ("ISAs (UK & Ireland)"). Those standards require us to comply with the Auditing Practices Board'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.

What an audit of Annual Accounts involves

An audit involves obtaining evidence about the amounts and disclosures in the annual accounts sufficient to give reasonable assurance that the annual 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 the 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 accounts.

We primarily focus our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the annual accounts.

We test and examine information, using sampling and other auditing techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited annual accounts and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Gary Shaw (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Newcastle upon Tyne
23 February 2017

Income Statements for the year ended 31 December 2016

	Note	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Interest receivable and similar income	2	**69.8**	78.0	**70.5**	78.2
Interest payable and similar charges	3	**(42.7)**	(50.9)	**(42.7)**	(50.9)
Net interest income		**27.1**	27.1	**27.8**	27.3
Other income	4	**30.1**	24.6	**29.9**	22.8
Other charges	4	**(2.7)**	(1.7)	**(2.7)**	(1.7)
Gains less losses on financial instruments and hedge accounting		**0.1**	0.1	**0.1**	0.1
Income from shares in subsidiary undertakings (dividends)			**-**	-	**3.0**
-					
Total operating income		**54.6**	50.1	**58.1**	48.5
Administrative expenses	5	**(40.3)**	(36.1)	**(43.2)**	(36.5)
Depreciation	14	**(2.4)**	(2.1)	**(1.3)**	(1.5)
Operating profit before impairment charges and provisions		**11.9**	11.9	**13.6**	10.5
Impairment charges on loans and advances to customers	11	**(3.2)**	(4.6)	**(3.2)**	(4.6)
Provisions for liabilities and charges	22	**(0.6)**	(1.9)	**(0.6)**	(1.9)
Profit for the year before taxation		**8.1**	5.4	**9.8**	4.0
Taxation expense	7	**(2.0)**	(2.1)	**(2.0)**	(2.0)
Profit after taxation for the financial year		**6.1**	3.3	**7.8**	2.0

The notes on pages 44 to 76 form part of these Accounts.

Statements of Comprehensive Income for the year ended 31 December 2016

	Note	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Profit for the financial year		**6.1**	3.3	**7.8**	2.0
Other comprehensive income / (expense):					
Items that may be reclassified to income statement					
Movement on available for sale reserve		**1.0**	(0.8)	**1.0**	(0.8)
Income tax on items that may be reclassified to income statement		**(0.2)**	0.2	**(0.2)**	0.2
Total items that may be reclassified to income statement		**0.8**	(0.6)	**0.8**	(0.6)
Items that may not be reclassified to income statement					
Actuarial remeasurements on retirement benefit obligations	27	**2.6**	0.4	**2.6**	0.4
Income tax on items that will not be reclassified to income statement	15	**(0.4)**	(0.1)	**(0.4)**	(0.1)
Total items that will not be reclassified to income statement		**2.2**	0.3	**2.2**	0.3
Total comprehensive income for the financial year		**9.1**	3.0	**10.8**	1.7

The notes on pages 44 to 76 form part of these Accounts.

Balance Sheets as at 31 December 2016

	Note	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
ASSETS					
Cash and balances with the Bank of England		**196.4**	183.1	**196.4**	183.1
Loans and advances to banks	9	**235.8**	195.7	**234.7**	194.8
Debt securities	10	**344.3**	347.2	**344.3**	347.2
Derivative financial instruments	29	**6.5**	7.3	**6.5**	7.3
Loans and advances to customers	11	**2,563.8**	2,478.6	**2,557.6**	2,470.2
Fair value adjustments for hedged risk	12	**233.8**	190.8	**233.8**	190.8
Investment in subsidiaries	13	**-**	-	**28.3**	29.8
Property, plant and equipment	14	**22.8**	23.4	**12.3**	12.7
Deferred tax assets	15	**5.2**	7.8	**5.1**	7.7
Retirement benefit asset	27	**2.6**	-	**2.6**	-
Other assets	16	**10.3**	11.6	**16.6**	18.4
TOTAL ASSETS		**3,621.5**	3,445.5	**3,638.2**	3,462.0

The notes on pages 44 to 76 form part of these Accounts.

Balance Sheets as at 31 December 2016

	Note	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
LIABILITIES					
Due to Members	17	**2,709.2**	2,678.8	**2,709.2**	2,678.8
Fair value adjustments for hedged risk	12	**5.2**	5.3	**5.2**	5.3
Due to other customers	18	**211.1**	205.3	**222.9**	217.6
Deposits from banks	19	**187.3**	100.8	**187.3**	100.8
Debt securities in issue	20	**-**	1.0	**-**	1.0
Derivative financial instruments	29	**234.3**	190.4	**234.3**	190.4
Other liabilities	21	**14.1**	10.3	**18.4**	15.6
Provisions for liabilities and charges	22	**2.0**	2.7	**2.0**	2.7
Retirement benefit obligations	27	**-**	1.7	**-**	1.7
Subordinated liabilities	23	**50.0**	50.0	**50.0**	50.0
Subscribed capital	24	**30.0**	30.0	**30.0**	30.0
Reserves		**178.3**	169.2	**178.9**	168.1
TOTAL LIABILITIES		**3,621.5**	3,445.5	**3,638.2**	3,462.0

These Accounts were approved by the Board of Directors on 23 February 2017 and signed on its behalf by:

Phil Moorhouse, Chairman
Richard Bottomley, Chairman of Audit Committee
Andrew Haigh, Chief Executive

The notes on pages 44 to 76 form part of these Accounts.

Statements of Movements in Members' Interests for the year ended 31 December 2016

GROUP	General reserve £m	Available for sale reserve £m	Total £m
At 1 January 2016	169.7	(0.5)	169.2
Movement in the year	8.3	0.8	9.1
At 31 December 2016	**178.0**	**0.3**	**178.3**

	General reserve £m	Available for sale reserve £m	Total £m
At 1 January 2015	166.1	0.1	166.2
Movements in the year	3.6	(0.6)	3.0
At 31 December 2015	**169.7**	**(0.5)**	**169.2**

SOCIETY	General reserve £m	Available for sale reserve £m	Total £m
At 1 January 2016	168.6	(0.5)	168.1
Movements in the year	10.0	0.8	10.8
At 31 December 2016	**178.6**	**0.3**	**178.9**

	General reserve £m	Available for sale reserve £m	Total £m
At 1 January 2015	166.3	0.1	166.4
Movements in the year	2.3	(0.6)	1.7
At 31 December 2015	**168.6**	**(0.5)**	**168.1**

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

The notes on pages 44 to 76 form part of these Accounts.

Cash Flow Statements for the year ended 31 December 2016

	Note	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Cash inflows / (outflows) from operating activities	26	**18.1**	(61.6)	**15.4**	(51.9)
Payment into defined benefit pension scheme		**(2.0)**	(2.0)	**(2.0)**	(2.0)
Net cash inflows / (outflows) from operating activities		**16.1**	(63.6)	**13.4**	(53.9)
Cash inflows / (outflows) from investing activities					
Purchase of property, plant and equipment		**(2.1)**	(2.5)	**(1.2)**	(1.8)
Sale of property, plant and equipment		**0.2**	-	**0.2**	2.6
Decrease / (increase) in loans to subsidiary undertakings		**-**	-	**1.5**	(13.8)
Purchase of investment securities		**(133.3)**	(317.4)	**(133.3)**	(317.4)
Sale and maturity of investment securities		**137.2**	271.1	**137.2**	271.1
Net cash inflows / (outflows) from investing activities		**2.0**	(48.8)	**4.4**	(59.3)
Cash outflows from financing activities					
Interest paid on subordinated liabilities		**(2.6)**	(3.0)	**(2.6)**	(3.0)
Interest paid on subscribed capital		**(3.5)**	(3.5)	**(3.5)**	(3.5)
Repayment of subordinated liabilities		**-**	(9.6)	**-**	(9.6)
Repayments under finance lease agreements		**(0.1)**	(0.1)	**(0.1)**	(0.1)
Net cash outflows from financing activities		**(6.2)**	(16.2)	**(6.2)**	(16.2)
Net increase / (decrease) in cash		**11.9**	(128.6)	**11.6**	(129.4)
Cash and cash equivalents at start of year		**186.5**	315.1	**185.7**	315.1
Cash and cash equivalents at end of year	26	**198.4**	186.5	**197.3**	185.7

The notes on pages 44 to 76 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 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 and meet its liabilities throughout the period of assessment.

Accordingly the financial statements of the Society and the Group have been prepared on a going concern basis with no material uncertainties that the going concern basis of accounting is appropriate.

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 through profit and loss or as available for sale. 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.

Other income and charges

Fees and Commissions

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

Income in respect of the Groups' Solutions business reflects charges invoiced to customers on a monthly basis, in line with contractual provisions. The income recognised reflects services that have been provided during the year.

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.

The Group holds equity release mortgage assets on the Balance Sheet for which a limited portion contains no-negative-equity guarantees. The guarantees meet the IFRS 4 criteria for classification as insurance contracts. Income on the equity release mortgage assets is recognised in line with the Group's disclosed loans and receivables accounting policy. The Group performs liability adequacy testing on its insurance liabilities to ensure that the carrying amount of liabilities is sufficient to cover current estimates of future cash flows. At 31 December 2016 the insurance component of the Group Equity Release assets is wholly immaterial.

At Fair Value through Profit and Loss

The Group enters into derivative financial instruments primarily to hedge its exposures relating to interest rates. At the balance sheet date the Group has entered into contracts which lead to derivatives designated as either fair value hedges or cash flow hedges in accordance with the risks that the hedges have been set up to mitigate. In accordance with the Treasury Policy and the Building Societies Act 1986 the Group does not hold or issue derivative financial instruments for trading purposes.

Derivatives are recognised at fair value on the date the derivative contract is entered into, and subsequently re-measured at their fair value. In accordance with IAS 39, derivative financial instruments designated as hedging 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. Changes in derivative fair values are recognised 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.

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.

Significant Accounting Policies Continued

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. For operational purposes, the Group's debt security portfolio is maintained for liquidity purposes with the assets therein demonstrably convertible into cash regardless of maturity. The Group does not include encumbered assets in its cash and cash equivalents. The Group does not consider the timing of derivative collateral inflows to be sufficiently reliably estimated to include such collateral placed with counterparties as a liquid asset for cash flow presentation.

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 cash flows as per rules laid out in international accounting standard, IAS39. In considering future cash flows 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 Group's 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 (without a new product being taken). 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 are initially measured at fair value, being the issue proceeds, net of premia, discounts and transaction costs incurred. Derivative financial liabilities remain accounted for at fair value on the balance sheet date. Hedged risk and capital protection bond fair value adjustments are also held on the balance sheet at fair value. The remaining Group financial liabilities including shares, deposits, debt securities, subordinated liabilities and Permanent Interest Bearing Shares are subsequently measured at amortised cost, using the EIRM.

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 and intangible assets are stated at cost (or 'deemed cost') less accumulated depreciation/ amortisation 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. The Group's intangible assets reflect externally purchased software. No internally generated intangible assets have been capitalised as at 31 December 2016. Depreciation/amortisation 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 50 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
Computer software	- 20% per annum, straight line

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.

Operating Leases

The Group leases a number of branch and office properties under operating leases. Lease discounts or other incentives are recognised as an integral part of the net consideration agreed for the use of a leased asset with the aggregate benefit of incentives recognised as a reduction of rental expense over the lease term, on a straight line basis.

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 the revised 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 remeasurements are recognised immediately in the Statements of Comprehensive income with service cost and net interest recognised in the Income Statements.

Significant Accounting Policies Continued

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 Report and 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, take up of the Pension Increase Exchange offer and future salary increases. The Board receives independent external advice from actuarial consultants in arriving at the scheme assumptions which are outlined together with sensitivity analysis in Note 27 to the Annual Report and Accounts.

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 £0.1m. 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.

Fair Value of Derivatives and Financial Assets
Fair values are determined by the three tier valuation hierarchy as defined within IFRS 7, Financial Instruments. Where available, quoted market prices are used to facilitate valuations made. Financial valuation models using observable input data are used to value derivative financial instruments for which no active market exists. Further details are given in Note 29 to the Annual Report and Accounts.

Financial Services Compensation Scheme Provision
As explained in Note 22, the Society is committed to paying a levy to the Financial Services Compensation Scheme (FSCS). The provision for FSCS interest costs in this year's accounts is dependent on the interest charge levied which will not be invoiced until July 2017. The Society has estimated its obligation to the Scheme with reference to currently available external information on interest due on the loan.

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 15 to the Annual Report and 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 Annual Report and Accounts the following new and amended International Financial Reporting Standards are mandatory for the first time for the financial year beginning 1 January 2016.

Annual improvements 2010-2012 and Annual improvements 2012-2014. The cycles of annual amendments have not had significant impact to the Group or Society accounts.

Amendments to IAS 19, 'Employee benefits'. Narrow scope amendments to simplify the accounting for contributions that are independent of the number of years of employee service.

Amendments to IAS 1,'Presentation of financial statements'. Amendments clarify guidance in IAS 1 on materiality and aggregation, the presentation of subtotals, the structure of financial statements and the disclosure of accounting policies. The amendments form part of the IASB's Disclosure Initiative, which explored how financial statement disclosures can be improved.

Amendments were also made to IFRS 11, 'Joint arrangements', IAS 16 ,'Property, plant and equipment', IAS 38,'Intangible assets', IAS 41, 'Agriculture', IAS 27, 'Separate financial statements', IFRS 10, 'Consolidated financial statements' and IAS 28,'Investments in associates and joint ventures. These amendments have not impacted the Group or Society accounts.

Developments not effective at 31 December 2016
There are a number of new or amended standards which become effective in 2016, and beyond, which allow for early adoption but the Society is not taking up any of those standards before their mandatory date.

- IFRS 9 Financial instruments will supersede IAS 39 giving classification and measurement, impairment and hedge accounting requirements for financial instruments. The Society has monitored the development of IFRS 9 closely. Further detail is given in Note 29.

Notes to the Accounts for the year ended 31 December 2016

2 Interest receivable and similar income

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
On loans and advances to customers	**89.2**	98.2	**89.9**	98.5
On debt securities				
- interest and other income	**5.0**	4.1	**5.0**	4.0
- profits net of losses on realisation	**0.2**	0.2	**0.2**	0.2
On other liquid assets				
- interest and other income	**1.5**	2.0	**1.5**	2.0
Net expense on derivatives hedging assets	**(26.1)**	(26.5)	**(26.1)**	(26.5)
	69.8	78.0	**70.5**	78.2

3 Interest payable and similar charges

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
On shares held by individuals	**37.1**	49.6	**37.1**	49.6
On subscribed capital	**3.5**	3.5	**3.5**	3.5
On deposits and other borrowings				
- subordinated liabilities	**2.6**	3.0	**2.6**	3.0
- to other depositors and borrowers	**3.1**	2.3	**3.1**	2.3
Net income on derivatives hedging liabilities	**(3.6)**	(7.5)	**(3.6)**	(7.5)
	42.7	50.9	**42.7**	50.9

4 Other income and charges

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Other income				
Fee and commission income	**7.1**	6.3	**3.7**	2.9
Other operating income	**23.0**	18.3	**26.2**	19.9
	30.1	24.6	**29.9**	22.8

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Other charges				
Fee and commission expense	**2.7**	1.7	**2.7**	1.7

5 Administrative expenses

	Note	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Staff costs	6	**27.6**	24.8	**15.2**	18.5
Rentals under operating leases for land and buildings					
- payable to third parties		**1.6**	1.6	**1.6**	1.6
- payable to subsidiary undertaking		**-**	-	**0.1**	0.1
Other administrative expenses		**11.1**	9.7	**26.3**	16.3
		40.3	36.1	**43.2**	36.5

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

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Fees payable to the Society's auditors for audit of Society and consolidated financial statements	**0.2**	0.2	**0.2**	0.2
Fees payable to the Society's auditors for other services	**-**	-	**-**	-
	0.2	0.2	**0.2**	0.2

Fees payable to the Society's auditors for the audit of consolidated financial statements includes **£17k** (2015: £17k) attributable to subsidiary companies. Fees payable to the Society's auditors for other services includes **£1k** (2015: £1k) for tax services, and **£38k** (2015: £47k) for other non-audit services.

6 Staff costs

	Note	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Wages and salaries		**23.2**	20.7	**12.6**	15.4
Social security costs		**2.1**	1.9	**1.1**	1.3
Pension costs for:					
- defined contribution scheme		**2.3**	2.2	**1.5**	1.8
	5	**27.6**	24.8	**15.2**	18.5

Directors' emoluments are disclosed in the Remuneration Committee report on page 27.

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

	GROUP 2016	GROUP 2015	SOCIETY 2016	SOCIETY 2015
Full time	**745**	662	**346**	484
Part time	**206**	213	**150**	191
	951	875	**496**	675
Principal Office	**763**	674	**326**	494
Branches	**188**	201	**170**	181
	951	875	**496**	675

7 Taxation expense

	Note	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Deferred tax					
Current year		**2.0**	1.6	**2.0**	1.5
Adjustments in respect of prior years		**-**	0.5	**-**	0.5
Total deferred tax		**2.0**	2.1	**2.0**	2.0
Total taxation expense in the Income Statements	15	**2.0**	2.1	**2.0**	2.0

Analysis of taxation expense for the year

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

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Profit for the year before taxation	**8.1**	5.4	**9.8**	4.0
Profit before taxation at the standard rate of corporation tax in the UK of **20.00%** (2015: 20.25%)	**1.6**	1.1	**2.0**	0.8
Expense not deductible for tax purposes:				
Non-taxable dividend income received	**-**	-	**(0.6)**	-
Expenses	**0.1**	0.1	**0.4**	0.3
Rate change	**0.3**	0.5	**0.2**	0.4
Adjustments in respect of previous years	**-**	0.4	**-**	0.5
Total taxation expense	**2.0**	2.1	**2.0**	2.0

Factors affecting future tax charges

The Society has unrelieved trading losses which are expected to affect future taxable profits (see further details in note 15).

8 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 (also referred to as NSSL) 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 and FSCS levy 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 2016	**Member Business £m**	**Solutions Business £m**	**Total £m**
Net interest receivable	**27.1**	**-**	**27.1**
Other income and charges	**5.5**	**22.0**	**27.5**
Administrative expenses	**(28.4)**	**(11.9)**	**(40.3)**
Depreciation	**(1.7)**	**(0.7)**	**(2.4)**
Operating profit before impairment charges and FSCS levy	**2.5**	**9.4**	**11.9**
Impairment charges on loans and advances to customers	**(3.2)**	**-**	**(3.2)**
Provisions for liabilities and charges	**(0.6)**	**-**	**(0.6)**
(Loss) / profit for the year before taxation	**(1.3)**	**9.4**	**8.1**
Taxation expense			**(2.0)**
Profit after taxation for the financial year			**6.1**
Total assets	**3,617.6**	**3.9**	**3,621.5**

Year to 31 December 2015	Member Business £m	Solutions Business £m	Total £m
Net interest receivable	27.1	-	27.1
Other income and charges	5.4	17.6	23.0
Administrative expenses	(26.1)	(10.0)	(36.1)
Depreciation	(1.5)	(0.6)	(2.1)
Operating profit before impairment charges and FSCS levy	4.9	7.0	11.9
Impairment charges on loans and advances to customers	(4.6)	-	(4.6)
Provisions for liabilities and charges	(1.9)	-	(1.9)
(Loss) / profit for the year before taxation	(1.6)	7.0	5.4
Taxation expense			(2.1)
Profit after taxation for the financial year			3.3
Total assets	3,441.0	4.5	3,445.5

Notes to the Accounts for the year ended 31 December 2016

9 Loans and advances to banks

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

	GROUP		SOCIETY	
	2016 £m	2015 £m	**2016 £m**	2015 £m
Accrued interest	**-**	0.1	**-**	0.1
On demand	**1.8**	2.3	**0.7**	1.4
In not more than three months	**235.6**	205.1	**235.6**	205.1
Gross loans and advances to banks	**237.4**	207.5	**236.3**	206.6
Less: allowance for losses on loans and advances to banks	**(1.6)**	(11.8)	**(1.6)**	(11.8)
	235.8	195.7	**234.7**	194.8

Allowance for losses on loans and advances to banks

	GROUP and SOCIETY **2016 £m**	2015 £m
Balance at 1 January	**11.8**	11.8
Amounts utilised during the year	**(10.2)**	-
At 31 December	**1.6**	11.8

At 31 December 2016 the Society had loans and advances to banks totalling **£1.8m** (2015: £13.2m), against which allowance for losses of **£1.6m** (2015: £11.8m) has been made.

10 Debt securities

Transferable debt securities	GROUP and SOCIETY **2016 £m**	2015 £m
Issued by public bodies - listed	**72.3**	50.3
Issued by other borrowers - unlisted	**272.0**	296.9
	344.3	347.2
These have remaining maturities as follows:		
Accrued interest	**2.7**	2.8
In not more than one year	**104.6**	43.4
In more than one year but not more than five years	**157.2**	239.8
In more than five years	**79.8**	61.2
	344.3	347.2

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 rated holdings of Residential Mortgage Backed Securities and Covered Bonds.

11 Loans and advances to customers

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Loans fully secured on residential property	**2,455.9**	2,321.9	**2,449.7**	2,313.5
Loans fully secured on land	**103.9**	158.3	**103.9**	158.3
Other loans	**15.6**	16.8	**15.6**	16.8
Gross loans and advances	**2,575.4**	2,497.0	**2,569.2**	2,488.6
Less: allowance for losses on loans and advances	**(11.6)**	(18.4)	**(11.6)**	(18.4)
	2,563.8	2,478.6	**2,557.6**	2,470.2

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

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
On demand	**5.5**	6.2	**5.5**	6.2
In not more than three months	**57.1**	66.9	**57.1**	66.9
In more than three months but not more than one year	**71.7**	54.2	**71.7**	54.1
In more than one year but not more than five years	**235.2**	280.3	**234.9**	279.7
In more than five years	**2,205.9**	2,089.4	**2,200.0**	2,081.7
Gross loans and advances	**2,575.4**	2,497.0	**2,569.2**	2,488.6
Less: allowance for losses on loans and advances	**(11.6)**	(18.4)	**(11.6)**	(18.4)
	2,563.8	2,478.6	**2,557.6**	2,470.2

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.

11 Loans and advances to customers Continued

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 2016	0.7	0.2	15.2	2.0	0.3	-	16.2	2.2	18.4
Charge for the year	0.3	0.4	1.3	1.2	-	-	1.6	1.6	3.2
Utilised during the year	(0.1)	-	(9.7)	-	-	-	(9.8)	-	(9.8)
Interest suspended adjustment	-	-	0.3	(0.5)	-	-	0.3	(0.5)	(0.2)
At 31 December 2016	**0.9**	**0.6**	**7.1**	**2.7**	**0.3**	**-**	**8.3**	**3.3**	**11.6**

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 2015	0.9	0.5	18.5	3.6	0.3	-	19.7	4.1	23.8
Charge / (credit) for the year	0.4	(0.3)	5.6	(1.1)	-	-	6.0	(1.4)	4.6
Utilised during the year	(0.6)	-	(9.4)	-	-	-	(10.0)	-	(10.0)
Interest suspended adjustment	-	-	0.5	(0.5)	-	-	0.5	(0.5)	-
At 31 December 2015	**0.7**	**0.2**	**15.2**	**2.0**	**0.3**	**-**	**16.2**	**2.2**	**18.4**

12 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 cumulative fair value adjustment for hedged risk for assets for the Group and Society was **£233.8m** (2015: £190.8m). The cumulative fair value adjustment for hedged risk for liabilities for the Group and Society was **£5.2m**, (2015: £5.3m).

13 Investment in subsidiaries undertakings

SOCIETY

	Shares £m	Loans £m	Total £m
Investments in subsidiary undertakings			
Cost			
At 1 January 2016	12.0	21.5	33.5
Additions	-	1.2	1.2
Repayments received	-	(2.7)	(2.7)
At 31 December 2016	**12.0**	**20.0**	**32.0**
Provisions			
At 1 January and 31 December 2016	**0.6**	**3.1**	**3.7**
Net book amount at 31 December 2016	**11.4**	**16.9**	**28.3**

	Shares £m	Loans £m	Total £m
Investments in subsidiary undertakings			
Cost			
At 1 January 2015	6.0	13.7	19.7
Additions	6.0	10.8	16.8
Repayments received	-	(3.0)	(3.0)
At 31 December 2015	**12.0**	**21.5**	**33.5**
Provisions			
At 1 January and 31 December 2015	**0.6**	**3.1**	**3.7**
Net book amount at 31 December 2015	**11.4**	**18.4**	**29.8**

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
Newcastle Financial Advisers 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
Newcastle Systems Management Limited	Provision of managed IT services and property services

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.

Further information on transactions between Group entities can be found in the Related Parties note, Note 28 on pages 65 and 66.

14 Property, plant and equipment

GROUP

	Freehold buildings £m	Leasehold land and buildings £m	Equipment, fixtures, fittings and motor vehicles £m	Intangible Assets £m	Total £m
Cost					
At 1 January 2016	6.7	12.2	18.3	5.6	42.8
Additions	-	-	1.5	0.6	2.1
Disposals	(0.3)	-	(1.2)	-	(1.5)
At 31 December 2016	**6.4**	**12.2**	**18.6**	**6.2**	**43.4**
Accumulated depreciation					
At 1 January 2016	1.1	3.6	10.6	4.1	19.4
Charge for the year	0.1	0.2	1.6	0.5	2.4
Disposals	(0.1)	-	(1.1)	-	(1.2)
At 31 December 2016	**1.1**	**3.8**	**11.1**	**4.6**	**20.6**
Net book amount at 31 December 2016	**5.3**	**8.4**	**7.5**	**1.6**	**22.8**

GROUP

	Freehold buildings £m	Leasehold land and buildings £m	Equipment, fixtures, fittings and motor vehicles £m	Intangible Assets £m	Total £m
Cost					
At 1 January 2015	6.7	12.2	23.0	8.5	50.4
Additions	-	-	1.8	0.7	2.5
Disposals	-	-	(6.5)	(3.6)	(10.1)
At 31 December 2015	**6.7**	**12.2**	**18.3**	**5.6**	**42.8**
Accumulated depreciation					
At 1 January 2015	1.0	3.4	15.7	7.3	27.4
Charge for the year	0.1	0.2	1.4	0.4	2.1
Disposals	-	-	(6.5)	(3.6)	(10.1)
At 31 December 2015	**1.1**	**3.6**	**10.6**	**4.1**	**19.4**
Net book amount at 31 December 2015	**5.6**	**8.6**	**7.7**	**1.5**	**23.4**

14 Property, plant and equipment Continued

SOCIETY

	Freehold buildings £m	Leasehold land and buildings £m	Equipment, fixtures, fittings and motor vehicles £m	Intangible Assets £m	Total £m
Cost					
At 1 January 2016	6.7	0.9	12.7	1.5	21.8
Additions	-	-	1.0	0.2	1.2
Disposals	(0.3)	-	(0.8)	-	(1.1)
At 31 December 2016	**6.4**	**0.9**	**12.9**	**1.7**	**21.9**
Accumulated depreciation					
At 1 January 2016	1.1	0.1	6.8	1.1	9.1
Charge for the year	0.1	-	1.0	0.2	1.3
Disposals	(0.1)	-	(0.7)	-	(0.8)
At 31 December 2016	**1.1**	**0.1**	**7.1**	**1.3**	**9.6**
Net book amount at 31 December 2016	**5.3**	**0.8**	**5.8**	**0.4**	**12.3**

SOCIETY

	Freehold buildings £m	Leasehold land and buildings £m	Equipment, fixtures, fittings and motor vehicles £m	Intangible Assets £m	Total £m
Cost					
At 1 January 2015	6.7	0.9	21.1	8.3	37.0
Additions	-	-	1.5	0.3	1.8
Disposals	-	-	(9.9)	(7.1)	(17.0)
At 31 December 2015	**6.7**	**0.9**	**12.7**	**1.5**	**21.8**
Accumulated depreciation					
At 1 January 2015	1.0	0.1	13.7	7.2	22.0
Charge for the year	0.1	-	1.1	0.3	1.5
Disposals	-	-	(8.0)	(6.4)	(14.4)
At 31 December 2015	**1.1**	**0.1**	**6.8**	**1.1**	**9.1**
Net book amount at 31 December 2015	**5.6**	**0.8**	**5.9**	**0.4**	**12.7**

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

	GROUP and SOCIETY 2016 £m	2015 £m
Cost		
At 1 January	**0.8**	0.8
Accumulated depreciation	**(0.1)**	(0.1)
Net book amount	**0.7**	0.7

15 Deferred tax assets

The movement on the deferred tax account is shown below.

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
At 1 January	**7.8**	9.8	**7.7**	10.3
Income Statements expense	**(2.0)**	(1.6)	**(2.0)**	(1.5)
Under provision in respect of prior years	**-**	(0.5)	**-**	(0.5)
Credited on items taken directly through reserves	**(0.6)**	0.1	**(0.6)**	0.1
Transfer of capital assets to subsidiary undertaking	**-**	-	**-**	(0.7)
At 31 December	**5.2**	7.8	**5.1**	7.7

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

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Deferred tax assets				
Other items	**(0.6)**	0.3	**(0.6)**	0.3
Trading losses	**4.4**	6.0	**4.2**	6.0
Depreciation in excess of capital allowances	**1.4**	1.5	**1.5**	1.4
	5.2	7.8	**5.1**	7.7

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Deferred tax assets				
Deferred tax asset to be recovered in less than 12 months	**1.9**	1.6	**1.9**	1.2
Deferred tax asset to be recovered in more than 12 months	**3.3**	6.2	**3.2**	6.5
	5.2	7.8	**5.1**	7.7

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

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Short term timing differences	**-**	(0.1)	**-**	(0.1)
Other items	**(0.3)**	(0.9)	**(0.3)**	(0.9)
Trading losses	**(1.7)**	(1.0)	**(1.8)**	(0.9)
Depreciation in excess of capital allowances	**-**	0.3	**0.1**	0.3
Adjustment to tax rate	**-**	(0.4)	**-**	(0.4)
	(2.0)	(2.1)	**(2.0)**	(2.0)

Deferred tax assets are recognised for tax losses carried forward only to the extent that realisation of the related tax benefit is probable. Deferred tax assets are recognised based on the expected prevailing rate of tax at the time of utilisation. Where there is a reduction in the expected tax rate an adjustment is made to write down deferred tax assets. In 2016 the Chancellor announced a reduction in the future Corporation tax rate to 17% having been subsequently substantively enacted, this has been utilised for calculations.

Notes to the Accounts for the year ended 31 December 2016

16 Other assets

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Receivable from subsidiary undertakings	**-**	-	**1.4**	1.1
Prepayments and accrued income	**7.8**	9.4	**13.0**	15.1
Other	**2.5**	2.2	**2.2**	2.2
	10.3	11.6	**16.6**	18.4

17 Due to Members

	GROUP and SOCIETY 2016 £m	GROUP and SOCIETY 2015 £m
Held by individuals	**2,709.0**	2,678.5
Other shares	**0.2**	0.3
	2,709.2	2,678.8

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

	2016 £m	2015 £m
Accrued interest	**12.7**	18.0
On demand	**1,541.0**	1,431.5
In not more than three months	**757.0**	682.1
In more than three months but not more than one year	**104.5**	350.5
In more than one year but not more than five years	**293.6**	183.3
In more than five years	**0.4**	13.4
	2,709.2	2,678.8

Included in share balances is a contractual balance of **£2.8m** (2015: £15.1m) of Capital Protection Bonds. The fair value includes adjustments of **£0.4m** (2015: £1.9m) which are attributable to changes in benchmark equity and interest rate indices. The Society is contractually required to pay only the par value of the shares on maturity, plus the relative performance of the index.

18 Due to other customers

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Amounts owed to subsidiary undertakings	**-**	-	**11.8**	12.3
Other	**211.1**	205.3	**211.1**	205.3
	211.1	205.3	**222.9**	217.6

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

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Accrued interest	**1.1**	0.9	**1.1**	0.9
On demand	**2.9**	3.3	**2.9**	3.3
In not more than three months	**109.6**	87.2	**109.6**	87.2
In more than three months but not more than one year	**97.5**	78.9	**109.3**	91.2
In more than one year but not more than five years	**-**	35.0	**-**	35.0
	211.1	205.3	**222.9**	217.6

Notes to the Accounts for the year ended 31 December 2016

19 Deposits from banks

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

	GROUP and SOCIETY 2016 £m	GROUP and SOCIETY 2015 £m
Accrued interest	**0.2**	0.2
In not more than three months	**133.6**	69.6
In more than three months but not more than one year	**3.5**	31.0
In more than one year but not more than five years	**50.0**	-
	187.3	100.8

20 Debt securities in issue

	GROUP and SOCIETY 2016 £m	GROUP and SOCIETY 2015 £m
Certificates of deposit	**-**	1.0

Debt securities have remaining maturities of more than 3 months but not more than one year.

21 Other liabilities

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Amounts payable to subsidiary undertakings	**-**	-	**5.5**	6.8
Third party income tax withheld	**-**	0.3	**-**	0.3
Current tax liabilities	**0.2**	-	**-**	-
Obligations under finance leases	**1.1**	1.1	**1.1**	1.1
Other creditors	**1.5**	1.1	**1.2**	1.1
Accruals and deferred income	**11.3**	7.8	**10.6**	6.3
	14.1	10.3	**18.4**	15.6

Obligations under finance leases fall due as follows:

	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £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.

22 Provisions for liabilities and charges

GROUP and SOCIETY

	FSCS Levy £m	Other Provisions £m	Total £m
Opening Provision at 1 January 2016	**1.1**	**1.6**	**2.7**
New Provisions during the year	**0.6**	**-**	**0.6**
Amounts utilised during the year	**(1.0)**	**(0.3)**	**(1.3)**
Closing Provision at 31 December 2016	**0.7**	**1.3**	**2.0**

GROUP and SOCIETY

	FSCS Levy £m	Other Provisions £m	Total £m
Opening Provision at 1 January 2015	1.3	1.8	3.1
New Provisions during the year	1.9	-	1.9
Amounts utilised during the year	(2.1)	(0.2)	(2.3)
Closing Provision at 31 December 2015	1.1	1.6	2.7

Provision for Financial Services Compensation Scheme Levy
FSCS is the compensation scheme for customers of UK authorised financial services firms. The FSCS can compensate customers if a firm has stopped trading or does not have enough assets to pay claims made against it.

In the latter part of 2008, claims against the FSCS were triggered following the default of a number of deposit takers. 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.

The FSCS recovers the interest cost, together with ongoing management expenses, by way of annual levies on Member firms.
While the FSCS recovers part of its debt owed through residual sale of assets of failed institutions as they are wound up, through 2013-2015 the FSCS funded expected capital shortfalls through extended industry levies.

The last of the announced capital levies was concluded in 2015 with the Society's 2016 charge reflecting its share of anticipated interest costs only. At 31 December 2016 the Society held a provision of £0.6m in relation to interest payable in respect of the 2016/17 Scheme year. The Society's provision is calculated based on the Society's current share of protected deposits and the FSCS estimate of interest expense for the scheme year. Interest payable is calculated using the latest available data from the FSCS.

Other provisions
Other provisions include an estimate of the costs of potential consumer redress and repositioning costs.

23 Subordinated liabilities

	GROUP and SOCIETY 2016 £m	2015 £m
7.190% fixed rate subordinated notes 2017	**25.0**	25.0
3.849% fixed rate subordinated notes 2019	**25.0**	25.0
	50.0	50.0

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, with the prior consent of the Regulators, only on the payment of a penalty, on any interest date within five years of the maturity date.

24 Subscribed capital

	GROUP and SOCIETY 2016 £m	2015 £m
12.625% permanent interest bearing shares	**10.0**	10.0
10.750% permanent interest bearing shares	**10.0**	10.0
12.000% permanent interest bearing shares	**10.0**	10.0
	30.0	30.0

The 12.625% and 10.750% subscribed capital issues were issued for an indeterminate period and are only repayable in the event of the winding up of the Society. The £10m 12.0% PIBS can be called by the Society on 18 December 2018 by giving 30 to 60 days notice to the PIBS holders, subject to having gained regulatory consent in advance of sending the notices.

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

	GROUP and SOCIETY 2016 £m	2015 £m
Irrevocable undrawn committed loan facilities	**124.6**	112.6
Payments under non-cancellable operating lease agreements		
Total minimum lease payments:		
Within one year	**1.4**	1.4
In one to five years	**3.9**	4.1
Over five years	**2.0**	2.6
	7.3	8.1

Notes to the Accounts for the year ended 31 December 2016

26 Note to the Cash Flow Statements

Reconciliation of profit before taxation to net cash inflow / from operating activities	GROUP 2016 £m	GROUP 2015 £m	SOCIETY 2016 £m	SOCIETY 2015 £m
Profit before taxation	**8.1**	5.4	**9.8**	4.0
Depreciation and amortisation	**2.4**	2.1	**1.3**	1.5
Interest on subordinated liabilities	**2.6**	3.0	**2.6**	3.0
Interest on subscribed capital	**3.5**	3.5	**3.5**	3.5
Increase / (decrease) in derivative financial instruments	**44.7**	(2.1)	**44.6**	(2.1)
(Increase) / decrease in other financial liabilities at fair value through profit or loss	**(43.1)**	7.9	**(43.1)**	7.9
Changes in retirement benefit obligations	**(2.2)**	0.1	**(2.2)**	0.1
Other non-cash movements	**(5.5)**	(4.9)	**(5.4)**	(4.0)
Net cash inflow before changes in operating assets and liabilities	**10.5**	15.0	**11.1**	13.9
(Increase) / decrease in loans and advances to customers	**(78.4)**	186.9	**(80.6)**	184.4
(Increase) / decrease in cash collateral pledged	**(41.6)**	7.0	**(41.6)**	7.0
Increase / (decrease) in shares	**30.4**	(294.9)	**30.4**	(294.9)
Increase in amounts due to other customers and deposits from banks	**92.3**	27.6	**91.8**	39.8
Decrease / (increase) in other assets, prepayments and accrued income	**1.6**	(2.9)	**2.0**	(2.7)
Increase / (decrease) in other liabilities	**3.3**	(0.3)	**2.3**	0.6
Net cash inflow / (outflow) from operating activities	**18.1**	(61.6)	**15.4**	(51.9)
Cash and cash equivalents				
Cash and balances with the Bank of England	**196.4**	183.1	**196.4**	183.1
Loans and advances to banks repayable on demand	**1.8**	2.3	**0.7**	1.4
Investment securities	**0.2**	1.1	**0.2**	1.2
At 31 December	**198.4**	186.5	**197.3**	185.7

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.

27 Retirement benefit obligations

Group and Society Pension schemes

The Society operates a UK registered trust based pension scheme, Newcastle Building Society Pension and Assurance Scheme, that provides defined benefits. The Scheme was closed to new entrants in 2000 and closed to future accrual of benefits in 2010. Pension benefits are linked to the members' final pensionable salaries and service at their retirement (or date of leaving if earlier). The Trustees are responsible for running the Scheme in accordance with the Scheme's Trust Deed and Rules, which sets out their powers. The Trustees of the Scheme are required to act in the best interests of the beneficiaries of the Scheme. There is a requirement that one-third of the Trustees are nominated by the members of the Scheme.

There are two categories of pension scheme members:

- Deferred members: members with deferred benefits in the Scheme who are not yet receiving their pension; and
- Pensioner members: members in receipt of a pension.

The defined benefit obligation is valued by projecting the best estimate of future benefit obligations (allowing for revaluation to retirement for deferred members and annual pension increases for all members) and then discounting to the balance sheet date. The majority of benefits receive increases linked, at least partly, to inflation (subject to a cap of no more than 5% pa). The valuation method used is known as the Projected Unit Method. The approximate overall duration of the Scheme's defined benefit obligation as at 31 December 2016 was 18 years (2015: 18 years).

Notes to the Accounts for the year ended 31 December 2016

27 Retirement benefit obligations Continued

Future funding obligation

The Trustees are required to carry out an actuarial valuation every 3 years. The last actuarial valuation of the Scheme was performed by the Scheme Actuary for the Trustees as at 30 June 2013. In respect of the deficit in the Scheme as at 30 June 2013, the Society agreed to pay £1.7m per annum for 6 years. In addition, the Society will pay £0.3m per annum to meet the cost of running the Scheme. The Society therefore expects to pay £2.0m to the Scheme during the accounting year beginning 1 January 2017.

The actuarial valuation as at 30 June 2016 is currently underway, the results of which have not yet been finalised. Once this valuation has been finalised a new Schedule of Contributions will be agreed and the deficit contributions required may be different from those described above.

Assumptions

The assumptions and data underpinning the draft triennial valuation as at 30 June 2016 have been fed through to the position at 31 December 2016 to arrive at the most accurate position at the year end. The assumptions used for the IAS19 year end valuations are as follows:

Significant actuarial assumptions	**2016**	2015
Discount rate	**2.60%**	3.70%
RPI inflation	**3.30%**	3.10%
CPI inflation	**2.30%**	2.10%
Mortality assumption		
Mortality (post-retirement) - tables used	**S2PA CMI_2015_M/F [1.25%] (yob)**	S1PA CMI_2013_M/F [1.00%] (yob)
Other actuarial assumptions		
RPI pension increases	**3.20%**	3.00%
Revaluation of deferred pensions in excess of GMP	**2.30%**	2.10%
Life expectancies (in years)		
For an individual aged 62		
Male	**24.9 years**	24.7 years
Female	**27.1 years**	27.0 years
At age 62 for an individual aged 42 in 2016		
Male	**26.8 years**	26.2 years
Female	**29.0 years**	28.6 years

Risks

Through the Scheme, the Society is exposed to a number of risks:

- **Asset volatility:** the Scheme's defined benefit obligation is calculated using a discount rate set with reference to corporate bond yields, however the Scheme invests significantly in equities and other growth funds. These assets are expected to outperform corporate bonds in the long term, but provide volatility and risk in the short term.
- **Changes in bond yields:** a decrease in corporate bond yields would increase the Scheme's defined benefit obligations, however this would be partially offset by an increase in the value of the Scheme's bond and Liability Driven Investment (LDI) holdings (see below).
- **Inflation risk:** a significant proportion of the Scheme's defined benefit obligation is linked to inflation, therefore higher inflation will result in a higher defined benefit obligation (subject to the appropriate caps in place), although the Scheme's LDI holdings look to hedge inflation rate changes to some extent.
- **Life expectancy:** if Scheme members live longer than expected, the Scheme's benefits will need to be paid for longer, increasing the Scheme's defined benefit obligation.

The Trustees and Society manage risks in the Scheme through the following strategies:

- **Diversification:** investments are well diversified, such that the failure of any single investment would not have a material impact on the overall level of assets.
- **Investment strategy:** the Trustees are required to review their investment strategy on a regular basis.
- **Liability Driven Investment (LDI):** the Scheme invests in LDI assets, whose long-term investment returns are expected to partially hedge interest rate and inflation rate movements.
- **Pension increase exchange:** an option allows members to exchange their pension increases for a higher immediate pension. This has reduced the Scheme liabilities for retired members who have already taken up the option and, based on the assumption of future take up, for deferred members who will retire in the future.

27 Retirement benefit obligations Continued

Sensitivity analysis Assumption	Change in assumption	Change in defined benefit obligation
Discount rate	+ 0.5% / – 0.5%	– 8% / + 10%
RPI and CPI inflation	+ 0.5% / – 0.5%	+ 5% / – 4%
Assumed life expectancy	+ 1 year	+ 4%

Limitations of the sensitivity analysis

These calculations provide an approximate guide to the sensitivity of results and may not be as accurate as a full valuation carried out on these assumptions. Each assumption change is considered in isolation, which in practice is unlikely to occur, as changes in some of the assumptions are correlated.

Assets

The assets of the Scheme were invested as follows:

Asset class at market value	2016 %	2015 %
Equities and growth	45.7	45.3
Bonds	18.3	19.4
Gilts	35.2	34.5
Cash	0.8	0.8
Total	100.0	100.0
Actual return on assets over year	20.5	1.7

All assets listed above have a quoted market price in an active market.

Reconciliation to the Balance Sheets

	2016 £m	2015 £m
Market value of assets	111.2	92.0
Present value of defined benefit obligation	108.6	93.7
Funded status	2.6	(1.7)
Pension asset / (liability) recognised in the Balance Sheets before allowance for deferred tax	2.6	(1.7)

Analysis of changes in the value of the defined benefit obligation over the year

	2016 £m	2015 £m
Value of defined benefit obligation at start of year	93.7	95.5
Interest cost	3.4	3.4
Benefits paid	(3.0)	(3.2)
Actuarial (gains): experience differing from that assumed	(5.1)	(1.3)
Actuarial losses: changes in demographic assumptions	0.7	-
Actuarial losses / (gains): changes in financial assumptions	18.9	(0.7)
Value of defined benefit obligation at end of year	108.6	93.7

Analysis of changes in the value of the Scheme assets over the year

	2016 £m	2015 £m
Market value of assets at start of year	92.0	91.8
Interest income	3.4	3.3
Actual return on assets less interest	17.1	(1.6)
Employer contributions	2.0	2.0
Benefits paid	(3.0)	(3.2)
Administration costs	(0.3)	(0.3)
Market value of assets at end of year	111.2	92.0

27 Retirement benefit obligations Continued

Amount recognised in Income Statements

	2016 £m	2015 £m
Administration costs	0.3	0.3
Net interest	-	0.1
Amount charged to Income Statements	0.3	0.4

Amounts recognised in Statements of Comprehensive Income

	2016 £m	2015 £m
Actuarial (losses) / gains on defined benefit obligations	(14.5)	2.0
Actual return on assets less interest	17.1	(1.6)
Amounts recognised in Statements of Comprehensive Income	2.6	0.4

28 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

	2016 £000	2015 £000
At 31 December	314	331

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

	2016 £000	2015 £000
At 31 December	412	280

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

The Society receives managed IT and property services from Newcastle Systems Management Limited and business support services from Newcastle Strategic Solutions Limited, both wholly owned subsidiaries of the Society. The Society provides financial and administrative services to both Newcastle Systems Management Limited and Newcastle Strategic Solutions Limited.

During the year, the following transactions were carried out with related parties:

(a) Sales of financial and administrative services

	2016 £000	2015 £000
Newcastle Systems Management Limited	991	523
Newcastle Strategic Solutions Limited	4,732	1,637

Sales of services are negotiated with related parties on commercial terms.

(b) Purchases of services:

	2016 £000	2015 £000
Managed IT and Property Services		
Newcastle Systems Management Limited	4,436	2,084
Business Support Services		
Newcastle Strategic Solutions Limited	13,709	5,859
Property Rental		
Newcastle Portland House Limited	66	66

28 Related parties Continued

Purchased services are negotiated with related parties on commercial terms.

At 31 December 2016 the following unsecured balances remained outstanding with related parties:

(c) Outstanding balances:

	Amounts owed to Society		Amounts owed by Society	
	2016 £000	2015 £000	**2016 £000**	2015 £000
Newcastle Systems Management Limited	**732**	735	492	341
Newcastle Strategic Solutions Limited	**606**	345	1,341	706
Newcastle Financial Advisers Limited	**-**	-	797	2,882
Newcastle Portland House Limited	**19**	19	2,920	2,921
Newcastle Mortgage Loans (Jersey) Limited	**34**	34	-	-

At 31 December 2016 the following borrowings and cash deposits remained outstanding with related parties:

(d) Borrowings/ cash deposits:

	Amounts borrowed from Society		Amounts deposited with Society	
	2016 £000	2015 £000	**2016 £000**	2015 £000
Newcastle Systems Management Limited	**7,050**	6,575	**5,663**	5,900
Newcastle Strategic Solutions Limited	**3,941**	3,676	**6,151**	6,387
Newcastle Mortgage Loans (Jersey) Limited	**5,922**	8,177	**-**	-

	Interest paid to Society		Interest paid by Society	
	2016 £000	2015 £000	**2016 £000**	2015 £000
Newcastle Systems Management Limited	**475**	225	**13**	9
Newcastle Strategic Solutions Limited	**265**	126	**14**	9
Newcastle Mortgage Loans (Jersey) Limited	**413**	582	**-**	-

(e) Lease relationships:

Newcastle Systems Management Limited and Newcastle Strategic Solutions Limited lease office space from the Society under 5 year operating leases.

In the next financial year the Society expects to receive £174,000 and £128,000 from the subsidiaries respectively.

In over 1 year but not more than 5 years time the Society expects to receive £435,000 and £321,000 in respect of currently agreed operating leases from the subsidiaries respectively.

29 Financial instruments

These disclosures are given on a Group basis, as the risks of the organisation are managed on a Group basis. The Society basis is not materially different from the Group basis for any of the disclosures in this note.

Categories of financial instruments

The accounting policies note (Note 1 on page 44) 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 2016	Note	Amortised Cost £m	Available for sale £m	Fair value through income statements £m	Total £m
Financial assets					
Cash in hand and balances with Bank of England		196.4	-	-	196.4
Loans and advances to banks	9	235.8	-	-	235.8
Debt securities	10	-	344.3	-	344.3
Derivative financial instruments	29	-	-	6.5	6.5
Fair value adjustments for hedged risk	12	-	-	233.8	233.8
Loans and advances to customers	11	2,563.8	-	-	2,563.8
Total financial assets		**2,996.0**	**344.3**	**240.3**	**3,580.6**
Financial liabilities					
Due to Members - shares	17	2,708.8	-	0.4	2,709.2
Fair value adjustments for hedged risk	12	-	-	5.2	5.2
Due to other customers	18	211.1	-	-	211.1
Deposits from banks	19	187.3	-	-	187.3
Derivative financial instruments	29	-	-	234.3	234.3
Subordinated liabilities	23	50.0	-	-	50.0
Subscribed capital	24	30.0	-	-	30.0
Total financial liabilities		**3,187.2**	**-**	**239.9**	**3,427.1**

At 31 December 2016 the Group held £10.3m (2015: £11.6m) 'Other assets' on Balance Sheet of which £5.1m (2015: £6.8m) were financial assets. The assets are held at amortised cost which also reflects the assets' fair value.

The Group held £14.1m (2015:10.3m) 'Other liabilities' on Balance Sheet of which £13.4 (2015: £8.4m) were financial in nature. The liabilities are held at amortised cost which also reflects the liabilities' fair value.

Cash in hand and balances with the Bank of England

Cash held for liquidity and operational purposes earning interest income.

Loans and advances to banks

Cash lent to financial institutions to generate an interest income return and cash collateral placed with derivative counterparties to be repaid to the Society in future periods.

Debt securities

Assets comprising mainly covered bonds and residential mortgaged backed securities. Investments made to utilise liquid cash reserves to generate interest income.

Derivative financial instruments

Financial instruments whose value is derived from an underlying asset, index or reference rate to which it is linked to. The Group does not operate a derivative financial instruments trading book. Exposures in the treasury portfolio are held for liquidity purposes or in the case of fair value exposures on derivatives, for hedging purposes.

Fair value adjustments for hedged risk

Adjustments to reflect the fair value of financial instruments that are designated as hedged items as part of the Group's interest rate risk hedging activities.

Loans and advances to customers

Cash lent to individual Members of the Society, corporates and housing associations.

29 Financial instruments Continued

Due to Members – shares
Cash deposits made by customers held by the Society.

Due to other customers
Cash deposits made by non-Members of the Society.

Deposits from banks
Deposits made by financial institutions with the Society.

Debt securities in issue
Debt securities issued by the Society.

Subordinated liabilities
Loan notes issued by the Society incurring fixed annual interest expense.

Subscribed capital
Permanent Interest Bearing Shares issued by the Society, with further details given in Note 23.

Note: The Society had issued a number of structured customer share products whose interest depends on movement in equity indices. In line with IAS39, the derivative equity component of the liability is split out and measured at fair value reflecting observable market prices.

Group as at 31 December 2015	Note	Amortised Cost £m	Available for sale £m	Fair value through income statements £m	Total £m
Financial assets					
Cash in hand and balances with Bank of England		183.1	-	-	183.1
Loans and advances to banks	9	195.7	-	-	195.7
Debt securities	10	-	347.2	-	347.2
Derivative financial instruments	29	-	-	7.3	7.3
Fair value adjustments for hedged risk	12	-	-	190.8	190.8
Loans and advances to customers	11	2,478.6	-	-	2,478.6
Total financial assets		**2,857.4**	**347.2**	**198.1**	**3,402.7**
Financial liabilities					
Due to Members - shares	17	2,676.9	-	1.9	2,678.8
Fair value adjustments for hedged risk	12	-	-	5.3	5.3
Due to other customers	18	205.3	-	-	205.3
Deposits from banks	19	100.8	-	-	100.8
Debt securities in issue	20	1.0	-	-	1.0
Derivative financial instruments	29	-	-	190.4	190.4
Subordinated liabilities	23	50.0	-	-	50.0
Subscribed capital	24	30.0	-	-	30.0
Total financial liabilities		**3,064.0**	**-**	**197.6**	**3,261.6**

29 Financial instruments Continued

Fair values of financial assets and liabilities
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.

The Group has financial assets and liabilities for which there is a practical right to set off the recognised amounts, and which are settled net in practise. However, the netting arrangements do not result in an offset of balance sheet assets and liabilities for accounting purposes as the right to set off is not unconditional in all circumstances.

Under IAS32: Financial Instruments: Presentation, there are no financial assets or liabilities which are offset with the net amount presented on the balance sheet.

Under IFRS 7, the Group must disclose the effect of its netting arrangements, including the effects of potential rights of set off associated with its recognised financial assets and liabilities.

Group as at 31 December 2016

	Gross fair value presented in the Balance Sheet	Offsetting financial collateral (received*)/ pledged not meeting the offsetting criteria of IAS 32	Net collateralised position	Net position under Master Netting Agreements not meeting the offsetting requirements of IAS 32 (pre-collateral)
Financial assets	**£m**	**£m**	**£m**	**£m**
Interest rate swaps	6.5	(1.0)	5.5	0.4
Financial liabilities				
Interest rate swaps	(234.3)	233.8	(0.5)	(226.7)

Group as at 31 December 2015

	Gross fair value presented in the Balance Sheet	Offsetting financial collateral (received*)/ pledged not meeting the offsetting criteria of IAS 32	Net collateralised position	Net position under Master Netting Agreements not meeting the offsetting requirements of IAS 32 (pre-collateral)
Financial assets	£m	£m	£m	£m
Interest rate swaps	7.3	(2.4)	4.9	3.0
Financial liabilities				
Interest rate swaps	(190.4)	192.2	1.8	(182.4)

*Offsetting collateral is pledged and received in line with underlying Credit Support Annexes (CSA) with the Groups' financial counterparties. The Group posts and receives cash collateral on a daily basis to minimise its own and counterparty exposures to mark-to-market positions. Collateral posted is measured against counterparty mark-to-market values and may not reflect the Society's internal valuation of its financial instruments.

The Society has entered into International Swaps and Derivatives Association (ISDA) Master agreements with financial counterparties in line with standard industry practise. Netting arrangements contained within are not considered sufficient alone to satisfy the offsetting criteria of IAS 32. The netting arrangements are intended to protect the Society against fair value loss in the unlikely future event of counterparty default.

The Society has continued to make extended use of the London Clearing House (LCH) through 2016, minimising its exposure to non-LCH counterparties. The protected manner of LCH collateral placements mitigates counterparty credit risk with respect to collateral that would otherwise be pledged to derivative counterparties.

Where the Society holds multiple financial assets and liabilities with a single counterparty, and a Master netting agreement is in effect, the net fair value exposure for each counterparty is calculated. Net exposures placed with counterparties are consolidated into the financial assets disclosure above, net exposures received from counterparties similarly consolidated into the financial liabilities.

Collateral
In the ordinary course of business, the Group may from time to time access market-wide facilities provided by central banks secured against non-cash collateral.

Cash collateral has been posted and received in line with Credit Support Annexes with the Group's financial counterparties, as detailed above.

Cash collateral received is the legal property of the Group with no obligation to return. Similarly, cash collateral pledged is no longer under the legal ownership or control of the Group.

The fair value of collateral pledged and received is as set out below:

	GROUP and SOCIETY 2016 £m	GROUP and SOCIETY 2015 £m
Cash collateral received under CSA agreements	**1.0**	2.4
Other financial assets; collateral pledged under repurchase agreements	**362.4**	145.9
Cash collateral paid under CSA agreements	**233.8**	192.2

Cash collateral is held to mitigate exposures to counterparties with postings updated daily to reflect mark-to-market exposures across the Society's derivative transactions.

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. These assets and liabilities are held at values reflecting their intended use. This is deemed to also reflect their highest and best use. If the Society's intended use of an asset or liability changes the accounting adopted for the item is revisited for reclassification. The carrying values below reflect the Groups' maximum exposure to counterparty credit risk at 31 December 2016.

29 Financial instruments Continued

GROUP

	Note	Level*	Carrying value 2016 £m	Carrying value 2015 £m	Fair value 2016 £m	Fair value 2015 £m
Financial assets						
Cash and balances with the Bank of England		1	**196.4**	183.1	**196.4**	183.1
Loans and advances to banks	9	1	**235.8**	195.7	**235.8**	195.7
Loans and advances to customers	11	3	**2,563.8**	2,478.6	**2,776.7**	2,632.8
Financial liabilities						
Due to Members - shares	17	2	**2,709.2**	2,678.8	**2,716.2**	2,704.9
Due to other customers	18	2	**211.1**	205.3	**211.1**	205.3
Deposits due to other banks	19	2	**187.3**	100.8	**187.3**	100.8
Debt securities in issue	20	2	**-**	1.0	**-**	1.5
Subordinated liabilities	23	2	**50.0**	50.0	**52.5**	55.3
Subscribed capital	24	2	**30.0**	30.0	**43.8**	49.0

*Level defined below. The Group does not trade in financial instruments. Sale of financial assets to demonstrate their liquidity and divestment of financial assets that are not felt to meet the Groups' risk profile and appetite have had a limited impact on the Group's financial result during 2016.

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 Members - shares

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

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.

Subordinated liabilities

The fair value of subordinated liabilities is calculated based on discounted cash flows reflecting the contractual liabilities.

Subscribed capital

The fair value of subscribed capital is calculated based on discounted cash flows reflecting the contractual liabilities.

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:

	2016 Level 1 £m	2016 Level 2 £m	2016 Level 3 £m	2016 Total £m	2015 Level 1 £m	2015 Level 2 £m	2015 Level 3 £m	2015 Total £m
Financial assets								
Debt securities - available for sale	**344.3**	**-**	**-**	**344.3**	347.2	-	-	347.2
Derivative financial instruments	**-**	**6.5**	**-**	**6.5**	-	7.3	-	7.3
Fair value adjustments for hedged risk on underlying instruments	**-**	**233.8**	**-**	**233.8**	-	190.8	-	190.8
Financial liabilities								
Derivative financial instruments	**-**	**234.3**	**-**	**234.3**	-	190.4	-	190.4
Fair value adjustments for hedged risk on underlying instruments	**-**	**5.6**	**-**	**5.6**	-	7.2	-	7.2

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 13 'Improving Disclosures: Financial Instruments'.

The Society uses modelling software to measure fair value movements on its hedging instruments and hedged items on a portfolio (macro) basis. Industry anticipated interest rate movements are factored into the calculations to give an expected fair value of the derivative portfolio.

29 Financial instruments Continued

Derivatives held for hedging

Derivative financial instruments used by the Group have been described previously in the Risk Management Report and footnotes to the table on page 67 of Note 29. The derivative financial instruments are held primarily to mitigate interest rate risk across the Group's balance sheet. The Group actively monitors and manages interest rate risk using hedging as part of that strategy in line with IAS 39. Both fair value and cash flow hedge transactions have been undertaken with the fair values of the derivative instruments held at the Balance Sheet date set out below:

	2016 Notional Amount £m	2016 Fair Value Assets £m	2016 Fair Value Liabilities £m	2015 Notional Amount £m	2015 Fair Value Assets £m	2015 Fair Value Liabilities £m
At 31 December						
Interest rate swaps designated as fair value hedges	**1,186.3**	**6.4**	**(234.2)**	1,402.3	7.3	(190.4)
Interest rate swaps designated as cash flow hedges	**425.0**	**0.1**	**(0.1)**	250.0	-	-
Interest rate swaps	**-**	**-**	**-**	10.4	-	-
		6.5	**(234.3)**		7.3	(190.4)

Hedge Ineffectiveness

	2016 £m	2015 £m
(Losses) / gains on hedging instruments	**(44.6)**	2.1
Gains / (losses) on hedged items attributable to the hedged risk	**44.6**	(2.2)
Net gains representing ineffective portions of the fair value hedges	**-**	**(0.1)**

Liquidity risk

Liquidity risk is the risk that the Society does not hold sufficient liquid resources (resources readily transferable to cash or cash equivalents) to meet its obligations as they fall due.

For each material category of financial liability a maturity analysis is provided in Notes 17 to 20, 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 contractual undiscounted cash flows.

Maturity has been defined by the earliest contractual date of repayment with reference to product terms and conditions. However, management information, both internally generated and through experience, indicates deposits are likely to be repaid later than the earliest date on which repayment is contractually required. The amounts disclosed in the table are contractual undiscounted cash flows and reflect a worst case repayment scenario.

The Groups' liquidity risk is managed by the Asset and Liability Committee (ALCO). ALCO review and approve the results of liquidity stress testing scenarios monitoring cash flow forecasts for the next 3 years under base case and stresses scenarios. Lead by the Group Balance Sheet Management and Product Development departments ALCO appraise long term funding plans and scenarios to ensure adequate liquid assets are in place to meet both regulatory and operational requirements. For further detail see the Risk Management Report on page 31.

GROUP

At 31 December 2016	**Repayable on demand £m**	**Up to 3 months £m**	**Between 3 and 12 months £m**	**Between 1 and 5 years £m**	**Over 5 years £m**	**Total £m**
Due to Members - shares	**1,553.7**	**757.0**	**104.5**	**293.6**	**0.4**	**2,709.2**
Due to other customers	**4.0**	**109.6**	**97.5**	**-**	**-**	**211.1**
Deposits from banks	**0.2**	**133.6**	**3.5**	**50.0**	**-**	**187.3**
Debt securities in issue	**-**	**-**	**-**	**-**	**-**	**-**
Derivative financial instruments	**-**	**0.1**	**1.6**	**7.2**	**225.4**	**234.3**
Fair value adjustments for hedged risk	**-**	**-**	**-**	**5.2**	**-**	**5.2**

At 31 December 2015	Repayable on demand £m	Up to 3 months £m	Between 3 and 12 months £m	Between 1 and 5 years £m	Over 5 years £m	Total £m
Due to Members - shares	1,449.5	682.1	350.5	183.3	13.4	2,678.8
Due to other customers	4.2	87.2	78.9	35.0	-	205.3
Deposits from banks	0.2	69.6	31.0	-	-	100.8
Debt securities in issue	-	-	1.0	-	-	1.0
Derivative financial instruments	-	-	0.5	7.9	182.0	190.4
Fair value adjustments for hedged risk	-	-	1.2	3.6	0.5	5.3

29 Financial instruments Continued

Credit risk

Credit risk is the risk that a customer or counterparty is unable to honour their repayment of obligations as they fall due. The Group Risk Committee, as detailed on page 31 of these Annual Report and Accounts, maintain oversight of the Retail and Commercial Credit Committees. The Committees are involved in the monitoring of the credit risk within the Group's assets.

Note 11 of the Accounts on page 52 contains details of total mortgage assets.

Once a mortgage has been written down as a result of an impairment loss, interest income is recognised in line with adjusted expected future cash flows on the mortgage.

The Groups' lending is all secured with a first charge registered against the collateral property. The average loan to value of the Groups' loan portfolios at 31 December 2016 is **58.1%** (2015: 60.6%) as detailed in the Strategic Report on page 12. Quarterly regional Halifax House Price Index data is used to monitor the value of residential collateral. Provisions are held against loan assets where the recovery of the asset is uncertain. Provisions of **£11.6m** (2015: £18.4m) are held against the Groups' loans and advances to customers at 31 December 2016, as detailed in Note 11 to the accounts on page 53. The Groups' Commercial Credit and Provisioning Committees consider a range of factors in identifying a loan's impaired status. These include where a property has been taken into possession, where a loan is no longer being serviced or difficulty in future servicing is expected, and review of watch lists.

The credit quality of the Groups' residential loans is considered to be excellent with the loans continuing to perform and arrears being below industry averages. At 31 December 2016 there were 24 loans in 12 months arrears or more with balances of **£1.3m** (2015: 19 loans totalling £0.9m). The Groups non-impaired commercial loan assets are also considered to be of a good credit quality.

Prime residential mortgage book

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

	2016	**2016**	2015	2015
Loan to value (indexed)	**£m**	**%**	£m	%
<70%	**1,256.1**	**69.9**	1,149.5	69.0
70% - <80%	**289.3**	**16.1**	289.1	17.4
80% - <90%	**181.0**	**10.1**	160.1	9.6
>90%	**69.2**	**3.9**	66.6	4.0
	1,795.6	**100.0**	1,665.3	100.0

The table below provides further information by payment due status:

	2016	**2016**	2015	2015
	£m	**%**	£m	%
Neither past due nor impaired	**1,776.0**	**98.9**	1,648.5	99.0
Past due up to 3 months but not impaired	**13.8**	**0.8**	10.4	0.6
Impaired and past due 3 to 6 months	**3.2**	**0.2**	3.8	0.2
Impaired and past due over 6 months	**2.5**	**0.1**	2.3	0.1
In possession	**0.1**	**-**	0.3	0.1
	1,795.6	**100.0**	1,665.3	100.0

Against past due and possession cases, **£55.9m** (2015: £60.2m) of collateral is held.

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

Retail Buy to Let Mortgage book

The retail buy to let mortgage book consists of buy to let to individuals <£1m.

	2016	**2016**	2015	2015
Loan to value (indexed)	**£m**	**%**	£m	%
<70%	**42.7**	**54.1**	9.6	44.0
70% - <80%	**33.3**	**42.2**	9.3	43.1
80% - <90%	**1.7**	**2.2**	1.6	7.5
>90%	**1.2**	**1.5**	1.2	5.4
	78.9	**100.0**	21.7	100.0

29 Financial instruments Continued

The table below provides further information by payment due status:

	2016	**2016**	2015	2015
	£m	**%**	£m	%
Neither past due nor impaired	**78.2**	**99.2**	21.1	97.4
Past due up to 3 months but not impaired	**0.2**	**0.2**	0.2	1.0
Impaired and past due over 6 months	**0.4**	**0.5**	0.3	1.1
LPA receivership	**-**	**-**	-	-
In possession	**0.1**	**0.1**	0.1	0.5
	78.9	**100.0**	21.7	100.0

Against past due and possession cases, **£0.2m** (2015: £0.8m) 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 larger buy to let loans and residential investment loans.

	2016	**2016**	2015	2015
Loan to value (indexed)	**£m**	**%**	£m	%
<70%	**52.8**	**77.8**	60.7	84.4
70% - <80%	**5.5**	**8.0**	2.1	2.9
80% - <90%	**8.1**	**11.9**	-	-
>90%	**1.5**	**2.3**	9.1	12.7
	67.9	**100.0**	71.9	100.0

The table below provides further information by payment due status:

	2016	**2016**	2015	2015
	£m	**%**	£m	%
Neither past due nor impaired	**53.3**	**78.6**	61.9	86.1
Past due up to 3 months but not impaired	**13.2**	**19.4**	8.3	11.5
Impaired and past due over 6 months	**-**	**-**	-	-
LPA receivership	**1.4**	**2.0**	1.7	2.4
In possession	**-**	**-**	-	-
	67.9	**100.0**	71.9	100.0

Against past due, LPA receivership and possession cases, **£0.9m** (2015: £14.8m) collateral is held.

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

The average LTV of the specialist residential mortgage book is **51.2%** at 31 December 2016 (2015: 62.5%).

Commercial lending book

The commercial lending book comprises:

GROUP	**2016**	**2016**	2015	2015
	£m	**%**	£m	%
Loans secured on commercial property	**82.1**	**13.2**	136.1	18.7
Loans secured on serviced apartments to retail customers	**22.7**	**3.6**	23.1	3.2
Loans to Housing Associations	**520.5**	**83.2**	570.4	78.1
	625.3	**100.0**	729.6	100.0

29 Financial instruments Continued

Loans secured on commercial property

Loan to value	2016 £m	2016 %	2015 £m	2015 %
<70%	**46.2**	**56.3**	46.4	34.1
70% - <80%	**2.4**	**2.9**	38.0	27.9
80% - <90%	**-**	**-**	6.5	4.8
>90%	**33.5**	**40.8**	45.2	33.2
	82.1	**100.0**	136.1	100.0

The table below provides further information by payment due status:

	2016 £m	2016 %	2015 £m	2015 %
Neither past due nor impaired	**65.3**	**79.6**	100.8	74.1
Not past due but impaired	**16.8**	**20.4**	24.5	18.0
Impaired and past due up to 3 months	**-**	**-**	3.3	2.4
Impaired and past due over 6 months	**-**	**-**	-	-
Impaired LPA receivership	**-**	**-**	7.5	5.5
	82.1	**100.0**	136.1	100.0

At 31 December 2016 the Society had no commercial investment loans in arrears of 3 months or more. This compared to one at the end of 2015 with a balance of **£3.3m**. The Society had no commercial loans in possession at the end of 2016 (2015: none). At the end of 2016 the Society had no commercial investment exposures subject to LPA receivership (2015: two). The approach of appointing an LPA receiver for impaired commercial loans has produced acceptable outcomes in the past few years and the Society expects to continue to adopt this approach should any further similar situations arise.

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. providing the borrower with a little more time to sell the security property following a tenant renewal.

The Society extended the loan term on three loans in 2016 with total balances of **£4.5m**, on original commercial terms and conditions. One of these loans, with a balance of **£0.9m** was subsequently fully repaid in 2016. There has been no requirement identified to hold specific provisions against either of the remaining loans, but the collective provision remains in place to cover any shortfall.

29 Financial instruments Continued

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

	2016 £m	2016 %	2015 £m	2015 %
Retail	**47.0**	**57.3**	88.7	65.2
Office	**13.9**	**16.9**	14.9	10.9
Industrial	**16.0**	**19.5**	21.4	15.7
Hotel / Leisure	**4.7**	**5.7**	10.6	7.8
Other	**0.5**	**0.6**	0.5	0.4
	82.1	**100.0**	136.1	100.0

Loans to Housing Associations Loan to value (unindexed)	2016 £m	2016 %	2015 £m	2015 %
<70%	**284.5**	**54.6**	257.4	45.1
70% - <80%	**146.6**	**28.2**	99.1	17.4
80% - <90%	**89.4**	**17.2**	214.0	37.5
>90%	**-**	**-**	-	-
	520.5	**100.0**	570.5	100.0

Loans to Housing Associations are secured on residential property.
No Housing Association loans are past due or impaired.

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.

At 31 December 2016	**+1% £m**	**+2% £m**	**-1% £m**	**-2% £m**
Next 12 months	**1.5**	**2.9**	**(1.5)**	**(2.9)**
Next 2 years	**3.0**	**5.9**	**(3.0)**	**(5.9)**
Next 3 years	**4.1**	**8.1**	**(4.1)**	**(8.1)**

At 31 December 2015	+1% £m	+2% £m	-1% £m	-2% £m
Next 12 months	1.1	2.2	(1.1)	(2.2)
Next 2 years	2.0	4.0	(1.3)	(2.6)
Next 3 years	3.6	7.1	(1.3)	(2.6)

The main risk measure used by ALCO is an immediate 200 basis points parallel shift in rates.

Due to the sustained 2016 low interest rate environment, the rate shocks for interest rate reductions communicated to ALCO have remained at -0.10% and -0.20% throughout 2016.

An immediate 2% upward movement in interest rates would increase Members' interests by **£6.9m** (2015: £5.1m).

29 Financial instruments Continued

Currency risk
The Group has no exposure to currency risk.

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.

IFRS 9
IFRS 9 "Financial Instruments" will replace the current IAS 39 "Financial Instruments" on 1 January 2018. IFRS 9 introduces substantial changes to the required accounting for financial instruments with principal requirements as follows:

Classification and measurement
Classification of financial assets is based on the cash flow characteristics of the assets and the business model under which the assets are held. Assets may be classified at amortised cost, fair value through other comprehensive income and fair value through profit and loss.

Where the contractual cash flow characteristics of an asset reflect "solely payments of principal and interest on the principal amount outstanding" (SPPI), an asset may be classified at 'amortised cost', with income recognised under the effective interest rate method, where the asset's objective business model is 'held to collect contractual cash flows'. The Group expects to continue to hold most of its non-debt instrument, non-derivative financial assets at amortised cost. A limited number of the Group's financial assets contain contractual cash flow characteristics that do not meet the SPPI requirements with the assets to be re-classified at fair value through profit and loss accordingly.

Where the contractual cash flow characteristics of an asset reflect SPPI, an asset may be classified at 'fair value through comprehensive income' with fair value movements recognised through other comprehensive income, where the asset's objective business model is 'held to collect contractual cash flows, or for sale'. The Group expects to classify its debt security financial assets at fair value through comprehensive income as the assets are typically held for liquidity purposes, as well as to generate an interest income return. This reclassification is not expected to impact the Group as the IFRS 9 'fair value through comprehensive income' is broadly analogous to the IAS 39 'Available for Sale' classification under which the Group's debt securities are currently held.

Where the contractual cash flow characteristics of an asset do not reflect SPPI, or where neither of the above business models suitably reflect management of the asset, an asset is to be classified at 'fair value through profit or loss', with fair value movements recognised through the Income Statement. The Group's derivative financial instruments will be classified at fair value through profit and loss, in line with their current IAS 39 classification.

IFRS 9 remains broadly aligned with IAS 39 in respect of the classification and measurement of financial liabilities. The Group does not expect to be significantly impacted by the IFRS 9 financial liability classification and measurement requirements.

The Society's balance sheet holds the material bulk of the Group's financial assets. The Society operates under a simple and straightforward building society model and does not trade in financial instruments. This allows for a more objective assessment of the business model under which financial assets are managed. To present the initial conclusions highlighted above, the Society has considered how financial asset performance is evaluated and reported to senior management, the key risks affecting this performance and how these are managed, and how managers of the business are compensated in respect of asset performance. This analysis was undertaken over aggregated assets, at a more granular level than is presented in the Group's Balance Sheet or Notes to the Accounts. More focused and detailed consideration was given particularly to loans and advances to customers and debt securities due to varying interest and risk characteristics across portfolios of these financial assets.

Impairment of financial assets
IFRS 9 replaces the IAS 39 'incurred losses' provisioning model with a forward looking assessment of impairment. Expected credit losses are recognised across applicable financial assets based on whether there has been a significant increase in credit risk since the asset's origination.

Loss allowances for expected credit losses are to be recognised on all financial assets held at either amortised cost, in which case loss allowances impact the Income Statement, or at fair value through other comprehensive income, in which case loss allowances impact other comprehensive income and become reserves reductions. A simplified approach can be adopted for trade receivables and contract assets.

Loss allowances against in-scope assets are to be recognised differently depending upon the initial credit risk of the assets at their origination, and the movement in said credit risk up to the current reporting date. Assets can be assessed on an individual or collective basis and assessment should consider forward looking information.

The change in the risk of default occurring is key, not the change in the amount of any expected credit loss.

Scenarios should be modelled to determine 12 month and lifetime expected credit losses. Multiple scenarios to allow a probability weighted model are expected and while it is not necessary to identify every scenario, and it is advised not to select unlikely scenarios, the International Accounting Standards Board still expect at least one scenario to be included that is 'expecting to default', even if historically or presently there is no indication that a default will occur.

Where an asset has not seen a significant increase in credit risk since its origination, 12 month expected credit losses are to be recognised as a loss allowance. These are the portion of lifetime expected credit losses that result from default events on the asset that are possible within the 12 months after the reporting date.

Where an asset has seen significant increase in credit risk since origination, but there is no objective evidence of impairment at the reporting date, lifetime expected credit losses are to be recognised. Where an asset has seen significant increase in credit risk since origination and there is objective evidence of impairment at the reporting date, lifetime expected credit losses are to be recognised and interest income is to be calculated against the net carrying amount of the financial asset, rather than the typical gross amount.

IFRS 9 introduces significant forward looking assessments of financial assets requiring loss allowances to be recognised against assets expected to default at any point in their lifetime. IFRS 9's multiple, forward looking scenarios can be expected to bring forward the recognition of loss allowances compared to the existing IAS 39 loss allowance requirements, particularly in the transitional phase through 2018 as the new standard is first applied to substantial pre-existing portfolios of financial assets. The Society has not yet concluded on a quantified expected provisions adjustment.

Implementation of high quality IFRS 9 impairment models requires significant management experience and judgement, both in assessing historic performance trends and factors and in projecting these into uncertain future economic environments. External professional modelling assistance will be coupled with the Society's extensive internal expertise to facilitate a robust and compliant implementation. Best practise guidance issued by consolidated professional audit and accountancy firms, IFRS implementation guidance, and banking centric governance and modelling guidance from European and domestic authorities form the foundation of the Society's IFRS 9 project.

Hedge Accounting
IFRS 9 intends to better align financial risk management with financial accounting requirements. IFRS 9 allows for the existing hedge accounting requirements of IAS 39 to be applied until a separate financial reporting standard, accounting for dynamic risk management (macro hedge accounting) is implemented. The Society expects to adopt this application option. Developments concerning the new macro hedge accounting standard are being closely monitored.

Implementation
The Group has a long established IFRS 9 steering committee consisting of members of finance, credit risk, balance sheet management and internal audit. An impairment sub-committee is also in place supported by external experts providing credit risk advice and modelling assistance. Extensive work has been undertaken through 2016 to facilitate development of robust, compliant and informative loss provisioning models with model building to continue through the first half of 2017 in advance of a second half parallel run alongside existing IAS 39 loss models.

A documented implementation strategy is in place with regular progress reported to the Audit Committee.

Annual Business Statement for the year ended 31 December 2016

1 Statutory percentages

	2016 %	Statutory %
Lending limit	**5.30**	25.00
Funding limit	**12.82**	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. Lending limit is calculated excluding all IAS 39 adjustments or derivatives and fair values.

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.

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:	2016 %	2015 %
Gross capital	**8.31**	8.34
Free capital	**7.70**	7.63
Liquid assets	**24.99**	24.31
Result for the year as a percentage of mean total assets	**0.17**	0.09
Management expenses as a percentage of mean total assets	**1.21**	1.06

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 but exclude liquid assets pledged under repo agreements and includes collateral.

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 are the average of the 2016 and 2015 total assets.

Annual Business Statement for the year ended 31 December 2016 (continued)

Directors at 31 December 2016

	Date of Birth	Date of Appointment	Business Occupation
RJ Bottomley OBE, FCA	22.05.53	22.09.14	Financial and Business Consultant
	Other Directorships: Newcastle Portland House Limited; Marsden Packaging Limited; MSL Energy Limited; MSL Property Care Services Limited; TL Dallas Group Limited; Skillsbridge Limited; Durham Cricket Limited (ceased 26 January 2017); Greggs 1978 Pension Scheme Trustee Limited; The Beckfoot Estate Company Limited (appointed 4 January 2017); The Craven Family Trust.		
DJ Buffham	13.08.59	24.05.10	Company Director
	Other Directorships: Newcastle Systems Management Limited; Northern Homes and Estates Limited; William Leech (Investments) Limited; The William Leech Foundation Limited; Zytronic PLC.		
P Ferguson BSc, CA	06.03.69	19.02.14	Building Society Strategy, Planning and Risk Director
	Other Directorships: Hadrian Learning Trust.		
AS Haigh BSc	26.01.63	27.01.14	Building Society Chief Executive Officer
	Other Directorships: Community Foundation serving Tyne & Wear and Northumberland.		
K Ingham	20.02.65	04.09.14	Customer Service Director
	Other Directorships: Newcastle Strategic Solutions Limited; Customer Service Director (Virgin Media Limited); Virgin Media Pension Scheme (Trustee).		
RJ McCormick FCA, FCIIA	09.05.49	16.08.07	Business Consultant
	Other Directorships: Newcastle Strategic Solutions Limited; Threshfield Quarry Development Trust Limited.		
PJ Moorhouse FCCA	18.01.53	31.10.11	Company Director
	Other Directorships: Newcastle Systems Management Limited; Newcastle Strategic Solutions Limited; Molins Public Limited Company; Transflex Vehicle Rental Limited; North Group.		
J Morris BA, FCA	13.09.56	31.10.11	Chartered Accountant
	Other Directorships: None.		
AM Russell BA, FCA, CPA	18.03.67	01.07.10	Building Society Deputy Chief Executive & Finance Director
	Other Directorships: Newcastle Financial Advisers Limited; Newcastle Mortgage Loans (Jersey) Limited; Newcastle Portland House Limited; The Percy Hedley Foundation.		
D Thompson	30.01.72	22.08.16	Building Society Customer Director
	Other Directorships: Newcastle Financial Advisers Limited.		
IW Ward FCIB	04.05.49	09.07.13	Director
	Other Directorships: Newcastle Systems Management Limited; Charter Court Financial Services Group Limited; Charter Court Financial Services Limited; Exact Mortgage Experts Limited; Broadlands Finance Limited; Charter Mortgages Limited; Harrogate and District NHS Foundation Trust.		

Documents may be served on any of the above named Directors at: "Newcastle Building Society" c/o Addleshaw Goddard LLP (Ref. GAB), Milton Gate, 60 Chiswell Street, London EC1Y 4AG. The Executive Directors have service contracts which can be terminated at any time by the Society on six months' notice. The Executive Directors' service contracts were entered into on the dates of their appointment, excepting A S Haigh who was appointed to the role of Chief Executive on 1 May 2015, having previously held the role of Chief Operating Officer. There are no contracts for Non-Executive Directors and no compensatory terms for loss of office.

Country-by-Country Reporting

The reporting obligations set out in Article 89 of the European Union's Capital Requirements Directive IV (CRD IV) have been implemented in the UK by the Capital Requirements (Country-by-Country Reporting) Regulations.

Newcastle Building Society is the biggest building society in the North East and the eighth largest in the UK with assets in excess of £3.6 billion.

As a mutual organisation, the Society's primary focus is its Members and it aims to provide mortgage, savings and insurance products supported by excellent customer service. Additionally, the Society offers financial advice through Newcastle Financial Advisers Limited and provides outsourcing of financial services through the Newcastle Strategic Solutions division.

The consolidated financial statements of the Newcastle Building Society Group include the audited results of the Society and its subsidiary undertakings. The consolidated entities, their principal activities and countries of incorporation, are detailed in Note 13 to the Annual Report and Accounts. All of the consolidated entities were incorporated in the United Kingdom, with the exception of Newcastle Mortgage Loans (Jersey) Limited, which is incorporated and operates with no employees in Jersey. The Society also operates a branch in Gibraltar.

For the year ended 31 December 2016:

- Group total operating income was **£54.6m** (2015: £50.1m), the proportion not arising from UK-based activity is not considered material for the purposes of this disclosure.
- The average number of Group full time equivalent employees was **873.3**, (2015: 790.4) of which **865.9** (2015: 783.4) were employed in the UK and **7.4** (2015: 7.0) in Gibraltar.
- Group profit before tax **£8.1m** (2015: £5.4m) with tax a charge of **£2.0m** (2015: £2.1m). The profit before tax and the tax charged relates to UK-based activity and the UK tax jurisdiction.
- No public subsidies were received by the Group.

Auditors' Report on Country-by-Country Reporting

Independent auditors' report to the Directors of Newcastle Building Society

We have audited the accompanying schedule of Newcastle Building Society for the year ended 31 December 2016 ("the schedule"). The schedule has been prepared by the directors based on the requirements of the Capital Requirements (Country-by-Country Reporting) Regulations 2013.

Directors' Responsibility for the schedule

The directors are responsible for the preparation of the schedule in accordance with the Capital Requirements (Country-by-Country Reporting) Regulations 2013, for the appropriateness of the basis of preparation and the interpretation of the Regulations as they affect the preparation of the schedule, and for such internal control as the directors determine is necessary to enable the preparation of the schedule that is free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on the schedule based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the schedule is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the schedule. The procedures selected depend on the auditors' judgement, including the assessment of the risks of material misstatement of the schedule, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the schedule in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the schedule.

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

Opinion

In our opinion, the country-by-country information in the schedule as at 31 December 2016 is prepared, in all material respects, in accordance with the requirements of the Capital Requirements (Country-by-Country Reporting) Regulations 2013.

Basis of Preparation and Restriction on Distribution

Without modifying our opinion, we draw attention to the schedule, which describes the basis of preparation. The schedule is prepared to assist the directors to meet the requirements of the Capital Requirements (Country-by-Country Reporting) Regulations 2013. As a result, the schedule may not be suitable for another purpose.

Our report is intended solely for the benefit of the directors of Newcastle Building Society. We do not accept or assume any responsibility or liability to any other party save where terms are agreed between us in writing.

PricewaterhouseCoopers LLP
Chartered Accountants
Newcastle upon Tyne
23 February 2017

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. A customer is 3 months in arrears when they have missed the equivalent of 3 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 PRA 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.

Buy to Let (BTL) - A mortgage designed to support customers purchasing an investment property to let out.

Capital Requirements Directive (CRD IV) - The EU legislative package covering prudential rules for banks, building societies and investment firms. CRD IV is made up of the Capital Requirements Directive and Capital Requirements Regulation, it is designed to implement the Basel III agreement across the EU.

Commercial lending / mortgage - Loans secured on commercial property.

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

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.

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 Conduct Authority (FCA) - FCA regulates the conduct of financial firms providing services to consumers and maintains the integrity of the UK's financial markets.

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

Gilts - These 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.

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 PRA on the minimum level of capital that must be held.

Individual Liquidity Guidance (ILG) - Guidance from the PRA 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 incurred.

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.

Internal Liquidity Adequacy Assessment Process (ILAAP) - The Group's internal assessment of the liquidity levels needed to meet its regulatory liquidity requirements.

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.

Leverage ratio - A Basel III ratio which measures Tier 1 capital against total on and off balance sheet assets.

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 Coverage Ratio (LCR) - A Basel III measure of the amount of highly-liquid assets against cash outflows over a 30 day period.

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) - A PRA 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 capital. PIBS rank behind the claims of all subordinated debt holders, depositors, payables and investing Members of Newcastle Building Society.

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

Prudential Regulation Authority (PRA) - Part of the Bank of England and responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms.

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.

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 assets (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 subsidiary 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.

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 Common Equity Tier 1 and other Tier 1 capital. Common Equity Tier 1 capital comprises general reserves from retained profits. Other regulatory adjustments may be made for the purposes of capital adequacy. Under the grandfathering rules of Basel III qualifying capital instruments such as PIBS can be included in other Tier 1 capital (i.e. not Common Equity Tier 1) transferring to Tier 2 over the grandfathering period.

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.

Branch Directory

Alnwick - 28 Bondgate Within, NE66 1TD	Tel: (01665) 603 344
Ashington - 10 Station Road, NE63 9UJ	Tel: (01670) 815 919
Berwick Upon Tweed - 12 Hide Hill, TD15 1AB	Tel: (01289) 306 417
Carlisle - 2/4 English Street, CA3 8HX	Tel: (01228) 524 518
Chester-Le-Street - 42 Front Street, DH3 3BG	Tel: (0191) 388 5266
Consett - 19/21 Middle Street, DH8 5QP	Tel: (01207) 502 636
Cramlington - 34/35 Craster Court, NE23 6UT	Tel: (01670) 735 813
Darlington - 87/88 Skinnergate, DL3 7LX	Tel: (01325) 383 656
Dumfries - 2/6 Queensberry Square, DG1 1BL	Tel: (01387) 253 815
Durham - 25 Elvet Bridge, DH1 3AA	Tel: (0191) 384 3182
Gateshead - 12 Ellison Walk, Trinity Square, NE8 1BF	Tel: (0191) 477 2547
Gibraltar - 197-201 Main Street	Tel: (00 350) 200 41143
Gosforth - 105/107 High Street, NE3 1HA	Tel: (0191) 285 5965
Hartlepool - 133/135 York Road, TS26 9DR	Tel: (01429) 233 014
Hexham - 3 Beaumont Street, NE46 3LZ	Tel: (01434) 605 106
Middlesbrough - 38 Linthorpe Road, TS1 1RD	Tel: (01642) 243 617
Morpeth - 14 Market Place, NE61 1HG	Tel: (01670) 514 702
Newcastle - 136 Northumberland Street, NE1 7DQ	Tel: (0191) 261 4940
Newcastle - Portland House, New Bridge Street, NE1 8AL	Tel: (0191) 232 0505
North Shields - 76 Bedford Street, NE29 0LD	Tel: (0191) 259 5286
Penrith - 12 Market Square, CA11 7BX	Tel: (01768) 862 888
Ponteland - 23 Broadway, Darras Hall, NE20 9PW	Tel: (01661) 821 828
South Shields - 67 Fowler Street, NE33 1NS	Tel: (0191) 454 0407
Stokesley - 19 High Street, TS9 5AD	Tel: (01642) 711 742
Sunderland - 14 Waterloo Place, SR1 3HT	Tel: (0191) 565 0464
West Denton - 22 Denton Park Centre, NE5 2RA	Tel: (0191) 267 5038
Whickham - 28 Front Street, NE16 4DT	Tel: (0191) 488 1766
Whitley Bay - 78/84 Park View, NE26 2TH	Tel: (0191) 252 0642
Yarm Library - 41 The High Street, TS15 9BH	Tel: (01642) 785 985

Agency

Allen Sykes, 17 Galgate, Barnard Castle, DL12 8EQ	Tel: (01833) 690 474

Financial Advice Centres

Newcastle - 136 Northumberland Street, NE1 7DQ	Tel: (0191) 261 4940
Newcastle - Portland House, New Bridge Street, NE1 8AL	Tel: (0191) 232 0505