HODGE

Annual Report and Financial Statements

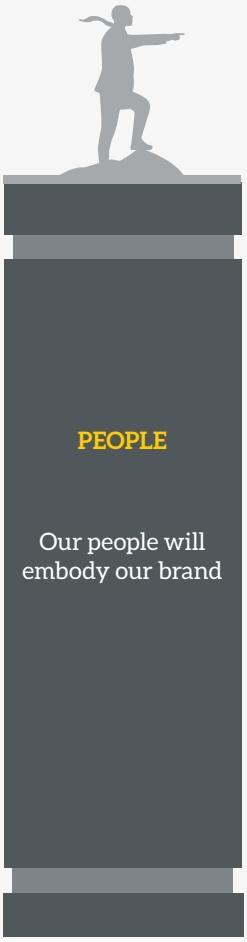
31 October 2018

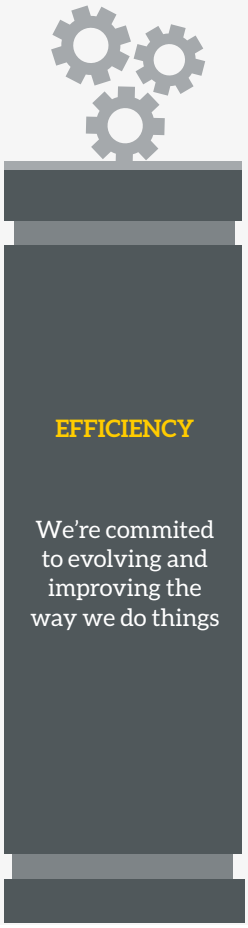
A Year of Progress

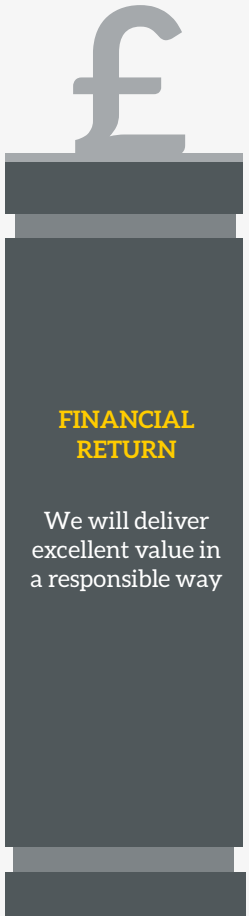
We have made significant progress in delivering our strategic objectives which are aligned to our vision of the Hodge Limited group (the "Group") being a widely recognised and trusted partner for brilliant financial services designed to delight our customers.

The strategy for the Group is based on four key pillars that together drive our activity and enable us to achieve our vision.

To be widely recognised and trusted for brilliant financial services, designed and delivered in ways to delight our customers.







Our **People**

Our people are the driving force behind the fulfilment of our vision and are key to embodying everything we stand for.

This year, we formed the Colleague Alliance, to provide a link between colleagues and the Board and to champion the values that drive our culture. The successful creation and launch of a new set of values for our people which align to the strategy and vision of the Group culminated in a 'We are Hodge' company event. This event celebrated our history and our future ambition and recognised the important contribution the Group's colleagues make in delivering for our customers.

We continue to invest in our people, with leadership support and mentoring across the business. This commitment will enhance strategic leadership as well as strengthening capability at multiple levels throughout the organisation. We have taken steps to drive colleague engagement through reward and recognition schemes aligned with our desire to delight our customers and we have made enhancements to our internal communication so that all our colleagues are aware of the business's direction.

Be Confident

Be Curious

Be United

Be Trusted

Be Human

Our **Customers**

We have continued to deliver improved products and services to our customers. We have introduced a Net Promoter Score as a key customer measure in our savings and mortgage operations, and we are piloting real time customer feedback so that we continually improve our service proposition.

In February, we launched a new Hodge Lifetime website specifically for mortgage intermediaries. This platform provides an additional tool to build awareness, understanding and engagement with our broker community across the later life lending market. In June, we were one of the first to launch a Retirement Interest Only mortgage in response to regulatory changes. The product has been well received by mortgage advisers and customers alike and is providing good customer outcomes.

We have created a Business Intelligence function which is delivering greater insight into our customers and their needs. We've invested in strengthening our marketing and product areas to focus on delivering compelling products and services as well as delighting our customers in their dealings with us.

Our specialist Commercial Lending proposition continues to be highly valued by our clients which is evident in the amount of repeat and client referred opportunities we receive.

Client feedback shows the high regard for our relationship teams with whom they deal.

We have helped
over 700 customers
across our unique mix of equity release and lifetime mortgages.

We have opened
over 7,000 savings accounts
for almost ***4,000 new customers***
who can now benefit from our digital application and servicing proposition.

Administered record new Commercial Lending business volumes of ***£128 million***.

Efficiency

Improving our operational and digital capability is vital in delivering our promises to our customers.

In June we launched on-line account servicing for savings, following the successful introduction of the online application service in September 2017. This ongoing investment in digital capability brings efficiency and scalability to our operations, whilst delivering great service to our customers.

We have made significant progress in developing the Intermediary Management Portal for mortgage advisers that will be delivered in 2019. This will provide a seamless online service to support our network of advisers and bring efficient mortgage application processing to our operational areas.

Financial Return

2018 has been another successful year albeit not without its challenges. A summary of our financial performance is set out on page 11.

Our **Awards**

Several of our people have won awards in recognition of their commitment and contribution to the markets and professions we operate in:

Client feedback shows the high regard for our relationship teams with whom they deal.

Young Finance Director of the Year
Finance Awards Wales 2018

Financial Services Finance Team of the Year
Finance Awards Wales 2018

Woman in Later Life Lending
Financial Reporter Women in Finance Awards 2018

Rising Star Lender
British Mortgage Awards 2018

Equity Release/Lifetime Lender
Mortgage Strategy Awards 2018

Best Lender for Later Life Lending
Legal & General Mortgage Club Awards 2018

Finalist, Best Equity Release Lender
Mortgage Strategy Awards 2018

Funder of the Year
Insider Media Wales Property Awards

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Chairman's Statement

As noted last year, the Hodge Limited group ("the Group") was created to consolidate the Group's financial services entities, Julian Hodge Bank ("the Bank") and Hodge Life Assurance Company ("Hodge Life"), under a single "Hodge" brand.

Over the course of the year, we have focussed our attention on promotion of that brand, whilst at the same time ensuring that the crucial differentiators which make our individual businesses attractive to their customers are not lost.

During 2018, we took these changes a step further, with Hodge Limited acquiring Hodge Life from the Bank at its book value. This had the effect of improving the Bank's regulatory capital base, thereby improving its new business growth capability and creating a more logical group structure for our regulated entities.

The main financial highlights for the year are detailed in the Financial Performance section outlined on page 11.

Whilst the overall result for the year is down on the previous year, both net interest income and adjusted net operating income has improved markedly. This measure, which is explained and shown in note 3 to the accounts, is considered to better reflect the underlying operating performance of the Group as it removes elements which distort year on year comparisons.

The improvement in net interest income has, however, largely been absorbed by adverse fair value movements and increased overheads, reflecting our investment in our financial products and the way in which we deliver them to our customers. The end result after removing the fair value movements is an adjusted profit before tax of £12.6m, virtually the same as the prior year. The challenge for the future will be to increase the scale and profitability of our businesses in order to significantly reduce the cost income ratio from this year's 58.9% (2017: 54.9%).

Even allowing for the lower profit before tax, when compared with the previous year, the Group's financial position remains strong.

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

The Board re-affirmed the Group's lending strategy during the year, which is to focus on equity release, later life lending and commercial real estate, where our expertise and knowledge are widely recognised, but also to leverage that expertise, without the need to deploy capital, by utilising third-party funding.

We continue to make significant investment in our business, particularly within the digital arena...

Hodge Lifetime

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

Equity release

Residential property remains the principal form of saving for most retirees and it is inevitable that a growing proportion will utilise their major asset to improve their retirement prospects through equity release. In 2017, the UK market topped £3 billion new lending for the first time and has seen further strong growth in 2018. Market commentators expect the total UK new lending market for 2018 to be in excess of £4 billion.

The Group believe that equity release assets remain an appropriate asset class for the investment of annuity premiums.

Later life lending

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

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

In March 2018, the FCA facilitated the introduction of a further product type into this market by amending the definitions in the MCOB Sourcebook to permit RIO mortgages, recognising that for many people, the only viable repayment option will be from the sale of their property on death or entry into long-term care.

We welcome this additional product choice for consumers and were amongst the first lenders to offer a RIO mortgage alongside our other product options.

The 55+ Mortgage, Retirement mortgage and RIO mortgage products are offered by the Bank.

Hodge Lifetime is one of the only UK businesses currently offering a full range of later life lending and equity release products, which puts us in a strong position to capitalise on this growing market.

We continue to heavily invest in technology and are developing an intermediary portal to allow advisers to transact with us on-line. The first phase of this development, a Key Facts Illustration generation tool, is due to go-live early in the new financial year. Other core components, comprising on-line Decisions-in-Principle and application services, document exchange and case tracking are scheduled to be delivered during 2019.

Whilst we believe that our product range in the later life lending market is unrivalled, this needs to be complemented with systems which assist the adviser to interact with us when and how they want; the intermediary portal is a key component in delivering this aspiration.

Pension annuities

In March 2018, new rules came into effect requiring that annuity providers must furnish potential annuitants with an 'information prompt' setting out whether the annuity rate they are offering is the most competitive in the market, together with the potential income that might be foregone by a failure to shop around. This is having a positive effect on the size of the market available to us given that we only offer our annuity products on the open market.

In this respect we managed to increase earned premium income by 62% over the previous year, which is a significant achievement.

The concept of a guaranteed income for life remains a compelling one for many retirees, with an emerging trend that annuities are used to secure a base level of retirement income, with excess funds being accessed on a more flexible basis. Market statistics show that the annuity market has stabilised at around £4 billion per annum, and the Group remains confident that this market provides good growth prospects.

Commercial lending

Our specialist Commercial Lending proposition, whereby we provide bespoke, senior real estate debt for experienced investors and developers, continues to be highly valued by our clients and their advisers. This is evident in the amount of repeat and client referral opportunities that we see.

Regular client feedback strongly validates this approach, with the clients' voice in our independently produced annual survey emphasising the high regard in which they hold the key people with whom they deal.

We have achieved consistent and sustained momentum within Commercial Lending which has resulted in strong operating profits for the year, achieved through record new business volumes of £128 million, sustained margins and sound risk management.

These results were achieved from lending within our core and proven risk appetite parameters and with an average weighted new business loan-to-value ratio of under 65%. As ever, the strategy is to be highly selective in our asset origination, focussing on the quality of clients and proposals, rather than a volume-led lending target.

We have made good progress in exiting some legacy risk positions with the result that, we have experienced a net recovery on provisions for impairments. More broadly, key risk metrics have generally improved through the year and we are in the process of implementing an enhanced risk grading system using Standard & Poors credit risk model as we transition to IFRS 9.

Looking forward, we expect to see sustained challenges for some sectors, particularly UK High Street retail, as well as the manifest uncertainty that the Brexit process entails. Given this uncertainty and the attendant risks to the economy and asset prices, we have slowed our rate of new business origination in recent months. We envisage maintaining this approach into the early part of 2019, or until the outlook is more stable. We continue to serve and fund clients but, for now, are circumspect around any net portfolio growth.

Our existing mortgage lending is well spread across the UK and we consider that it does not contain undue concentration in any region. We also take care to ensure appropriate diversification in the types of property assets which secure our exposures. We have monitored closely the problems experienced by the UK High Street and consider the risks to us are reasonably mitigated through retail property exposures constituting less than 10% of our lending stock, with no significant reliance on any single tenant, occupier or loan counterparty.

At the strategic level, we are in the early stages of planning an innovative approach to increasing the scale and earnings of our Commercial Lending activity and embracing the growth of 'Fintech'. These plans remain in development, and there is much to do, but set a direction of travel for 2020 and beyond.

Savings

Delivery of our digital strategy continues apace, and we have added account servicing to our offering so that for many of our products, customers can now conduct their entire transaction with us on-line.

During the forthcoming year, we aim to expand the range of products that can be transacted in this manner, providing customers with even more choice as to how they engage with us.

At the same time, we recognise that there will always be a need for human interaction, either because that is the way our customers wish to do business with us, or to resolve queries and problems which might arise throughout the customer journey whether on-line or in the traditional manner.

In this respect we have extended the availability of our customer services team to include evenings and weekends to ensure that our advisers are available when our customers need them.

During the year, we achieved the milestone of £1 billion in customer balances, which is a testimony to the faith our customers have in our Savings proposition.

The success of our digital offering can be illustrated by the fact that £53.7 million of new Savings balances were raised in the year through the online channel.

The recent expansion of our digital offering to include on-line account servicing should attract more new customers and result in an increasing proportion of our Savings balances being raised through this channel.

The Group is a participant in the Bank of England's Term Funding Scheme, which provides a cost-effective source of funding in the form of central bank reserves to support additional lending to the real economy. The Term Funding Scheme balance represents 6.6% of the overall funding from deposits with banks and customers at 31 October 2018.

Economic environment

For the most part, the general economic environment during 2018 can be characterised as relatively benign in that the UK continues to experience GDP growth, albeit of the tepid variety.

Unemployment remains at historic lows and at last there appears to be some semblance of real wage growth.

Whilst inflation has remained above the Bank of England's 2% target throughout the year, in recent months it has tracked in a relatively narrow range and the Bank of England has only seen fit to raise base rate once, seemingly of the view that inflation will fall back towards target over its policy horizon.

However, from our perspective, the environment has been somewhat more challenging. The key market factors that affect the Group's overall performance are longer term interest rates and residential real estate prices together with the rate of lifetime mortgage redemptions. This is due to the valuation methods we are required to apply to our lifetime mortgages and investment properties.

Increases in longer term interest rates and residential real estate prices are generally positive for the Group's results and although these have moved forward over the year, those movements have been offset by adverse changes to accounting estimates in relation to lifetime mortgages.

Lifetime mortgage redemptions have a negative impact on the Group's results and the level of such redemptions this year has been significantly higher than anticipated.

The uncertainty caused by Brexit is likely to have a negative impact on the Group's performance as a consequence of weakening residential real estate prices and lower long-term interest rates.

IBOR reform

In July 2017, the UK Financial Conduct Authority (FCA) announced a transition away from LIBOR as the key interest rate index used in calculating floating or adjustable rates for loans, bonds, derivatives and other financial contracts. The FCA's intention is that, at the end of 2021, it will no longer seek to persuade, or compel, banks to submit to LIBOR. The Group is currently assessing the impact of this change on its financial instruments which use LIBOR as their benchmark interest rate, this work will continue through 2019 as the impact on markets becomes clearer.

Culture

The Group continues to develop its culture and values following the review instigated in 2017 with the aim of unifying the organisation to work together towards a common purpose.

We have established a Culture Steering Committee with representatives from the Board and senior management to provide the focus necessary to ensure that this aim is successfully delivered.

This Committee is supported by the Colleague Alliance which comprises members drawn from a cross-section of colleagues. The Alliance has been formed to provide the link between colleagues and the Board and to champion the values which it had a key role in developing.

The Alliance's work has been invaluable in creating engagement within Hodge and driving the importance of the values to the success of the Group's strategy and delivering on its mission and vision.

The Alliance's greatest achievement during the year was the organisation, in July, of a "Hodge" event, which brought together the whole business for an entire day, outside the work environment, to showcase, in practical terms, the Hodge values.

The event was a tremendous success, significantly enhanced by the attendance of some of the Hodge Foundation's charity partners, who delivered inspirational examples of how the Foundation's assistance had enabled them to materially improve the lives of those who benefited from their help.

Our people

I referred last year to the fact that to facilitate our expansion we had taken extra space in our central Cardiff location. During the year, we completed the fit-out for this new space which has now become the hub for all the change activity being undertaken across the Group.

This collaborative space has enabled us to bring together colleagues from different parts of the business to concentrate their activities on delivering the vital change which is imperative for the future success of the organisation.

It is a great example of the Hodge values in action and something we wish to replicate across the rest of the organisation.

As always, Hodge is totally dependent on its people for its success. We now have over 190 colleagues, who continue to show their dedication and commitment, but above all their enthusiasm, for the aims of the organisation and the values for which it stands.

In this respect, I would like to express my appreciation, to people for their continued support, and I have no doubt that, with their help, Hodge will go from strength to strength.

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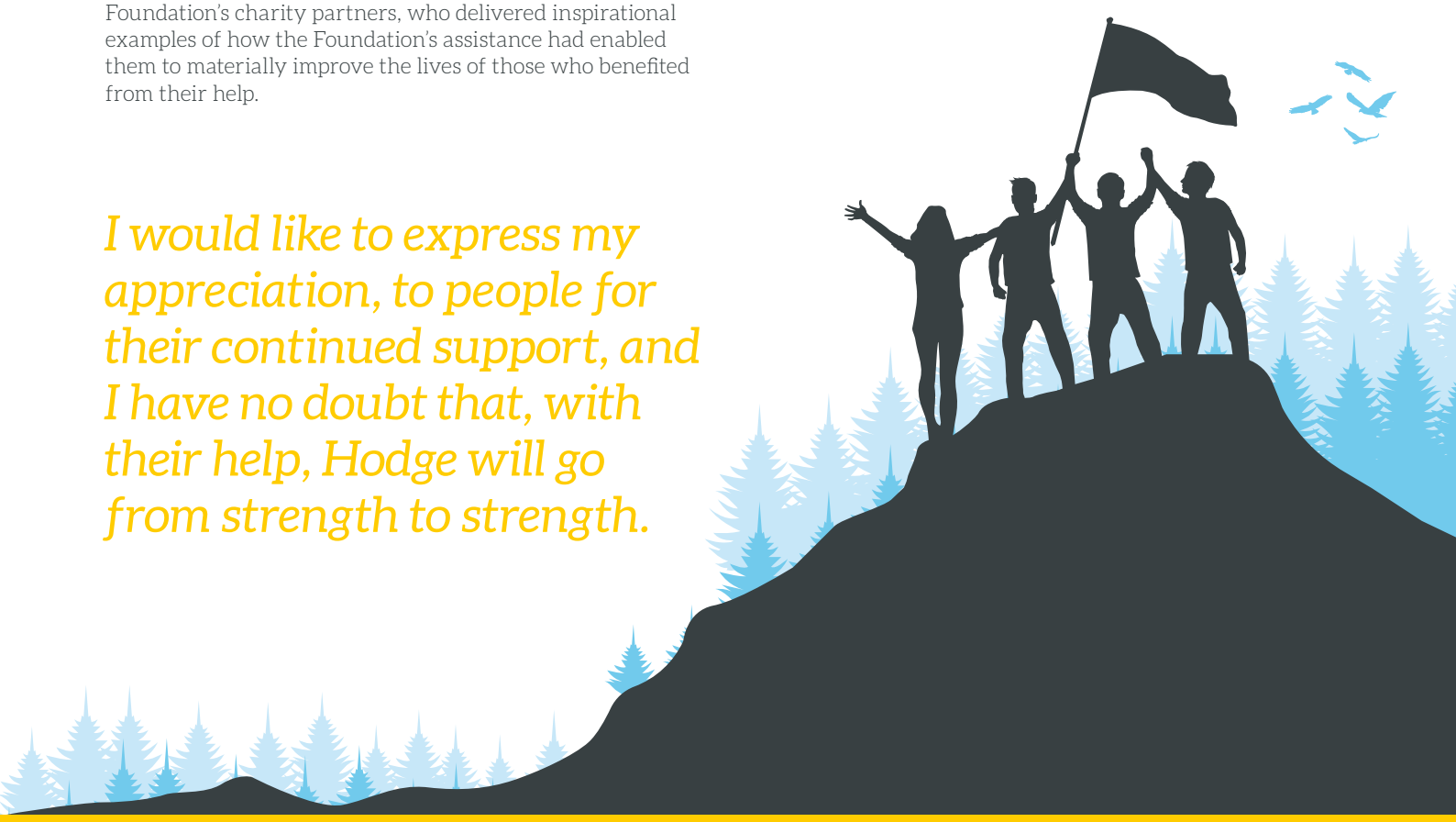


Governance and the Board

From a Board perspective this has been a year of significant change. David Austin, who has been with the Group for 28 years and been its Chief Executive for 21 years is retiring in early 2019. I would like to thank David for his outstanding dedication and commitment over that period.

In light of David's impending departure, much of the year has been spent identifying and recruiting his replacement. In this respect we are delighted to have engaged the services of Steve Pateman who has had a long and distinguished career at a number of financial institutions, most recently as Chief Executive of Shawbrook Bank.

Prior to his role at Shawbrook, Steve led the UK banking businesses of Santander and was responsible for building out Santander's business and corporate banking activities. Before joining Santander, he had a number of senior management roles at Royal Bank of Scotland across its Corporate and Retail Banking Divisions.

Steve has recently joined Bank of Ireland as a Non-Executive Director; he is Vice President of the Chartered Banker Institute and a member of Council. He also chairs the Advisory Board of Arora Hotels. Steve will commence employment, subject to regulatory approval, with Hodge in January 2019 and we look forward to him joining the team.

Our Company Secretary, Rhian Yates is set to leave Hodge when her current maternity leave ends to take a career break and spend time with her young children. Rhian has been with the Group for 14 years, not only acting as Company Secretary but also as Head of Risk and Compliance. We would like to offer her our best wishes for the future.

The vacancy as Company Secretary has been filled by Kirsty Carlick who has been with Hodge for five years and previously acted as assistant to Rhian. I have no doubt that Kirsty will provide great support to the Board in her new role.

Maintaining the highest standards of corporate governance within Hodge remains central to my role, and in light of increased regulatory expectations with regards to the role of the non-executive director, we anticipate recruiting additional members to the Board during 2019.

Outlook

The defining issue for the economy over the next year and certainly the first half of 2019 will be Brexit. The market and political turbulence caused by the draft Brexit agreement announced in November is only likely to amplify as the March 2019 deadline for withdrawal approaches.

Against this backdrop we are taking a cautious approach to new business until we have greater clarity on the Brexit outcome.

Nevertheless, it is vital that we see through short-term volatility and position ourselves for the long-term. In this respect, we continue to invest significantly in people and systems to ensure that we have a business fit for purpose for the digital age whilst still retaining the key Hodge values which have brought us great success to date.

Adrian Piper
Chairman
19 December 2018

We continue to invest significantly in people and systems to ensure that we have a business fit for purpose for the digital age

Our Business, Strategy and Social Responsibility

Our business

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

Savings

The Group raises funds through Hodge Bank's retail savings offering with a range of deposit and saving accounts for personal, non-personal and business customers.

Annuities

The Group also raises funds through Hodge Lifetime offering competitive annuity rates to help maximise a customer's return from pension savings.

Lending: Mortgages

Hodge Lifetime provides mortgages specifically for the 55+ market, enabling customers to enhance their quality of life whilst retaining their home throughout retirement.

Commercial Lending

Hodge Bank offers bespoke funding solutions to active property investors as well as commercial mortgages for business owner occupiers.

We offer a full range of later life products assisting our customers prior to, at and post- retirement. Having been in this market since 1965 we have unrivalled expertise which allows us to develop products for customers based on a clear understanding of their needs.

Within our commercial lending business, we create value by providing a bespoke, tailored service in niche markets which are under-served by major banks and the emerging "challenger" banks.

We fund ourselves from the retail savings market and from customers wishing to convert their pension savings into an annuity.

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

Group strategy

The Board has adopted a strategic plan with the long-term aim of achieving strong and sustainable returns for our shareholder. At the heart of the Group's philosophy is a wish to protect its capital base for the benefit of its depositors, annuitants and shareholder by conducting business in those areas where it has the greatest expertise and experience and best understands the risks which it is taking.

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

Investment programme

During 2018, we continued to build deeper insight into our customers' needs, embedding the customer perspective into all that we do and allowing us to identify where we need to refine existing product and service offerings and develop new propositions which delight our customers.

These customer insights have once again reinforced our commitment to invest in our customer offerings, ensuring excellent service across online and more traditional paper and telephone channels.

Savings and investment

Building on our previous investment which allowed customers to apply for and open accounts online, customers can now also view their account balance, change personal details and choose options at maturity.

Mortgage Products

Within the year we have made significant progress in developing the capability to serve the mortgage advisers community through online channels, building the foundations of an intermediary portal, with a planned go live date scheduled for early in the new financial year.

Improved productivity, collaboration and security

We have continued the roll-out of new technology platforms and mobile devices to better support the increased flexibility and collaboration needs of our workforce, while ensuring we are well protected against the ever-changing cyber security threat landscape.

Improved management information

We have developed the business and technical capabilities to allow us to gain more meaningful insight from our data and have started to leverage this to better serve our customers and inform management decisions.

Information Management and Regulatory Compliance

Within the year GDPR was implemented and has led to the Group making significant progress in improving the management of our customer data.

Social responsibility

Being a socially responsible business is part of our DNA. 79% of the Group is owned by the Hodge Foundation, the charitable trust established by our late founder, Sir Julian Hodge.

The Foundation's aim is to support projects that have effective solutions to helping those most in need. It is exclusively grant-making and does not raise funds from the public. All its income is derived from its investments, most significantly its shareholding in our immediate parent, The Carlyle Trust Limited.

Our aim is to create a sustainable long-term business, generating profits that can assist the Foundation in achieving its aims of supporting projects in the medical, education, welfare and religious sectors.

We believe that our two primary businesses, commercial and later life lending are suitable activities to deliver that sustainability.

Financial Performance

2018 has been another successful year with a strong set of results continuing to deliver sustainable growth for our shareholders.

Key performance indicators

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

	2018	2017
Non-financial performance		
Customer Service Net Promoter Score (NPS)	+56.0 [1]	+53.0 [2]
Financial performance	**£m**	**£m**
Profit before tax	12.3	25.4
Adjusted profit before tax (note 3)	12.6	12.4
Net operating income	30.1	38.3
Adjusted net operating income (note 3)	30.4	25.3
Loans and advances to customers	1,242.3	1,153.9
Group financial ratios	**%**	**%**
Net interest margin [3]	1.99	1.76
Cost income ratio [4]	58.9	54.9
Financial soundness - Hodge Bank	**%**	**%**
Common Equity Tier 1 ratio	22.3	21.1
Leverage ratio	11.9	11.4
Liquidity Coverage Ratio (LCR)	236.8	169.0
Financial soundness - Hodge Life		
Solvency Capital Ratio (SCR)	183.0	202.0

[1] Source: Based on internal and external survey data
[2] Source: Based on external survey data
[3] Net interest margin: net interest income as a proportion of total assets.
[4] Cost income ratio: Administration expenses; as a proportion of adjusted net operating income.

Customer experience

As part of our commitment to deliver for our customers, we continue to measure customer service Net Promote Score (NPS). NPS captures the likelihood of our customers recommending Hodge based on their experience of our service. We have improved the approach to gathering this feedback through real time surveys which records the experience accurately and is allowing us to drive service improvements across a number of key touchpoints. This in turn reflects the increasing focus we are placing on customer feedback by establishing a wider voice of the customer programme. We are extremely pleased that our efforts in improving our customer experience have been reflected in an improved NPS score in 2018.

Income Statement overview

	2018 £m	2017 £m	% Change
Net interest and net fee income	39.4	32.0	23.1
Operating expenses	(18.8)	(14.5)	29.7
Impairment credit	1.0	1.6	(37.5)
Other income and fair value movements	(9.3)	6.3	(247.6)
Profit before tax	**12.3**	**25.4**	**(51.6)**

The Group's performance at both a net operating income and profit before tax level has deteriorated due to a planned increase in overheads, adverse fair value movements, changes in assumptions used to calculate the provision for insurance contracts and inclusion in the prior period performance of a one off fair value uplift of £3.9 million on a freehold investment property, the disposal of which was completed in 2018 at £nil gain or loss. Our preferred measure to assess the underlying performance of the group is adjusted net operating income.

Adjusted net operating income

Adjusted net operating income for the year which excludes these items amounted to £30.4 million (2017: £25.7 million) an increase of 20.2%. This was primarily driven by an increase in net interest earned.

Net interest income

The Group's net interest margin improved during the year at 1.99% (2017: 1.76%). This is a result of improved margins on our loans and advances to customers.

Operating expenses

Operating expenses rose by 29.7% in line with management expectations. Operating expenses have continued to increase due to substantial investment in people, premises and systems to enable us to carry out our plans to grow the business over the coming years.

Impairment provisions for losses on loans and advances

The Group retains a robust approach to risk management and this, combined with a relatively benign credit environment, has resulted in an impairment credit of £1.0 million (2017: £1.6 million credit), within which our collective charge fell to £0.1 million (2017: £0.2 million) reflecting the reduced risk profile of the Group's loan book. The individual impairment provision of £3.6 million was 42% lower than 2017 (£6.2 million) as the Group successfully resolved a number of legacy cases.

Other income and fair value movements

Other income and fair value movements amounted to a loss of £9.3 million (2017: gain of £6.3 million). This loss relates to one-off adjustments due to changes in assumptions used to calculate the fair value of lifetime mortgages.

Balance Sheet overview

	2018 £m	2017 £m	% Change
Liquid assets	513.1	450.4	13.9
Loans and advances to customers	1,242.3	1,153.9	7.7
Investment properties	179.1	205.2	(12.7)
Other assets	13.7	11.4	20.1
Total assets	**1,948.2**	**1,820.9**	**7.0**
Deposits from banks	72.5	2.8	2,589.3
Deposits from customers	994.1	941.8	5.6
Provision for long term business	437.0	416.9	4.8
Share capital and reserves	316.1	306.8	3.3
Other liabilities	128.5	152.6	(15.8)
Total liabilities and equity	**1,948.2**	**1,820.9**	**7.0**

Loans and advances to customers

The Group continues to focus on its core markets of commercial and later life lending; the Group has seen continued growth in both of these markets with net lending of £88.4 million up 7.7% from 2017. The net lending figure has been driven by record gross lending of £225.9 million (2017: £202.0 million) offset by redemptions due to the maturity profile of our loan books and the successful exit of a number of legacy commercial lending exposures.

Funding

Retail savings remain a primary funding source and during the year we have focused on enhancing the services we provide to customers through improving our digital efficiency. At the year-end savings balances were £994.1 million (31 October 2017: £941.8 million); this increase was driven by our on-line presence.

The Group also provides pension annuities in the open market through its Hodge Lifetime brand. Hodge Lifetime offers competitive annuity products to our customers, regularly featuring in best buy tables. During the year the Group generated £47.5 million (2017: £29.3 million) of new annuity premiums.

Liquidity

The Group holds liquid assets to meet its financial obligations in both business as usual and stressed situations. As at the year end, the Group held £513.1 million of liquid assets (31 October 2017: £450.4 million) which are available to protect it from liquidity stresses.

Bank segment
Liquidity levels continued to be within Board risk appetite and regulatory requirements throughout the period. This includes the Liquidity Coverage Ratio (LCR), which ensures that sufficient high-quality liquid assets are held to survive a short term severe but plausible liquidity stress. The Bank's LCR as at 31 October 2018 was above the regulatory minimum of 100% and increased to 236.8% (2017: 169.0%) due to strong retail deposit performance increasing the liquid asset buffer.

The Net Stable Funding Ratio (NSFR) is a longer-term stable funding metric, which measures the sustainability of the Bank's long-term funding. Based on current interpretations of the regulation, the NSFR is in excess of 100%, and the Bank aims to hold sufficient stable funding to meet the new requirements.

The Bank is a participant in the Bank of England's Term Funding Scheme, and also has access to contingent liquidity through the Bank of England's Sterling Monetary Framework.

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

Defined benefit pension scheme

The Group operates a defined benefit scheme available to all employees as part of our commitment to provide competitive remuneration packages. As at 31 October 2018 the scheme had a deficit (the difference between scheme assets and scheme liabilities) of £12.8 million (31 October 2017: £13.0 million); the fall in deficit was caused by a reduction in the scheme liabilities due to an increase in bond yields which increased the discount rate for scheme liabilities. The Group made contributions to the scheme of £2.0 million in 2018 (2017: £1.6 million).

Capital

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

Bank segment
The Bank's primary measure for assessing capital adequacy is the Common Equity Tier 1 ratio (CET1); this ratio assesses the amount of the highest quality of capital as a proportion of risk weighted assets. The Bank uses standardised risk weights to calculate the risk weighted exposure. As at 31 October 2018 the Bank's CET1 ratio stood at 22.3% (2017: 21.1%).

Leverage
Alongside the CET1 ratio we actively monitor our leverage ratio; this is a capital ratio that excludes the risk weighting of assets. The leverage ratio at 31 October 2018 was 11.9% (2017: 11.4%), calculated in accordance with CRD IV. At present, we are not captured under the Financial Policy Committee's leverage ratio framework. However, the leverage ratio will not become a binding requirement until 2022, albeit the Bank comfortably meets the new requirements.

Life assurance segment
Hodge Life's primary metric in assessing capital adequacy is the Solvency Capital Ratio (SCR) which was introduced in 2016 as part of the Solvency II package of measures. This ratio assesses available capital resources as a proportion of capital requirements. Hodge Life uses the Standard formula to calculate its capital requirements. As at 31 October 2018, the SCR stood at 183% (2017: 202%); the fall in ratio was driven by a £16.0 million dividend paid during the year to Hodge Limited.

Solvency II has had the effect of increasing the capital cost of writing new business and we are in the process of preparing our Matching Adjustment and Partial Internal Model application to the PRA, which would allow us to increase new business volumes to a more sustainable level. During the year the Bank of England published its Consultation Paper 13/18 which proposes changes to the treatment of Equity Release Mortgages within Solvency II. The consultation has wide ranging impacts for the equity release firms who hold Equity Release Mortgages and have been successful in developing their own Partial Internal model and matching application, given these wide-ranging implications the Bank of England has delayed implementation to December 2019. Hodge Life will continue to monitor developments as it continues its own process of gaining the requisite approval.

Corporate Governance

A comprehensive corporate governance framework is vital in supporting executive management in its execution of strategy and in driving long-term sustainable performance.

It helps ensure that the shareholder's investment in Hodge is protected, while at the same time recognising the interests of our wider stakeholders.

The Board's agenda during 2018 was focused on overseeing and supporting executive management to deliver on Hodge's strategic objectives. It is during periods of significant change, which Hodge is currently undergoing, that leadership and good governance are more important than ever.

The Boards of Hodge Limited and those of its regulated subsidiaries, Hodge Bank and Hodge Life comprise two executive and five non-executive directors. In each case the roles of Chairman and Chief Executive are separate to ensure that neither can exercise unfettered powers of decision-making on matters of material importance.

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

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

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

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

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

The Audit Committee has reviewed the effectiveness of the Group's system of internal financial control during the year.

Governance framework

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

The Board

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

The Board holds regular discussions with the Group's major shareholders to ensure a clear understanding of their views and requirements. A shareholder covenant has been agreed detailing the shareholder expectations of the Group.

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

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

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

Adrian Piper – Chairman

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

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

Alun Bowen - Non-executive director

Alun joined the Board in 2013, is the Chair of the Risk and Conduct Committee and is a trustee of the Hodge Foundation.

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

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

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

Jonathan Hodge - Non-executive director

Jonathan is the son of the Group's founder, Sir Julian Hodge, and represents the family's interest on the Board.

Jonathan joined the group in 1983, was appointed Group Managing Director in 1985 and held that position until reverting to a non-executive role in 2011. He continues to chair the parent Company, The Carlyle Trust Limited, and the Board of Trustees of the Hodge Foundation, as well as the Nomination Committee of Hodge.

Helen Molyneux - Non-executive director

Helen joined the Board in June 2015, is Chair of the Remuneration Committee and is a trustee of the Hodge Foundation.

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

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

The Board (continued)

John Barbour - Non-executive director

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

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

David Landen – Chief Financial Officer

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

David Austin – Chief Executive

David joined the Board in 1991 as Finance Director and was appointed Chief Executive of the Bank in 1997 and of the Group in 2011. David is a chartered accountant having spent twelve years at KPMG in its Cardiff office.

Board Committees

The Board has established the following standing committees:

Audit Committee:

John Barbour (Chair), Jonathan Hodge, Helen Molyneux, Adrian Piper and Alun Bowen.

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

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

The committee meets at least four times a year.

A report from the chair of the Audit Committee can be found on page 31.

Risk and Conduct Committee:

Alun Bowen (Chair), Jonathan Hodge, Helen Molyneux, John Barbour and Adrian Piper.

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

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

The committee meets at least four times a year.

A report from the chair of the Risk and Conduct Committee can be found on page 37.

Board Committees (continued)

Remuneration Committee:

Helen Molyneux (Chair), Alun Bowen, Jonathan Hodge, John Barbour and Adrian Piper.

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

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

The committee meets as required.

A report from the chair of the Remuneration Committee can be found on page 44.

Nomination Committee:

Jonathan Hodge (Chair), Alun Bowen, Helen Molyneux, John Barbour and Adrian Piper.

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

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

The committee meets as required.

A report from the chair of the Nomination Committee can be found on page 43.

Board and Committee Membership and Attendance

Name	Board (c)		Audit Committee		Risk and Conduct Committee		Remuneration Committee		Nomination Committee	
	(a)	(b)	(a)	(b)	(a)	(b)	(a)	(b)	(a)	(b)
Adrian Piper	8	8	4	4	4	4	3	3	4	4
John Barbour	8	7	4	4	4	3	3	2	4	3
Jonathan Hodge	8	7	4	4	4	3	3	3	4	4
Helen Molyneux	8	8	4	4	4	4	3	3	4	4
Alun Bowen	8	8	4	4	4	4	3	3	4	4
David Austin	8	8	4	4	4	4	-	-	-	-
David Landen	8	8	4	4	4	4	-	-	-	-

(a) Number of meetings held
(b) Number of meetings attended
(c) Board meetings of the immediate parent, The Carlyle Trust Limited

Risk Management

As a Group, managing risk effectively is fundamental to our strategy and to operating successfully.

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

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

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

Three Lines of Defence Model

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

First line of defence - Day-to-day risk management

The first line of defence has responsibility for implementation of the Group's strategy and for the management of risk across the organisation and comprises executive committees, management and staff. The first line of defence ensures all key risks are identified, monitored and mitigated by appropriate controls. Each employee has responsibility for the risks that fall within their day-to-day activities.

Second line of defence - Risk oversight

The second line of defence, the Compliance and Risk function and Risk and Conduct Committee, is responsible for providing independent oversight and challenge of activities undertaken by the first line and provides guidance on risks relevant to the strategy. The Risk function is led by the Head of Risk, who reports to the Chief Executive Officer and has an independent reporting line to the Chairman of the Risk and Conduct Committee. It maintains and reports an aggregate view of risks and performance in relation to risk appetite to the Risk and Conduct Committee on a quarterly basis. The Risk function is not customer facing and has no responsibility for business targets or performance.

Third line of defence - Internal Audit

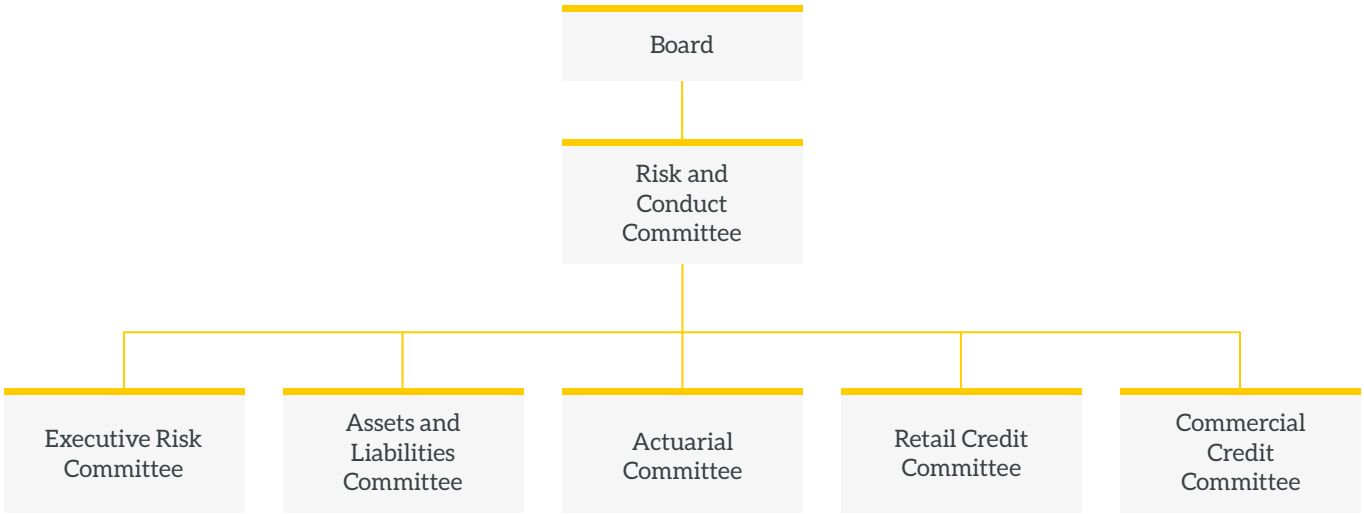
The third line of defence provides objective assurance on the effectiveness of the Group's governance and risk management processes and controls. This assurance is obtained through the use of internal audit services provided by PwC, to the Audit Committee. Internal audit reports directly to the Chairman of the Audit Committee as well as the Chief Executive Officer and is independent of the first and second lines of defence.

Risk Governance

The Board is ultimately responsible for the overall risk governance and effective management of risk within the Group. The Board determines the risk strategy and ensures that risk is monitored and controlled effectively. The Risk and Conduct Committee is a Board committee that reviews, on behalf of the Board, the key risks inherent in the business and the control framework in place to manage such risks, presenting its findings to the Board.

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

Risk governance is supported by a structure comprising five executive committees, each reporting into the Risk and Conduct Committee and Board as shown below:



Risk and Conduct Committee

Risk and Conduct Committee is chaired by a Non-Executive Director and oversees the management of risk and the conduct of business on behalf of the Board to ensure significant risks are identified, understood, assessed and managed and that good customer outcomes are achieved.

Executive Committees

Each committee is chaired by the Chief Executive, with the exception of the Actuarial Committee, which is chaired by the Chief Executive of Hodge Life. Each committee includes appropriate representation from the Senior Leadership Team and risk specialists. The responsibilities of each of the committees is set out below:

Executive Risk Committee

The Executive Risk Committee is responsible for monitoring and overseeing exposure to operational and conduct risks arising from the Group's activities. The committee meets quarterly.

Assets and Liabilities Committee

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

Executive Committees (continued)

Actuarial Committee

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

Retail Credit Committee

The Retail Credit Committee's principal responsibility is to monitor and control retail credit risk throughout the Group and ensure risk underwriting is appropriate. The primary credit risk arises from loans to customers through the Hodge Lifetime division. The Committee meets as required, but as a minimum will meet four times a year.

Commercial Credit Committee

The Commercial Credit Committee's principal responsibility is the implementation and maintenance of the overall risk management framework relating to commercial credit risk. The Committee is also responsible for reviewing, challenging and if appropriate, approving credit proposals for new commercial lending deals that are within its remit as set by the Board. The Committee meets as required, but as a minimum will meet four times a year.

Risk Strategy

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

Risk Appetite

The Board sets a Risk Appetite to define the level of risk that the Group is willing to accept or wishes to avoid in order to meet its business objectives. A risk appetite statement is in place that includes both qualitative statements and quantitative measures and addresses each of the key risk types faced by the Group as articulated within the Risk Strategy. The risk appetite statements are linked to the Group's strategy and supported by a suite of risk metrics, limits and triggers designed to monitor the Group's exposure to the principal risks.

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

Risk Culture

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

Stress testing and planning

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

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

Stress testing and planning (continued)

Banking segment

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

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

Life assurance segment

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

Reverse Stress Testing

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

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

Recovery Planning

There continues to be a strong focus on 'resolvability' from UK and European regulators with requirements issued through the Bank Recovery and Resolution Directive (BRRD) allowing a common approach to be taken. A key element of this directive is the continual maintenance of a formal Recovery Plan and a Resolution Plan which are also submitted to regulators on an annual basis. The Recovery Plan describes the strategy and a 'menu of actions' that could be taken by management to allow the recovery of the Bank from a significant adverse event which would otherwise lead to failure. The Resolution Plan provides data required by the PRA to be used to facilitate a rapid and orderly resolution in the event that the recovery of the Bank could not be achieved whilst maintaining any critical functions provided by the Bank to the economy.

The Recovery Plan is informed by the outcomes of the stress and scenario testing framework which the Board and senior management use to determine the strategy and actions to support a potential recovery.

Current threats and emerging risks

An emerging risk is a risk that has the potential to have a significant detrimental impact on the Group's performance, but currently the outcome and time horizon is more uncertain or more difficult to predict than for other risks that are inherent in the Group's Balance Sheet. The Group conducts on-going horizon scanning to identify new risks that could threaten achievement of the strategy and ensure they are captured in the risk management framework as early as possible. The governance structure in place enables a strong awareness of current and emerging risks, which are recorded and monitored to ensure that appropriate mitigation and monitoring strategies are adopted. Each risk on the register is assessed to determine its potential impact and likelihood of crystallising, in line with the Group's risk rating methodology. Mitigating actions are logged, business owners allocated and warning indicators identified to ensure effective ongoing monitoring. Oversight of emerging risks is provided by the Risk and Conduct Committee.

Principal Risks

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

Credit risk

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

Key drivers and appetite
Credit risk emerges from commercial lending exposures, mortgage loans to retail customers and from investments held by the Treasury function. The Group is willing to be exposed to a moderate level of risk for an acceptable return.

Our Approach
The Group assesses its exposure to and management of credit risk with reference to three sub-categories:

Retail Credit Risk
The risk of financial loss from mortgages due to the customer's failure to service interest or repay capital.

Commercial Credit Risk
The risk of financial loss from a commercial lending customer's failure to settle financial obligations as they fall due or movements in commercial real estate prices.

Treasury Credit Risk
The risk that a debt issuer or counterparty will fail to make payments (either interest or principal) in a timely manner or the credit worthiness of borrowers deteriorate reducing the value of investments.

Within each business line there is dedicated first line risk management provided by appropriately skilled credit managers and treasury staff. Pricing of lending products includes a component of margin to cover expected credit losses. Treasury counterparties are restricted to a number of well-established and externally rated institutions.

The following mitigation practices are in operation:

- Board approved underwriting policies and authorisation mandates are in place for each sub-category in order to direct lending decisions, ensuring that the Group lends responsibly while taking an acceptable level of credit risk.
- Strong rating and scoring systems and controls to support lending decisions with the addition of affordability stress tests for individual retail customers.
- Limitations on concentration risk across portfolios are implemented via risk appetite limits on large exposures, geographical and sectoral exposures, and loan to income ratios.
- Appropriately skilled colleagues are employed by the Group to monitor and manage credit risk within the defined parameters set by the Board.
- Portfolio level stress testing and scenario analysis.

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

Pension risk

The risk of a financial loss due to adverse movements in the value of scheme asset and liabilities.

Key drivers and appetite
Pension risk arises due to adverse movements in market factors such as interest rates and inflation, as well as longevity assumptions negatively affecting the value of the scheme asset and liabilities.

Our approach
The Trustees actively manages risks arising from its defined benefit scheme through the management of the scheme's investment strategy to mitigate the potential mismatch of investments with its obligations under the scheme. The Trustees regularly monitors the scheme deficit and future funding requirements. Every three years the trustees of the scheme agree a plan to ensure the scheme eliminates any deficit arising over an acceptable time horizon; the last formal valuation was agreed by trustees and approved by the Group in 2016 and a plan to eliminate the deficit was agreed. The Group regularly monitors actual performance of the scheme against this agreed recovery plan.

GMP equalisation
On the 26 October 2018, in a long awaited ruling, the High Court determined that defined benefit pension schemes will be required to equalise benefits for the effect of inequalities between males and females in respect of Guaranteed Minimum Pensions (GMP) accrued after 17 May 1990. The method for equalisation remains unclear with further announcements expected during 2019, as such the Group has not recognised any liability for this equalisation but initial estimates show that the potential impact is not material.

Liquidity risk

The risk that the Group is unable to meet its financial obligations as they fall due, or can do so only at excessive cost.

Key drivers and appetite
The Group maintains a prudent liquidity profile to ensure it has sufficient liquid resources to meet anticipated outflows/commitments in business-as-usual and under stressed conditions.

Our approach
Treasury provides strong first line risk management expertise in liquidity risk management and risk management processes and has day to day responsibility for the management of liquidity within defined Board policies and limits.

The following mitigation techniques are in operation:

- Maintenance of a liquidity buffer of high quality liquid assets.
- Well matched maturity profile of assets and liabilities.
- Composition, credit quality and maturity profile of liquidity portfolio and funding balances in line with agreed policies.
- Liquidity stress tests run to ensure the Group maintains adequate levels of liquidity for business purposes even under stress.
- Extensive contingency funding plans in place.
- Reporting of regulatory liquidity metrics; Liquidity Coverage Ratio, Net Stable Funding Ratio and internal metrics i.e. Overall Liquidity Adequacy Requirement.
- Weekly monitoring of liquidity adequacy, portfolio composition and changes and refreshed cashflow forecasts by ALCo.

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

Property price risk

The risk of changes in values caused by market prices or volatility of market prices differing from their expected values.

Key drivers and appetite
Property price risk is driven by commercial lending, reversions, lifetime mortgages and the No Negative Equity Guarantee on lifetime mortgage products. The Group is willing to accept a moderate level of property price risk for an acceptable return but wishes to employ risk management strategies to reduce associated volatility.

Our approach
The Group has a depth of risk management expertise within its first line underwriting functions to ensure the active management and on-going monitoring of property price risk exposure and Actuarial Committee monitors historical performance and the future outlook for house prices.

The following mitigation techniques are in operation:

- Limits on the loan-to-value acceptable for individual loans.
- Limits on the exposure to individual borrowers.
- Limits on the exposure to individual types of commercial lending.
- Geographical concentration limits on lending.

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

Interest rate risk

The risk that movements in market interest rates result in loss of economic value or reduction to net earnings.

Key drivers and appetite
Interest rate risk arises due to the different repricing characteristics of the Group's assets and liabilities. The Group aims to minimise the interest rate risk that it is exposed to where it is commercially viable to do so.

Our approach
The Treasury function has day to day responsibility for the management of interest rate risk within defined Board policies and limits. Where possible the interest rate structure of assets is matched with liabilities to create a natural hedge to interest rate risk. Where this is not possible interest rate derivatives may be used to mitigate the exposure. A perfect match is not always commercially effective which leads the remaining interest rate risk exposures to be managed within approved limits.

The following mitigation techniques are in operation:

- Use of derivatives to mitigate the exposure to interest rate risk.
- Specific product characteristics considered for hedging requirements.
- Assessment of interest rate risk in line with regulatory requirements.
- Various interest rate stress tests are applied to the portfolio.
- Well-defined policies for the management of interest rate risk and derivative instruments.

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

Underwriting risk

Interest/Mortality risk
The risk that longer/shorter policyholder life expectancy results in financial losses for the Group.

Lapse Risk
The risk that a high rate of mortgage lapse results in financial losses for the Group.

Key drivers and appetite
Insurance risk exposure is driven primarily through annuities and legacy reversions and is partially offset by the exposure to mortality risk driven through lifetime mortgages. The exposure to lapse risk is primarily driven by lifetime mortgages and is heightened in times of low interest rates and increased competitor activity.

Our approach
Strong expertise is maintained within the first line actuarial function to support the active management and monitoring of underwriting risk exposure. The Chief Actuary is treated as a first line role rather than formal second line oversight. Additional oversight in this area is provided by an external technical adviser, to help to mitigate potential conflicts of interest and to assist the Board with decision-making on technical actuarial matters.

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

Conduct risk

The risk that the Group's behaviour results in poor outcomes for customers.

Key drivers and appetite
Conduct risk is inherent in any business that provides products or services to customers. Failing to treat customers fairly and deliver good outcomes would have a detrimental impact on the success and sustainability of the Group. The Group is only willing to tolerate negligible levels of conduct risk. The Board recognises that later life customers are at greater risk of vulnerability and so products and services are designed with this in mind.

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

- **Distribution and Sales** - Products offered by the Group may be unsuitable for certain people or circumstances, but purchased regardless. Products may not be the best match for their needs.
- **Product Servicing** - Post sale, customers may not be treated fairly by the Group.
- **Product Design** - Terms and conditions may include inherent flaws or issues that result in poor outcomes for customers, whether in aggregate or under certain scenarios.
- **Culture and Governance** - The Group's governance processes are insufficient, weak or poorly designed resulting in a failure to identify the instances of poor outcomes. Culture and management direction may result in deliberate or consequential bias towards group performance to the detriment of customer outcomes.

Conduct risk - Continued

Our Approach
Distribution and Sales
The Board requires that all later life lending products are distributed via independent brokers to ensure that customers receive independent advice. Further, deposits and commercial lending products are offered on an execution-only basis. Approval processes are in place to ensure that product literature is clear, fair and not misleading and complies with relevant regulation and legislation.

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

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

Culture and Governance
Reward strategies and incentives are not based on sales targets and mandatory conduct risk and customer outcomes training is in place for all new and existing employees.

Strategic risk

The risk of loss through failure to define, develop and implement an effective and realistic strategic plan.

Key drivers and appetite
Strategic risk can arise from changes to the business model and also the risk of the business model or strategy proving inappropriate due to macroeconomic, political, regulatory or other impacts. The risk to delivery of the strategy is deemed to be the principal risk.

Our approach
Close management and monitoring of the strategic plan along with in-depth stress testing reported regularly through the Group's committee structure to Board and senior management. This is supported through additional risk reporting and monitoring of the key threats to the business on risk registers and horizon scanning to ensure the business can respond in appropriately.

Operational risk

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

Key drivers and appetite
The Group accepts that operational risks arising from its people, processes, systems or the external environment are a natural consequence of its business operations but seeks to avoid or mitigate the risk to a minor level wherever practical.

The Group assesses its exposure to and management of operational risk with reference to ten core sub-categories:

- **Process** - Losses from failed transaction processing or process management.
- **Model** - Models are incorrect or mis-used, leading to inappropriate business decisions.
- **Fraud** - Losses due to acts of a type intended to defraud, misappropriate property or circumvent regulations, the law or group policy.
- **People** - Failure to manage the human resources of the Group in order to maximise its value.
- **Compliance** - Failure to comply with legal and regulatory requirements.
- **Systems** - IT systems do not meet the requirements of the Group or are not maintained to a high standard to ensure agreed availability.
- **External** - Disruption to business model and / or operations due to political, legal or regulatory changes, adverse publicity or external disasters.
- **Change** - Failure to successfully deliver change to achieve defined strategic benefits or failure to operate robust change implementation controls resulting in disruption to operational processes and/or the customer journey.
- **Security** - Failure to manage the physical or information security of the Group leading to disruption to operational processes, customer impact and/or financial loss.
- **Third Party** - Services provided by third parties fail to meet required standards leading to disruption to operational processes, customer impact and/or financial loss.

Our approach
Operational policies and procedures, supported by staff training, are in place to govern the way in which these risks are managed across the business. Senior management are responsible for understanding the nature and magnitude of risks within each business area, and for implementing appropriate controls to mitigate those risks. Operational losses and near-misses are recorded and analysed to determine whether there are any systemic issues that need to be addressed by the business.

Horizon scanning is conducted to identify emerging regulatory and legal developments to ensure that the business can respond appropriately.

The Board is mindful that, as the digital capability of the Group increases, the risk associated with cyber-attacks also increases. As such, particular focus continued to be given to this area throughout the year to ensure a robust cyber response.

Long-term Viability Statement and Going Concern

We benefit from diversification between our Hodge Lifetime business and our commercial lending business, which enables our services to be provided in a capital-effective way allied with our track record in attracting funding from different sources.

Assessment of prospects

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

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

The Board believes that the market for our later life lending products will be strong for at least the next ten years. This is supported by demographic trends and the increasing customer demand to release equity. The market for annuity products is less clear, however, the directors believe there is still a good baseline demand. The reduction in annuity providers has reduced competition and a "normalisation" of interest rates over the next ten years would make annuities more attractive. Our commercial lending proposition is more dependent on shorter-term client relationships; however, the team has a good track record of identifying new relationships and converting them into customers. The digitalisation of our deposit and savings products will assist in making Hodge less dependent on its existing customer base and our commitment to ensuring that customers can deal with us through their channel of their choice means that the directors are confident that Hodge will continue to retain and attract loyal depositors.

Viability statement

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

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

- The Plan is reviewed by the directors in detail at least annually. The Plan makes certain assumptions about the performance of the Group and the economic, market and regulatory environments in which it operates. The planning process is underpinned by a robust stress testing framework to ensure compliance with the Group's risk appetite.

- Alternative forecasts are also constructed against a number of stress scenarios, including a robust downside scenario as part of the Board's review of Hodge Bank's ICAAP. This involves considering a severe stress to the UK economy, with a significant fall in both residential property prices and secondary commercial real estate values and low interest rates for a sustained period. The results of the ICAAP are submitted to and discussed with the PRA. Hodge Life carries out a similar process as part of its ORSA. The principal stress scenarios that have been tested are a significant fall in residential house prices, a significant increase in longevity and sustained low interest rates.

- Liquidity stress tests are conducted as part of the Bank's ILAAP. The ILAAP demonstrates that the Bank holds sufficient liquid assets to meet cash outflows during a severe-but-plausible scenario where there is a combined, market-wide and firm specific stress.

- The review also considered all aspects of emerging regulation where there is sufficient clarity to inform the analysis. For example, the assessment of the Bank's capital position reflects the latest understanding of the capital buffer and leverage requirements likely to be imposed on the Bank.

Based on this assessment, the directors confirm that they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due during the period to 31 October 2023. Accordingly, the financial statements continue to be prepared on a going concern basis.

Adrian Piper
Chairman
19 December 2018

Report from John Barbour, Chair of the Audit Committee

This report follows my first full year as Chair of the Audit Committee and I thank my fellow Board members and senior management for their support and contributions over the year.

The year ended 31 October 2019 will represent the first year in which Julian Hodge Bank Limited reports under IFRS9. A great deal of work has gone into preparing for this change and thanks are due to all involved for the work performed on this important project.

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

Financial statement reporting issues

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

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

Area of Focus	Role of Audit Committee	Conclusion / Action Taken
Annuities The judgement in relation to the longevity of Hodge Life's annuitants is important. Although the assessment of mortality is subjective, there is a lot of mortality data available. Hodge makes its assessment in the context of industry data plus the information and experience it has in relation to its own portfolio of annuitants.	The Committee reviewed a paper prepared by the Chief Actuary in relation to longevity. The paper recommended that the mortality tables used for determining longevity should be based on the Continuous Mortality Improvements (CMI) table published in 2017, as opposed to the equivalent table published in 2016. The Committee challenged the Chief Actuary on his proposal and also took advice from the Board's actuarial advisor in relation to industry experience and his own experience.	The Committee was satisfied that the move to the latest mortality/ longevity basis was supported by industry trends and was also appropriate in the specific circumstances of Hodge Life's annuity portfolio.

Area of Focus	Role of Audit Committee	Conclusion / Action Taken
Equity release mortgages Hodge exercises judgement in the valuation of its equity release assets in Hodge Bank and Hodge Life. The assumptions relating to the timing and quantum of value realised in equity release properties are subjective due to a number of variables more of which can be estimated with certainty. Realised value is impacted by the timing of individuals; • selling their property due to downsizing; • moving into long-term care; or • refinancing the mortgage with another lender. Other assumptions arise in relation to determining an appropriate value for the "no negative equity guarantee" embedded in equity release products. Future house price inflation (specifically relating to the type of properties that are held by Hodge) and longevity are key variables, as is the assumption regarding the discount rate used to value its equity release mortgages. The work that has been carried out in relation to the MA/PIM project has meant that Hodge's data has been subject to more scrutiny than ever before. This has led to the refinement of a number of assumptions, in the area of property experience.	The Committee reviewed a paper produced by the Chief Actuary, which included a detailed analysis of the Group's lapse experience relating to refinancing, downsizing and moving into long-term care. It also challenged the basis of the assumption made in relation to long-term house price inflation and longevity (as for annuities on page 31). It also obtained information from the Board's actuarial advisor.	The Committee concluded that the assumptions included in the valuation of the equity release mortgage portfolio of Hodge Bank and Hodge Life were appropriate.
Commercial lending The assessment of the loan loss provision required on the commercial lending portfolio in Hodge Bank requires a number of assumptions in relation to size and timing of future cash flows, including the value of collateral. This will be the last time that this exercise is carried out in this form as in future years Hodge will be subject to IFRS 9.	The Committee considered a report from management on the adequacy of loan impairments at 31 October 2018, including assessing internal and external trends, methodologies and key management judgements.	The Committee challenged a number of the judgements made in management's impairment report and after discussion agreed both the individual impairment and collective loan loss provision assessments.

Financial statement reporting issues (continued)

Area of Focus	Role of Audit Committee	Conclusion / Action Taken
Expenses Assumptions have to be made in relation to the future growth of Hodge Life's business and the current and future cost base, to assess the costs included in both asset valuations and provisions for future liabilities.	The Committee reviewed a paper prepared by the Chief Actuary on the expense assumptions and also took advice from the Board's actuarial advisor.	The Committee confirmed that it was satisfied with the assumptions made by the Chief Actuary in relation to expenses.
Derivatives Hodge Bank has a substantial number of derivative financial instruments, relative to its Balance Sheet size. These hedge the risk to changes in interest rates and yield curves. The majority of these derivatives are valued at fair value as at the Balance Sheet date. A proportion of interest rate derivatives are accounted for under IAS 39 hedge accounting rules. Significant changes in rates can affect their effectiveness as a hedge, which might lead to income volatility or a different accounting treatment.	The Committee obtained confirmation from management that the valuation of derivatives at the year-end are in accordance with the amounts recognised by the relevant counterparties and that the hedge effectiveness calculations had been carried out appropriately. Management were also able to evidence, for derivatives settled in the year, that the value attributed by counterparties prior to breaking the derivative was in line with the valuation held by the Group.	The Committee was satisfied that the fair value of the derivatives was appropriately reflected in the financial statements and that, where hedge accounting was applied, it was effective.
IFRS 9 A significant activity for the Committee during the year has been overseeing the Group's preparation for the implementation of IFRS 9. IFRS 9 Financial Instruments is effective for Hodge from 1 November 2018 and replaces the IAS 39 accounting standard.	The Committee reviewed the guidance note to non-executive Directors from the PRA in relation to IFRS 9 implementation and was comfortable that the areas highlighted by the PRA were being addressed. The Committee received regular updates on the status, judgements and financial impacts relating to the implementation of IFRS 9 during the year. It has overseen the steps required for Hodge's transition to the new standard. In particular the delivery into production of the models which are required for its implementation.	The Committee has been closely involved in the review of financial reporting relating to IFRS 9 and has focused on ensuring clarity, completeness and appropriateness of the Group's disclosures, particularly given the complexity and technical challenges of this standard. Throughout the process, the Committee has emphasised to management the importance of developing the models to support business decision making to manage risk appropriately and ensure that IFRS 9 is fully embedded in Hodge Bank's systems.

Area of Focus	Role of Audit Committee	Conclusion / Action Taken
Long term viability The Directors make a statement in the Annual Report as to the long-term viability of Hodge. The Committee provides advice to the Board on the form and content of the statement, including the underlying assumptions.	The Committee reviews the Board's assessment of long term viability through consideration of the Group's rolling five-year strategy, the Bank's assessment of capital (ICAAP), the Bank's assessment of liquidity (ILAAP) and Hodge Life's assessment of its own risk and solvency (ORSA).	The Committee agreed to recommend the long-term viability statement to the Board.
Fair, balanced and understandable reporting Hodge endeavours to ensure that its external reporting is fair, balanced and understandable. The Committee undertakes an assessment on behalf of the Board in order to provide the Board with assurance that it can make the statement recommended by the Financial Reporting Council's Corporate Governance Code.	The Committee assessed, via discussion with, and challenge of, management (including the Chief Executive and Chief Financial Officer), as to whether disclosures in Hodge's published financial statements were fair, balanced and understandable.	Having evaluated all of the available information and the assurances provided by management the Committee concluded, and were able to recommend to the Board, that Hodge's published report and financial statements were fair, balanced and understandable.

External audit

The relationship with Ernst and Young (EY) is now well-established. Andy Blackmore has been Hodge's audit partner for three years, since the last audit tender.

For the first time Julian Hodge Bank Limited conducted an interim profits review in order to permit profits earned in the first half to be included in the capital base. This went smoothly and has helped to raise further the level of understanding of Hodge within the audit team. The increased familiarity of the Hodge business continues to contribute to an improved audit process and outcomes.

A formal review of the effectiveness and audit quality of EY was carried out in 2018, including the EY's team's professional scepticism and objectivity.

The Committee is responsible for assessing the objectivity and independence of EY. This responsibility was discharged through the Audit Committee meetings and during private meetings with EY.

The Committee has a policy whereby all services which are not covered in the audit are approved by the Committee. It also enhanced Hodge's policy in relation to non-audit fees to reflect, inter alia, the issue of the Ethical Standard by the Financial Reporting Council. The Audit Committee asked EY to assist it on five matters outside of the annual statutory audit and Solvency II audit: GDPR awareness training; assistance, consistent with its external auditor responsibilities in relation to IFRS 9; assurance on the model validation for the MA/PIM project; assurance services relating to the term funding scheme submission and the interim net profits review. The skills and experience made EY the most suitable supplier of the non-audit service as they already had considerable relevant knowledge of the subject. The payments made to EY for non-audit fees in the year ended 31 October 2018 was £305k (2017: £51k). This reflects a non-audit fee to audit fee ratio of 210.3%, the average for the last two financial years since the new regulations was introduced is 133.8%. I will ensure that the average non-audit fee for the first three financial years since the new regulations were introduced is below the 70% limit set by the FRC.

Internal audit

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

The Committee scrutinises and agrees Internal Audit's plans, including agreeing the areas of focus, which this year included a review of the Group's Change Programme, Risk Management Framework, Treasury Operations, Know Your Client & Anti Money Laundering ML and IT Operations.

Internal Audit also reviewed some of the major returns required by the regulator, such as the ORSA and ICAAP, enabling the Group to benefit from PwC's experience of similar returns prepared by other companies.

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

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

Internal control

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

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

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

Committee composition and meetings

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

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

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

Whistleblowing

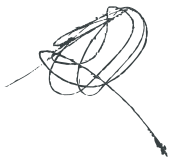
I am the Whistleblowing Champion for Hodge and have reviewed the integrity, independence and effectiveness of Hodge's whistleblowing policies and procedures and also those policies and procedures intended to protect whistleblowers from being victimised and I am satisfied that these are appropriate.

Interaction with regulators

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

Committee performance

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



John Barbour
Chairman of the Audit Committee
19 December 2018

Report from Alun Bowen,
Chair of the Risk and Conduct Committee

The Committee's work continues to be driven by a number of challenges, arising from regulatory change, an evolving market and external threats.

In last year's report I commented that Hodge had a number of projects underway and that the effective management of risk in these projects would be important. A Change Board has been established in the first line of defence to ensure that this risk is managed as effectively as possible. I also commented that the Risk Management Framework continues to be developed; during the year greater clarity has been provided on reporting lines, escalation procedures have been enhanced and limits and triggers have been reviewed to ensure that they are appropriate and effective. In addition, a considerable amount of work has taken place to ensure that the management information provided to the Committee is relevant and focused enough to enable good decision making.

The Committee has been actively involved with ensuring that Hodge's cyber security control environment continues to develop. Hodge's increasing digital presence, combined with the increased threat of cyber risk generally, means that our digital security capability needs continuing enhancement.

My prescribed responsibilities as Chair of the Risk and Conduct Committee are to safeguard the independence of, and oversee the performance of, both the risk and compliance functions. During the year the Head of Risk and Compliance was on maternity leave and ultimately, she decided not to return to work.
The decision was taken to appoint an experienced Head of Compliance and appoint a Head of Risk, which has provided a greater focus on both these activities. The Head of Compliance has been involved heavily in overseeing the implementation of GDPR which came into place on 26 May 2018. This was a significant project where Hodge took the opportunity to widen the scope to include a comprehensive review of data quality and data retention policies and practices and implemented changes to make these processes more effective.

I have regular one-to-one meetings with the Head of Risk and Compliance to ensure that their views are communicated directly to me, independent of management. They are continually looking to enhance their respective functions and I am actively involved in supporting their efforts, as appropriate, with management. Both teams continue to be strengthened and members of the risk and compliance teams now participate fully in all Hodge's projects at an early stage, ensuring that their input can be integrated in an effective manner.

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

The behaviours that I see within Hodge, from a risk management perspective, continue to be good. However, it is important that this behaviour takes place within a risk management framework which is well-established, well understood and is "fit for purpose".

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

Area of Focus	Action taken by the Risk and Conduct Committee	Conclusion or further action taken
Risk appetite and stress testing This involves considering the level of risk Hodge chooses to take in pursuit of its business objectives, including testing whether Hodge's financial position and risk profile provides sufficient resilience to withstand the impact of severe economic stress.	Assessed the risk context for Hodge's Strategic Plan, including general economic and financial conditions and how these are reflected in the Strategic Plan. Approved a Group Risk Strategy to ensure that Hodge's Strategic Plan is closely linked with its risk appetite. Held a risk workshop, with executive management, and debated the key risks and macro-economic factors facing Hodge and determined plausible stress test scenarios for further work. Reviewed the mandated and internal stress tests and approved revised limits and triggers.	The Committee recommended the proposed Risk Appetite to the Board for approval. It again emphasised to management that the mix of new business written by Hodge should become more capital efficient. It also encouraged management to investigate the highly capital intensive commercial lending business where possible.
Capital and funding Ensuring there is sufficient capital to meet Hodge's regulatory requirements and to support shareholder expectations. A high percentage of longer-term assets and liabilities in both Hodge Bank and Hodge Life are held at fair value and hence subject to market volatility. Changes in, for example, the yield curve can lead to volatility in the financial results and increased capital requirements.	Debated on a regular basis, capital performance against plan and regulatory requirements. Reviewed the implementation of management's plans, to reduce as far as possible the volatility on longer-term assets and liabilities held at market value.	The Committee recommended to the respective boards the approval of Hodge Bank's ICAAP and Hodge Life's ORSA and their subsequent submission to the regulator. The Committee supported the forecast capital and the actions identified by management to manage the Group's capital position and the actions taken to reduce volatility. However, it also encouraged management to continue to explore the options available to further reduce portfolio volatility.
Liquidity Ensure there is sufficient liquidity so that Hodge can meet its obligations, as they fall due, and meet regulatory requirements.	Assessed on a regular basis liquidity performance against both internal and regulatory requirements.	The Committee recommended to the respective boards the approval of Hodge Bank's ILAAP and the liquidity aspects of Hodge Life's ORSA.

Area of Focus	Action taken by the Risk and Conduct Committee	Conclusion or further action taken
Risk management framework The framework's policies, talent and tools in place to support effective risk management and oversight.	Reviewed the maturity of the risk management framework and management's plans to continue to enhance it. Provided management with input on the quality and relevance of risk information being provided to the Committee and recommended improvements.	The Committee will continue to track the planned improvements in the risk management framework and the information provided to the Committee. The Committee recognises that management information needs to be dynamic and respond quickly to market, regulatory and internal changes.
Cyber security The threat of individuals or organisations penetrating Hodge's digital and other business systems for the purpose of compromising data or committing fraud.	Reviewed the actions proposed by management in Hodge's digital journey to ensure that cyber security risk is minimised. Received presentations from a third party on its assessment of Hodge's cyber security maturity.	The Committee was encouraged at the pace of progress and will keep under review due to the ever-changing cyber security landscape.
Conduct risk The risk of detriment to customers from the inappropriate supply of financial services.	Continued to review all Hodge's products on a cyclical basis to ensure that product features remain appropriate and reviewed management's proposed actions to address any issues identified during the reviews. Reviewed the processes to identify vulnerable customers ensuring that the assistance provided to them is relevant to their circumstances. Reviewed Hodge's complaints record and the actions taken by management to resolve issues. Reviewed the features of the RIO mortgage product before its launch to ensure that any potential conduct issues had been appropriately identified and addressed.	The Committee was satisfied that Hodge's product range and any actions proposed are appropriate in the current economic and regulatory climate. It was pleased with the relatively low number and minor nature of the complaints received and the speedy and effective action taken by management to resolve issues. The Committee encouraged management to continue its efforts to embed awareness of conduct risk. A refresher training programme was carried out for all colleagues.
General Data Protection Regulation ("GDPR") The implementation of GDPR, which came into effect on 26 May 2018, means that the regulation of personal data is much more prescriptive as individuals have more rights in relation their data. It also introduced a strict monetary fine regime if organisations breach the regulations.	The Committee reviewed management's plans to comply with GDPR and had regular updates on progress and ensured that the team implementing GDPR had access to sufficient resources and that the project was given enough emphasis within the organisation.	The Committee was satisfied with the progress that was made by the implementation date and has continued to monitor progress with follow-up actions to improve the management of customer data.

Area of Focus	Action taken by the Risk and Conduct Committee	Conclusion or further action taken
Credit, house price, longevity, pension, regulatory and emerging risks Significant risks that could have a material impact on Hodge's business and also its capital requirements.	Received regular reports on the impact of these risks and the work being carried out by management to manage these risks and the investigations carried out to ensure that the data is as robust as possible. Evaluated the potential impact of regulatory developments on Hodge's risk profile. Debated extensively each area of material risk, the trends and the controls in place. Engaged with Hodge's actuarial adviser as to developments in longevity and the approach taken by Hodge's in-house actuarial team in relation to its review of assumptions. Evaluated emerging risks and their potential effect on the business.	The Committee was satisfied that there was sufficient focus on the key risks facing the business and that actions proposed by management were being effectively implemented. It was also satisfied, based on its own experience, with support from its actuarial adviser, that the approach being adopted by the in-house actuarial team is appropriate and in accordance with best practice.
Business Continuity Plan and Recovery and Resolution Plan The policies and procedures in place to ensure that Hodge can meet its regulatory and business obligations in the event of a major change in circumstances.	The Recovery and Resolution Plan prepared by management had been reviewed in 2017, and is currently being reviewed to meet enhancements required by changes in regulations. The Committee discussed the current state of business continuity plans and the extent they had been tested in practice.	The Committee encouraged management to ensure that the Recovery and Resolutions Plans were practical and focused on Hodge's particular circumstances. The Committee was satisfied with the current status of business continuity planning.

Risk information provided to the Committee

The Committee receives regular reports on risk management issues and tracks a wide range of metrics through a Consolidated Risk Report produced by the Head of Risk. This report provides an overview of the Group's risk profile compared with the Group's Risk Appetite. The Head of Risk's report contains commentary on the Group's principal risks and includes a Risk Appetite Dashboard which highlights at a glance those area that might require attention through a "traffic light" system with further detailed provided on significant matters.

Interaction with management

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

Interaction with regulators

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

Ongoing training and development

In last year's report I stated that the issue of training was being assessed at Board level, this programme will be implemented in the next financial year, however members' programme of development included the following training activity during the year:

- GDPR;
- Cyber security;
- Interest rate risk refresher;
- Regulatory changes.

Committee performance

The Committee carried out a self-assessment of its performance (last year the Committee's performance was assessed by an independent facilitator) and concluded that the changes from previous assessments had been appropriately implemented. The Committee recommended that the Board should review the number of meetings of the Risk and Conduct Committee that are held annually in order to ensure that its coverage of activity is sufficient and avoid having to delegate any activity back to the Board.

Alun Bowen
Chair of the Risk and Conduct Committee
19 December 2018

Report by Jonathan Hodge, Chair of the Nomination Committee

In addition to its regular review of succession planning, the Committee has this year dealt with the planning for one significant change to the board. As noted by the Chairman of Hodge earlier in this Annual Report, David Austin, the Group chief executive, indicated in late 2017 his wish to retire in early 2019, subject to the successful recruitment of a successor in the intervening period.

The Committee appointed a sub-committee comprising the Chair, Adrian Piper and Helen Molyneux to oversee the recruitment exercise, supported by our Head of People Services. Proposals were invited from leading recruitment agencies, resulting in the appointment of the recruitment firm Odgers Berndtson. With their assistance, we formulated the desired profile for the next CEO and agreed a search and selection process.

To support this, the Committee requested the Remuneration Committee to give guidance on an indicative remuneration package for the role. Adverts were placed on two of the main internet-based recruitment services and a long list of candidates was drawn up, both from respondents to the adverts and from those approached directly by Odgers Berndtson, for consideration by the sub-committee. These included internal candidates.

Following a detailed review of the profiles prepared by Odgers Berndtson, the sub-committee agreed a short list of five candidates for interview. Following a lengthy process involving two interviews by the sub-committee and expert psychometric testing, one outstanding candidate was identified for recommendation to the full Nomination Committee and the Board. The Board then approved the candidate together with a remuneration package recommended by the Remuneration Committee. Following this, terms were agreed with the chosen candidate, subject to satisfactory references and regulatory approval.

The appointment of Steve Pateman, subject to regulatory approval, was announced on 26 October 2018. It has been agreed that Steve will join the Group on 7 January 2019.

Besides ad-hoc meetings to deal specifically with the recruitment of a new Chief Executive Officer, the Committee met on four occasions to conduct routine business, including reviews of the executive and non-executive director succession plans and the appointment of a new Company Secretary, the previous incumbent, Rhian Yates having decided that she would not return to the business following her maternity leave. In this respect we were delighted to appoint Kirsty Carlick, previously Assistant to the Company Secretary, to this role.

We also reviewed and approved plans for the further development of the knowledge and skills of board members and improved governance processes around individual and collective performance reviews.

Members of the Committee sat on the selection and interview panels for the recruitment of the Head of People Services, Head of Savings and Head of Compliance.

Looking to the future, we acknowledge that there is a desirability to recruit additional non-executive directors with expertise in particular fields pertinent to the business sectors in which we are engaged.

The appointment of John Barbour in 2017, who has extensive knowledge of treasury matters, has demonstrated the benefits that the board can derive from such recruitment.

Over the coming year, we will seek to extend this initiative with at least two more appointments and the ultimate aim is to have a broad range of experience and expertise on each of the boards of our regulated companies, some with expertise specific to our businesses and some with more general business expertise who can bring their knowledge and experience of other sectors.

As part of this exercise we will look to improve the diversity of board members provided suitable candidates can be identified.

Jonathan Hodge
Chair of the Nomination Committee
19 December 2018

Report from Helen Molyneux, Chair of the Remuneration Committee

Following the recruitment of our new Head of People Services, Sarah-Ellen Stacey, this has been a year of review, planning and prioritisation for the Remuneration Committee. Our work on culture which began last year moved on apace, with the establishment of the Colleague Alliance, creation of our values and the staging of our first Colleagues' 'We are Hodge' away day event, when every colleague was invited to spend the day away from the office discussing what our culture and values mean and exploring the relationship between the business and our Foundation shareholder.

Remuneration and reward

The Remuneration Committee, working with our new Head of People Services, set the key priorities for the year, focusing on those areas of reward and remuneration that required immediate attention and planning for the future review of those that required more detailed and strategic consideration.

The employment market in South Wales is buoyant with recruitment of talented staff becoming more competitive. Overseeing and approving strategies designed to enable us to offer competitive packages and retain colleagues was therefore a key focus for the Remuneration Committee. In particular, the following areas were addressed:

- The Group's Maternity and Paternity Policy was reviewed and the benefits considerably enhanced, to support the retention of key talent and attract high calibre female candidates.
- A benchmarking exercise was conducted to establish the competitiveness of our salary strategy, and adjustments made to bring any outliers into line. As a result, our lowest salary is now above the Living Wage set by the living wage foundation.
- Better internal communications of our current benefits package was established to promote the value already offered.
- Volunteer Days' are being introduced, allowing colleagues to take up to 4 days paid leave per annum to work as a volunteer.
- The efficacy of the LTIP (Long Term Incentive Plan) scheme for senior executives was reviewed to ensure that it was delivering its objectives. Renewal of the LTIP has been postponed to coincide with the arrival of the new Chief Executive.
- The annual bonus scheme for all staff was reviewed in line with the outputs from our culture project and a new measure – NPS scores – was introduced to ensure that the scheme drives the cultural behaviours that we are seeking to reinforce.

Chief Executive Recruitment

The Remuneration Committee supported the successful appointment process for the new Chief Executive, establishing and approving an appropriate remuneration and reward package which was independently benchmarked.

Looking Ahead

Our key priorities for 2019 have been established and include a complete review of our Remuneration Strategy, from which will flow a number of projects including consideration of the gender pay gap; a flexible benefits review, including the introduction of a total rewards benefit statement, flexible working and wellbeing measures, and a review of our bonus scheme strategy – both for our senior and more junior colleagues – with a view to ensuring that it motivates our colleagues and supports the culture and behaviours we are working hard to embed throughout the organisation.

Helen Molyneux
Chair of the Remuneration Committee
19 December 2018

Directors' Report

The directors present their report together with the audited financial statements for the year ended 31 October 2018.

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

Directors and directors' interests

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

Adrian Piper *	Chairman
David Austin	Chief Executive
David Landen	Chief Financial Officer
Alun Bowen *	
Jonathan Hodge *	
Helen Molyneux *	
John Barbour *	

* Non-executive

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

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

Political contributions

The Group made no political contributions during either year.

Post Balance Sheet events

There were no post Balance Sheet events to disclose.

Dividend

No dividends have been declared or paid during the year.

Qualifying third-party indemnity provisions

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

Re-appointment of auditors

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

Employees

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

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

On behalf of the Board of Directors

David Landen
Director
19 December 2018

Statement of Directors' Responsibilities in respect of the Strategic Report, the Directors' Report and the Financial Statements

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

Company law requires the directors to prepare financial statements for each financial year. Under that law they have elected to prepare the Group financial statements in accordance with International Financial Reporting Standards and Interpretations (collectively IFRSs) issued by the International Accounting Standards Board (IASB) as adopted by the European Union ('adopted IFRSs') and those parts of the Companies Act 2006 that are applicable to companies that prepare financial statements in accordance with IFRS. The Company has elected to prepare the financial statements in accordance with UK Accounting Standards and applicable law (UK Generally Accepted Accounting Practice) including Financial Reporting Standard 101 Reduced Disclosure Framework (FRS 101).

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

- Select suitable accounting policies and then apply them consistently;
- Make judgements and estimates that are reasonable and prudent;
- State whether applicable IFRS or UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements;
- Prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the Company will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

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

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

1. The Group financial statements prepared in accordance with IFRS, give a true and fair view of the assets, liabilities, financial position and profit of the Group.
2. The Strategic Report includes a fair view of the development and performance of the business and the position of the Group together with the description of the principal risks and uncertainties that it faces.
3. The Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary for the shareholder to assess the Group's position and performance, business model and strategy.
4. The directors who held office at the date of approval of this directors' report confirm that, so far as they are each aware, there is no relevant audit information of which the Group's auditor is unaware; and each director has taken all the steps that he ought to have taken as a director to make himself aware of any relevant audit information and to establish that the Group's auditor is aware of that information.

Independent Auditor's Report
to the Members of Hodge Limited

Opinion

In our opinion:

- Hodge Limited's Group financial statements and parent Company financial statements (the "financial statements") give a true and fair view of the state of the Group's and of the parent Company's affairs as at 31 October 2018 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;
- the parent Company financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

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

Group	Parent Company
Consolidated Income Statement for the year then ended	Company Balance Sheet as at 31 October 2018
Consolidated Balance Sheet as at 31 October 2018	
Consolidated Statement of Comprehensive Income for the year then ended	
Consolidated Statement of Changes in Equity for the year then ended	Company Statement of Changes in Equity for the year then ended
Consolidated Statement of Cash Flows for the year then ended	
Related notes 1 to 39 to the financial statements, including a summary of significant accounting policies	Related notes 1 to 39 to the financial statements including a summary of significant accounting policies

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

Basis for opinion

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

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

Conclusions relating to going concern

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

- the directors' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate;

  or

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

Overview of our audit approach	
Key audit matters	• The risk that inappropriate actuarial assumptions are used in the valuation of equity release mortgage assets • The risk that inappropriate property valuations are applied in the calculation of the commercial loan loss provision • The risk of incorrect valuation of derivatives
Audit scope	• We performed an audit of the complete financial information of both subsidiaries of the Group, being Julian Hodge Bank Limited and Hodge Life Assurance Company Limited.
Materiality	• Overall Group materiality of £6.4m which represents 2.0% of equity.

Key audit matters

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

Risk	Our response to the risk	Key observations communicated to the Audit Committee
Actuarial assumptions relating to the equity release mortgage assets and annuity liabilities (Loans and advances to customers (lifetime mortgages): £685.2m, 2017: £692.5m, Investment properties – reversionary interest in properties: £179.1m, 2017: £192.4m, Long term business provision: £437.0m, 2017: £416.9m) The valuation of the equity release mortgage assets (lifetime mortgages and reversionary interest in properties) and annuity liabilities is highly judgemental as it relies upon a number of assumptions with high estimation uncertainty, including those in respect of the No Negative Equity Guarantee (NNEG), voluntary early redemption, discount rate, policyholder mortality/longevity and expenses. Inappropriate assumptions may lead to a material misstatement in the financial statements. The lifetime mortgages are disclosed as loans and advances to customers in note 18 of the financial statements, with the principal assumptions, sensitivities and analysis of changes to key assumptions disclosed in note 34(d). The reversionary interest in properties are disclosed as investment property in note 21 of the financial statements, which also includes sensitivity analysis of changes to key assumptions.	We performed a walkthrough to understand the assumption setting process and tested controls within the process. Utilising our actuarial specialists, we assessed and challenged the assumptions used within the Equity Release Mortgage (ERM) asset and the annuity liability valuations to ensure that they are in line with peer companies, internal experience analysis and the requirements of financial reporting and regulatory standards. The key assumptions we focussed our audit work on were as follows: **No Negative Equity Guarantee** We have considered each of the assumptions used within the NNEG calculation, considering a combination of historic and projected future house price growth, the potential variability in it and as well as the specific experience of the portfolio. **ERM voluntary early redemption** We considered the voluntary early redemption assumptions on the business compared with observed experience in the portfolio and compared with the assumptions of other peer companies in the sector. Particular attention was paid to the implications for actual experience of the revised ERM operating environment that has emerged over the last 2-3 years.	Overall, we consider the assumptions that are used within the ERM asset valuations and annuity liability technical provisions to be reasonable with individual assumptions closer to the middle of our acceptable range than the prior year.

Key audit matters (continued)

Risk	Our response to the risk	Key observations communicated to the Audit Committee
The annuity liabilities are disclosed as Provisions for long term business - liabilities arising from insurance contracts in note 27 of the financial statements, which also includes sensitivity analysis of changes to key assumptions.	**Discount rate** We assessed the discount rate assumption used in the valuation of the ERM assets and long term provision. This includes benchmarking the discount rates against the discount rates used by other companies in the sector as well as relative liquidity levels and customer rates available in the market. **Policyholder mortality/longevity** We assessed the mortality assumptions by considering recent actual experience and comparing the assumption adopted by management for future improvements with those used by other companies in the sector, allowing for particular factors around the profile of the Group's business compared to the industry experience **Expenses** Our assessment considered both recent and future expected expense experience and how this has been appropriately reflected within the unit costs and inflation assumptions used within the valuation.	
Collateral valuations for the commercial loan loss provision: £3.7m (2017: £6.4m) The assessment of the loan loss provision is inherently judgemental, with the valuation of the collateral a key input to the calculation of the provision. The loan collateral is disclosed in note 34 of the financial statements.	We performed a walkthrough to understand the provisioning process, and tested the controls over the valuation of collateral. We also assessed the provisioning methodology to ensure compliance with financial reporting standards. For a sample of individually impaired loans we utilised our property valuation team specialists to evaluate whether a sample of the property valuations were materially correct at the reporting date. This involved understanding the latest developments on the property and performing an independent valuation of the collateral. The sample covered £30.2m (2017: £32.6m) of the collateral for the loans with indicators of impairment.	The controls within the process were tested and were operating effectively. For the sample selected for testing, each item was evaluated and determined to be within an acceptable range.

Key audit matters (continued)

Risk	Our response to the risk	Key observations communicated to the Audit Committee
Valuation of derivative financial instruments: £107.6m (2017: £131.2m) The Group has significant derivative financial instruments, which it uses to manage interest rate risk. The valuation of these derivatives is determined through the application of valuation techniques which often involve the exercise of judgement and the use of assumptions and estimates. Due to the significance of the financial instruments and the related estimation uncertainty this is considered a key audit risk. The financial statement value is the counterparty valuation, which is independently assessed for reasonableness by management. The fair value of these derivative financial instruments is disclosed in note 26 of the financial statements.	Utilising our derivative valuation specialists we reperformed the valuation of a sample of derivative financial instruments. We compared our independent valuation to management's valuation and considered whether management's value was within an acceptable threshold. The sample selected covered £85.6m (2017: £125.3m) of the total population.	The valuation of the sample selected was determined to be within an acceptable range.

An overview of the scope of our audit

Tailoring the scope

Our assessment of audit risk, our evaluation of materiality and our allocation of performance materiality determine our audit scope for each entity within the Group. Taken together, this enables us to form an opinion on the consolidated financial statements. We take into account size, risk profile, the organisation of the Group and effectiveness of controls, including controls and changes in the business environment when assessing the level of work to be performed.

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

Our application of materiality

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

Materiality

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

We determined materiality for the Group to be £6.4m (2017: £6.1m), which is 2.0% (2017: 2.0%) of equity. We believe equity to be the most appropriate basis as the key stakeholders (including the principal shareholder and the PRA for the regulated subsidiaries) are focused on the financial strength and solvency position of the business, which is represented in the financial statements by equity.

We determined materiality for the parent Company to be £1.3m (2017: £1.3m), which is 1.6% (2017: 2.0%) of equity. We believe equity to be the most appropriate basis as the parent Company is a holding Company with limited trading activity.

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

Performance materiality

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

On the basis of our risk assessments, together with our assessment of the Group's overall control environment, our judgement was that performance materiality was 75% (2017: 50%) of our planning materiality, namely £4.8m (2017: £3.1m) for the Group. We have set performance materiality at this percentage because our prior year audit experience indicates a lower risk of misstatements, both corrected and uncorrected.

Audit work at component locations for the purpose of obtaining audit coverage over significant financial statement accounts is undertaken based on a percentage of total performance materiality. The performance materiality set for each component is based on the relative scale and risk of the component to the Group as a whole and our assessment of the risk of misstatement at that component. In the current year, the allocated performance materiality for Julian Hodge Bank Limited was £2.6m (2017: £1.7m) and for Hodge Life Assurance Company Limited was £3.4m (2017: £2.3m).

Reporting threshold

An amount below which identified misstatements are considered as being clearly trivial.

We agreed with the Audit Committee that we would report to them all uncorrected audit differences in excess of £0.1m (2017: £0.1m), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

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

Other information

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

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

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of the other information, we are required to report that fact.

We have nothing to report in this regard.

Opinions on other matters prescribed by the Companies Act 2006

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

- the information given in the strategic report and the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the strategic report and directors' report have been prepared in accordance with applicable legal requirements.

Matters on which we are required to report by exception

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

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

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

Responsibilities of directors

As explained more fully in the Directors' Responsibilities Statement set out on page 47, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

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

Auditor's responsibilities for the audit of the financial statements

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

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

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

Our approach was as follows:

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

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

This description forms part of our auditor's report.

Other matters we are required to address

- We were appointed by the Group on 30 November 2017 to audit the financial statements for the year ending 31 October 2017 and subsequent financial periods.
- The period of total uninterrupted engagement including previous renewals and reappointments is 2 year, covering the years ending 31 October 2017 to 31 October 2018.
- Non-audit services prohibited by the FRC's Ethical Standard were not provided to the parent Company or Group and we remain independent of the parent Company and Group in conducting the audit.
- The audit opinion is consistent with the additional report to the Audit Committee.

Use of our report

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

Ernst & Young LLP

Andy Blackmore
(Senior statutory auditor) for and on behalf of
Ernst & Young LLP, Statutory Auditor
Bristol
20 December 2018

Notes

[1] The maintenance and integrity of the Hodge Limited web site is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the web site.

[2] Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Annual Report and
Financial Statements 2018

Financial Statements

Consolidated Income Statement

For the year ended 31 October 2018

	Notes	2018 £m	2017 £m
Interest receivable and similar income	5	66.6	60.0
Interest payable and similar charges	6	(27.8)	(27.9)
Net interest income		**38.8**	**32.1**
Fees and commissions receivable		2.4	1.8
Fees and commissions payable		(1.8)	(1.9)
Net fee and commission income/(expense)		**0.6**	**(0.1)**
Earned premiums	7	47.5	29.3
Investment income	8	15.4	15.9
Gross claims and benefits paid		(24.5)	(23.6)
Movement in long-term business provision	27	(20.1)	11.8
Other operating income	9	0.1	1.0
Other fair value losses	10	(27.7)	(28.1)
Net operating income		**30.1**	**38.3**
Administrative expenses	11	(17.9)	(13.9)
Depreciation and amortisation		(0.9)	(0.6)
Impairment provision for losses on loans and advances to customers		1.0	1.6
Profit before taxation	**12**	**12.3**	**25.4**
Tax on profit	13	(1.9)	(3.2)
Profit for the financial year		**10.4**	**22.2**

Consolidated Statement of Other Comprehensive Income

For the year ended 31 October 2018

	Notes	2018 £m	2017 £m
Profit for the financial year		10.4	22.2
Items that will not be reclassified subsequently to profit and loss:			
Re-measurement of defined benefit pension plan	31	0.6	0.4
Deferred tax thereon	22	(0.1)	(0.1)
Movement of pension scheme reimbursement asset	23	(0.1)	(0.9)
Deferred tax thereon	22	-	0.1
Items that may be transferred to the Income Statement Available-for-sale investments:			
Fair value movements taken to reserves		(1.8)	(0.1)
Deferred tax thereon	22	0.3	(0.8)
Total other comprehensive income		**(1.1)**	**(1.4)**
Total comprehensive income for the year		**9.3**	**20.8**

The results for the year ended 31 October 2018 relate entirely to continuing operations.
The notes on pages 67 to 142 form part of these financial statements.

Consolidated Balance Sheet

For the year ended 31 October 2018

	Notes	2018 £m	2017 £m
Assets			
Cash and balances held at central banks	14	153.2	87.0
Treasury bills	15	99.6	97.3
Debt securities	16	148.4	131.2
Loans and advances to credit institutions	17	111.9	134.9
Loans and advances to customers	18	1,242.3	1,153.9
Intangible assets	19	3.1	1.7
Property, plant and equipment	20	2.2	2.0
Investment properties	21	179.1	205.2
Deferred tax assets	22	2.2	2.2
Other assets	23	6.2	5.5
Total assets		**1,948.2**	**1,820.9**

	Notes	2018 £m	2017 £m
Liabilities			
Deposit from banks	24	72.5	2.8
Deposits from customers	25	994.1	941.8
Derivative financial instruments	26	107.6	131.2
Provisions for long term business - liabilities arising from insurance contracts	27	437.0	416.9
Accruals and deferred income	28	3.2	3.7
Other liabilities	29	4.8	4.4
Other provisions	30	0.1	0.3
Pension scheme deficit	31	12.8	13.0
Total liabilities		**1,632.1**	**1,514.1**
Share capital and reserves			
Called-up share capital	32	66.0	66.0
Other reserves		250.1	240.8
Total equity		**316.1**	**306.8**
Total equity and liabilities		**1,948.2**	**1,820.9**

These financial statements were approved by the Board of directors on 19 December 2018 and were signed on its behalf by David Landen.

David Landen
Director

Company Balance Sheet

For the year ended 31 October 2018

	Notes	2018 £m	2017 £m
Assets			
Shares in group undertakings	38	82.0	66.0
Total assets		**82.0**	**66.0**

	Notes	2018 £m	2017 £m
Share capital and reserves			
Called-up share capital	32	66.0	66.0
Other reserves		16.0	-
Total equity		**82.0**	**66.0**
Total equity and liabilities		**82.0**	**66.0**

These financial statements were approved by the Board of directors on 19 December 2018 and were signed on its behalf by:

David Landen
Director

Consolidated Statement of Changes in Equity

For the year ended 31 October 2018

Group	Called up Share Capital £m	Profit and Loss Account £m	Available - for - sale Reserve £m	Pension Reserve £m	Total £m
2018					
At beginning of year	66.0	245.3	4.2	(8.7)	306.8
Profit for the financial year	-	10.8	-	(0.4)	10.4
Other comprehensive income	-	-	(1.5)	0.4	(1.1)
At end of year	**66.0**	**256.1**	**2.7**	**(8.7)**	**316.1**

Group	Called up Share Capital £m	Profit and Loss Account £m	Available - for - sale Reserve £m	Pension Reserve £m	Total £m
2017					
At beginning of year	-	283.7	5.1	(7.8)	281.0
Profit for the financial year	-	22.6	-	(0.4)	22.2
Other comprehensive income	-	-	(0.9)	(0.5)	(1.4)
Issue of share capital	66.0	(61.0)	-	-	5.0
At end of year	**66.0**	**245.3**	**4.2**	**(8.7)**	**306.8**

Company Statement of Changes in Equity

For the year ended 31 October 2018

Company	Called up Share Capital £m	Profit and Loss Account £m	Total £m
2018			
At beginning of year	66.0	-	66.0
Profit for the financial year	-	16.0	16.0
At end of year	**66.0**	**16.0**	**82.0**

Company	Called up Share Capital £m	Profit and Loss Account £m	Total £m
2017			
At beginning of year	-	-	-
Profit for the financial year	-	-	-
Issue of share capital	66.0	-	66.0
At end of year	**66.0**	**-**	**66.0**

Consolidated Statement of Cash Flows

For the year ended 31 October 2018

	Notes	2018 £m	2017 £m
Cash flows from operating activities		**71.2**	**(85.6)**
Taxation paid		(2.2)	(12.6)
Net cash inflow (outflow) from operating activities		**69.0**	**(98.2)**
Cash flows from investing activities			
Purchase of treasury bills	15	(45.5)	(21.3)
Proceeds from sale of treasury bills	15	41.7	17.9
Purchases of debt securities	16	(55.4)	(31.6)
Proceeds from sale of debt securities	16	36.0	29.5
Additions to intangible assets	19	(2.0)	(0.7)
Additions to plant property and equipment	20	(0.6)	(0.2)
Net cash (outflow) from investing activities		**(25.8)**	**(6.4)**
Cash flows from financing activities			
Issue of share capital		-	5.0
Net inflow from financing activities		**-**	**5.0**
Net increase/(decrease) in cash and cash equivalents		43.2	(99.6)
Cash and cash equivalents at start of year		221.9	321.5
Cash and cash equivalents at end of year		**265.1**	**221.9**
Cash held at central banks repayable on demand	14	153.2	87.0
Loans and advances to credit institutions repayable on demand (1)	17	111.9	134.9
Cash and cash equivalents at year end		**265.1**	**221.9**

(1) Loans and advances to credit institutions includes collateral held by swap counterparties of £83.6 million (2017: £104.9 million) which is pledged against the market value of derivative instruments and comprises interest-bearing cash deposits. Collateral that has been pledged and held is not restricted and is returned at the end of the contract.

A Analysis of The Balance of Cash and Cash Equivalents

2018	Notes	At 31 October 2017 £m	Cash flow £m	At 31 October 2018 £m
Cash held at central banks repayable on demand	14	87.0	66.2	153.2
Loans and advances to credit institutions repayable on demand	17	134.9	(23.0)	111.9
		221.9	43.2	265.1

2017	Notes	At 31 October 2016 £m	Cash flow £m	At 31 October 2017 £m
Cash held at central banks repayable on demand	14	168.0	(81.0)	87.0
Loans and advances to credit institutions repayable on demand	17	153.5	(18.6)	134.9
		321.5	(99.6)	221.9

B Reconciliation of Operating Profit to Operating Cash Flows

	Notes	2018 £m	2017 £m
Cash flows from operating activities			
Profit before tax		12.3	25.4
Depreciation of plant property and equipment	12	0.4	0.4
Amortisation of intangible assets	12	0.5	0.2
Impairment provision credit for losses on loans	12	(1.0)	(1.6)
Net Income Statement losses on treasury bills	15	1.3	1.7
Net Income Statement losses on debt securities	16	0.6	0.4
Net change in loans and advances to customers	18	(87.4)	(38.4)
Net change in investment property	21	26.1	3.2
Net change in other assets	23	(0.2)	(2.9)
Net change in deposits from banks	24	69.7	-
Net change in deposits from customers	25	52.3	(44.9)
Net change in derivatives	26	(23.6)	(20.0)
Net change in provision for long term business liabilities	27	20.1	(11.8)
Net change in other liabilities and accruals	28 & 29	(0.1)	2.9
Net change in other provisions	30	(0.2)	(0.1)
Net change in pension scheme deficit		0.4	(0.1)
Net cash inflow from operating activities		**71.2**	**(85.6)**

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies

Basis of preparation

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

The preparation of the Group financial statements in compliance with adopted IFRS requires the use of certain critical accounting estimates. It also requires management to exercise judgement in applying the Company's accounting policies. The areas where significant judgements and estimates have been made in preparing the financial statements and their effect are disclosed in Note 2.

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

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

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

- A Cash Flow Statement and related notes;
- Disclosures in respect of transactions with members of a group;
- Disclosures in respect of the compensation of Key Management Personnel and related parties.

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

The parent Company has taken advantage of Section 408 of the Companies Act 2006 and has not included its own Income Statement in these financial statements. The parent Company profit for the year after taxation includes a profit of £16.0 million (2017: profit of £nil) which is dealt with in the financial statements of the parent Company.

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

New Standards and interpretations not yet adopted

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

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

IFRS 9 Financial Instruments

In July 2014, the IASB issued the complete version of IFRS 9, which replaces IAS 39 Financial Instruments: Recognition and Measurement. The new classification and measurement and impairment requirements will be applied by adjusting our Balance Sheet on 1 November 2018, the date of initial application.

Based on current estimates, the adoption of IFRS 9 is expected to result in a decrease in the Group's total assets of approximately £2.5 million, with a related reduction in deferred tax asset of £0.4 million. The overall impact on retained earnings is therefore expected to be a reduction of approximately £2.1 million.

The impact is primarily attributable to increases in the allowance for credit losses under the new impairment requirements as outlined in the relevant section below. The adoption of IFRS 9 is also expected to impact the Group's regulatory capital. The fully loaded day 1 reduction in the consolidated retained earnings for the regulatory group would reduce the CET1 capital ratio by 0.2% to 22.1%. However the Group will follow the transitional regulatory capital arrangements adopted by the EU which enable the expected increase in impairment provisions to be spread over a five-year period commencing 1 November 2018 for capital purposes. Adopting the transitional capital treatment, the Group's CET1 capital ratio is expected to reduce by approximately 0.01% as at 1 November 18.

Implementation approach
To manage our transition to IFRS 9, the Group's implementation project was initiated in early 2017. Dependent on the product type, the Expected Credit Loss (ECL) models were either built in-house by the Group's Actuarial function with support from external advisors, or built by outsourced service providers with oversight from the Group. All models were subject to user acceptance testing before the models went live on 1 November 2018. The Group continues to refine and validate the impairment models and related process.

Classification and measurement
IFRS 9 introduces a principles-based approach to the classification of financial assets. Financial assets are measured at fair value through profit or loss (FVTPL), fair value through other comprehensive income (FVOCI) or amortised cost. Classification is determined by the nature of the cash flows of the assets and the business model in which they are held. These categories replace the existing IAS 39 classifications. For financial liabilities, most of the pre-existing requirements for classification and measurement previously included in IAS 39 were carried forward unchanged into IFRS 9. The application of the IFRS 9 classification criteria will impact the available-for-sale assets which will be classified as FVOCI. IFRS 9 is not expected to result in significant recognition differences when compared to our classification under IAS 39.

Impairment
IFRS 9 introduces an ECL impairment model that differs significantly from the incurred loss model under IAS 39 and is expected to result in earlier recognition of credit losses.

Additional details on the key elements of the new ECL model are described below. The most significant impact will be on the Bank's commercial loans.

ECL impairment model
Under IFRS 9, credit loss allowances will be measured on each reporting date according to a three-stage ECL impairment model. As soon as a financial instrument is originated or purchased, 12-month expected credit losses must be recognised in profit and loss and an impairment allowance will be established (Stage 1). If the credit risk increases significantly (and the resulting credit quality is not considered to be low credit risk) full lifetime expected credit losses will be provided for (Stage 2). Under both Stage 1 and Stage 2, interest income is recognised on the gross carrying value of the financial asset. Financial assets will move into Stage 3 when they are considered to be credit impaired, i.e. when one or more events have occurred that have a detrimental impact on the estimated future cash flows of the asset. Stage 3 assets will continue to recognise lifetime expected impairment losses and interest income will be recognised on the net carrying amount (i.e. gross amount less impairment allowance) – as under IAS 39.

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

IFRS 9 Financial Instruments (continued)

The expected day 1 increase in provisions, as quantified above, is driven by:

- For Stage 1 assets, the 12-month ECL provisions under IFRS 9 are generally higher than collective allowances under IAS 39 where the emergence period is less than 12 months.
- Recognition of lifetime ECL on assets which have experienced a significant increase in credit risk since origination (but are not yet credit impaired). This represents the ECL that will result from all possible default events over the expected life of an instrument.
- IFRS 9 provisions include ECL in respect of undrawn (i.e. off-Balance Sheet) loan commitments and guarantees.

Post-day 1 movements in the ECL provisions reported through the Income Statement are likely to be more volatile than under IAS 39 due to the forward-looking nature of the new approach and the need to take account of future macroeconomic conditions in the ECL modelling, which will be sensitive to management judgement and estimates.

Inputs into measurement of ECL
For the purposes of impairment provisioning, ECL is a function of the Probability of Default (PD), the Exposure at Default (EAD) and Loss given Default (LGD) discounted to the reporting date, using the effective interest rate, or an approximation thereof. An expected credit loss estimate will be produced for individual exposures, including undrawn commitments on pipeline lending. The impairment requirements of IFRS 9 are complex and require management judgement, estimates and assumptions, particularly in the following areas:

Significant increase in credit risk
We have established thresholds for significant increases in credit risk based on a change in internal risk setting relative to initial recognition. The exact thresholds applied will differ by product and/or business. Additional qualitative reviews will be performed to assess the staging results and make adjustments, as necessary, to better reflect the positions which have significantly increased in risk. Additionally, we do not intend to rebut the presumption within IFRS 9 that instruments which are 30 days past due have experienced a significant increase in credit risk.

Definition of default
The definition of default under IFRS 9 will be broader than the individual assessment of financial assets for objective evidence of impairment under IAS 39. The definition of default used in the measurement of expected credit losses and the assessment to determine movement between stages will be consistent with the definition of default used for internal credit risk management purposes. IFRS 9 does not define default, but contains a rebuttable presumption that default has occurred when an exposure is greater than 90 days past due, which we do not intend to rebut.

The Group will consider a financial instrument in default if either one, or both, of the following conditions is met:

1. The exposure is 90 days or more past due date, or
2. The borrower exhibits unlikeliness to pay characteristics

Forward-looking information, macroeconomic factors and multiple scenarios
IFRS 9 requires that the measurement of expected credit losses for each stage and the assessment of significant increases in credit risk must consider information about past events and current conditions as well as reasonable and supportable forecasts of future events and economic conditions. The estimation and application of forward-looking information will require significant judgement. Credit loss allowances are modelled based on the macroeconomic variables (or changes in macroeconomic variables) that are most closely correlated with credit losses in the relevant portfolio. The variables used will include but not be limited to GDP, unemployment rates and change in S&P 500.

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

IFRS 9 Financial Instruments (continued)

The Group will use three probability weighted scenarios (base case, upside and downside) to determine ECL.

Governance
As part of the implementation of IFRS 9, we have designed new controls and governance procedures in several areas that contribute to the calculation of expected credit losses. These include controls over credit risk data and systems, expected credit loss models and calculation engine, forecasts of future macroeconomic variables, design and probability-weighting of future macroeconomic scenarios, and the determination of significant increases in credit risk.

Hedge accounting
When initially applying IFRS 9, the Group expects to exercise the accounting policy choice to continue to apply the hedge accounting requirements of IAS 39 for its macro hedging relationships.

IFRS 15 Revenue from Contracts with Customers

Effective from 1 January 2018, IFRS 15 replaces IAS 18 Revenue and several related interpretations. IFRS 15 introduces a single framework for revenue recognition based on a five-step model to determine when to recognise revenue and at what amount. The five steps of the model are: identify the contract; identify performance obligations; determine the transaction price; allocate the transaction price and recognise revenue. Depending on whether certain criteria are met, revenue is recognised either over time, in a manner that depicts the entity's performance, or at a point in time, when control of the goods or services is transferred to the customer. The new standard is not expected to have a significant impact on the financial statements of the Group. The Group will apply the new standard from 1 November 2018.

IFRS 16 Leases

Effective from 1 January 2019, IFRS 16 replaces IAS17 Leases, IFRIC 4 Determining Whether an Arrangement Contains a Lease and two related SIC interpretations. The new standard requires lessees to recognise right-of-use assets and lease liabilities for most leases over 12 months long. Lessor accounting has largely remained unchanged. The new standard is not expected to have a significant impact on the financial statements of the Group. The Group will apply the new standard from 1 November 2019.

IFRS 17 Insurance Contracts

IFRS 17, 'Insurance Contracts' was issued in May 2017 and is effective for the Group for the annual period commencing 1 November 2022. The standard will be applied retrospectively, subject to the transitional options provided for in the standard, and provides a comprehensive approach for accounting for insurance contracts including their valuation, Income Statement presentation and disclosure. The Group has mobilised a project team to assess the financial and operational implications of the standard and work will continue throughout 2019 to ensure technical compliance and to develop the required system capability to implement the standard.

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

Measurement convention

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

Basis of consolidation

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

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

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

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

Dividend income

Dividend income is recognised when the right to receive payment is established.

Dividend distribution

Dividend distributions to the Group's shareholders are recognised as a liability in the Group's financial statements in the period in which the dividends are approved by the Group's directors. Interim dividends are recognised when paid.

Interest receivable and interest payable

Interest receivable and payable for loans and advances to customers, lifetime mortgages and customer accounts are recognised in the Income Statement using the effective interest rate method (EIR).

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

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

Interest receivable and interest payable (continued)

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

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

Fees and commissions

Fee and commission income arises through a range of services the Group provides to its customers.

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

Fees and commissions receivable and payable that are not spread across expected asset lives under the EIR method are taken to income on an accruals basis as services are provided, or on completion of an act to which the fee relates. Loan commitment fees received are deferred and included in the EIR calculation upon completion of the loan.

Premium income

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

Investment income

Investment income consists of realised gains and losses on reversionary interests held at fair value through profit and loss.

Claims

Claims are recorded as an expense in the Income Statement as incurred.

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

Insurance contracts

Insurance contracts are those which transfer significant insurance risk. Such contracts may also transfer financial risk. As a general guideline, the Group defines as significant insurance risk the possibility of having to pay benefits on the occurrence of an insured event which are significantly more than the benefits payable if the insured event were not to occur. The Group's insurance products consist entirely of annuity products. Once a contract has been classified as an insurance contract, it remains an insurance contract for the remainder of its lifetime, even if the insurance risk reduces significantly over time.

Deferred acquisition costs

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

Financial assets

The Group classifies its financial assets at inception into the following categories:

i) Loans and receivables

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

ii) Fair value through profit or loss (FVTPL)

This category consists of derivative financial assets, Treasury bills and lifetime mortgages which are held at fair value. These financial assets are designated as FVTPL upon initial recognition and initially measured at fair value with transaction costs taken directly to the Income Statement. Subsequent measurement is at fair value with changes in value reflected in the Income Statement.

For those derivatives in fair value hedge accounting relationships, gains and losses arising from changes in the fair values are recognised in the Income Statement. The impact of hedging on the measurement of financial assets and liabilities is detailed in note 26.

The measurement of lifetime mortgage products is designated at fair value through profit and loss due to the existence of an embedded derivative in the form of a no negative equity guarantee which forms part of the terms and conditions applicable to these products.

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

Embedded derivatives

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

The "no-negative equity guarantee" is an embedded derivative and further details are disclosed in note 26. The Group does not separate the "no negative equity guarantee" embedded derivative from the host instrument.

iii) Available-for-sale

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

iv) Held-to-maturity

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

Impairment of financial assets

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

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

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

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

Impairment of financial assets (continued)

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

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

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

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

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

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

Cash and balances held at central banks

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

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

Financial liabilities

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

i) Other financial liabilities

Other financial liabilities include deposits from banks, deposits from customers, accruals, deferred income and other liabilities are initially measured at fair value. Subsequent to initial recognition these financial liabilities are measured on an amortised cost basis. This represents the face value adjusted for any unamortised premiums, discounts and transaction costs directly attributable to the acquisition or issue. The amortisation is recognised in interest payable and similar charges using the EIR method.

ii) Fair value through profit or loss

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

For those derivatives in fair value hedge accounting relationships and for any derivatives not in a hedge accounting relationship, gains and losses arising from changes in the fair values are recognised in the Income Statement. The impact of hedging on the measurement of financial assets and liabilities is detailed in note 26.

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

De-recognition of financial assets and financial liabilities

(i) Financial assets

A financial asset is de-recognised when:

- The rights to receive cash flows from the asset have expired.
- The Group has transferred its rights to receive cash flows from the asset or has assumed an obligation to pay the received cash flows in full without material delay to a third party under a "pass-through" arrangement; and either
- The Group has transferred substantially all the risks and rewards of the asset

Or

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

(ii) Financial liabilities

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

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

Derivative financial instruments

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

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

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

Loans and advances to credit institutions

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

Hedge accounting

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

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

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

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

Hedge accounting (continued)

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

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

Shares in subsidiaries

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

Offsetting financial assets and financial liabilities

In accordance with IAS32 Financial Instruments; the Group reports derivative financial instruments on a net basis as there is a legally enforceable right to set-off the recognised amounts and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously. A table is provided within note 26 which demonstrates the amounts which have been offset in the Balance Sheet.

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

Intangible assets

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

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

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

Intangible assets (continued)

Intangible assets are assessed for indicators of impairment at each Balance Sheet date.

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

Property, plant and equipment

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

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

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

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

- Fixtures, fittings and equipment — 5 years
- Short leasehold improvements — Shorter of remaining term of the lease and useful life
- Freehold buildings — 50 years
- Integral features to freehold buildings — 20 years

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

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

Investment properties

i) Investment properties held by Group

Investment property is property held to earn rentals, for capital appreciation or for both, rather than for sale or use in the business. The Group classifies property under investment property where it is held for capital appreciation, this includes property where the Group is a lessor. The Group recognises investment properties initially at cost and subsequently at fair value, with any change therein recognised in the Income Statement within other operating income.

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

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

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

ii) Reversionary interests in properties

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

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

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

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

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

Taxation including deferred tax

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

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

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

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

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

Employee benefits

i) Pensions

The Group operates a defined benefit pension scheme for members of staff. The Company's subsidiary undertakings Julian Hodge Bank Limited and the Hodge Life Assurance Company Limited are participating employers in The Carlyle (1972) Pension and Life Assurance Scheme, a defined benefits scheme operated by The Carlyle Trust Limited. The assets of the scheme are held separately from those of the Group.

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

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

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

Employee benefits (continued)

ii) Reimbursement asset on pension deficit

The Group has recognised a reimbursement asset in respect of its pension scheme deficit which relates to retired employees that were contracted to the Group's ultimate parent, The Carlyle Trust Limited (see note 31). The movement in the reimbursement asset each year (following its initial recognition in the year ended 31 October 2014) is recognised in the Income Statement to the extent that the reimbursement relates to a charge in the Group's Income Statement. Any movement in the reimbursement asset which does not relate to the Company's Income Statement is recognised in the Statement of Other Comprehensive Income.

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

iii) Short-term employment benefits

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

iv) Pension reserve

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

Leases

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

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

Long term business provision - liabilities under insurance contracts

The long-term business provision has been determined by the Board of Directors, on advice from the Chief Actuary, having due regard to the principles laid down in the Council Directive 92/96/EEC. The estimation process used in determining the long-term business provision involves projecting annuity payments and the costs of maintaining the contracts.

Notes to the Accounts

For the year ended 31 October 2018

1. Accounting policies (continued)

Provisions and contingent liabilities

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

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

Share capital

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

Available for sale reserve

The available-for-sale-reserve comprises changes in fair values of available-for-sale investments in the period.

Funding for lending scheme (FLS)

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

Notes to the Accounts

For the year ended 31 October 2018

2. Judgement in applying accounting policies and critical accounting estimates

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

Area of significant judgement or risk	
Judgements	
1.	Fair values of financial instruments
Estimates and assumptions	
1.	Value of reversionary investment properties
2.	Pension scheme assumptions
3.	Guaranteed Minimum Pensions ("GMP") equalisation
4.	Measurement of insurance liabilities arising from annuity insurance contracts
5.	Measurement of the no-negative guarantee with respect to lifetime mortgages
6.	Impairment losses on loans and advances to customers
7.	Change in accounting estimate for the measurement of lifetime mortgages

Judgements

1. Fair values of financial instruments

The group uses widely recognised valuation models for determining the fair value of common and simple financial instruments, such as interest rate swaps that use only observable market data: further analysis can be found in notes 26 and 34.

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

Where observable market data is unavailable, unobservable inputs are used in the actuarial valuation models to value lifetime mortgages. The key assumptions used and the related sensitivities are outlined in note 34.

Notes to the Accounts

For the year ended 31 October 2018

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

Estimates and assumptions

1. Value of reversionary investment properties

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

2. Pension scheme assumptions

Estimation uncertainty surrounds the measurement of the pension scheme liabilities. The assumptions used as part of the valuation include the rate of salary increase, the discount rate applied to scheme liabilities and inflation. The key assumptions used are disclosed in note 31.

3. Guaranteed Minimum Pensions ("GMP") equalisation

Uncertainty exists as to the methods for equalisation between males and females in respect of GMP. No liability has been recognised by the Group. Further information on this assumption is given in note 31.

4. Measurement of insurance liabilities arising from annuity insurance contracts.

The estimation of the ultimate liability arising from insurance contracts is a key Group accounting estimate.

For insurance contracts, the liabilities are calculated using a projection of cash flows after making assumptions about matters such as mortality and expenses. Discount rates used to value the liabilities are set with reference to the risk adjusted yields on the underlying assets. The most critical non-economic assumptions are mortality rates in respect of annuity business written and levels of future expenses.

Such assumptions are based on recent actual experience, supplemented by industry information where appropriate.

5. Measurement of the no-negative guarantee with respect to lifetime mortgages

Estimation uncertainty surrounds the measurement of liabilities arising from the no-negative guarantee in respect of lifetime mortgages. The key assumptions used as part of the valuation calculation include future property prices and their volatility, mortality and the rate of voluntary redemptions. Further information on these assumptions is given in note 34.

6. Impairment losses on loans and advances to customers

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

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

Notes to the Accounts

For the year ended 31 October 2018

2. Judgement in applying accounting policies and critical accounting estimates

Estimates and assumptions (continued)

6. Impairment losses on loans and advances to customers (continued)

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

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

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

7. Change in accounting estimate for the measurement of lifetime mortgages

There is significant judgement in the methodologies and assumptions applied in estimating the fair value of lifetime mortgages. These methodologies and assumptions contain unobservable inputs resulting in the fair value being classified as a Level 3 estimate within the IFRS 13 fair value hierarchy. Changes have been made to the methodology applied to the discounting and expected lapses used in calculating the no negative equity guarantee and the methodology used in the valuation of subsequent draws. The net impact of these changes amounts to a £3.2 million gain in 2018 which has been accounted for prospectively as a change in accounting estimate.

Notes to the Accounts

For the year ended 31 October 2018

3. Reconciliation to non-GAAP measures and performance

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

	2018 £m	2017 £m
Reconciliation of net operating income to adjusted net operating income		
Net operating income	30.1	38.3
Adjusted for:		
Earned premiums (note 7)	(47.5)	(29.3)
Net gains from derivative financial instruments (note 10);	(15.0)	(18.9)
Net losses arising from fair value re-measurements (note 10);	42.8	45.7
Movement in fair value of hedged items attributable to hedged risk (note 10);	(0.1)	1.3
Movement in long-term business provision (note 27).	20.1	(11.8)
Adjusted net operating income	**30.4**	**25.3**

	2018 £m	2017 £m
Reconciliation of profit before tax to adjusted profit before tax		
Profit before tax	12.3	25.4
Adjusted for:		
Earned premiums (note 7)	(47.5)	(29.3)
Net gains from derivative financial instruments (note 10);	(15.0)	(18.9)
Net losses arising from fair value re-measurements (note 10);	42.8	45.7
Movement in fair value of hedged items attributable to hedged risk (note 10);	(0.1)	1.3
Movement in long-term business provision (note 27).	20.1	(11.8)
Adjusted profit before tax	**12.6**	**12.4**

Notes to the Accounts

For the year ended 31 October 2018

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

The principal reconciling items are as follows:

Earned premiums

Earned premiums, all of which relate to direct insurance contracts, are individual, single premiums from annuity business as disclosed in note 7.

Net gains from derivative financial instruments

Under IFRS, the market value of the interest rate swaps is required to be reflected on the Balance Sheet. The fair value gain of £15.0 million for the year to 31 October 2018 (2017; gain of £18.9 million) represents the movement in market value of the derivative financial instruments for the year ending 31 October.

Net losses arising from fair value re-measurements

The fair value re-measurements relate to those assets and liabilities fair valued as disclosed in note 10. They reflect market value at 31 October discounted at an appropriate discount rate to reflect the time value of money.

Movement in fair value of hedged items attributable to hedged risk

The fair value movements relate to the fair value movements of items attributable to hedged risk as disclosed in note 10.

Movement in long-term business provision

The long-term business provision for insurance contracts has been calculated using estimation techniques for each contract, by use of a prospective calculation as disclosed in note 27. The movement relates to the change in the fair value of the long-term business provision.

Notes to the Accounts

For the year ended 31 October 2018

4. Segmental information

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

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

As at 31 October 2018	Banking £m	Life Assurance £m	Consolidation Adjustments £m	Reclassification £m	Total £m
Interest receivable	46.0	-	-	20.6	66.6
Interest payable	(27.7)	-	-	(0.1)	(27.8)
Fees and commissions receivable	2.5	-	-	(0.1)	2.4
Fees and commissions payable	(1.1)	-	-	(0.7)	(1.8)
Earned premiums	-	47.5	-	-	47.5
Investment income	6.4	10.6	-	(1.6)	15.4
Gross claims and benefits paid	-	(24.5)	-	-	(24.5)
Movement in long-term business provision	-	(20.1)	-	-	(20.1)
Other operating income	0.1	-	-	-	0.1
Other fair value losses	(8.0)	(0.7)	-	(19.0)	(27.7)
Administrative expenses	(12.2)	(6.7)	-	1.0	(17.9)
Depreciation and amortisation	(0.8)	-	-	(0.1)	(0.9)
Impairment provision for losses on loans and advances to customers	1.0	-	-	-	1.0
Profit before tax	**6.2**	**6.1**	**-**	**-**	**12.3**
Tax on profit	(0.7)	(1.2)	-	-	(1.9)
Profit after tax	**5.5**	**4.9**	**-**	**-**	**10.4**

Total equity	**171.8**	**144.3**	**-**	**-**	**316.1**
Total assets	**1,363.4**	**590.8**	**(6.0)**	**-**	**1,948.2**

Notes to the Accounts

For the year ended 31 October 2018

4. Segmental information (continued)

As at 31 October 2017	Banking £m	Life Assurance £m	Consolidation Adjustments £m	Reclassification £m	Total £m
Interest receivable	40.0	-	-	20.0	60.0
Interest payable	(27.8)	-	-	(0.1)	(27.9)
Fees and commissions receivable	1.8	-	-	-	1.8
Fees and commissions payable	(1.2)	-	-	(0.7)	(1.9)
Earned premiums	-	29.3	-	-	29.3
Investment income	4.8	12.0	-	(0.9)	15.9
Gross claims and benefits paid	-	(23.6)	-	-	(23.6)
Movement in long-term business provision	-	11.8	-	-	11.8
Other operating income	1.0	-	-	-	1.0
Other fair value gains	0.3	(9.3)	-	(19.1)	(28.1)
Administrative expenses	(9.4)	(5.4)	-	0.9	(13.9)
Depreciation and amortisation	(0.5)	-	-	(0.1)	(0.6)
Impairment provision for losses on loans and advances to customers	1.6	-	-	-	1.6
Profit before tax	**10.6**	**14.8**	**-**	**-**	**25.4**
Tax on profit	(0.3)	(2.9)	-	-	(3.2)
Profit after tax	**10.3**	**11.9**	**-**	**-**	**22.2**

Total equity	**167.3**	**155.4**	**(15.9)**	**-**	**306.8**
Total assets	**1,267.4**	**582.3**	**(28.8)**	**-**	**1,820.9**

Notes to the Accounts

For the year ended 31 October 2018

5. Interest receivable and similar income

	2018 £m	2017 £m
Loans and advances to customers	60.6	54.6
Loans and advances to credit institutions	1.7	0.8
On other loans	-	0.3
Interest and other income on treasury bills and debt securities	4.3	4.3
	66.6	60.0

6. Interest payable and similar charges

	2018 £m	2017 £m
On customer accounts	13.9	14.2
On defined benefit pension scheme	0.4	0.4
On term funding scheme	0.3	-
On derivative financial instruments	13.2	13.3
	27.8	27.9

7. Earned premiums

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

All premiums are derived from contracts concluded in the United Kingdom. Commissions payable in respect of direct insurance amounted to £0.6m (2017: £0.5m).

	2018 £m	2017 £m
Earned premiums	47.5	29.3
	47.5	29.3

Notes to the Accounts

For the year ended 31 October 2018

8. Investment income

	2018 £m	2017 £m
Gains on realisation of investments	15.4	15.9
	15.4	15.9

9. Other operating income

	2018 £m	2017 £m
Rental income from investment properties	0.1	0.4
Other	-	0.6
	0.1	1.0

10. Other fair value gains/(losses)

	2018 £m	2017 £m
Gains on derivatives designated as fair value	15.0	18.9
(Losses) on assets designated as fair value	(42.8)	(45.7)
Movement in fair value of hedged items attributable to hedged risk	0.1	(1.3)
	(27.7)	(28.1)

Fair value losses on available-for-sale investments of £(1.8m) (2017: £0.1m) have been taken to the Statement of Other Comprehensive Income.

Notes to the Accounts

For the year ended 31 October 2018

11. Administrative expenses

	2018 £m	2017 £m
Staff costs		
Wages and salaries	6.8	5.9
Social security	0.8	0.6
Pension costs (note 31)	1.6	1.2
	9.2	7.7
Other administrative expenses	8.7	6.2
	17.9	13.9

Directors and employees

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

	2018 No	2017 No
Provision of finance and banking	147	105
Provision of life assurance services	32	40
	179	145

Staff costs include remuneration in respect of directors as follows:

	2018 £m	2017 £m
Fees	0.3	0.2
Aggregate emoluments as executives	0.5	0.4
	0.8	0.6

Notes to the Accounts

For the year ended 31 October 2018

11. Administrative expenses (continued)

Directors and employees (continued)

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

	2018 £m	2017 £m
Aggregate emoluments	0.2	0.2
	0.2	0.2

The pension accrued for the highest paid director was £nil (2017: £nil).

Retirement benefits are accruing to one director, in 2018 there was one director in the defined benefit scheme.

12. Profit on ordinary activities before taxation

	2018 £000	2017 £000
Profit on ordinary activities before taxation is stated after charging:		
Remuneration of the auditor and its associates		
Audit of these financial statements	17	15
Audit of financial statements of subsidiaries	118	96
Audit of pension scheme	10	10
Other assurance fees	85	51
Non audit fees	220	-
Depreciation	377	389
Amortisation	453	243
Impairment provision credit	(1,007)	(1,554)

Notes to the Accounts

For the year ended 31 October 2018

13. Tax on profit

		2018		2017
	£m	£m	£m	£m
Analysis of charge in year				
UK corporation tax				
Current tax on income for the year	2.2		3.7	
Prior period adjustment	(0.4)		0.1	
Total current tax		**1.8**		**3.8**
Deferred tax (see note 22)				
• Original reversal/timing difference	(0.8)			
• Current year	0.9		0.2	
• Prior period adjustment	**0.2**		**(0.8)**	
• Other	**(0.2)**		**-**	
Total deferred tax		**0.1**		**(0.6)**
Tax on profit on ordinary activities		**1.9**		**3.2**

The total tax charge for the year is lower (2017: lower) than the blended rate of corporation tax in the UK. The differences are explained below.

	2018	2017
	£m	£m
Total tax reconciliation		
Profit on ordinary activities before tax	12.3	25.4
Current tax at 19.0% (2017: 19.4%)	**2.3**	**4.9**
Investment properties	(0.1)	(0.8)
Index linked gilt RPI movement	(0.3)	(0.3)
Rate differences	-	(0.1)
Other	0.2	0.2
Adjustments in respect of previous years	(0.2)	(0.7)
Total tax charge (see above)	**1.9**	**3.2**

A reduction in the UK corporation tax rate to 17% (effective 1 April 2020) was substantively enacted on 6 September 2016. This will reduce the Group's future tax charge accordingly.

The deferred tax asset at 31 October 2018 has been calculated based on these rates.

Notes to the Accounts

For the year ended 31 October 2018

14. Cash and balances held at central banks

	2018 £m	2017 £m
Repayable on demand:		
Deposits with central banks	153.2	87.0
	153.2	87.0

15. Treasury bills

	2018 £m	2017 £m
Treasury bills – at amortised cost	11.2	8.4
Treasury bills – available-for-sale	13.2	20.6
Treasury bills – fair value through profit and loss	72.6	65.1
Fair value adjustment – hedge accounting	2.4	2.8
Fair value adjustment – available-for-sale	0.2	0.4
	99.6	97.3

Notes to the Accounts

For the year ended 31 October 2018

15. Treasury bills (continued)

The movement in treasury bills is summarised as follows:

	2018 £m	2017 £m
At start of period	97.3	95.3
Additions	45.5	21.3
Redemptions	(41.7)	(17.9)
Losses from hedge accounting – Income Statement	(0.4)	(1.0)
Losses from changes in fair value – Income Statement	(0.9)	(0.7)
(Losses)/gains from changes in fair value - OCI	(0.2)	0.3
At 31 October	**99.6**	**97.3**

Of this amount £29.5m (2017: £30.0m) has been provided as collateral for derivative financial instruments repurchase agreements from borrowing under the Bank of England Term Funding Scheme. (see note 26). Collateral that has been pledged is not restricted.

Of this amount £26.7m (2017: £nil) has been pledged as collateral under the Term Funding Scheme ("TFS"). Collateral that has been pledged is restricted.

16. Debt securities

	2018 £m	2017 £m
Debt securities – at amortised cost	6.9	3.5
Debt securities - available-for-sale	76.9	68.0
Debt securities – fair value through profit and loss	60.9	54.2
Fair value adjustment – hedge accounting	0.7	0.9
Fair value adjustment – available-for-sale	3.0	4.6
	148.4	**131.2**

Notes to the Accounts

For the year ended 31 October 2018

16. Debt securities (continued)

	2018 £m	2017 £m
At 1 November	131.2	129.9
Additions	55.4	31.6
Redemptions	(36.0)	(29.5)
Losses from hedge accounting - Income Statement	(0.2)	(0.5)
(Losses)/gains from changes in fair value – Income Statement	(0.4)	0.1
Losses from changes in fair value - OCI	(1.6)	(0.4)
At 31 October	**148.4**	**131.2**

Of this amount £19.4m (2017: £18.2m) has been pledged as collateral under the Funding for Lending Scheme ("FLS"). Collateral is provided by the Bank of England in the form of treasury bills against residential borrowing, as part of its participation in the FLS, which the Bank is permitted to re-use. Collateral that has been pledged is not restricted.

17. Loans and advances to credit institutions

	2018 £m	2017 £m
Repayable on demand	28.3	30.0
Collateral held by swap counterparties	83.6	104.9
	111.9	**134.9**

The collateral is pledged against the market value of derivative instruments and comprises interest-bearing cash deposits (see note 26). Collateral that has been pledged and held is not restricted and is returned at the end of the contract. There are no provisions held in respect of loans and advances to credit institutions (2017: £nil).

Notes to the Accounts

For the year ended 31 October 2018

18. Loans and advances to customers

	2018 £m	2017 £m
Loans and advances – classified as loans and receivables	556.3	461.0
Amounts owed from immediate parent and fellow subsidiaries	0.8	-
Fair value adjustment for hedged risk	-	0.4
	557.1	**461.4**
Loans and advances (lifetime mortgages) – classified as fair value through profit and loss – note 34	685.2	692.5
	1,242.3	**1,153.9**

Of this amount £74.9m (2017: £76.3m) has been pledged as collateral under FLS. Collateral is provided by The Bank of England in the form of Treasury Bills against residential mortgages, as part of the Group's participation in the FLS, which the Bank is permitted to re-use. Collateral that has been pledged and held is not restricted and is returned at the end of the contract.

Of this amount £64.7m (2017: £nil) has been pledged as collateral under the Term Funding Scheme ("TFS"). Collateral that has been pledged is restricted.

	2018 £m	2017 £m
Loans and advances to customers		
Gross balances	562.3	469.9
Less: Provision for impairment	(3.7)	(6.4)
Less: Loan fee deferral	(2.3)	(2.5)
Net balance	**556.3**	**461.0**

Notes to the Accounts

For the year ended 31 October 2018

18. Loans and advances to customers (continued)

Impairment provisions on loans and advances to customers

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

	Specific £m	Collective £m	Total £m
2017			
At 1 November 2016	9.8	0.2	10.0
Utilised on redemption	(2.0)	-	(2.0)
Income Statement			
Amounts written back during the year	(2.4)	-	(2.4)
Charge for loan impairment	0.8	-	0.8
	(1.6)	**-**	**(1.6)**
At 31 October 2017	**6.2**	**0.2**	**6.4**

For further details on loans and advances to customers refer to Note 35.

Notes to the Accounts

For the year ended 31 October 2018

19. Intangible assets

	Computer Software	
	2018 £m	2017 £m
Cost:		
At start of period	2.0	1.3
Disposals	(0.1)	-
Additions	2.0	0.7
At 31 October	3.9	2.0
Amortisation:		
At start of period	(0.3)	(0.1)
Amortisation	(0.5)	(0.2)
At 31 October	(0.8)	(0.3)
Net book value:		
At 31 October	3.1	1.7

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

Notes to the Accounts

For the year ended 31 October 2018

20. Property, plant and equipment

	Short Leasehold Improvements £m	Fixtures, Fittings and Equipment £m	Total £m
Cost:			
At 1 November 2017	1.6	0.7	2.3
Additions	0.5	0.1	0.6
At 31 October 2018	**2.1**	**0.8**	**2.9**
Depreciation:			
At 1 November 2017	(0.1)	(0.2)	(0.3)
Depreciation	(0.3)	(0.1)	(0.4)
At 31 October 2018	**(0.4)**	**(0.3)**	**(0.7)**
Net book value:			
At 31 October 2018	**1.7**	**0.5**	**2.2**
At 1 November 2017	1.5	0.5	2.0

Notes to the Accounts

For the year ended 31 October 2018

21. Investment properties

Group	Freehold £m	Reversionary Interests £m	Total £m
At 1 November 2017	12.8	192.4	205.2
Disposals	(12.8)	(18.6)	(31.4)
Fair value adjustments	-	5.3	5.3
At 31 October 2018	**-**	**179.1**	**179.1**

Group	Freehold £m	Reversionary Interests £m	Total £m
At 1 November 2016	8.8	199.6	208.4
Additions	0.1	-	0.1
Disposals	-	(20.3)	(20.3)
Fair value adjustments	3.9	13.1	17.0
At 31 October 2017	**12.8**	**192.4**	**205.2**

On the 19 January 2018, the Group sold a freehold property which had a carrying value of £12.8m to a third party, £nil profit or loss was generated from this sale.

All of the investment properties have been categorised as a Level 3 fair value based on the inputs to the valuation technique used (see note 34).

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

	2018 £m	2017 £m
Rental income from investment properties	0.1	0.4
	0.1	**0.4**

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

Notes to the Accounts

For the year ended 31 October 2018

21. Investment properties (continued)

Reversionary interests - principal assumptions

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

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

Mortality or entry into long term care
This is based on the expected death or entry into long term care of the tenant or the last remaining tenant in relation to a joint contract. Mortality assumptions have been derived by reference to the PCMA00/PCFA00 mortality tables and include an allowance for future mortality improvements.

Expenses
Assumptions for future policy expense levels are based on the Group's recent expense analyses. Expenses are modelled as an amount per policy per annum that incorporates an annual inflation rate allowance of 4.23% (2017: 4.16%).

Discount rate
The discount rate applied to the reversion cash flows comprises two parts: a risk-free yield curve and an allowance for illiquidity. The risk-free yield curve is based on the GBP curve published by EIOPA. The average discount rate for the portfolio (assumed to be the 15 year point on the yield curve based on average duration at 31 October 2018) was 2.62% (31 October 2017: 2.46%).

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

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

	Freehold	Reversionary Interests		
	Net Initial Yield + 1% £m	Delay in Mortality or Entry into Long Term Care by 10% £m	Expenses +10% £m	Property Prices -10% £m
At 31 October 2018	-	(2.1)	(0.2)	(15.9)
At 31 October 2017	(1.8)	(2.3)	(0.2)	(17.7)

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

Notes to the Accounts

For the year ended 31 October 2018

22. Deferred tax

	2018 £m	2017 £m
At 1 November	2.2	2.3
(Charged)/credited to the Income Statement	(0.2)	0.7
Credited/(charged) to the Statement of Other Comprehensive Income	0.2	(0.8)
At 31 October	**2.2**	**2.2**

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

	2018 £m	2017 £m
Accelerated capital allowances	0.1	0.3
Other timing differences	0.9	0.9
Timing differences on available-for-sale reserve	(0.5)	(0.8)
Timing differences on reimbursement asset	(0.4)	(0.4)
Defined benefit pension scheme	2.1	2.2
At 31 October	**2.2**	**2.2**

The provision held against the deferred tax asset is £nil (2017: £nil).

23. Other assets

	2018 £m	2017 £m
Due within one year:		
Prepayments and accrued income	1.8	1.7
Pension reimbursement asset	2.4	2.5
Corporation tax debtor	1.3	0.8
Other assets	0.7	0.5
At 31 October	**6.2**	**5.5**

Notes to the Accounts

For the year ended 31 October 2018

24. Deposits from banks

	2018 £m	2017 £m
Repurchase agreement	2.5	2.8
Term funding scheme	70.0	-
	72.5	2.8

25. Deposits from customers

	2018 £m	2017 £m
Repayable on demand	10.5	17.7
With agreed maturity dates or periods of notice and repayable:		
• within three months	286.1	337.7
• between three months and one year	364.6	366.3
• between one and five years	330.4	214.8
	991.6	**936.5**
Amounts owed to parent and fellow subsidiary undertakings	2.7	5.6
Fair value adjustment for hedged risk	(0.2)	(0.3)
	994.1	941.8

The amounts owed to parent and parent subsidiaries are repayable within a three-month notice period.

Notes to the Accounts

For the year ended 31 October 2018

26. Derivative financial instruments

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

	Contract/Notional Amount		Fair Value	
	2018 £m	2017 £m	2018 £m	2017 £m
Derivative liabilities held for hedging purposes and designated fair value hedges:				
Interest rate swaps	383.1	358.3	105.2	126.6
RPI index linked interest rate swaps	55.0	55.0	(1.1)	(0.1)
Fair value adjustment for hedged risk	234.8	176.5	3.5	4.7
Total recognised derivative liabilities	**672.9**	**589.8**	**107.6**	**131.2**

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

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

At 31 October 2018, the fixed interest rates vary from 0.9% to 5.4% (2017: 0.3% to 5.4%) and the main floating rates are LIBOR. Gains and losses recognised on interest rate swap contracts are credited/ charged to the Income Statement.

	2018 £m	2017 £m
Gains on derivatives designated as fair value	15.0	18.9
	15.0	**18.9**

Notes to the Accounts

For the year ended 31 October 2018

26. Derivative financial instruments (continued)

The Group agreed to exit a number of interest rate swaps during the year which were held at fair value of £6.8m. £nil profit or loss was incurred on disposal.

Offsetting

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

	Amounts subject to netting arrangements		
	Gross Amounts £m	Amounts Offset £m	Net Amounts Reported on Balance Sheet £m
2018			
Derivative financial assets	1.6	(1.6)	-
Impact on total assets	**1.6**	**(1.6)**	**-**
Derivative financial (liabilities)	(109.2)	1.6	(107.6)
Impact on total (liabilities)	**(109.2)**	**1.6**	**(107.6)**
2017			
Derivative financial assets	0.1	(0.1)	-
Impact on total assets	**0.1**	**(0.1)**	**-**
Derivative financial (liabilities)	(131.3)	0.1	(131.2)
Impact on total (liabilities)	**(131.3)**	**0.1**	**(131.2)**

The collateral pledged against the market value of derivative instruments comprises interest-bearing cash deposits, which are included in loans and advances to credit institutions (note 17), and treasury bills (note 15).

Notes to the Accounts

For the year ended 31 October 2018

27. Provisions for long term business - liabilities arising from insurance contracts

	2018 £m	2017 £m
At 1 November	416.9	428.7
Movement on existing liabilities	(23.2)	(30.5)
Impact of new insurance contracts	48.8	30.9
Impact of methodology and assumption changes	(5.5)	(12.2)
At 31 October	**437.0**	**416.9**

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

a) Rates of interest

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

As at 31 October 2018 and 2017 the risk-free yield curve is the GBP curve published by EIOPA.

The average discount rate for each product assumed to be the 15-year point on the yield curve based on the average duration of the portfolio at 31 October 2018 and 2017.

Rates of Interest	2018 %	2017 %
Pension business annuities	3.2	2.9
Reversionary scheme and renewable reversionary scheme	2.5	2.3
Purchased life annuities	2.5	2.3
Mortgage scheme annuities	1.8	1.6

Notes to the Accounts

For the year ended 31 October 2018

27. Provisions for long term business - liabilities arising from insurance contracts (continued)

b) Mortality tables

The mortality table used to calculate the technical provisions for annuity liabilities is the PCMA/PCFA00 table. This table is adjusted from 2000 by calendar year for mortality improvements based on the CMI 2017 mortality projection model. The mortality tables are further adjusted to reflect recent mortality experience by multiplying the mortality rates by a percentage factor which varies by the duration in force of the contract.

c) Provision for expenses

An explicit provision for expenses based on an amount per policy per annum has been determined from recent experience analysis. This provision increases with an annual inflation rate of 4.23% (2017: 4.16%). Included within the provision for expenses is £1.3 million (2017: £1.2 million) to cover anticipated expense overruns.

d) Sensitivity analysis

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

	Delay in Mortality by 10% £m	Expenses +10%	Interest Rates +100bps £m
At 31 October 2018	(11.3)	(3.0)	45.6
At 31 October 2017	(10.9)	(2.8)	51.4

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

28. Accruals and deferred income

	2018 £m	2017 £m
Due within one year:		
Accruals and deferred income	3.2	3.7
	3.2	3.7

Notes to the Accounts

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29. Other liabilities

Group	2018 £m	2017 £m
Due within one year:		
Other taxation and social security	0.4	0.2
Amounts owed to parent and fellow subsidiaries	-	1.5
Amounts owed in relation to insurance contracts	3.4	0.5
Amounts owed in relation to mortgages administered for third parties	0.6	1.8
Other creditors	0.4	0.4
	4.8	4.4

30. Other provisions

	2018 £m	2017 £m
At 1 November	0.3	0.4
Utilisation	(0.2)	(0.1)
At 31 October	0.1	0.3

The Group is a member of the Financial Services Compensation Scheme (FSCS), and has in the past had to contribute levies following the failure of a number of banks. The amount held on the Balance Sheet in relation to the above at 31 October 2018 was £nil (2017: £0.2m).

In addition, a provision of £0.1m (2017: £0.1m) for conduct risk in relation to PPI is included at the Balance Sheet date.

Notes to the Accounts

For the year ended 31 October 2018

31. Pension scheme

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

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

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

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

The weighted average duration of the defined pension obligation at the period ended 31 October 2018 is 21 years (2017: 21 years).

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

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

The calculations are based upon an assessment of the Scheme's liabilities as at 31 October 2018. These have been based upon the results of the 1 April 2016 formal triennial valuation projected forward with allowance for benefit accrual and expected investment return. The next triennial valuation will be carried out on 1 April 2019. No further provision has been recognised.

The Group's total expense for the year amounted to £2.0m (2017: £1.6m). The Group has agreed that it will aim to eliminate the pension scheme deficit over the next 10 years and additional contributions of £0.5m were paid into the scheme in the year ended 31 October 2018. Funding levels are monitored on an annual basis and the Group has agreed to maintain the contribution rate at 19.5% from 1 November 2018.

The IAS 19 valuation as at 31 October 2018 has been produced by a qualified independent actuary, and is based on the results of the valuation as at 1 April 2016.

GMP equalisation
On the 26 October 2018, in a long awaited ruling, the High Court determined that defined benefit pension schemes will be required to equalise benefits for the effect of inequalities between males and females in respect of Guaranteed Minimum Pensions (GMP) accrued after 17 May 1990. The method for equalisation remains unclear with further announcements expected during 2019, as such the Group has not recognised any liability for this equalisation but initial estimates show that the potential impact is not material.

Notes to the Accounts

For the year ended 31 October 2018

31. Pension scheme (continued)

Scheme assets and liabilities

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

	2018 £m	2017 £m
Fair value of plan assets	24.2	24.2
Present value of defined benefit obligations	(37.0)	(37.2)
Deficit	**(12.8)**	**(13.0)**

Movements in present value of defined benefit obligation

	2018 £m	2017 £m
Present value of scheme liabilities at start of the period	37.2	39.2
Interest cost	1.0	1.1
Current service cost	1.6	1.2
Member contributions	0.2	0.2
Actuarial loss/(gain) on defined benefit obligation of which:		
due to demographic assumptions	(0.4)	(0.4)
due to financial assumptions	(1.6)	0.1
Benefits paid	(1.0)	(4.2)
Present value of scheme liabilities at end of the period	**37.0**	**37.2**

Notes to the Accounts

For the year ended 31 October 2018

31. Pension scheme (continued)

Movements in fair value of plan assets

	2018 £m	2017 £m
Market value of assets at the beginning of the year	24.2	25.7
Interest income	0.6	0.7
Actuarial (loss)/gain	(1.4)	0.1
Member contributions	0.2	0.2
Employer contributions	1.6	1.7
Benefits paid	(1.0)	(4.2)
Market value of assets at the end of the year	**24.2**	**24.2**

Expense recognised in the profit and loss account

	2018 £m	2017 £m
Current service cost – staff costs	1.6	1.2
Net Interest expense – other finance costs	0.4	0.4
	2.0	**1.6**

The total amount recognised in the Statement of Other Comprehensive Income in respect of actuarial gains and losses is a gain of £0.6m (2017: gain of £0.4m) before tax.

Cumulative actuarial losses reported in the statement of other comprehensive income are losses of £8.1m (2017: losses of £8.7m) before tax.

Notes to the Accounts

For the year ended 31 October 2018

31. Pension scheme (continued)

Plan assets

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

	Fair Value	
	2018 £m	2017 £m
Quoted equity investments	1.2	5.8
Diversified growth funds	19.0	16.1
Private investments	2.3	-
Property	-	0.2
Bonds	1.4	1.3
Cash	0.3	0.8
Total market value of assets	**24.2**	**24.2**

The actual return on assets was £0.7m (2017: £0.7m).

Future contributions

The Group expects to contribute approximately £2.0m (2017: £2.0m) to its defined benefit scheme in the next financial year.

Major assumptions

The major assumptions underpinning the defined benefit obligation are:

	2018 %	2017 %
Rate of increase in salaries	4.40	4.40
Pension increases – RPI capped at 5.0% per annum	3.30	3.30
Rate of CARE revaluation	2.40	2.40
Discount rate applied to scheme liabilities	2.90	2.70
RPI inflation assumption	3.40	3.40

Notes to the Accounts

For the year ended 31 October 2018

31. Pension scheme (continued)

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

	2018	2017
Current pensioners age 65 – male	86.7	87.0
Current pensioners age 65 – female	88.6	88.8
Future pensioners age 65 (current age 45) – males	87.8	88.0
Future pensioners age 65 (current age 45) – females	89.9	90.0

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

Impact on present value of obligation:

	Change in Assumption %	Change in Deficit £m
Discount rate	0.1%	0.8
Rate of Inflation (RPI or CPI)	0.1%	0.6
Life expectancy	1 year	1.1

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

Notes to the Accounts

For the year ended 31 October 2018

31. Pension scheme (continued)

History of plan Balance Sheets

(* the year 2014 was measured under UK GAAP)	2018 £m	2017 £m	2016 £m	2015 £m	2014 £m
Fair value of plan assets	24.2	24.2	25.7	24.7	23.5
Present value of funded defined benefit obligations	(37.0)	(37.2)	(39.2)	(29.1)	(27.1)
Deficit	**(12.8)**	**(13.0)**	**(13.5)**	**(4.4)**	**(3.6)**

History of experience gains and losses

(*the year 2014 was measured under UK GAAP)	2018	2017	2016	2015	2014
Difference between the expected and actual return on scheme assets:					
Present value of funded defined benefit obligations	£(1.4)m	£0.1m	£0.5m	£0.2m	£(0.6)m
Percentage of year end scheme assets	5.6%	0.0%	1.5%	0.7%	2.5%
Experience gains and losses on scheme liabilities:					
Amount	£(0.0)m	£(0.0)m	£(0.4)m	£(0.0)m	£(0.0)m
Percentage of year end present value of scheme liabilities	0.0%	0.0%	1.0%	0.0%	0.0%
Total amount recognised in Statement of Comprehensive Income:					
Losses before tax	£0.6m	£0.4m	£(9.1)m	£(0.6)m	£(1.7)m
Percentage of year end present value of scheme liabilities	1.6%	1.1%	23.0%	2.0%	6.3%

32. Called up share capital

	2018 £m	2017 £m
Authorised, allotted, called-up and fully paid:		
66,045,191 (2017: 66,045.191) ordinary shares of £1 each	66.0	66.0
	66.0	**66.0**

During the previous year, Hodge Limited issued 66,045,191 ordinary shares of £1 each to its immediate parent Company, The Carlyle Trust Limited.

Notes to the Accounts

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33. Financial commitments and contingent liabilities

Loan commitments

	2018 £m	2017 £m
Commitments		
expiring in less than one year	33.4	83.8
expiring in more than one year	66.7	57.6
	100.1	141.4

Capital commitments
The Group had contracted capital commitments amounting to £nil at 31 October 2018 (2017: £nil).

Commitments under non-cancellable operating leases
In 2017, the Group leased an office building as its head office under a non-cancellable operating lease agreement. The lease term is 15 years, and is renewable at the end of the lease period.

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

	2018 £m	2017 £m
Within one year	0.5	0.5
Between one and five years	2.2	2.2
After five years	4.1	4.7
	6.8	7.4

Notes to the Accounts

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34. Financial instruments

a) Categories of financial assets and liabilities

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

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

As at 31 October 2018	At Amortised Cost £m	Loan and Receivables £m	Available-for-Sale £m	Fair Value Through Profit and Loss £m	Total £m
Assets					
Cash and balances held at central banks	153.2	-	-	-	153.2
Treasury bills	13.7	-	13.3	72.6	99.6
Debt securities	7.6	-	79.9	60.9	148.4
Loans and advances to credit institutions	111.9	-	-	-	111.9
Loans and advances to customers	0.8	556.3	-	685.2	1,242.3
Total financial assets	**287.2**	**556.3**	**93.2**	**818.7**	**1,755.4**
Total non-financial assets					192.8
Total assets					**1,948.2**
Liabilities					
Deposit from banks	72.5	-	-	-	72.5
Deposit from customers	994.1	-	-	-	994.1
Derivative financial instruments	-	-	-	107.6	107.6
Accruals and deferred income	3.2	-	-	-	3.2
Other liabilities	4.8	-	-	-	4.8
Total financial liabilities	**1,074.6**	**-**	**-**	**107.6**	**1,182.2**
Total non-financial liabilities					449.9
Total equity					316.1
Total equity and liabilities					**1,948.2**

Notes to the Accounts

For the year ended 31 October 2018

34. Financial instruments (continued)

a) Categories of financial assets and liabilities (continued)

As at 31 October 2017	At Amortised Cost £m	Loan and Receivables £m	Available-for-Sale £m	Fair Value Through Profit and Loss £m	Total £m
Assets					
Cash and balances held at central banks	87.0	-	-	-	87.0
Treasury bills	11.6	-	20.6	65.1	97.3
Debt securities	9.0	-	68.0	54.2	131.2
Loans and advances to credit institutions	134.9	-	-	-	134.9
Loans and advances to customers	0.4	461.0	-	692.5	1,153.9
Total financial assets	**242.9**	**461.0**	**88.6**	**811.8**	**1,604.3**
Total non-financial assets					216.6
Total assets					**1,820.9**
Liabilities					
Deposit from banks	2.8	-	-	-	2.8
Deposit from customers	941.8	-	-	-	941.8
Derivative financial instruments	-	-	-	131.2	131.2
Accruals and deferred income	3.7	-	-	-	3.7
Other liabilities	4.4	-	-	-	4.4
Total financial liabilities	**952.7**	**-**	**-**	**131.2**	**1,083.9**
Total non-financial liabilities					430.2
Total equity					306.8
Total equity and liabilities					**1,820.9**

Notes to the Accounts

For the year ended 31 October 2018

34. Financial instruments (continued)

b) Fair value estimation

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

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

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

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

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

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

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

Notes to the Accounts

For the year ended 31 October 2018

34. Financial instruments (continued)

b) Fair value estimation (continued)

As at 31 October 2017	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial assets at fair value through profit or loss				
Treasury bills	65.1	-	-	65.1
Debt securities	54.2	-	-	54.2
Loans and advances to customers	-	-	692.5	692.5
Total financial assets at FVTPL	**119.3**	**-**	**692.5**	**811.8**
Financial liabilities at fair value through profit or loss				
Derivative financial instruments	-	131.2	-	131.2
Total financial liabilities at FVTPL	**-**	**131.2**	**-**	**131.2**

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

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

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

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

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

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

Notes to the Accounts

For the year ended 31 October 2018

34. Financial instruments (continued)

d) Level 3 assets and liabilities measured at fair value

Loans and advances to customers – Lifetime mortgages:
Loans and advances to customers include £685.2m (2017: £692.5m) of assets which have been classed as fair value through the profit and loss as they relate to lifetime mortgages.

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

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

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

	2018 £m	2017 £m
At start of period	74.7	77.4
Amounts deferred in the period	10.4	4.6
Amounts recognised in the Income Statement in the period	(5.3)	(7.3)
At end of period	**79.8**	**74.7**

Reconciliation of the opening and closing recorded amount of Level 3 loans secured by lifetime mortgages:

	2018 £m	2017 £m
At start of period	692.5	739.3
Total gains/(losses) in Income Statement	0.3	(15.2)
Loans advanced	39.7	22.9
Redemptions	(47.3)	(54.5)
At end of period	**685.2**	**692.5**

Notes to the Accounts

For the year ended 31 October 2018

34. Financial instruments (continued)

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

Lifetime mortgages - principal assumptions
Principal assumptions underlying the calculation of lifetime mortgages include the following:

Mortality or entry into long term care
This is based on the expected death or entry into long term care of the customer or the last remaining customer for a joint contract. Mortality assumptions have been derived by reference to PCMA00/PCFA00. This table is adjusted from 2000 by calendar year for mortality improvements based on the CMI 2017 mortality projection model. The mortality tables are further adjusted to reflect recent mortality experience by multiplying the mortality rates by a percentage factor.

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

Expenses
Assumptions for future policy expense levels are based on the Group's recent expense analyses. Expenses are modelled as an amount per policy per annum that incorporates an annual inflation rate allowance of 4.23% (2017: 4.16%).

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

The average discount rate for the portfolio (assumed to be the 15-year point on the yield curve based on average duration at 31 October 2018) was 2.62% (2017: 2.46%).

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

The property growth and volatility assumed at 31 October 2018 were 3.28% (2017: 3.04%) and 13% (2017: 11%) respectively. The value of the no-negative equity guarantee as at 31 October 2018 was £20.4m (2017: £28.5m).

Notes to the Accounts

For the year ended 31 October 2018

34. Financial instruments (continued)

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

Sensitivity analysis

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

	Interest Rates +100 BP £m	Maintenance Expenses +10% £m	Property Inflation -100bps £m	Property Prices -10% £m	Lapses +10% £m	Increase in Mortality by 10% £m
At 31 October 2018	**(81.6)**	**(1.2)**	**(11.5)**	**(6.2)**	**(14.2)**	**(7.2)**
At 31 October 2017	(87.0)	(1.4)	(17.7)	(9.4)	(17.4)	(7.1)

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

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

Notes to the Accounts

For the year ended 31 October 2018

34. Financial instruments (continued)

e) Maturity profile of financial assets and liabilities

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

As at 31 October 2018	Not more than three months £m	More than three months but not more than six months £m	More than six months but not more than one year £m	More than one year but not more than five years £m	More than five years £m	Total £m
Assets						
Cash and balances held at central banks	153.2	-	-	-	-	153.2
Treasury bills	13.5	5.0	2.6	68.5	10.0	99.6
Debt securities	6.8	4.3	10.8	71.2	55.3	148.4
Loans and advances to credit institutions	111.9	-	-	-	-	111.9
Loans and advances to customers	51.3	12.9	46.3	289.7	842.1	1,242.3
Total financial assets	**336.7**	**22.2**	**59.7**	**429.4**	**907.4**	**1,755.4**
Liabilities						
Deposit from banks	2.5	-	-	70.0	-	72.5
Deposit from customers	299.1	80.2	284.4	330.4	-	994.1
Derivative financial instruments	-	-	0.3	9.1	98.2	107.6
Accruals and deferred income	3.2	-	-	-	-	3.2
Other liabilities	4.8	-	-	-	-	4.8
Total financial liabilities	**309.6**	**80.2**	**284.7**	**409.5**	**98.2**	**1,182.2**
Loan commitments liabilities	**23.4**	**1.4**	**8.6**	**50.1**	**16.6**	**100.1**

Notes to the Accounts

For the year ended 31 October 2018

34. Financial instruments (continued)

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

As at 31 October 2017	Not more than three months £m	More than three months but not more than six months £m	More than six months but not more than one year £m	More than one year but not more than five years £m	More than five years £m	Total £m
Assets						
Cash and balances held at central banks	87.0	-	-	-	-	87.0
Treasury bills	4.1	7.5	9.2	66.1	10.4	97.3
Debt securities	0.2	0.1	0.6	10.3	120.0	131.2
Loans and advances to credit institutions	134.9	-	-	-	-	134.9
Loans and advances to customers	36.1	29.3	19.4	288.8	780.3	1,153.9
Total financial assets	**262.3**	**36.9**	**29.2**	**365.2**	**910.7**	**1,604.3**
Liabilities						
Deposit from banks	2.8	-	-	-	-	2.8
Deposit from customers	360.7	114.0	252.3	214.8	-	941.8
Derivative financial instruments	0.2	0.1	0.6	10.3	120.0	131.2
Accruals and deferred income	3.7	-	-	-	-	3.7
Other liabilities	4.4	-	-	-	-	4.4
Total financial liabilities	**371.8**	**114.1**	**252.9**	**225.1**	**120.0**	**1,083.9**
Loan commitments liabilities	**82.2**	**0.8**	**0.8**	**50.2**	**7.4**	**141.4**

Notes to the Accounts

For the year ended 31 October 2018

34. Financial instruments (continued)

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

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

As at 31 October 2018	Book Value £m	Not more than three months £m	More than three months but not more than six months £m	More than six months but not more than one year £m	More than one year but not more than five years £m	More than five years £m	Total £m
Financial liabilities							
Deposit from banks	72.5	2.5	-	-	71.7	-	74.2
Deposit from customers	994.1	299.2	80.8	288.2	342.5	-	1,010.7
Derivative financial instruments	107.6	2.4	0.8	4.1	41.7	75.7	124.7
Accruals and deferred income	3.2	3.2	-	-	-	-	3.2
Other liabilities	4.8	4.8	-	-	-	-	4.8
Total financial liabilities	**1,182.2**	**312.1**	**81.6**	**292.3**	**455.9**	**75.7**	**1,217.6**

As at 31 October 2017	Book Value £m	Not more than three months £m	More than three months but not more than six months £m	More than six months but not more than one year £m	More than one year but not more than five years £m	More than five years £m	Total £m
Financial liabilities							
Deposit from banks	2.8	2.8	-	-	-	-	2.8
Deposit from customers	941.8	360.7	114.5	254.9	224.6	-	954.7
Derivative financial instruments	131.2	7.8	4.4	7.1	45.1	90.9	155.3
Accruals and deferred income	3.7	3.7	-	-	-	-	3.7
Other liabilities	4.4	4.4	-	-	-	-	4.4
Total financial liabilities	**1,083.9**	**379.4**	**118.9**	**262.0**	**269.7**	**90.9**	**1,120.9**

Notes to the Accounts

For the year ended 31 October 2018

34. Financial instruments (continued)

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

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

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

g) Foreign currencies

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

35. Financial risk management objectives and policies

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

The evaluation of the various risks and the setting of policy is carried out through the Group's Executive Risk Committee which reports to the Risk and Conduct Committee, which ensures adherence to the Group's risk management policy and framework.

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

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

(a) Credit risk

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

The maximum credit risk as at 31 October is the carrying value recognised on the Balance Sheet as disclosed in the table in note 34(a), along with the loan commitments as disclosed in the table in note 34(e).

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

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

Notes to the Accounts

For the year ended 31 October 2018

35. Financial risk management objectives and policies (continued)

(a) Credit risk (continued)

The primary driver of credit risk within lifetime mortgages and reversionary interests in property is a fall in house prices, which would cause credit losses should house prices fall sufficiently in real terms at the date of redemption.
The primary driver of credit risk within the treasury assets portfolio, which comprises deposits with other banks, gilts and debt securities is counterparty default, meaning the counterparty can no longer repay its obligations. Only instruments issued by counterparties with a minimum rating of BBB - at the point of purchase are held. The Group intends to hold its treasury assets to maturity and is therefore not directly affected by market risk.

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

The Group manages credit risk through its Retail Credit Committee, Commercial Credit Committee and Assets and Liabilities Committee. Regular credit exposure reports are produced which include information on credit and property underwriting, large exposures, asset concentration and levels of bad debt provisioning.

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

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

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

	2017	
	£m	%
Fully secured by a first charge on residential property	678.5	100.0
	678.5	100.0
Fair value adjustments	173.6	
	852.1	

The cumulative change in fair values due to credit risk amounts to losses of £20.4m (2017: £28.5m), and the change in the year is a profit of £8.1m (2017: £2.8m).

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

Notes to the Accounts

For the year ended 31 October 2018

35. Financial risk management objectives and policies (continued)

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

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

Residential: Performance
Performance risk is measured by those accounts in arrears. Total arrears balances as at 31 October 2018 amounted to £nil (2017: £nil). The Group has no accounts where forbearance options have been utilised. There are no residential loans and receivables that are impaired.

Credit risk: Commercial lending

Commercial: Analysis of risk concentration
Loans secured on commercial property are as follows:

	2018		2017	
	Loan Balance £m	Collateral Held £m	Loan Balance £m	Collateral Held £m
Commercial mortgage	35.7	73.8	26.0	48.2
Development finance	62.7	94.4	45.6	70.8
Investment loans	235.2	411.7	217.8	373.4
	333.6	579.9	289.4	492.4

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

Commercial: Analysis of risk concentration
The Group's commercial loan portfolio comprises the following:

	2018		2017	
	£m	%	£m	%
Loans secured on commercial property	333.6	94.2	289.4	93.2
Loans relating to renewable energy sector	20.7	5.8	20.9	6.8
	354.3	100.0	310.3	100.0
Less: Loan fee deferral	(2.3)		(2.5)	
Provisions for impairment	(3.7)		(6.4)	
	348.3		301.4	

Notes to the Accounts

For the year ended 31 October 2018

35. Financial risk management objectives and policies (continued)

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

	2018		2017	
	£m	%	£m	%
Wales	81.3	23.0	85.8	27.7
London - England	123.8	34.8	106.1	34.2
South East & East of England	16.2	4.6	22.4	7.2
Midlands - England	31.0	8.8	4.9	1.6
South West of England	68.6	19.4	73.4	23.6
North West & North East of England	19.9	5.6	4.1	1.3
Scotland	13.5	3.8	13.0	4.2
Mixed/Other	-	-	0.6	0.2
	354.3	100.0	310.3	100.0

The average loan to value (LTV) in respect of commercial loans is estimated to be 54.2% (2017: 58.8%). LTV analysis has been undertaken by using a combination of external valuations and internal and external desktop reviews which consider the type and quality of security, lease term/tenant as well as geographical location.

£13.2m (2017: £16.2m) of exposures have an LTV of greater than 100%. Of these, £12.8m (2017: £14.8m) are already classified as impaired and a further £nil (2017: £nil) are on the Watchlist, leaving £0.4m (2017: £1.4m) of exposures considered to be satisfactory. In these instances, management is satisfied that the cash flows generated by the underlying assets will be sufficient to fully repay the debt over time.

The largest exposure to one counterparty is £18.5m (2017: £23.0m) or 5.2% (2017: 7%) of gross balances.

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

	2018		2017	
	£m	%	£m	%
Satisfactory	310.3	87.6	277.3	89.4
Watchlist	28.0	7.9	18.1	5.8
Impaired	16.0	4.5	14.9	4.8
	354.3	100.0	310.3	100.0

As at 31 October 2018 there were £16.9m of commercial loans in arrears (2017: £nil).

Notes to the Accounts

For the year ended 31 October 2018

35. Financial risk management objectives and policies (continued)

Commercial: lending provisions
Provisions are held against impaired loans as follows:

	2018 £m	2017 £m
Specific provisions	3.6	6.2
Collective provisions	0.1	0.2
	3.7	6.4

Past due but not impaired
As at 31 October 2018 there were 16.9m of (2017: £nil) commercial loans that were past due but not impaired.

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

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

	2018 £m	2017 £m
UK government and amounts held with central banks	153.2	87.0
Treasury bills	99.6	97.3
Debt securities	148.4	131.2
Loans and advances to credit institutions	111.9	30.0
	513.1	345.5

None of these exposures are past due or impaired.

Notes to the Accounts

For the year ended 31 October 2018

35. Financial risk management objectives and policies (continued)

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

	2018 £m	2017 £m
AAA to AA-	458.7	298.4
A+ to A-	29.9	25.4
BBB+ to BBB-	20.9	17.8
BB+ to BB-	3.6	3.9
	513.1	345.5

Concentration of credit risk
The geographical exposure is as follows:

	2018 £m	2017 £m
UK	469.2	305.5
Other	43.9	40.0
	513.1	345.5

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

Notes to the Accounts

For the year ended 31 October 2018

35. Financial risk management objectives and policies (continued)

b) Liquidity risk

Liquidity risk is the risk that the Group will encounter difficulty in realising assets or otherwise raising funds to meet commitments as they fall due. The Group manages its liquidity risk through its Assets and Liabilities Committee, and monitors its liquidity position on a daily basis and has adopted a policy to ensure that it has adequate resources to enable it to conduct its normal business activities without interruption. The maturity analysis of assets and liabilities is disclosed in note 34 (e) & (f) to the financial statements.

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

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

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

c) Interest rate risk

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

The table in note 34(d) shows an estimate of the interest rate sensitivity gap as at 31 October 2018. The principal risk management tool to mitigate interest rate risk is the use of derivatives to align the interest rate re-pricing profile of assets and liabilities. All of the derivatives used by the Group are interest rate swap contracts of varying maturities and start dates.

The Group's interest rate risk management policy defines the type of derivative transactions that can be undertaken, which are all actioned by the Group's treasury function, and are subject to review and approval at the dealing stage. The Treasurer, who is responsible for treasury matters on a day to day basis, prepares a treasury report for the Board, which includes analysis of interest rate risk exposures.

d) House price risk

House price risk is the risk that arises when there is an adverse mismatch between actual house prices and those implicit in the costing of the Group's lifetime mortgages and reversionary interests, such that the ultimate realisation of the property would not yield the expected return to the Group and could, in certain circumstances, result in a capital loss. The Group mitigates house price risk by monitoring maximum Loan to Value at inception of the loan and reversionary interests. The reversionary interests are a legacy product which is being run-off over the medium term.

Notes to the Accounts

For the year ended 31 October 2018

35. Financial risk management objectives and policies (continued)

Geographical analysis of loans secured on lifetime mortgages

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

	2018		2017	
	£m	%	£m	%
Wales	18.6	3.4	18.1	3.5
South East	149.9	27.5	141.9	27.6
South West	68.6	12.6	66.4	12.9
London	71.6	13.2	61.6	11.9
East Anglia	62.8	11.5	59.1	11.5
North West	43.6	8.0	42.1	8.2
West Midlands	30.5	5.6	28.6	5.6
North East	19.8	3.6	18.9	3.7
Yorkshire & Humberside	17.7	3.3	17.8	3.5
East Midlands	19.4	3.6	18.8	3.7
Scotland	24.1	4.4	23.0	4.5
Northern Ireland & Other	17.7	3.3	17.4	3.4
	544.3	100.0%	513.7	100.0%

e) Conduct risk

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

The Group holds a provision of £0.1m as at 31 October 2018 (2017; £0.1m) in respect of conduct risk which is disclosed in note 30.

Notes to the Accounts

For the year ended 31 October 2018

35. Financial risk management objectives and policies (continued)

f) Operational risk

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

g) Insurance risk

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

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

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

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

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

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

Notes to the Accounts

For the year ended 31 October 2018

36. Related parties

The Company has relationships with its immediate parent Company, The Carlyle Trust Limited and fellow subsidiaries of The Carlyle Trust Limited. All transactions are carried out on an arm's length basis with the exception of the acquisition of Hodge Life Assurance Company Limited, which was acquired at cost. The other group related party transactions are disclosed below:

	Interest income/(expense)	
	2018 £'000	2017 £'000
Jane Hodge Foundation – shareholder of The Carlyle Trust Limited	(5.3)	-
The Carlyle Trust Limited – parent	(4.8)	(23.2)
	(10.1)	(23.2)

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

	2018 £m	2017 £m
Amounts owed from parent and fellow subsidiaries		
The Carlyle Trust Limited – parent	0.3	-
Carlyle Property Development Company Limited – fellow subsidiary	0.4	-
Sterling House Limited – fellow subsidiary	0.1	-
Total	**0.8**	**-**
Amounts owed to parent and fellow subsidiaries		
The Carlyle Trust Limited – parent	-	(0.7)
Carlyle Property Development Company Limited – fellow subsidiary	-	(0.8)
Total	**-**	**(1.5)**
Deposits owed to parent and fellow subsidiaries		
Jane Hodge Foundation – shareholder of The Carlyle Trust Limited	(2.5)	(2.2)
The Carlyle Trust Limited – parent	(0.2)	(3.4)
Total	**(2.7)**	**(5.6)**

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

	2018 £m	2017 £m
Short-term employee benefits:	0.8	0.6

Notes to the Accounts

For the year ended 31 October 2018

37. Ultimate parent undertaking

The ultimate parent undertaking and controller is The Carlyle Trust (Jersey) Limited (incorporated in Jersey), a company controlled by a Hodge family trust, whose sole natural trustee is Jonathan Hodge.

38. Shares in group undertakings

Company	£m
At beginning of year	66.0
Additions	16.0
Issue of new shares	-
At end of year	**82.0**

On 31 July 2018 Hodge Limited acquired an investment in Hodge Life Assurance Company Limited for £16.0 million.

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

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

39. Capital risk management

Banking segment

The banking segment conducts an Internal Capital Adequacy Assessment Process ("ICAAP"), at least annually, which is approved by the Board. This is used to assess the Bank's capital adequacy and to determine the level of capital required to support the future development of the business as set out in the strategic plan.

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

Notes to the Accounts

For the year ended 31 October 2018

39. Capital risk management (continued)

Banking segment (continued)
The Bank's capital resources requirements are calculated based on the CRD IV and CRR regulatory framework as implemented by the PRA, namely:

- Pillar 1 - based on a Standardised Approach for credit risk, operational risk and market risk;
- Pillar 2 - set by the PRA via the ICG to address those risks not covered under Pillar 1.

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

This means that the Bank will:

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

	2018 £m	2017 £m
Common Equity Tier 1 capital	168.0	149.3
Total risk weighted assets	751.7	706.3
Common Equity Tier 1 capital ratio	**22.3%**	**21.1%**
Total own funds	168.0	149.5
Total risk weighted assets	751.7	706.3
Total capital ratio	**22.3%**	**21.2%**

The Bank had a common equity tier 1 capital ratio of 22.3% (2017: 21.1%) and a total capital ratio of 22.3% (2017: 21.2%).

Notes to the Accounts

For the year ended 31 October 2018

39. Capital risk management (continued)

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

- Name, nature of activities and geographical location: The Bank operates only in the United Kingdom. The principal activities of the Bank are noted in the Strategic Report.
- Average number of employees: as disclosed in Note 11 to the accounts.
- Annual turnover (Net Interest Income) and profit before tax: as disclosed in the Income Statement.
- Corporation Tax paid by Julian Hodge Bank Limited: 2018 £0.3m (2017: £8.4m).
- Public subsidies: There were none received in the year.

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

The banking segment's objectives when managing capital are:

- To have sufficient capital to safeguard the Bank's ability to continue as a going concern so that it can continue to provide returns for the shareholder and benefits for other stakeholders;
- To comply with the bank capital requirements set out by the PRA in the UK.

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

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

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

All minimum regulatory requirements were met during the year.

The objectives when managing capital are:

- To have sufficient capital to safeguard its ability to continue as a going concern so that it can continue to provide returns for the shareholder and benefits for other stakeholders;
- To comply with the insurance capital requirements set out by the regulators of the insurance markets in which the insurer operates (the PRA in the UK);
- To provide an adequate return to the shareholder by pricing insurance contracts according to the level of risk associated with the business written.

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

Notes to the Accounts

For the year ended 31 October 2018

39. Capital risk management (continued)

Pillar 1 capital position

	2018 Unaudited £m	2017 Audited £m
Total capital resources	143.9	154.8
Solvency capital requirement (SCR)	(78.4)	(76.7)
Excess available capital resources	65.5	78.1
Cover ratio	183%	202%

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

	2018 Unaudited £m	2017 Audited £m
Total equity	144.3	155.4
Less: share capital	(6.8)	(6.8)
Less: other non-distributable reserves	(72.0)	(70.5)
Distributable reserves	**65.5**	**78.1**

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

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Registered Number
0390216