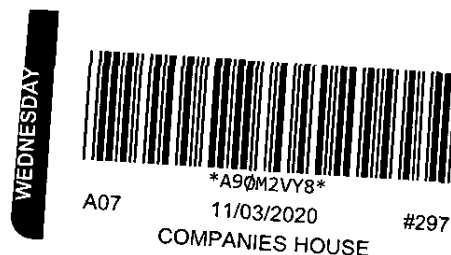


# **The Carlyle Trust Limited**

**Annual report and financial  
statements**

**31 October 2019**

**Registered number 0361131**



## **Officers and professional advisers**

### **Directors**

Jonathan Hodge

Chairman

Stephen Pateman

Chief Executive Officer  
F.C.I.B.S.

Adrian Piper

B.A., M.Sc.,  
M.C.I.P.D.,  
M.C.I.M.

Alun Bowen

F.C.A.,  
M.A.

Helen Molyneux

LLD (Hons),  
LLB (Hons).

John Barbour

M.B.A.,  
B.Sc.

### **Company Secretary**

Kirsty Williams

LLB (Hons).

### **Registered Office**

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Cardiff  
CF10 1FS

### **Auditor**

Ernst & Young LLP  
Bristol

### **Principal bankers**

Lloyds Bank Plc  
London

### **Economic adviser**

Professor Patrick Minford  
Cardiff Business School

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## **Chairman's Statement**

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

The main trading entities are: Julian Hodge Bank Limited (the 'Bank') and Hodge Life Assurance Company Limited ('Hodge Life').

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

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

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

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

Our strategy is discussed in greater detail by our new Chief Executive on page 7. Steve Pateman joined us in January 2019 from Shawbrook and has made a very encouraging start; I and the Board would like to extend our appreciation to David Austin who retired as our Chief Executive Officer (CEO) this year after 28 years with the Group. David made a significant contribution to our business over many years working through many challenges and we wish him well in his retirement.

Our results have been discussed in detail by the Group's Chief Financial Officer in detail on page 10. It was undoubtedly a challenging environment for both our Life and Banking businesses with significant volatility in equity and debt markets and historically low interest rates, all of which impacted capital levels as well as the IFRS results despite a robust performance at an operating profit level; notwithstanding a significant £4.3m loss on a commercial lending development transaction.

We took the opportunity to reduce our holding of legacy equity release mortgages in the banking business and this crystallised a gain of £19.5m compared with the balance outstanding of the mortgages but a loss of £4.6m on the fair value of £122.0m. The liquidity and capital created from this disposal will be deployed into our core businesses to produce less volatile returns in the future. We will look for further opportunities to reduce our legacy assets over the coming months and we have adjusted the fair value of the remaining assets to reflect the current market conditions.

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

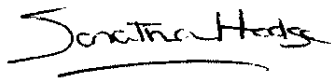
Notwithstanding the clarity provided by the general election result and the potential for a recovery in confidence and investment, there remains much uncertainty at this time both in the United Kingdom and on a global level and our central assumption is that interest rates and growth will remain low: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

## Chairman's Statement

Alongside the changes in executive leadership, the Board has continued to evolve. David Gulland has joined us to chair the newly formed Risk and Conduct Committee within Hodge Life. David has an extensive background in life assurance and his actuarial experience will help the Board provide appropriate challenge and oversight as we seek to optimise our capital profile in Hodge Life.

Graeme Hughes has been appointed as Senior Independent Director at a Hodge Limited level (Hodge Limited sub-group level includes the Bank and Hodge Life). Graeme joins us after a long and successful career at Nationwide where he was the Group Distribution Director; responsible for all sales and service activities across 720 branches and 10,000 staff.

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



**Jonathan Hodge**

Chairman

19 December 2019

### **Our Business and Corporate Social Responsibility**

#### **Our Business**

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

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

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

#### **Specialist mortgages**

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

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

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

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

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

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

#### **Professional buy-to-let**

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

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

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

#### **Later life**

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

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

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

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

## **Our Business and Corporate Social Responsibility**

### **Commercial lending**

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

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

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

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

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

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

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

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

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

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

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

### **Savings**

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

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

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

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

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

## **Our Business and Corporate Social Responsibility**

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

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

### **Hodge Life**

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

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

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

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

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

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

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

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

### **Colleagues**

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

- **Training and development**

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

- **Health and wellbeing**

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



## Our Business and Corporate Social Responsibility

- **Flexible working**

We recognise creating a healthy work-life balance is essential for the Group. In 2019 we introduced greater flexibility for our people, empowering and enabling them to manage their work-life balance effectively. We will continue to invest in solutions that equip the business and our team to succeed in all aspects of their career with the Group.

- **Gender diversity**

The Group is proud to have signed HM Treasury's Women in Finance Charter. The Group has a target of 45% of women in senior leadership roles by October 2022. At September 2019 35% of the senior leadership team are women. By signing the charter the Group has pledged to promote gender diversity by:

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

### **Corporate Social Responsibility (CSR)**

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

#### **Customers & community**

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

- **Age Cymru**

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

- **Shelter Cymru**

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

- **Colleague fundraising and support**

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

## **Chief Executive Officer's Statement**

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

Our results, which are discussed in greater detail in the Group's Chief Financial Officer's Report on Page 10, reflect the challenges of operating in a low interest rate and low growth environment where our performance has been constrained by the impact on capital availability in both the Life and Banking businesses. Our plans for the future will seek to reduce the impact of interest rates on both businesses.

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

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

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

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

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

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

The strategy anticipates significant growth in assets, particularly mortgages, over the period to 2023 building on our traditional strengths in later life whilst also adding capability that plays to our strengths as a specialist lender in both the residential and commercial markets.

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

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

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

## Chief Executive Officer's Statement

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

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

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

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

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

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

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

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


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

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

## **Chief Executive Officer's Statement**

The Group is in many ways a unique business: its ownership creates a unique social purpose and an environment which encourages innovation, people development and commercial performance but with an integrity and long-term commitment that is difficult to achieve in other ownership structures. An awareness, respect for and engagement in that culture is a prerequisite for the Group and we have shaped our longer-term ambitions around these cultural themes.

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



**Steve Pateman**  
Chief Executive Officer  
19 December 2019

### Chief Financial Officer's Report

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

#### Key performance indicators

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

	2019	2018
<b>Financial performance</b>	<b>£m</b>	<b>£m</b>
Net operating income	65.2	54.4
Operating profit	35.4	35.8
Profit before tax	12.4	11.7
Loans and advances to customers	1,240.2	1,242.6
<b>Group financial ratios</b>	<b>%</b>	<b>%</b>
Net interest margin <sup>1</sup>	2.0	2.0
Cost income ratio <sup>2</sup>	37.3	34.0
<b>Financial soundness - Hodge Bank</b>	<b>%</b>	<b>%</b>
Common Equity Tier 1 ratio	22.5	22.3
Leverage ratio	11.1	11.9
Liquidity Coverage Ratio	516.9	236.8
<b>Financial soundness - Hodge Life</b>		
Solvency Capital Ratio	165.0	183.0

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

#### Net operating income

An increase of 19.9% in net operating income mainly due to the significant profit achieved on the sale of land within a property development subsidiary of £6.1m. In addition, net operating income increased due to the growth of our residential mortgage business and as a result of increased realised gains on the reversionary product.

#### Operating profit

The increase in net operating income did not flow in its entirety through to operating profit, mainly due to a significant impairment on commercial lending exposures of £4.3million. Progress has been made in 2019 to resolve commercial lending exposures in IFRS 9 Stage 2 and 3, with related balances decreasing by £3.9m.

Operating profit was also adversely impacted by planned increases in administrative expenses due to substantial investment in people, premises and systems to enable us to carry out our plans to grow the business over the coming years.

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

#### Profit before tax

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

<sup>1</sup> Net interest margin: net interest income as a proportion of total assets.

<sup>2</sup> Cost income ratio: Administration expenses; as a proportion of net operating income.

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

The overall result is a profit before tax of £12.4m and an increase in shareholder's funds of £1.4m which was depleted by actuarial losses of £3.3m on the defined benefit pension scheme and adverse adjustments on transition to IFRS 9 of £3.4m.

### Balance Sheet overview

	2019 £m	2018 £m	% Change
Liquid assets <sup>1</sup>	599.7	513.2	16.9
Loans and advances to customers	1,240.2	1,242.6	(0.2)
Investment properties	179.8	189.7	(5.2)
Other assets <sup>2</sup>	36.1	28.3	27.6
<b>Total assets</b>	<b>2,055.8</b>	<b>1,973.8</b>	<b>4.2</b>
Deposits from banks	72.5	72.5	-
Deposits from customers	1,039.5	993.9	4.6
Provision for long term business	498.7	437.0	14.1
Other liabilities <sup>3</sup>	103.0	129.7	(20.6)
Share capital and reserves	342.1	340.7	0.4
<b>Total liabilities and equity</b>	<b>2,055.8</b>	<b>1,973.8</b>	<b>4.2</b>

### Loans and advances to customers

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

### Funding

Retail savings remain a primary funding source and during the year we have focused on enhancing the services we provide to customers through improving our digital efficiency. At the year-end savings balances were £1,039.5million (31 October 2018: £993.9million); this increase was driven by both our on-line and continued competitive presence.

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

### Liquidity

The Group holds liquid assets to meet its financial obligations in both business-as-usual and stressed situations. As at the year end, the Group held £599.7m of liquid assets (31 October 2018: £513.2 million) which are available to protect it from liquidity stresses.

#### Banking segment

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

#### 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.

<sup>1</sup> Liquid assets: made up of Cash and balances held at central bank, Treasury Bills, Debt securities and loans and advances to credit institutions

<sup>2</sup> Other assets: made up of Intangible assets, Property plant and equipment, Investments, Deferred tax assets and Inventory

<sup>3</sup> Other liabilities: made up of Derivative financial instruments, Other liabilities and the net deficit on the Pension scheme

### Defined benefit pension scheme

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

### 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.

#### *Banking segment*

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

#### *Leverage*

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

#### *Life assurance segment*

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

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



**David Landen**

Chief Financial Officer  
19 December 2019

## Long-term Viability Statement and Going Concern

### Long-term Viability Statement and Going Concern

#### Assessment of prospects

The resilience of our business model is relevant to any consideration of our prospects and viability. We benefit from diversification between our specialist mortgages, portfolio buy-to-let, Hodge Life and our commercial lending businesses, which enables our services to be provided in a capital-effective way allied with our track record in attracting funding from different sources. We assess our prospects on a regular basis through our financial planning process. Our rolling five-year strategy forecasts profitability, cash flows, capital and funding requirements at a Hodge Limited sub-group level (includes Hodge Bank and Hodge Life) 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 savings business will assist in making the Group 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 the Group will continue to retain and attract loyal depositors. Given the long-term nature of many of the businesses mortgage products, the directors have also given due regard to the possible impact of climate change on its future prospects.

#### UK withdrawal from EU

The decision to leave the EU has led to continuing uncertainty throughout 2019. At the date of signing the financial statements, there remains the possibility of a range of outcomes; further delays and uncertainty are probable but a 'no deal' disorderly exit is considered unlikely.

#### The Group's response

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

#### Consideration of risks

Consideration of the risks may be summarised as follows:

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

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



## Long-term Viability Statement and Going Concern

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

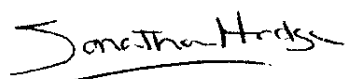
### Viability statement

The directors have carried out an assessment of the longer-term viability of the Group. The assessment covers a period of five years, as this is the period covered by the Hodge Limited sub-group 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 rolling five-year Plan and the programme of regulatory and internal stress testing it undertakes, further details of which are as follows:

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

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



**Jonathan Hodge**  
Chairman  
19 December 2019

## **Corporate Governance**

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

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

The Board of the Group comprises of one executive and six non-executive directors. The roles of Chairman and Chief Executive are separate to ensure that neither can exercise unfettered powers of decision-making on matters of material importance.

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

- Distributing papers sufficiently in advance of meetings;
- Considering the adequacy of the information provided before making decisions; and
- Deferring decisions when directors have concerns about the quality of information.

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

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

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

### **Governance framework**

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

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

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

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

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

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

### **The Board**

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

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

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

Details of the members of the Board of the Group are set out below:

#### **Jonathan Hodge - Chair**

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 Company and the Board of Trustees of the Hodge Foundation.

#### **Adrian Piper – Non-executive director**

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

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

#### **Alun Bowen - Non-executive director**

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

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

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

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

#### **Helen Molyneux - Non-executive director**

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

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

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

**John Barbour - Non-executive director**

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

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

**Steve Pateman – Chief Executive Officer**

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

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

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

**Board Committees**

The Board has established the following standing committees which operate throughout the Group:

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

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), Helen Molyneux, John Barbour, Jonathan Hodge 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 historically meets at least four times a year and is increasing the number of meetings per year to eight. A report from the Chair of the Risk and Conduct Committee can be found on page 37.

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

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

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

The Committee meets at least twice per year. A report from the Chair of the Remuneration Committee can be found on page 48.

- **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 at least twice per year. A report from the Chair of the Nomination Committee can be found on page 46.

### **Board and Committee Membership and Attendance**

Adrian Piper	8	8	5	5	5	5	4	4	3	3
John Barbour	8	7	5	5	5	5	4	3	3	2
Jonathan Hodge	8	8	5	5	5	5	4	4	3	3
Helen Molyneux	8	7	5	5	5	5	4	3	3	3
Alun Bowen	8	7	5	4	5	5	4	2	3	2
Steve Pateman	6	6	-	-	-	-	-	-	-	-
David Austin	3	3	-	-	-	-	-	-	-	-

**(a)** Number of meetings held

**(b)** Number of meetings attended

### **Notes**

Steve Pateman joined the Board on 7 February 2019

David Austin retired from the Board on 7 February 2019

## **Risk Management**

Managing risk effectively is fundamental to our strategy and to operating successfully. The Group 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 the Group:

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

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

### **Three Lines of Defence Model**

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

<p><b>First line of defence - Day-to-day risk management</b></p> <p>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.</p> <p>The first line of defence:</p> <ul style="list-style-type: none"> <li>• Owns and manages the Group's risks;</li> <li>• Responsible for compliance with relevant regulation &amp; legislation;</li> <li>• Identifies, manages and mitigates the risks of the Group;</li> <li>• Defines and operates controls;</li> <li>• Assess key risk indicators and market conditions;</li> <li>• Produces management information and reports on risks.</li> </ul>
<p><b>Second line of defence - risk oversight</b></p> <p>The Second line of defence is responsible for providing independent oversight and challenge of activities undertaken by the first line and provides guidance on risks relevant to the strategy. This is provided through the Risk function, which is led by the Chief Risk Officer (CRO), who reports to the CEO and has an independent reporting line to the Chairman of the Risk and Conduct Committee. It maintains and reports an aggregate view of risks and performance in relation to risk appetite to the Risk and Conduct Committee. The Risk function is not customer facing and has no responsibility for business targets or performance.</p> <p>The Second line of defence:</p> <ul style="list-style-type: none"> <li>• Designs, interprets and develops executive risk management fund and monitors business as usual adherence to the framework;</li> <li>• Advising the Board on risk appetite;</li> <li>• Provides oversight, challenge and assurance over the management of risks;</li> <li>• Develops compliance policies, supports delivery of regulatory change and monitors and reports on regulatory issues.</li> </ul>

### Third line of defence - internal audit

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

The third line of defence:

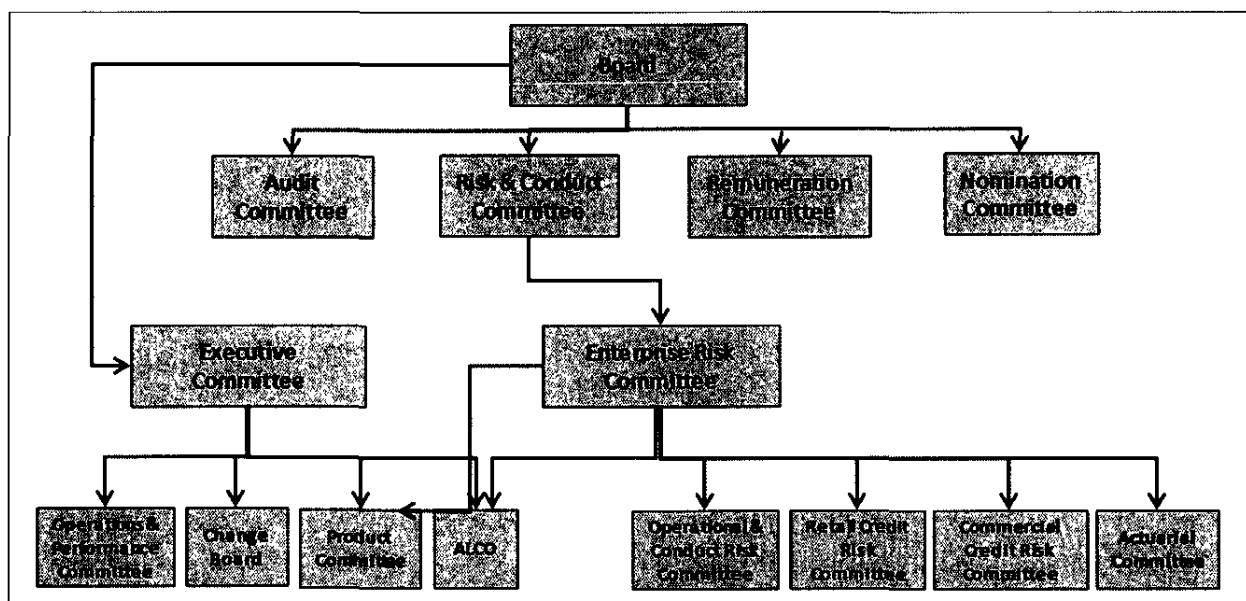
- Conducts independent testing and verification of the efficacy of the Group's business model, controls, policies, processes and business line compliance;
- Provides assurance that the risk management process is functioning as designed.

### Risk Governance

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

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

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



### Executive Committees:

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

#### Operations & Performance Committee

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

### **Change Board**

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

### **Product Committee**

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

### **Assets & Liabilities Committee (ALCO)**

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

### **Operational & Conduct Risk Committee**

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

### **Retail Credit Risk Committee**

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

### **Commercial Credit Risk Committee**

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

### **Actuarial Committee**

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

### **Risk Strategy**

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

### **Risk Culture**

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

### **Risk Appetite**

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

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



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

### Top and emerging risks

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

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

Current threat/Emerging risk	Principal risk category	Mitigation/Strategic response
<p><b>UK political and economic uncertainty</b> Continued lack of clarity on the eventual outcome of the EU withdrawal which is subduing investment and purchase activity and therefore macroeconomic fundamentals. In addition, the withdrawal from the EU could lead to changes in the regulatory framework.</p>	<ul style="list-style-type: none"> <li>• Strategic risk</li> <li>• Market risk</li> <li>• Credit risk</li> </ul>	<p>It is anticipated the UK withdrawal from the EU will have limited to no direct impact on the Group as its UK based with no services or relationships with other EEA countries.</p> <p>However, the Group remains exposed to the impact that the withdrawal may have on the UK economy including housing market, interest rates, unemployment and inflation.</p> <p>Economic conditions are actively monitored. Risk appetites have been established for Balance Sheet sensitivity to external factors.</p> <p>Supporting this, is the wider stress testing framework that tests for scenario vulnerabilities and impacts on capital &amp; liquidity required to cover risks.</p>

## Risk Management

<p><b>Market/competitive environment</b> Disruptive technologies, new competitors (traditional and non-traditional) and search for yield have the ability to threaten the current business model and achievement of the Group's strategy.</p>	<ul style="list-style-type: none"> <li>• Strategic risk</li> <li>• Market risk</li> </ul>	<p>Continual monitoring of the competitive environment is undertaken and discussed regularly alongside strategy development meetings. Competitor benchmarking and networking forums allow insight into firm's potential strategic intent. Appropriate market research and a new product development governance process are conducted to ensure strategic initiatives are properly controlled.</p>
<p><b>Change &amp; execution risk</b> The Group has committed to a number of strategic change initiatives which are key to the achievement of our strategic objectives. These significant activities increase cost and execution risk.</p>	<ul style="list-style-type: none"> <li>• Strategic risk</li> <li>• Operational risk</li> </ul>	<p>The change programme will deliver additional resilience to the Group's business model and its operational resilience once fully implemented. The change programme has risk management processes in place to ensure safe and controlled delivery of the initiatives required.</p>
<p><b>Climate risk</b> Financial risks from climate change arise through two primary channels; physical i.e. specific weather events &amp; damage to assets and transition risks i.e. increased regulation to adjust to low carbon economy. These manifest as increasing underwriting, credit, or market risk for firms.</p>	<ul style="list-style-type: none"> <li>• Strategic risk</li> <li>• Credit risk</li> <li>• Operational risk</li> </ul>	<p>A climate change policy has been implemented outlining governance structures, disclosures, risk management approach, Senior Management Function responsibility has been allocated and an internal working group established to develop Hodge's approach and understanding of the risk posed by climate change. Climate change is being addressed specifically as part of the regulatory risk management documents; ORSA and ICAAP.</p>
<p><b>Operational resilience</b> The firm's key services utilise IT systems and operational processes, failure of these resources can lead to customer disruption, adverse impacts on the firm's reputation and cost associated with remediating these failures.</p>	<ul style="list-style-type: none"> <li>• Strategic risk</li> </ul>	<p>The risk management framework in place across the organisation covering both operational and IT risks helping to identify, measure, manage and monitor these risks. Plans are in place to minimise and recover from business disruption and information security events.</p>

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

### Principal Risks

These are the most significant risks faced by the Group 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, residential mortgages to retail customers and from investments held by the Treasury function. The Group is willing to be exposed to a moderate level of risk for an acceptable return.

#### 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 residential mortgages due to the customer's failure to service interest or repay capital.
- **Commercial credit risk** - the risk of financial loss from a commercial lending customer's failure to settle financial obligations as they fall due or movements in commercial real estate prices.
- **Treasury credit risk** - the risk that a debt issuer or counterparty will fail to make payments (either interest or principal) in a timely manner or the credit worthiness of borrowers deteriorate reducing the value of investments.

Within each business line dedicated first line risk management is provided by appropriately skilled credit managers and treasury staff. The 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 the Trustees and approved by the Group in April 2019 and a plan to eliminate the deficit was agreed. The Group regularly monitors actual performance of the scheme against this agreed recovery plan.

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

**Key drivers and appetite**

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

**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 the Asset and Liability Committee.

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

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

**Key drivers and appetite**

Property price risk is driven by commercial lending, reversions, equity release and retirement mortgages and the no negative equity guarantee (NNEG) on equity release and retirement mortgage products. The Group is willing to accept a moderate level of property price risk for an acceptable return but wishes to employ risk management strategies to reduce associated volatility.

**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; and
- 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; and
- Well-defined policies for the management of interest rate risk.

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

**Strategic risk** – the risk of loss through failure to define, develop and implement an effective and realistic strategic plan.

**Key drivers and risk 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 the Board and senior management. This is supported through additional risk reporting and monitoring of the key threats to the business on risk registers and horizon scanning to ensure the business can respond in appropriately.

### Underwriting risk including:

**Insurance / Mortality risk** – the risk that longer/shorter policyholder life expectancy results in financial losses for the Group.

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

### Key drivers and appetite

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

### 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, 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.

### 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. 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.

**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 risk 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 the Group's policy;
- **People** - failure to manage the human resources of the Group in order to maximise its value;
- **Compliance** - failure to comply with legal and regulatory requirements;
- **Systems** - IT systems do not meet the requirements of the Group or are not maintained to a high standard to ensure agreed availability;
- **External** - disruption to business model and/or operations due to political, legal or regulatory changes, adverse publicity or external disasters;
- **Change** - failure to successfully deliver change to achieve defined strategic benefits or failure to operate robust change implementation controls resulting in disruption to operational processes and/or the customer journey;
- **Security** - failure to manage the physical or information security of the Group leading to disruption to operational processes, customer impact and/or financial loss; and
- **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.

### 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.

### *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 the Board and help guide decision-making by taking into account the risks the firm faces.

### **Reverse Stress Testing**

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

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

### **Recovery Planning**

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

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



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

### **Operational Resilience**

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

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

## Report from Chair of the Audit Committee

### Report from John Barbour, Chair of the Audit Committee

The financial year ended 31 October 2019 has been a year of change with the appointment of a new CEO. In addition, this is the first set of financial statements incorporating the impact of IFRS 9. The Audit Committee thanks all employees involved in the hard work performed to transition the organisation to IFRS 9.

The Audit Committee's agenda continues to include its responsibilities as the 'third line of defence' in the Group'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 the Group'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 the Group's financial statements are fair, balanced and understandable.

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

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

## Report from Chair of the Audit Committee

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

## Report from Chair of the Audit Committee

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

## Report from Chair of the Audit Committee

Area of focus	Role of the Audit Committee	Conclusion/Action taken
<p><b>Derivatives</b></p> <p>The 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.</p> <p>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.</p>	<p>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.</p> <p>Management were also able to evidence, for all the derivatives settled in the year, that the value attributed by counterparties prior to breaking the derivative was in line with the valuation held by the Group.</p>	<p>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.</p>
<p><b>Long term viability</b></p> <p>The directors make a statement in the Annual Report as to the long-term viability of the Group. The Committee provides advice to the Board on the form and content of the statement, including the underlying assumptions.</p>	<p>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).</p>	<p>The Committee agreed to recommend the long-term viability statement to the Board.</p>
<p><b>Fair, balanced and understandable reporting</b></p> <p>The Group 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.</p>	<p>The Committee assessed, via discussion with, and challenge of, management (including the CEO and CFO), as to whether disclosures in the Group's published financial statements were fair, balanced and understandable.</p>	<p>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 the Group's published report and financial statements were fair, balanced and understandable.</p>

## Report from Chair of the Audit Committee

### External audit

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

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

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

The Committee has a policy whereby all services which are not covered in the audit are approved by the Committee. The Group continues to examine non-audit fees in light of the Ethical Standard issued by the Financial Reporting Council (FRC). The Audit Committee asked EY to assist it on one matter outside of the annual statutory audit and Solvency II audit: finalisation of the assurance on the model validation for the MA/PIM project that commenced last year. The payments made to EY for non-audit fees in the year ended 31 October 2019 was £85,000 (2018: £100,000). This reflects a non-audit fee to audit fee ratio of 33%, the average for the last three financial years is 55%. As promised in my report last year the average non-audit fee for the last three financial years is below the 70% limit set by the FRC.

### Internal audit

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

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

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

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

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

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

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

## Report from Chair of the Audit Committee

### Internal control

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

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

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

### Whistleblowing

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

### Committee composition and meetings

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

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

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

### Interaction with regulators

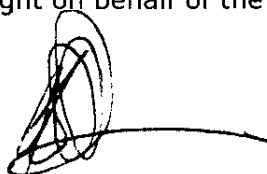
As Chair of the Audit Committee I meet with the members of the Group's regulatory team at the PRA, without management present, during their annual visit to the Group.

### Committee performance

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

### Looking ahead

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



**John Barbour**

Chairman of the Audit Committee  
19 December 2019

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

In my report last year, I commented that the Committee's work was driven by a number of challenges, arising from regulatory change, an evolving market and external threats. This year again there was a lot of uncertainty and a higher degree of regulatory interaction than hitherto both in Hodge Bank and Hodge Life.

### *Separation of the Committee*

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

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

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

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

### *My responsibilities*

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

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

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

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



## Report from Chair of the Risk and Conduct Committee

### Activity during the year

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

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

## Report from Chair of the Risk and Conduct Committee

I also commented in last year's report that the Group had a number of projects underway and that the effective management of risk in these projects would be important. The Change Board that was established last year in the first line of defence to ensure that this risk is managed, appears to be working effectively. This is even more important as the number and the complexity of the Group's projects continues to increase. These include; the building of the residential mortgage business which has a high technology input; the sale of a significant part of Hodge Bank's legacy assets, the investigation of a longevity swap and the potential application for the use of a PIM for Hodge Life. The Committee receives an excellent comprehensive report at each meeting setting out the risks and challenges of each major project and an assessment of its status, allowing the Committee to discuss and challenge management's assessment of each project.

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

Area of focus	Action taken by the Risk and Conduct Committee	Conclusion or further action taken
<b>Interest rate risk</b>		
<i>Hodge Bank</i> A significant amount of volatility arises in Hodge Bank as a result of its legacy business, primarily equity release mortgages and reversionary interests in residential property, together with the related interest rate derivatives.	<i>Hodge Bank</i> The Risk and Conduct Committee in conjunction with the Board approved management's plans to sell a significant part of Hodge Bank's equity release mortgage portfolio and break the related derivatives. Although this resulted in a loss being recognised in the financial statements it had been agreed that it was very important to reduce the volatility within Hodge Bank's Balance Sheet.	<i>Hodge Bank</i> The Risk and Conduct Committee is satisfied that management has achieved a significant reduction in volatility but continues to encourage management to explore ways of reducing interest rate volatility in the legacy portfolio.
<i>Hodge Life</i> The current low and turbulent interest rate environment makes close management of Hodge Life's SCR a challenge.	<i>Hodge Life</i> The Risk and Conduct Committee has supported management's actions to reduce new business activity in order to endeavour to stabilise the SCR which has reduced significantly in the year. It has also encouraged management to explore other options to increase the SCR, such as reinsurance and the judicious use of derivatives.	<i>Hodge Life</i> The Risk and Conduct Committee is satisfied that management is focused on taking action to improve Hodge Life's SCR and monitors progress carefully. It is planned that significant progress will be made in the next financial year.

## Report from Chair of the Risk and Conduct Committee

<p><b>Operational resilience</b></p> <p>Ensuring that if there is a disruption (from cyber-attacks or other operational issues) that the Group can respond, recover and minimise the impact for customers.</p>	<p>The Risk and Conduct Committee ensured that management had fully considered the PRA's initiative in providing greater focus on operational resilience. The Committee checked that the changes in the Group's systems and business, increasing digitalisation and use of suppliers, had not resulted in any increased risk that the Group is not resilient to disruption.</p> <p>Management has engaged fully with the Committee on its plans and at each meeting (and since July for Hodge Bank and Hodge Life separately) there is an update on the progress made on implementing the operational resilience programme.</p>	<p>The Risk and Conduct Committee is satisfied with the progress that has been made. The intention is to close the remaining gaps early in the new financial year.</p>
<p><b>Risk appetite and stress testing</b></p> <p>This involves considering the level of risk the Group chooses to take in pursuit of its business objectives, including testing whether the Group's financial position and risk profile provides sufficient resilience to withstand the impact of severe economic stress.</p>	<p>The Committee has assessed the risk context for the Group's Strategic Plan, including general economic and financial conditions and how these are reflected in the Strategic Plan.</p> <p>The Committee approved a Group Risk Strategy to ensure that the Group's Strategic Plan is closely linked with its risk appetite.</p> <p>It also held a risk workshop, with executive management, and debated the key risks and macro-economic factors facing the Group and determined plausible stress test scenarios for further work.</p> <p>The Committee also reviewed the mandated and internal stress tests and approved revised limits and triggers.</p>	<p>The Committee recommended the proposed Risk Appetite to the Board.</p> <p>In previous years it had emphasised to management that the mix of new business written by Hodge Bank should become more capital efficient. The actions resulting in an increasing level of mortgage and portfolio buy-to-let business has meant that the blend of new business is now more capital efficient.</p> <p>The Committee has in the past also encouraged Hodge Bank management to investigate ways the commercial lending business might become less capital intensive. The actions taken and those proposed by management, which are work-in-progress should make a significant difference.</p> <p>The Committee continues to encourage management to implement its plans for increasing the capital efficiency of the Group's business and monitors progress closely. For Hodge Bank, it has also encouraged management to develop more granular and robust measures of risk to monitor the newer lines of business. The Committee will continue to monitor progress in this area over the coming year.</p>

## Report from Chair of the Risk and Conduct Committee

<p><b>Capital and funding</b> Ensuring there is sufficient capital to meet the Group's regulatory requirements and to support shareholder expectations.</p> <p>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.</p>	<p><i>Hodge Bank</i> The Committee debated on a regular basis, capital performance against plan and regulatory requirements. It also reviewed the implementation of management's plans, to reduce as far as possible the volatility on longer-term assets and liabilities held at market value.</p> <p><i>Hodge Life</i> The Committee continued to monitor the work being carried out by Hodge Life on its Matching Adjustment and PIM application. Given the industry-wide issues with equity release mortgages a decision was taken to slow down the pace of the project. Reinsurance strategies were considered as a further way of improving the capital position of this company.</p>	<p>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.</p> <p>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.</p>
<p><b>Liquidity</b> Ensure there is sufficient liquidity so that the Group can meet its obligations, as they fall due, and meet regulatory requirements.</p>	<p>Assessed on a regular basis liquidity performance against both internal and regulatory requirements.</p>	<p>The Committee recommended to the respective boards the approval of Hodge Bank's ILAAP and the liquidity aspects of Hodge Life's ORSA.</p> <p>For Hodge Life the implications of the PRA's new expectations around liquidity management will be monitored but are not expected to lead to any significant changes.</p>

## Report from Chair of the Risk and Conduct Committee

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

## Report from Chair of the Risk and Conduct Committee

	<p>Reviewed the processes to identify vulnerable customers ensuring that the assistance provided to them is relevant to their circumstances.</p> <p>Reviewed the Group's complaints record, and the actions taken by management to resolve issues.</p> <p>Reviewed the work carried out to ensure compliance with the Mortgage Conduct of Business Rules and the suggested actions arising from the review.</p>	<p>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.</p> <p>The Committee was satisfied that the review of compliance with the Mortgage Conduct of Business Rules was carried out well and the proposed actions should result in further improvement in compliance.</p>
<p><b>Credit, house price, longevity, pension, regulatory and emerging risks</b></p> <p>Significant risks that could have a material impact on the Group's business and also its capital requirements.</p>	<p>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.</p> <p>Evaluated the potential impact of regulatory developments on the Group's risk profile.</p> <p>Debated extensively each area of material risk, the trends and the controls in place.</p> <p>Engaged with the Group's actuarial adviser as to developments in longevity and the approach taken by the Group's in-house actuarial team in relation to its review of assumptions.</p> <p>Evaluated emerging risks and their potential effect on the business.</p> <p>Supported and actively participated in the recruitment of a Head of Risk for Hodge Life.</p>	<p>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.</p> <p>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.</p>

## Report from Chair of the Risk and Conduct Committee

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

### Risk information provided to the Committee

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

### Interaction with management

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

## Report from Chair of the Risk and Conduct Committee

### Interaction with regulators

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

### Committee performance

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

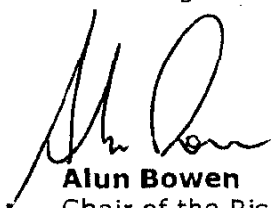
### Looking ahead

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

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

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

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



**Alun Bowen**

Chair of the Risk and Conduct Committee  
19 December 2019



## **Report by Jonathan Hodge, Chair of the Nomination Committee**

The last twelve months have been about looking to the future and ensuring that our board and Executive team are set up for success. The Nomination Committee agenda has therefore concentrated on further strengthening the Board of the Group and, along with our CEO, re-focused our Executive team.

We were delighted to welcome Steve Pateman to the Group as CEO in January 2019. Steve, with the Nomination Committee's support and oversight, very quickly set up his leadership team during the first quarter of his tenure. The new Executive Committee was extended to introduce a range of specialist capabilities and expertise, including a dedicated Chief Operations Officer, a Chief Marketing Officer and a Managing Director for our Mortgages business. The Executive Committee are fully motivated to delivering our 2023 strategy and the Nomination Committee will ensure that they receive the Board's full co-operation and support for their personal development, whilst continuing to drive strong performance in the delivery of our strategy. More recently, during July 2019, the Committee has reviewed plans for future development and succession of our leaders at the Group and this investment will continue into 2020.

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

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

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

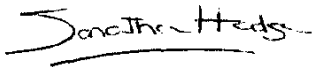
During 2019, the Nomination Committee oversaw the recruitment of two additional independent roles to the Board. The first appointment was David Gulland who joins Hodge Life as an actuarial specialist, bringing additional risk and conduct experience with him too. David will chair the newly formed Risk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

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

## **Report from Chair of the Nomination Committee**

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

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



**Jonathan Hodge**  
Chair of the Nomination Committee  
19 December 2019

### Report from Helen Molyneux, Chair of the Remuneration Committee

During the last twelve months, the Remuneration Committee completed the important task of shaping and agreeing a reward strategy for the Group that sets out our guiding principles and direction for the Group's reward policies, practices and offerings. Our reward strategy will ensure that we are clear about what we are trying to achieve when it comes to rewarding and recognising our colleagues.

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

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

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

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

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

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

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

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



**Helen Molyneux**

Chair of the Remuneration Committee  
19 December 2019

### Directors' Report

The directors present their report together with the audited financial statements for the year ended 31 October 2019. Certain disclosures are given in the Strategic Report and the financial statements and are incorporated here by cross-reference. Specifically, these incorporate the following disclosures:

Group strategy	- Page 7
Financial performance review	- page 10
Risk management policies	- page 19
Derivative financial instruments	- note 28

#### Directors and directors' interests

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

Jonathan Hodge*	Chairman
Stephen Pateman (CEO)	(Appointed February 2019)
Alun Bowen*	
Adrian Piper *	
Helen Molyneux*	
John Barbour*	
David Austin*	(Retired February 2019)

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

\* All non-executive directors excluding Jonathan Hodge are deemed to be independent by the Board. Jonathan Hodge is the holder of 45,724 ordinary shares in the Company. None of the other directors held any interests in the shares of any Group companies.

#### Political contributions

The Group made no political contributions during either year.

#### Post Balance Sheet events

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

#### Dividend

Two dividends have been declared and paid during the year totalling £3.3m (2018: £3.3m).

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

#### Re-appointment of auditors

A resolution for the re-appointment of EY as auditor of the Company is to be proposed at the forthcoming Annual General Meeting.

### Employees

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

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

### IBOR reform

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

On behalf of the Board of Directors



**Steve Pateman**

Director

19 December 2019

## **Statement of Directors' Responsibilities**

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

Company law requires the directors to prepare financial statements for each financial year. Under that law they have elected to prepare the Group and parent company 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 and parent 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 The Carlyle Trust Limited

### Independent Auditor's Report to the Members of The Carlyle Trust Limited

#### Opinion

In our opinion:

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

We have audited the financial statements of The Carlyle Trust Limited which comprise:

Group	Parent company
Consolidated Income Statement for the year then ended	Company Balance Sheet as at 31 October 2019
Consolidated Statement of Comprehensive Income for the year then ended	Company Statement of Changes in Equity for the year then ended
Consolidated Balance Sheet as at 31 October 2019	Related notes 1 to 40 to the financial statements, (except for the sections of notes 2 and 40 which are marked as unaudited) including a summary of significant accounting policies
Consolidated Statement of Changes in Equity for the year then ended	
Consolidated Statement of Cash Flows for the year then ended	
Related notes 1 to 40 to the financial statements (except for the sections of notes 2 and 40 which are marked as unaudited), including a summary of significant accounting policies	

The financial reporting framework that has been applied in the preparation of the Group's 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.

## Independent Auditor's Report to the Members of The Carlyle Trust Limited

### 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	<ul style="list-style-type: none"><li>• The risk that inappropriate actuarial assumptions are used in the valuation of equity release mortgages, reversionary interest in properties and annuity liability technical provisions;</li><li>• The risk that inappropriate property/collateral valuations are applied in the calculation of the IFRS 9 Expected Credit Loss ('ECL') provision;</li><li>• The risk that there is incomplete identification of loan assets held at amortised cost with significant increases in credit risk (Stage 2) or credit impairment (Stage 3) on a timely basis, including due to incorrect application of the internal risk and S&amp;P scorecard ratings applied in the commercial loan book;</li><li>• The risk of incorrect valuation of derivatives.</li></ul>
Audit scope	<ul style="list-style-type: none"><li>• To support the Group audit opinion we performed an audit of the complete financial information of the parent entity and both regulated entities within the Group, Julian Hodge Bank Limited and Hodge Life Assurance Limited.</li></ul>
Materiality	<ul style="list-style-type: none"><li>• Overall Group materiality of £6.8m which represents 2.0% of equity.</li></ul>

### 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.



## Independent Auditor's Report to the Members of The Carlyle Trust Limited

Risk	Our response to the risk	Key observations communicated to the Audit Committee
<p>The risk that inappropriate actuarial assumptions are used in the valuation of equity release mortgages, reversionary interest in properties and annuity liability technical provisions (equity release mortgages: £618.8m, 2018: £685.2m, investment properties – reversionary interest in properties: £170.1m, 2018: £179.1m, long term business provision: £498.7m, 2018: £437.0m)</p> <p>The valuation of the equity release mortgages, 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.</p> <p>Inappropriate assumptions may lead to a material misstatement in the financial statements.</p> <p>The equity release mortgages are disclosed as loans and advances to customers in note 17 of the financial statements, with the principal assumptions and sensitivity analysis of changes to key assumptions disclosed in note 34(d).</p> <p>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.</p>	<p>We performed a walkthrough to understand the assumption setting process and tested controls within the process.</p> <p>Utilising our actuarial specialists, we assessed and challenged the assumptions used within valuation of the equity release mortgages, reversionary interest in properties and the annuity liability valuations to ensure that they are in line with peer companies, internal experience analysis and the requirements of financial reporting and regulatory standards. The key assumptions we focussed our audit work on were as follows:</p> <p><u>No Negative Equity Guarantee</u> We considered each of the assumptions used within the NNEG calculation, considering a combination of historic and projected future house price growth, the potential variability in house price growth and the allowance made for property dilapidations within the portfolio.</p> <p><u>Voluntary early redemption</u> We compared the voluntary early redemption assumptions in the valuation with observed experience in the portfolio and with those used by peer companies in the sector.</p> <p>Particular attention was paid to the implications for experience in light of the increased competition in the market over the last 3-4 years and the relevance of historic data to future VER assumption setting in light of these changes.</p>	<p>Overall, we consider the assumptions that are used in the valuation of the equity release mortgages, reversionary interest in properties and annuity liability technical provisions to be within a reasonable range, with the majority of assumptions towards the middle of the range, and the discount rate for Hodge Bank's equity release mortgages at the optimistic end of the acceptable range.</p>

## Independent Auditor's Report to the Members of The Carlyle Trust Limited

<p>The annuity liabilities are disclosed as long term business provisions - liabilities arising from insurance contracts in note 29 of the financial statements, which also includes sensitivity analysis of changes to key assumptions.</p>	<p><u>Discount rate</u> We tested whether the discount rate used in the valuation of equity release mortgages, reversionary interest in properties and the long term business provision was consistent with discount rates used by other companies in the sector, relative liquidity levels and customer rates available in the market.</p> <p><u>Policyholder mortality/longevity</u> We assessed the mortality assumptions by considering management's experience analysis and comparing the assumption adopted by management for future improvements with those used by other companies in the sector, allowing for particular factors around the profile of the Group's business compared to the industry experience.</p> <p><u>Expenses</u> We tested current and forecast expense levels to evaluate if the unit costs and inflation assumptions used within the valuation were reasonable.</p> <p>We tested the allocation of expenses between Hodge Life Assurance Company Limited and Julian Hodge Bank Limited.</p>	
<p>The risk that inappropriate property/collateral valuations are applied in the calculation of the IFRS 9 Expected Credit Loss ('ECL') provision (Stage 3 credit impairment provision on loans and advances to customers): £9.0m (2018: £5.0m)</p> <p>The assessment of the expected credit loss provision is inherently judgemental, with the valuation of the collateral a key input to the calculation of the provision.</p> <p>The loan collateral is disclosed in note 35 of the financial statements.</p>	<p>We performed a walkthrough to understand the provisioning process and tested the controls over the valuation of collateral.</p> <p>For a sample of Stage 3 loans we utilised our property valuation team specialists to perform an independent valuation of the collateral used within the ECL provision calculation.</p> <p>The sample we tested in our audit covered £20.8m (2018: £30.2m) of the collateral value for the Stage 3 loans.</p>	<p>The controls within the process were tested and were found to be operating effectively.</p> <p>For the sample of Stage 3 property loan collateral selected for testing, each item was evaluated and the valuation of the collateral was determined to be within an acceptable range.</p>

## Independent Auditor's Report to the Members of The Carlyle Trust Limited

<p>The risk that there is incomplete identification of loan assets held at amortised cost with significant increases in credit risk (Stage 2) or credit impairment (Stage 3) on a timely basis, including due to incorrect application of the internal risk and S&amp;P scorecard ratings applied in the commercial loan book (gross loan balance for commercial loans): £329.3m (2018: £356.8m)</p> <p>The loan impairment is disclosed in note 18 of the financial statements.</p>	<p>We performed a walkthrough to understand the IFRS 9 estimated credit loss process and tested the controls for the assignment of risk ratings which are used to determine the staging of the loans.</p> <p>We tested the S&amp;P scorecard ratings and a sample of internal risk ratings to ensure the inputs to the staging calculation were appropriate.</p> <p>Using the S&amp;P scorecard ratings and internal risk ratings, we reperformed the staging assessment, to verify the accuracy of the staging formulas within the estimated credit loss model.</p>	<p>The controls within the process were tested and were found to be operating effectively.</p> <p>No material exceptions were identified in the testing of the year end staging assessment.</p>
<p>The risk of incorrect valuation of derivatives: £81.3m (2018: £108.5m)</p> <p>The Group holds a significant number of derivative financial instruments, which it uses to manage interest rate risk. The valuation of these derivatives is determined through the application of valuation techniques which often involve the exercise of judgement and the use of assumptions and estimates.</p> <p>Due to the significance of the financial instruments and the related estimation uncertainty this is considered a key audit risk.</p> <p>The financial statement value is the counterparty valuation, which is assessed for reasonableness by management.</p> <p>The fair value of these derivative financial instruments is disclosed in note 28 of the financial statements.</p>	<p>Utilising our derivative valuation specialists, we independently valued a sample of derivative financial instruments. We compared our independent valuation to management's valuation and considered whether management's value was within an acceptable range.</p> <p>The sample selected covered £70.9m (2018: £85.6m) of the total population.</p>	<p>The valuation of the sample selected was determined to be within an acceptable range.</p>

## Independent Auditor's Report to the Members of The Carlyle Trust Limited

### 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 98% of the equity of the consolidated Group. All audit work performed for the purposes of the audit was undertaken by the Group audit team.

The remaining 7 entities within the Group together represent 2% of the Group's equity. For these components, we performed other specific procedures for balances with higher materiality or higher deemed risk. This allowed us to respond to any potential risks of material misstatement to the Group financial statements.

#### 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 £6.8m (2018: £6.9m), which is 2.0% of equity (2018: 2.0%). 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 £1.8m (2018: £1.6m), which is 2.0% (2018: 1.8%) of equity. We believe equity to be the most appropriate basis as the parent Company is a holding Company with limited trading activity.

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

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

On the basis of our risk assessments, together with our assessment of the Group's overall control environment, our judgement was that performance materiality was 75% (2018: 75%) of our planning materiality, namely £5.1m (2018: £5.2m) 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 the Group opinion was as follows:

- The Carlyle Trust Limited parent entity: £2.8m (2018: £2.6m)
- Julian Hodge Bank Limited: £2.6m (2018: £2.9m)
- Hodge Life Assurance Company Limited: £3.3m (2018: £3.6m)

## **Independent Auditor's Report to the Members of The Carlyle Trust Limited**

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

We agreed with the Audit Committee that we would report to them all uncorrected audit differences in excess of £0.1m (2018: £0.1m), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

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

### **Other information**

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

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

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

We have nothing to report in this regard.

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

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

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

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

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

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

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

### **Responsibilities of directors**

As explained more fully in the Directors' Responsibilities Statement set out on page 51, 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.

## **Independent Auditor's Report to the Members of The Carlyle Trust Limited**

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

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

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

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

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

Our approach was as follows:

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

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

## **Independent Auditor's Report to the Members of The Carlyle Trust Limited**

### **Other matters we are required to address**

- We were appointed by the Group on 22 April 2016 to audit the financial statements for the year ending 31 October 2016 and subsequent financial periods.
- The period of total uninterrupted engagement including previous renewals and reappointments is 4 years, covering the years ending 31 October 2016 to 31 October 2019.
- Non-audit services prohibited by the FRC's Ethical Standard were not provided to the parent Company or Group and we remain independent of the parent Company and Group in conducting the audit.
- The audit opinion is consistent with the reporting 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 2019

### **Notes:**

1. The maintenance and integrity of The Carlyle Trust 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.

## **Consolidated Income Statement**

For the year ended 31 October 2019

	Notes	2019 £m	2018 £m
Interest receivable and similar income	5	70.0	66.7
Interest payable and similar charges	6	(28.4)	(28.1)
<b>Net interest income</b>		<b>41.6</b>	<b>38.6</b>
Fees and commissions receivable		0.6	2.4
Fees and commissions payable		(0.9)	(1.8)
<b>Net fee and commission income</b>		<b>(0.3)</b>	<b>0.6</b>
Dividend income receivable		0.1	-
Earned premiums	7	41.6	47.5
Impact of new insurance contracts	29	(42.4)	(48.8)
Investment income		17.2	15.4
Gross claims and benefits paid		(26.9)	(24.5)
Impact of gross claims and benefits paid on the provision for long-term business	29	26.9	24.5
Other operating income		1.3	1.1
Profit on sale of inventory	11	6.1	-
<b>Net operating income</b>		<b>65.2</b>	<b>64.4</b>
Administrative expenses	8	(24.3)	(18.5)
Depreciation and amortisation		(1.3)	(0.9)
Impairment losses on loans and advances to customers	18	(4.2)	0.8
<b>Operating profit</b>		<b>35.4</b>	<b>35.8</b>
Other fair value gains/(losses)	10	24.8	(28.3)
Gains arising from the derecognition of financial assets managed at amortised cost	15	3.1	-
Loss on disposal of loans and advances to customers	17	(4.6)	-
Movement in long-term business provision	29	(46.3)	4.2
<b>Profit before taxation</b>	<b>9</b>	<b>12.4</b>	<b>11.7</b>
Tax on profit	12	(1.6)	(1.9)
<b>Profit for the financial year</b>		<b>10.8</b>	<b>9.8</b>



## **Consolidated Statement of Other Comprehensive Income**

For the year ended 31 October 2019

	Notes	2019	2018
		£m	£m
Profit for the financial year		10.8	9.8
<b>Items that will not be reclassified subsequently to profit and loss:</b>			
Re-measurement of defined benefit pension plan	31	(3.3)	0.6
Deferred tax thereon	23	0.6	(0.1)
<b>Items that may be transferred to the Income Statement</b>			
<b>Available-for-sale investments:</b>			
Fair value movements taken to reserves		-	(1.8)
Deferred tax thereon	23	-	0.3
<b>Total other comprehensive income</b>		<b>(2.7)</b>	<b>(1.0)</b>
<b>Total comprehensive income for the year</b>		<b>8.1</b>	<b>8.8</b>

The results for the year ended 31 October 2019 relate entirely to continuing operations.  
The notes on pages 69 to 130 form part of these financial statements.

## Financial Statements

### Consolidated Balance Sheet For the year ended 31 October 2019

	Notes	2019	2018
		£m	£m
<b>Assets</b>			
Cash and balances held at central banks	13	321.9	153.2
Treasury bills	14	55.5	99.6
Debt securities	15	134.9	148.5
Loans and advances to credit institutions	16	87.4	111.9
Loans and advances to customers	17	1,240.2	1,242.6
Intangible assets	19	5.8	3.1
Property, plant and equipment	20	1.9	2.2
Investment properties	21	179.8	189.7
Investments	22	6.8	6.6
Deferred tax assets	23	3.7	2.8
Other assets	24	10.1	5.2
Inventory	25	7.8	8.4
<b>Total asset</b>		<b>2,055.8</b>	<b>1,973.8</b>
<b>Liabilities</b>			
Deposit from banks	26	72.5	72.5
Deposits from customers	27	1,039.5	993.9
Derivative financial instruments	28	81.3	108.5
Provisions for long term business - liabilities arising from insurance contracts	29	498.7	437.0
Other liabilities	30	5.1	8.3
Other provisions		-	0.1
Pension scheme deficit	31	16.6	12.8
<b>Total liabilities</b>		<b>1,713.7</b>	<b>1,633.1</b>
<b>Share capital and reserves</b>			
Called-up share capital	32	1.1	1.1
Other reserves		341.0	339.6
<b>Total equity</b>		<b>342.1</b>	<b>340.7</b>
<b>Total equity and liabilities</b>		<b>2,055.8</b>	<b>1,973.8</b>

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

  
**Steve Pateman**  
Director

## Company Balance Sheet

For the year ended 31 October 2019

		2019	2018
		£m	£m
<b>Assets</b>			
Debt securities	15	0.1	0.1
Loans and advances to credit institutions	16	1.1	0.2
Investment properties	21	-	0.8
Investments	22	6.8	6.6
Deferred tax asset	23	0.6	0.4
Other assets	24	0.7	1.8
Shares in group undertakings and participating interests	37	86.5	83.5
<b>Total assets</b>		<b>95.8</b>	<b>93.4</b>

	2019	2019	2018
		£m	£m
<b>Liabilities</b>			
Other liabilities	30	6.8	2.8
<b>Total liabilities</b>		<b>6.8</b>	<b>2.8</b>
<b>Share capital and reserves</b>			
Called-up share capital	32	1.1	1.1
Other reserves		87.9	89.5
<b>Total equity</b>		<b>89.0</b>	<b>90.6</b>
<b>Total equity and liabilities</b>		<b>95.8</b>	<b>93.4</b>

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

  
**Steve Pateman**  
Director

## Consolidated Statement of Changes in Equity

For the year ended 31 October 2019

Group	Called up share capital	Retained earnings	Average for-sale reserve	Pension reserve	Total
	£m	£m	£m	£m	£m

### 2019

At beginning of year	1.1	347.7	2.7	(10.8)	340.7
IFRS 9 adoption impact (note 2)	-	(0.7)	(2.7)	-	(3.4)
Regulated Income	0.1	347.0	-	(10.8)	336.3
Profit for the financial year	-	11.2	-	(0.4)	10.8
Dividends	-	(3.3)	-	-	(3.3)
Other comprehensive income	-	-	-	(2.7)	(2.7)
At end of year	1.1	354.9	-	(13.9)	342.1

Group	Called up share capital	Retained earnings	Average for-sale reserve	Pension reserve	Total
	£m	£m	£m	£m	£m

### 2018

At beginning of year	1.1	340.8	4.2	(10.9)	335.2
Profit for the financial year	-	10.2	-	(0.4)	9.8
Dividends	-	(3.3)	-	-	(3.3)
Other comprehensive income	-	-	(1.5)	0.5	(1.0)
At end of year	1.1	347.7	2.7	(10.8)	340.7

# **Company Statement of Changes in Equity**

For the year ended 31 October 2019

Statement of Changes in Equity	Statement of Financial Position 2019	Statement of Financial Position 2018	Statement of Financial Position 2017
	2019	2018	2017

## **2019**

At beginning of year	1.1	89.5	90.6
IFRS 9 adoption impact (note 2)	-	-	-
Profit for the financial year	-	1.7	1.7
Dividends	-	(3.3)	(3.3)
At end of year	1.1	87.9	89.0

Statement of Changes in Equity	Statement of Financial Position 2019	Statement of Financial Position 2018	Statement of Financial Position 2017
	2019	2018	2017

## **2018**

At beginning of year	1.1	81.7	82.8
Profit for the financial year	-	11.1	11.1
Dividends	-	(3.3)	(3.3)
At end of year	1.1	89.5	90.6

**Consolidated Statement of Cash Flows**

For the year ended 31 October 2019

	Notes	2019	2018
		£m	£m
<b>Cash flows from operating activities</b>		<b>95.1</b>	<b>74.2</b>
Taxation paid		(0.2)	(2.2)
<b>Net cash inflow from operating activities</b>		<b>94.9</b>	<b>72.0</b>
<b>Cash flows from investing activities</b>			
Purchase of treasury bills	14	(92.4)	(45.5)
Proceeds from sale of treasury bills	14	83.0	41.7
Disposals due to restructuring exercise	14	53.4	-
Proceeds from sale of debt securities	15	18.8	36.0
Purchase of debt securities	15	(34.5)	(55.4)
Disposals due to restructuring exercise	15	28.1	-
Additions to intangible assets	19	(3.5)	(2.0)
Additions to property, plant and equipment	20	(0.2)	(0.6)
Purchase of investments	22	(0.5)	(1.1)
Proceeds from sale of investments	22	0.4	1.4
<b>Net cash inflow/(outflow) from investing activities</b>		<b>57.6</b>	<b>(25.5)</b>
<b>Cash flows from financing activities</b>			
Dividends paid		(3.3)	(3.3)
<b>Net (outflow) from financing activities</b>		<b>(3.3)</b>	<b>(3.3)</b>
Net increase in cash and cash equivalents		144.2	43.1
Cash and cash equivalents at start of year		265.1	222.0
<b>Cash and cash equivalents at end of year</b>		<b>409.3</b>	<b>265.1</b>
Cash held at central banks repayable on demand	13	321.9	153.2
Loans and advances to credit institutions repayable on demand (1)	16	87.4	111.9
<b>Cash and cash equivalents at year end</b>		<b>409.3</b>	<b>265.1</b>

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

**A Analysis of the balance of cash and cash equivalents**

		2019	2018	2017
		£m	£m	£m
Cash held at central banks repayable on demand	13	153.2	168.7	321.9
Loans and advances to credit institutions repayable on demand	16	111.9	(24.5)	87.4
		265.1	144.2	409.3
		2019	2018	2017
		£m	£m	£m
Cash held at central banks repayable on demand	13	87.0	66.2	153.2
Loans and advances to credit institutions repayable on demand	16	135.0	(23.1)	111.9
		222.0	43.1	265.1

**B Reconciliation of operating profit to operating cash flows**

		2019	2018
		£m	£m
<b>Cash flows from operating activities</b>			
Profit before tax		12.4	11.7
Depreciation of plant property and equipment	9	0.5	0.4
Amortisation of intangible assets	9	0.8	0.5
Impairment provision credit for losses on loans	9	4.2	(0.8)
Net Income Statement (gain)/losses on treasury bills	14	(0.1)	1.3
Net Income Statement (gain)/losses on debt securities	15	(1.9)	0.6
Net change in loans and advances to customers	17	(1.8)	(86.8)
Net change in investment property	21	9.9	25.1
Net change in investments	22	(0.2)	0.2
Net change in other assets	24	(6.6)	(0.6)
Net change in inventory	25	0.6	(0.3)
Net change in deposits from banks	26	-	69.7
Net change in deposits from customers	27	45.6	55.4
Net change in derivatives	28	(27.2)	(23.8)
Net change in provision for long term business liabilities	29	61.7	20.1
Net change in other liabilities	30	(3.2)	1.3
Net change in other provisions		(0.1)	(0.2)
Net change in pension scheme deficit	31	0.5	0.4
Net cash inflow from operating activities		95.1	74.2

## **Notes to the Financial Statements**

For the year ended 31 October 2019

### **1 Accounting policies**

#### **Basis of preparation**

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

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

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

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

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

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

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

The 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 was £1.7 million (2018: profit of £11.1 million) which is dealt with in the consolidated financial statements.

#### **Changes in presentation**

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

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



## **1 Accounting policies (continued)**

### **New standards and interpretations not yet adopted**

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

#### **IFRIC 23 - Uncertainty over Income Tax Treatments**

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

#### **IFRS 16 – Leases**

IFRS 16 'Leases' was issued in January 2016 and introduces a comprehensive model for the identification of lease arrangements and accounting treatments for both lessors and lessees and will supersede the current lease guidance including IAS 17 'Leases' and the related interpretations. The standard is effective for annual periods beginning on or after 1 January 2019 and will be adopted by the Group for the financial year commencing 1 November 2019.

IFRS 16 distinguishes leases and service contracts on the basis of whether an identified asset is controlled by a customer. The current distinction of operating leases (off Balance Sheet) and finance leases (on Balance Sheet) is removed for lessee accounting and is replaced by a model where a right-of-use asset and a corresponding liability have to be recognised for all leases by lessees (i.e. all on balance sheet) except for short-term leases and leases of low value assets.

The standard represents a significant change in the accounting and reporting of leases, impacting the Income Statement and Balance Sheet as well as performance measures used by the Group.

The Group has chosen to adopt the modified retrospective approach to transition. The Group has performed an extensive review of all the Group's leasing arrangements in light of the new accounting standard. The work has identified that as at the 1 November 2019 the expected recognition of a right-of-use asset and lease liability will be as follows:

- Recognition of a right-of-use asset in the region of £4.9 million, and
- Recognition of a corresponding lease liability in the region of £4.9 million.

Interest will be unwound based on the amortisation schedules for the underlying leases and the right-of-use asset will be depreciated on a straight-line basis over the remaining useful life of the assets.

#### **IFRS 17 – Insurance Contracts**

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

## **1 Accounting policies (continued)**

### **Changes in Accounting Policy**

#### **Adoption of new and revised standards and interpretations**

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

#### **IFRS 9 – Financial Instruments**

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

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

#### **Classification of financial assets**

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

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

#### **Impairment of financial assets**

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

#### **Transition**

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

#### **IFRS 15 Revenue from Contracts with Customers**

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

#### **Changes in accounting policies**

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

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

#### **Transition**

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

## **1 Accounting policies (continued)**

### **Summary of Significant Accounting Policies**

#### **Measurement convention**

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

#### **Basis of consolidation**

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

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

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

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

#### **Interest receivable and interest payable**

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

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

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

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

#### **Revenue Recognition**

##### *Investment income*

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

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

##### *Fees and commissions*

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

##### *Premium income*

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

## **1 Accounting policies (continued)**

### *Insurance contracts*

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

### *Profit on sale of inventory*

Profit on sale of inventory relates to the sale of land for development. The profit on sale is equal to the revenue generated of the sale less the costs related to the sale.

Revenue is recognised to the extent that it is probable that the economic benefit will flow to the Group and the revenue can be reliably measured. All such revenue is reported net of discounts, and value added and other sales taxes.

Cost of sale comprises land, direct materials and direct labour costs that have been incurred in bringing the inventories to their location and condition prior to sale.

### **Deferred acquisition costs**

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

### **Financial Instruments**

#### **Recognition**

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

#### **Financial assets**

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

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

- Amortised cost - residential, buy-to-let and commercial loans, loans and advances to credit institutions, non-index-linked treasury bills, debt securities and other assets.
- FVTPL - lifetime mortgages including retirement mortgages and equity release mortgages; index-linked treasury bills and debt securities.

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

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

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

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

## **1 Accounting policies (continued)**

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

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

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

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

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

Initial measurement of financial assets is as follows:

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

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

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

### **Financial liabilities**

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

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

- FVTPL - derivatives
- Amortised cost - other liabilities.

Initial measurement of financial liabilities is as follows:

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

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

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

### **De-recognition of financial assets and financial liabilities**

#### **(i) Financial assets**

A financial asset is de-recognised when:

- The rights to receive cash flows from the asset have expired,
- The Group has transferred its rights to receive cash flows from the asset or has assumed an obligation to pay the received cash flows in full without material delay to a third party under a pass-through arrangement; and either:
- The Group has transferred substantially all the risks and rewards of the asset; or
- The Group has neither transferred nor retained substantially all the risks and rewards of the asset but has transferred control of the asset.

Where an existing financial asset is replaced by another to the same customer on substantially different terms, or the terms of an existing facility are substantially modified, such an exchange or modification is treated as a de-recognition of the original asset and the recognition of a new asset.

#### **(ii) Financial liabilities**

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

## **1 Accounting policies (continued)**

### **Fair value of financial instruments**

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

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

The Group uses a fair value hierarchy that categorises financial instruments into three different levels as detailed in note 34. Levels are reviewed at each reporting date and this determines whether transfers between levels are required.

### **Equity release and retirement mortgages**

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

On initial recognition, the fair value of these lifetime mortgages is calculated by discounting the future cash flows at swap rates together with an allowance for illiquidity. If the difference between the fair value at transaction date and the transaction price is a gain, it is not recognised but deferred against the lifetime mortgage balance and recognised uniformly over the expected life of the loan into the Income Statement. Any changes to assumptions used in the calculation of this deferred reserve will result in a recalculation which is then spread over the expected total life of the loan from inception. If the difference between the fair value and the transaction price is a loss either upon initial recognition or as a result of a recalculation, it is expensed to the Income Statement.

On subsequent measurement, the value of lifetime mortgages 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 variant of the Black Scholes option pricing method. These cash flows are then discounted at the swap yield plus a margin to reflect the illiquidity of mortgage assets. An allowance for possible early redemption of the mortgages has been determined by reference to historic rates of lapse within the portfolio.

### **Embedded derivatives**

The NNEG is an embedded derivative. The Group does not separate the NNEG embedded derivative from the host instrument. The fair value of lifetime mortgages takes into account an explicit provision in respect of the NNEG which is calculated using a variant of the Black Scholes option pricing model. Further details are disclosed in note 34(d).

### **Measurement of Expected Credit Loss (ECL)**

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

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

## **1 Accounting policies (continued)**

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

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

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

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

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

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

### **Significant increase in credit risk**

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

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

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

### **Definition of default and credit-impaired assets**

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

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

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

### **Write offs**

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

### **Presentation of loss allowances in the Balance Sheet**

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

### **Hedge accounting**

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

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

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

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

### **Offsetting financial assets and financial liabilities**

In accordance with IAS 32 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 28 demonstrates the amounts which have been offset in the Balance Sheet.

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

### **Investment properties**

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

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

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

Investment properties are derecognised either when they have been disposed of, or when the investment property is permanently withdrawn from use and no future economic benefit is expected from its disposal. Any gains or losses on derecognition are recognised in the Income Statement in the year of disposal within investment income.



## **1 Accounting policies (continued)**

### **Intangible assets**

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

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

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

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

### **Property, plant and equipment**

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

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

- |                                    |  |
|------------------------------------|--|
| - Fixtures, fittings and equipment | 5 years  |
| - Short leasehold improvements     | Shorter of remaining term of the lease and useful life |

### **Taxation including deferred tax**

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

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

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

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

Corporation tax is recognised in the Income Statement.

## **1 Accounting policies (continued)**

### **Inventories**

Inventories are held at the lower of cost and net realisable value. Inventories comprise land held for development that has planning permission and is being developed for onward sale. Cost comprises land, direct materials and direct labour costs that have been incurred in bringing the inventories to their present location and condition. Net realisable value represents the estimated selling price less any further costs expected to be incurred to completion and disposal.

### **Share capital**

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

### **Long term business provision - liabilities under insurance contracts**

The long-term business provision has been determined by the Board of Directors, on advice from the Chief Actuary, 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.

### **Employee benefits**

#### **i) Pensions**

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

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

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

#### **ii) Reimbursement asset on pension deficit**

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

## 2 IFRS 9 Adoption

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

### Classification and measurement

#### Financial assets

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

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

Financial assets					
Cash and balances held at central banks	153.2	Amortised Cost	Held to collect contractual cash flows	✓	Amortised Cost
Treasury bills	72.6	FVTPL	Recognised at FV to prevent accounting mismatch	N/A	FVTPL (1)
Treasury bills - non-index linked	27.0	Available for Sale (FVOCI) and Amortised Cost	Held to collect contractual cash flows	✓	Amortised Cost
Debt securities	87.5	Available for Sale (FVOCI) and Amortised Cost	Held to collect contractual cash flows	✓	Amortised Cost
Debt securities	61.0	FVTPL	Recognised at FV to prevent accounting mismatch	N/A	FVTPL (2)
Loans and advances to credit institutions	111.9	Amortised Cost	Held to collect contractual cash flows	✓	Amortised Cost
Residential mortgages and commercial loans	453.6	Amortised Cost	Held to collect contractual cash flows	✓	Amortised Cost
Retirement mortgages	103.8	Amortised Cost	Recognised at FV due to existence of NNEG	×	FVTPL (3)
Equity release mortgages	685.2	FVTPL	Recognised at FV due to existence of NNEG	×	FVTPL (3)
Other assets	5.2	Amortised Cost	Held to collect contractual cash flows	✓	Amortised Cost

## 2 IFRS 9 Adoption (continued)

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

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

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

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

	Carrying amount as at 1 November 2018	Impact of IFRS 9	Carrying amount as at 1 November 2018
<b>Assets</b>			
Residential mortgages and commercial loans (1)	453.6	(2.2)	451.4
Retirement mortgage (2)	103.8	1.3	105.1
Treasury bills - non-index linked (3)	27.0	(0.2)	26.8
Debt securities (3)	87.5	(3.1)	84.4
Deferred tax asset (4)	2.8	0.8	3.6
<b>Equity</b>			
Retained earnings	347.7	(0.7)	347.0
Available for sale reserve	2.7	(2.7)	-

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

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

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

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

An assessment was made on the implementation date and at 31 October 2019 on the Company Balance Sheet and it was determined that there are no adjustments to be made from adopting IFRS 9.

## 2 IFRS 9 Adoption (continued)

### Impairment of financial assets

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

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

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

	31 October 2018	1 November 2018	1 November 2018	1 November 2018	1 November 2018	1 November 2018
Residential mortgages	-	-	-	-	-	-
Commercial loans	5.1	2.2	7.3	2.0	0.3	5.0
Debt securities	-	-	-	-	-	-
<b>Total</b>	<b>5.1</b>	<b>2.2</b>	<b>7.3</b>	<b>2.0</b>	<b>0.3</b>	<b>5.0</b>

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

### Regulatory Capital (unaudited)

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

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

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

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

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

### **3 Judgement in applying accounting policies and critical accounting estimates**

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

#### Judgements

##### **Fair values of financial instruments**

The Group uses widely recognised valuation models for determining the fair value of common and simple financial instruments, such as interest rate swaps that use only observable market data: further analysis can be found in notes 28 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 equity release and retirement mortgages. The key assumptions used, and the related sensitivities are outlined in note 34.

#### Estimates and assumptions

##### **Value of reversionary investment properties**

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

##### **Pension scheme assumptions**

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

##### **Measurement of insurance liabilities arising from annuity insurance contracts.**

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

##### **Impairment losses on loans and advances to customers**

IFRS 9 has a single impairment model that applies to all financial instruments in its scope. Under this model, an entity must recognise either a 12-month or lifetime ECL. ECLs are the present value of all cash shortfalls over the expected life of the financial instrument. The key assumptions used, and the related sensitivities, are outlined in note 35.

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

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

##### **Change in accounting estimates**

There is significant judgement in the methodologies and assumptions applied in estimating the fair value of both lifetime mortgages and the provision for long-term business. The methodologies and assumptions contain unobservable inputs resulting in the fair value being classified as a Level 3 estimate within the IFRS 13 fair value hierarchy. Changes have been made to the methodology used to calculate the expense assumption as a result of a project to rationalise expenses across the Group. The impact of these changes is disclosed within notes 29 and 34 respectively and have been accounted for prospectively as a change in accounting estimate.

## Notes to the Financial Statements

For the year ended 31 October 2019

### 4 Segmental information

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

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

	2019	2018	2017	2016	2015
Interest receivable and similar income	48.3	-	-	21.7	70.0
Interest payable and similar charges	(28.1)	-	-	(0.3)	(28.4)
Fees and commissions receivable	0.7	-	-	(0.1)	0.6
Fees and commissions payable	(0.1)	-	-	(0.8)	(0.9)
Dividend income receivable	-	-	1.1	(1.0)	0.1
Earned premiums	-	41.6	-	-	41.6
Impact of new insurance contracts	-	(42.4)	-	-	(42.4)
Investment income	7.2	12.3	0.2	(2.5)	17.2
Gross claims and benefits paid	-	(26.9)	-	-	(26.9)
Impact of gross claims and benefits paid	-	26.9	-	-	26.9
Other operating income	-	-	-	1.3	1.3
Profit on sale of inventory	-	-	6.1	-	6.1
Administrative expenses	(16.4)	(7.4)	-	(0.5)	(24.3)
Depreciation and amortisation	(1.2)	-	-	(0.1)	(1.3)
Impairment on subsidiary investments	-	-	0.8	(0.8)	-
Impairment losses on loans and advances to customers	(3.9)	-	(0.3)	-	(4.2)

The £16.9m (2018: £9.1m) profit presented in the 'Consolidation Adjustments & Reclassification' column mainly relates to interest receivable on equity release mortgages which is reclassified from other fair value gains which is presented below operating profit in Hodge Life.

	2019	2018
Hodge Bank	1,378.7	1,363.4
Hodge Life	663.6	590.8
Property Investment	29.5	18.7
Consolidation adjustments and reclassification	(16.0)	0.9

## Notes to the Financial Statements

For the year ended 31 October 2019

### 4 Segmental information (continued)

As at 31 October 2019	Banking	Hedge and Investment	Property Investment	Leasehold Intangibles & Goodwill	Total
	£m	£m	£m	£m	£m
Interest receivable and similar income	46.0	-	0.2	20.5	66.7
Interest payable and similar charges	(27.7)	-	(0.4)	-	(28.1)
Fees and commissions receivable	2.5	-	-	(0.1)	2.4
Fees and commissions payable	(1.1)	-	-	(0.7)	(1.8)
Dividend income receivable	-	-	19.1	(19.1)	-
Earned premiums	-	47.5	-	-	47.5
Impact of new insurance contracts	-	(48.8)	-	-	(48.8)
Investment income	6.4	10.6	(0.6)	(1.0)	15.4
Gross claims and benefits paid	-	(24.5)	-	-	(24.5)
Impact of gross claims and benefits paid	-	24.5	-	-	24.5
Other operating income	0.1	-	-	1.0	1.1
Administrative expenses	(12.2)	(6.7)	(0.6)	1.0	(18.5)
Depreciation and amortisation	(0.8)	-	-	(0.1)	(0.9)
Impairment on subsidiary investments	-	-	(7.9)	7.9	-
Impairment losses on loans and advances to customers	1.0	-	0.1	(0.3)	0.8
<b>Operating profit</b>	<b>14.3</b>	<b>2.3</b>	<b>9.4</b>	<b>9.1</b>	<b>35.1</b>

### 5 Interest receivable and similar income

	2019	2018
	£m	£m
Loans and advances to customers	62.6	60.6
Loans and advances to credit institutions	2.3	1.7
On other loans	0.1	0.1
Interest and other income on treasury bills and debt securities	5.0	4.3
<b>Total</b>	<b>70.0</b>	<b>66.7</b>

### 6 Interest payable and similar charges

	2019	2018
	£m	£m
On customer accounts	16.1	13.9
On defined benefit pension scheme	0.4	0.4
On term funding scheme	0.5	0.3
On derivative financial instruments	11.4	13.5
<b>Total</b>	<b>28.4</b>	<b>28.1</b>



## Notes to the Financial Statements

For the year ended 31 October 2019

### 7 Earned premiums

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

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

	2019	2018
	£m	£m
Earned premiums	41.6	47.5

### 8 Administrative expenses

	2019	2018
	£m	£m
<b>Staff costs</b>		
Wages and salaries	9.1	6.8
Social security	1.1	0.8
Pension costs (note 31)	3.0	1.6
	13.2	9.2
Other administrative expenses	11.1	9.3
	24.3	18.5

#### Directors and employees

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

	2019	2018
	No.	No.
Provision of finance and banking	169	147
Provision of life assurance services	41	32
Property and investment	-	1
	210	180

Staff costs include remuneration in respect of directors as follows:

	2019	2018
	£m	£m
Fees	0.3	0.3
Aggregate emoluments as executives	0.4	0.2

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

	2019	2018
	£m	£m
Aggregate emoluments	0.2	0.2

The pension accrued for the highest paid director was £nil (2018: £nil). Retirement benefits are not accruing to any directors in 2019 (2018: nil) and there was one director in the defined benefit scheme.

## Notes to the Financial Statements

For the year ended 31 October 2019

### 9 Profit on ordinary activities before taxation

	2019	2018
	£000	£000
<b>Profit on ordinary activities before taxation is stated after charging:</b>		
Remuneration of the auditor and its associates		
Audit of these financial statements	21	20
Audit of financial statements of subsidiaries	224	138
Audit of pension scheme	11	10
Other assurance fees	-	85
Non audit fees	85	100
Depreciation	491	377
Amortisation	801	453
Impairment provision expense/(credit)	4,150	(818)

### 10 Other fair value gains/(losses)

	2019	2018
	£m	£m
(Losses)/gains on derivatives designated as fair value (note 28)	(28.4)	15.2
Movement in fair value of equity release and retirement mortgages	54.4	(32.3)
Reversal of unrealised gains on disposal of investment properties	(14.9)	(14.4)
Movement in fair value of investment properties (note 21)	12.0	4.7
Movement in fair value of debt securities and treasury bills (Notes 14 & 15)	1.3	(1.3)
Movement in fair value of equity investments (note 22)	0.1	(0.3)
Movement in fair value of hedged items attributable to hedged risk	0.3	0.1
	1.4	(18.3)

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

### 11 Profit on sale of inventory

	2019	2018
	£m	£m
Profit on sale of inventory	6.1	-

During the year, land with a cost of £1.2m was sold to unrelated third parties for consideration of £7.3m generating a profit on disposal of £6.1m.

During the year, development costs of £0.3m were recharged to St Aubins Development Company Ltd at cost. This company is a related party as a director of the Company has significant influence over both St Aubins and the Group.

## Notes to the Financial Statements

For the year ended 31 October 2019

### 12 Tax on profit

	2019	2018
	£m	£m

#### Analysis of charge in year

##### UK corporation tax

Current tax on income for the year	2.1	2.2
Prior period adjustment	(0.9)	(0.4)
<b>Total current tax</b>	<b>1.2</b>	<b>1.8</b>

##### Deferred tax (note 23)

- Original reversal/timing difference	0.1	0.7
- Current year	-	(0.7)
- Prior period adjustment	0.3	0.2
- Other	-	(0.1)

<b>Total deferred tax</b>	<b>0.4</b>	<b>0.1</b>
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<b>Total tax charge on ordinary activities</b>	<b>1.6</b>	<b>1.9</b>
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The total tax charge for the year is lower (2018: lower) than the blended rate of corporation tax in the UK. The differences are explained below.

	2019	2018
	£m	£m

#### Total tax reconciliation

Profit on ordinary activities before tax	12.4	11.7
<b>Current tax at 19.00% (2018: 19.00%)</b>	<b>2.4</b>	<b>2.2</b>
Expenses not detectable for tax purposes	-	0.3
Investment properties	-	(0.1)
Index linked gilt RPI movement	(0.2)	(0.3)
Other	(0.1)	-
Adjustments in respect of previous years	(0.5)	(0.2)

<b>Total tax reconciled to tax charge</b>	<b>1.6</b>	<b>1.9</b>
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A reduction in the UK corporation tax rate to 17% (effective 1 April 2020) was substantively enacted on 6 September 2016. This will reduce the Group's future tax charge accordingly. The deferred tax asset at 31 October 2019 has been calculated based on this rate.

### 13 Cash and balances held at central banks

	2019	2018
	£m	£m

#### Repayable on demand:

Deposits with central banks	321.9	153.2
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<b>Total cash and balances held at central banks</b>	<b>321.9</b>	<b>153.2</b>
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## Notes to the Financial Statements

For the year ended 31 October 2019

### 14 Treasury bills

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

The movement in treasury bills is summarised as follows:

	2019	2018
	£m	£m
At start of period	99.6	97.3
Adjustment on transition to IFRS 9	(0.2)	-
Additions	92.4	45.5
Disposals due to maturity	(83.0)	(41.7)
Disposals due to restructuring exercise	(53.4)	-
Gains/(losses) from hedge accounting – Income Statement	0.8	(0.4)
Losses from changes in fair value – Income Statement	(0.7)	(0.9)
Losses from changes in fair value - OCI	-	(0.2)
At 31 October	56.3	99.6

Of this amount £nil (2018: £29.5m) has been provided as collateral for derivative financial instruments (note 28). Collateral that has been pledged is not restricted.

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

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

### 15 Debt securities

	2019	2018
	£m	£m
Debt securities – at amortised cost	56.4	6.9
Debt securities – available-for-sale	-	76.9
Debt securities – fair value through profit and loss	77.9	61.0
Fair value adjustment – hedge accounting	0.6	0.7
Fair value adjustment – available-for-sale	-	3.0
	134.9	148.5

## Notes to the Financial Statements

For the year ended 31 October 2019

### 15 Debt securities (continued)

Amount	2019	2018
	£m	£m
At 1 November	148.5	131.2
Adjustment on transition to IFRS 9	(3.1)	
Additions	34.5	55.4
Disposals due to maturity	(18.8)	(35.9)
Disposals due to restructuring exercise	(28.1)	-
Losses from hedge accounting - Income Statement	(0.1)	(0.2)
Gain/(loss) from changes in fair value - Income Statement	2.0	(0.4)
Losses from changes in fair value - OCI	-	(1.6)
At 31 October	134.0	148.5

Of this amount £37.7m (2018: £19.4m) has been pledged as collateral under TFS. Collateral that has been pledged is restricted.

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

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

Category	2019	2018
	£m	£m
Debt securities – fair value through profit and loss	0.1	0.1
	0.1	0.1

### 16 Loans and advances to credit institutions

Amount	2019	2018
	£m	£m
Repayable on demand	7.9	28.3
Collateral held by swap counterparties	79.5	83.6
	87.4	111.9

The collateral is pledged against the market value of derivative instruments and comprises interest-bearing cash deposits (note 28). Collateral that has been pledged and held is not restricted and is returned at the end of the contract. There are no provisions held in respect of loans and advances to credit institutions (2018: £nil).

Amount	2019	2018
	£m	£m
Repayable on demand	1.1	0.2
	1.1	0.2

## Notes to the Financial Statements

For the year ended 31 October 2019

### 17 Loans and advances to customers

	2019	2018
	£m	£m
<i>Loans and advances – classified at amortised cost</i>		
Commercial	316.2	349.4
Residential	178.8	104.2
Retirement	-	103.8
Buy-to-let	20.9	-
	<b>515.9</b>	<b>557.4</b>
Fair value adjustment for hedged risk	0.3	-
Loans and advances (equity release and retirement mortgages) – classified as FVTPL (note 34)	724.0	685.2
	<b>1,240.2</b>	<b>1,242.6</b>

Of this amount £57.9m (2018: £64.9m) has been pledged as collateral under TFS. Collateral that has been pledged is restricted.

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

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

	2019	2018
	£m	£m
<i>Loans and advances to customers held at amortised cost</i>		
Gross balances	529.3	564.8
Less: Provision for impairment <sup>1</sup> (note 18)	(11.5)	(5.1)
Less: Loan fee deferral	(1.9)	(2.3)
<b>Net balance</b>	<b>515.9</b>	<b>557.4</b>

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

## Notes to the Financial Statements

For the year ended 31 October 2019

### 18 Impairment provisions on loans and advances to customers

2019	2019	2018	2017	2016
	£m	£m	£m	£m
<b>2019</b>				
At 1 November 2018	-	0.1	5.0	5.1
Impact of adopting IFRS 9	2.0	0.2	-	2.2
<b>Restated balance at 1 November 2018</b>	<b>2.0</b>	<b>0.3</b>	<b>5.0</b>	<b>7.3</b>
Utilised on redemption	-	-	-	-
<b>Income Statement</b>				
Amounts written back during the year	-	(0.2)	(0.6)	(0.8)
Charge for loan impairment	0.4	-	4.6	5.0
	<b>0.4</b>	<b>(0.2)</b>	<b>4.0</b>	<b>4.2</b>
<b>At 31 October 2019</b>	<b>2.4</b>	<b>0.1</b>	<b>9.0</b>	<b>11.5</b>
<b>2018</b>				
At 1 November 2017	7.4	0.2	7.6	
Utilised on redemption	(1.7)	-	(1.7)	
<b>Income Statement</b>				
Amounts written back during the year	(1.3)	(0.1)	(1.4)	
Charge for loan impairment	0.6	-	0.6	
	<b>(0.7)</b>	<b>(0.1)</b>	<b>(0.8)</b>	
<b>At 31 October 2018</b>	<b>6.7</b>	<b>0.1</b>	<b>6.8</b>	

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

Methodology and assumptions used to calculate the IFRS 9 ECL provision is disclosed in note 35.

## Notes to the Financial Statements

For the year ended 31 October 2019

### 19 Intangible assets

	Computers, software	
	2019	2018
	£m	£m
<b>Cost:</b>		
At start of period	3.9	2.0
Disposals	-	(0.1)
Additions	3.5	2.0
<b>At 31 October 2019</b>	<b>7.4</b>	<b>3.9</b>
<b>Amortisation:</b>		
At start of period	(0.8)	(0.3)
Amortisation	(0.8)	(0.5)
<b>At 31 October 2019</b>	<b>(1.6)</b>	<b>(0.8)</b>
<b>Net book value:</b>		
<b>At 31 October 2019</b>	<b>5.8</b>	<b>3.1</b>

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

### 20 Property, plant and equipment

	Short leasehold improvements	Fixtures, fittings and equipment	Total
	£m	£m	£m
<b>Cost:</b>			
At 1 November 2018	2.1	0.8	2.9
Additions	-	0.2	0.2
Disposals	-	(0.1)	(0.1)
<b>At 31 October 2019</b>	<b>2.1</b>	<b>0.9</b>	<b>3.0</b>
<b>Depreciation:</b>			
At 1 November 2018	(0.4)	(0.3)	(0.7)
Depreciation	(0.2)	(0.3)	(0.5)
Disposals	-	0.1	0.1
<b>At 31 October 2019</b>	<b>(0.6)</b>	<b>(0.1)</b>	<b>(0.7)</b>
<b>Net book value:</b>			
<b>At 31 October 2019</b>	<b>1.5</b>	<b>0.8</b>	<b>2.3</b>
At 1 November 2018	1.7	0.5	2.2



## Notes to the Financial Statements

For the year ended 31 October 2019

### 21 Investment properties

Group	2019	2018	2017
	£m	£m	£m
At 1 November 2018	10.6	179.1	189.7
Additions	0.1	-	0.1
Disposals	(0.8)	(21.2)	(22.0)
Fair value adjustments	(0.2)	12.2	12.0
At 31 October 2019	9.7	170.1	189.8
At 1 November 2017	22.4	192.4	214.8
Additions	1.5	-	1.5
Disposals	(12.8)	(18.6)	(31.4)
Fair value adjustments	(0.5)	5.3	4.8
At 31 October 2018	10.6	179.1	189.7

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

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

Group	2019	2018
	£m	£m
Rental income from investment properties	0.9	0.9
	0.0	0.9

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

#### Reversionary interests - principal assumptions

All gains and losses arising from reversionary interests are largely dependent on the longevity of the tenant. The principal assumptions underlying the calculation of reversionary interests include the following:

#### Mortality or entry into long term care

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

#### Expenses

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

#### Discount rate

The discount rate applied to the reversion cash flows comprises two parts: a risk-free yield curve and an allowance for illiquidity. The risk-free yield curve is based on the GBP curve published by EIOPA. The average discount rate for the portfolio (assumed to be the 15-year point on the yield curve based on average duration at 31 October 2019) was 1.78% (31 October 2018: 2.62%).

## 21 Investment properties (continued)

### 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:

	Discount	Reversionary Income		
	Decrease of 10%	Decrease in reversionary income of 10%	Decrease of 10%	Decrease of 10%
	£m	£m	£m	£m
At 31 October 2019	(1.2)	(1.4)	(0.2)	(15.6)
At 31 October 2018	(1.1)	(2.1)	(0.2)	(15.9)

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

Company	2019	2018
	£m	£m
At 1 November	0.8	0.8
Fair value adjustments	-	-
Disposal	(0.8)	-
At 31 October	-	0.8

During the year, the company disposed of its investment property for a consideration of £0.8m with a profit on disposal of £nil.

## 22 Investments

Group and/or Company	2019	2018
	£m	£m
Equity investments	6.8	6.6
At 31 October	6.8	6.6
Group and/or Company	2019	2018
	£m	£m
At 1 November	6.6	6.8
Additions	0.5	1.1
Disposals	(0.4)	(1.0)
Fair Value Adjustments	0.1	(0.3)
At 31 October	6.8	6.6

## Notes to the Financial Statements

For the year ended 31 October 2019

### 23 Deferred tax

	2019	2018
	£m	£m
At 1 November	2.8	2.8
IFRS 9 implementation adjustment	0.7	-
<b>Adjusted Opening Balance</b>	<b>3.5</b>	<b>2.8</b>
Charge to the Income Statement	(0.4)	(0.2)
Credit to the Statement of Other Comprehensive Income	0.6	0.2
<b>At 31 October</b>	<b>3.7</b>	<b>2.8</b>

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

	2019	2018
	£m	£m
Accelerated capital allowances	(0.2)	0.2
Other timing differences	1.2	1.0
Timing differences on available-for-sale reserve	-	(0.5)
Defined benefit pension scheme	2.7	2.1
<b>At 31 October</b>	<b>3.7</b>	<b>2.8</b>

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

	2019	2018
	£m	£m
At 1 November	0.4	0.4
Credit to the Income Statement	0.2	-
<b>At 31 October</b>	<b>0.6</b>	<b>0.4</b>

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

	2019	2018
	£m	£m
Defined benefit pension scheme	0.6	0.4
<b>At 31 October</b>	<b>0.6</b>	<b>0.4</b>

## Notes to the Financial Statements

For the year ended 31 October 2019

### 24 Other assets

Group	2019	2018
	£m	£m
<b>Due within one year</b>		
Prepayments and accrued income	2.7	2.7
Corporation tax debtor	0.3	1.2
Other assets	1.4	1.3
<b>Due greater than one year</b>		
Deferred consideration	5.7	-
<b>At 31 October</b>	<b>10.1</b>	<b>5.2</b>

The Group entered into an agreement with a third-party on the 31 October 2019 to dispose of land for a minimum consideration of £7.0m. Management has considered the five-step revenue recognition model in determining when and the amount of revenue to be recognised in relation to this contract. The performance obligation of the Group was deemed to have been completed on the 31 October following the transfer of control of the land to a third-party to develop the site.

This contract contains a significant financing arrangement where deferred consideration is to be received over a 42-month period to 30 April 2024. As a result, the initial revenue of £6.0m has been calculated by discounting the minimum consideration using the prevailing interest rate in the market of 4.5%. The finance income component will be unwound over 42-months and recognised separately from the contract revenue in the Statement of Comprehensive Income as finance income. Deferred consideration of £5.7m is due in more than one year.

Company	2019	2018
	£m	£m
Amounts due from group undertakings	0.4	1.5
Group relief	0.1	-
Other debtors	0.2	0.3
<b>At 31 October</b>	<b>0.7</b>	<b>1.8</b>

### 25 Inventory

	2019	2018
	£m	£m
At 1 November	8.4	8.1
Additions	0.9	0.3
Disposals	(1.5)	-
<b>At 31 October</b>	<b>7.8</b>	<b>8.4</b>

### 26 Deposits from banks

	2019	2018
	£m	£m
Repurchase agreement	2.5	2.5
Term funding scheme	70.0	70.0
<b>At 31 October</b>	<b>72.5</b>	<b>72.5</b>

## Notes to the Financial Statements

For the year ended 31 October 2019

### 27 Deposits from customers

	2019	2018
	£m	£m
Deposits from customers	1,036.3	991.6
Amounts owed to a shareholder of the Company	2.5	2.5
Fair value adjustment for hedged risk	0.7	(0.2)
	1,039.5	993.9

The amounts owed to a shareholder of the Company are deposit accounts which accrue a market rate of interest.

### 28 Derivative financial instruments and hedge accounting

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

	Contract/notional amount		Fair value	
	2019	2018	2019	2018
	£m	£m	£m	£m
<b>Derivative liabilities held for hedging purposes and designated fair value hedges:</b>				
Interest rate swaps	316.7	389.1	79.6	106.1
RPI index linked interest rate swaps	55.0	55.0	(1.8)	(1.1)
Derivatives held in fair value hedges	293.7	234.8	3.5	3.5
<b>Total designated derivatives liabilities</b>	<b>665.4</b>	<b>678.9</b>	<b>81.3</b>	<b>108.5</b>

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	Activities
Interest rate swap	Sensitivity to changes in interest rates	Fixed rate savings products, fixed rate residential mortgages, fixed rate debt securities, fixed rate treasury bills and fixed rate commercial loans.
RPI index linked interest rate swaps	Interest rates linked to retail price index	Investment securities linked to RPI

At 31 October 2019, the fixed interest rates vary from 0.4% to 5.4% (2018: 0.3% 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.

## Notes to the Financial Statements

For the year ended 31 October 2019

### 28 Derivative financial instruments and hedge accounting (continued)

	2019	2018
	£m	£m
Movement in fair value of interest rate swaps	(28.0)	15.2
Breakage costs	(0.4)	-
	<b>(28.4)</b>	<b>15.2</b>

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

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

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

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

#### 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		
	Group amounts	Amounts offset	Net amount reported on Balance Sheet
	£m	£m	£m
<b>2019</b>			
Derivative financial assets	2.5	(2.5)	-
<b>Impact on total assets</b>	<b>2.5</b>	<b>(2.5)</b>	<b>-</b>
Derivative financial (liabilities)	(83.8)	2.5	(81.3)
<b>Impact on total (liabilities)</b>	<b>(83.8)</b>	<b>2.5</b>	<b>(81.3)</b>
<b>2018</b>			
Derivative financial assets	1.6	(1.6)	-
<b>Impact on total assets</b>	<b>1.6</b>	<b>(1.6)</b>	<b>-</b>
Derivative financial (liabilities)	(110.1)	1.6	(108.5)
<b>Impact on total (liabilities)</b>	<b>(110.1)</b>	<b>1.6</b>	<b>(108.5)</b>

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 16), and treasury bills (note 14).

## 29 Provisions for long term business - liabilities arising from insurance contracts

	2019	2018
	£m	£m
At 1 November	437.0	416.9
Gross claims and benefits paid	(26.9)	(24.5)
Impact of new insurance contracts	42.4	48.8
<b>Fair value movement on existing liabilities</b>		
Expense cash flows and discount unwind	9.4	7.9
Mortality experience	(1.2)	(1.1)
Interest rate loss/(gain)	46.9	(5.4)
Movement in illiquidity premium	6.4	(0.4)
Change in expense inflation	(1.3)	0.3
<b>Impact of methodology and assumption changes</b>		
Expense policy assumption change	(7.6)	-
CMI mortality assumption change	(6.4)	(5.5)
At 31 October	498.7	477.0

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

### a) Rates of interest

#### Principal assumptions:

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

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

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

	2019	2018
	£m	£m
Pension business annuities	2.2	3.2
Reversionary scheme and renewable reversionary scheme	1.6	2.5
Purchased life annuities	1.6	2.5
Mortgage scheme annuities	1.0	1.8

### b) Mortality tables

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

## 29 Provisions for long term business - liabilities arising from insurance contracts (continued)

### c) Provision for expenses

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

### d) Sensitivity analysis

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

	Delay in maturity by 10%	Expenses + 10%	Interest rates +100bps
	£m	£m	£m
At 31 October 2019	(11.3)	(3.0)	54.3
At 31 October 2018	(11.3)	(3.0)	45.6

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

## 30 Other liabilities

Group	2019	2018
	£m	£m
<b>Due within one year:</b>		
Other taxation and social security	0.2	0.4
Amounts owed in relation to insurance contracts	0.5	3.4
Amounts owed in relation to mortgages administered for third parties	0.9	0.4
Other creditors	0.7	0.8
Accruals	2.8	3.3
	5.1	8.3
<b>Group total</b>	<b>2019</b>	<b>2018</b>
	£m	£m
<b>Due within one year:</b>		
Amounts due to group undertakings	6.2	2.7
Accruals	0.6	0.1
	6.8	2.8



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

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

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

The weighted average duration of the defined pension obligation at the period ended 31 October 2019 is 23 years (2018: 21 years).

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

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

The calculations are based upon an assessment of the scheme's liabilities as at 31 October 2019. These have been based upon the results of the 1 April 2019 formal triennial valuation projected forward with allowance for benefit accrual and expected investment return. The next triennial valuation will be carried out on 1 April 2022.

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

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

#### **GMP equalisation**

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

#### **Scheme assets and liabilities**

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

## Notes to the Financial Statements

For the year ended 31 October 2019

### 31 Pension scheme (continued)

	2019	2018
	£m	£m
Fair value of plan assets	27.3	24.2
Present value of defined benefit obligations	(43.9)	(37.0)
<b>Deficit</b>	<b>(16.6)</b>	<b>(12.8)</b>

#### Movements in present value of defined benefit obligation

	2019	2018
	£m	£m
Present value of scheme liabilities at start of the period	37.0	37.2
Interest cost	1.1	1.0
Current service cost	1.8	1.6
Member contributions	0.3	0.2
<b>Actuarial loss on defined benefit obligation of which:</b>		
due to experience	(1.9)	-
due to demographic assumptions	0.4	(0.4)
due to financial assumptions	5.4	(1.6)
Benefits paid	(0.9)	(1.0)
Past service cost	0.7	-
<b>Present value of scheme liabilities at end of the period</b>	<b>41.9</b>	<b>37.0</b>

#### Movements in fair value of plan assets

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

	2019	2018
	£m	£m
Market value of assets at the beginning of the year	24.2	24.2
Interest income	0.7	0.6
Actuarial gain/(loss)	0.6	(1.4)
Member contributions	0.3	0.2
Employer contributions	2.4	1.6
Benefits paid	(0.9)	(1.0)
<b>Market value of assets at the end of the year</b>	<b>27.3</b>	<b>24.2</b>

### 31 Pension scheme (continued)

#### Expense recognised in the Income Statement

	2019	2018
	£m	£m
Current service cost – staff costs	1.8	1.6
Net interest expense – other finance costs	0.4	0.4
Past service cost	0.7	-
Other admin costs	0.1	-
	2.9	2.0

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

Cumulative actuarial losses reported in the Statement of Other Comprehensive Income are losses of £13.9m (2018: losses of £10.8m) before tax.

#### Plan assets

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

	Fair Value	
	2019 £m	2018 £m
Quoted equity investments	4.4	1.2
Diversified growth funds	17.8	19.0
Private investments	2.5	2.3
Bonds	1.6	1.4
Cash	1.0	0.3
Total market value of assets	27.3	24.2

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

#### Future contributions

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

#### Major assumptions

The major assumptions underpinning the defined benefit obligation are:

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

## Notes to the Financial Statements

For the year ended 31 October 2019

### 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:

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

#### Sensitivities

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

Impact on present value of obligation	Change in assumption %	Change in deficit £m
Discount rate	0.1%	1.0
Rate of inflation (RPI or CPI)	0.1%	0.9
Life expectancy	1 year	1.4

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

#### History of plan Balance Sheets

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

## Notes to the Financial Statements

For the year ended 31 October 2019

### 31 Pension scheme (continued)

#### History of experience gains and losses

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

### 32 Called up share capital

	2019	2018
	£m	£m
<b>Authorised, allotted, called-up and fully paid:</b>		
1,100,000 (2018: 1,100,000) ordinary shares of £1 each	1.1	1.1

### 33 Financial commitments

	2019	2018
	£m	£m
<b>Loan commitments</b>		
expiring in less than one year	26.0	33.4
expiring in more than one year	47.3	66.7

#### Capital commitments

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

## Notes to the Financial Statements

For the year ended 31 October 2019

### 33 Financial commitments (continued)

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

	2019	2018
	£m	£m
Within one year	0.5	0.5
Between one and five years	2.2	2.2
After five years	3.6	4.1
	6.3	6.8

### 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 2019	At amortised cost	Fair value through profit and loss	Total
	£m	£m	£m
<b>Assets</b>			
Cash and balances held at central banks	321.9	-	321.9
Treasury bills	25.1	30.4	55.5
Debt securities	57.0	77.9	134.9
Loans and advances to credit institutions	87.4	-	87.4
Loans and advances to customers	516.2	724.0	1,240.2
Investments	-	6.8	6.8
Other assets	10.1	-	10.1
<b>Total financial assets</b>	<b>1,017.7</b>	<b>839.1</b>	<b>1,856.8</b>
<b>Total non-financial assets</b>			<b>199.0</b>
<b>Total assets</b>			<b>2,055.8</b>
<b>Liabilities</b>			
Deposit from banks	72.5	-	72.5
Deposit from customers	1,039.5	-	1,039.5
Derivative financial instruments	-	81.3	81.3
Other liabilities	5.1	-	5.1
<b>Total financial liabilities</b>	<b>1,117.1</b>	<b>81.3</b>	<b>1,198.4</b>
<b>Total non-financial liabilities</b>			<b>515.3</b>
<b>Share capital and other reserves</b>			<b>342.1</b>
<b>Total equity and liabilities</b>			<b>2,055.8</b>

## Notes to the Financial Statements

For the year ended 31 October 2019

### 34 Financial instruments (continued)

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

	2019	2018	2017	2016	2015
	£m	£m	£m	£m	£m
<b>Assets</b>					
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	61.0	148.5
Loans and advances to credit institutions	111.9	-	-	-	111.9
Loans and advances to customers	-	557.4	-	685.2	1,242.6
Investments	-	-	-	6.6	6.6
Other assets	5.2	-	-	-	5.2
<b>Total financial assets</b>	<b>280.6</b>	<b>557.4</b>	<b>93.2</b>	<b>825.4</b>	<b>1,767.6</b>
Total non-financial assets					206.2
<b>Total assets</b>					<b>1,973.8</b>
<b>Liabilities</b>					
Deposit from banks	72.5	-	-	-	72.5
Deposit from customers	993.9	-	-	-	993.9
Derivative financial instruments	-	-	-	108.5	108.5
Other liabilities	8.3	-	-	-	8.3
<b>Total financial liabilities</b>	<b>1,074.7</b>			<b>108.5</b>	<b>1,175.2</b>
Total non-financial liabilities					449.9
Share capital and other reserves					340.7
<b>Total equity and liabilities</b>					<b>1,973.8</b>

#### 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.

## Notes to the Financial Statements

For the year ended 31 October 2019

### 34 Financial instruments (continued)

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

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

As at 31 October 2019	Level 1	Level 2	Level 3	Total
	£m	£m	£m	£m
<b>Financial assets at fair value through profit or loss</b>				
Treasury bills	30.4	-	-	30.4
Debt securities	77.9	-	-	77.9
Loans and advances to customers	-	-	724.0	724.0
Investments	6.8	-	-	6.8
<b>Total financial assets at FVTPL</b>	<b>115.1</b>	<b>-</b>	<b>724.0</b>	<b>839.1</b>
<b>Financial liabilities at fair value through profit or loss</b>				
Derivative financial instruments	-	81.3	-	81.3
<b>Total financial liabilities at FVTPL</b>	<b>-</b>	<b>81.3</b>	<b>-</b>	<b>81.3</b>

As at 31 October 2018	Level 1	Level 2	Level 3	Total
	£m	£m	£m	£m
<b>Financial assets at fair value through profit or loss</b>				
Treasury bills	72.6	-	-	72.6
Debt securities	61.0	-	-	61.0
Loans and advances to customers	-	-	685.2	685.2
Investments	6.6	-	-	6.6
<b>Total financial assets at FVTPL</b>	<b>140.2</b>	<b>-</b>	<b>685.2</b>	<b>825.4</b>
<b>Financial liabilities at fair value through profit or loss</b>				
Derivative financial instruments	-	108.5	-	108.5
<b>Total financial liabilities at FVTPL</b>	<b>-</b>	<b>108.5</b>	<b>-</b>	<b>108.5</b>

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

##### Treasury bills and debt securities:

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

Instruments included in Level 1 comprise primarily UK Government investment securities (treasury bills) and debt securities classified as FVTPL.



### 34 Financial instruments (continued)

#### Derivative financial instruments:

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

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

#### Transfers

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

#### d) Level 3 assets and liabilities measured at fair value

##### Loans and advances to customers – equity release and retirement mortgages:

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

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

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

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

	2019	2018
	£m	£m
At start of period	79.8	74.7
Addition on transition to IFRS 9 – retirement mortgages	18.8	-
Disposal of equity release portfolio	(8.8)	-
Amounts deferred in the period	8.9	10.4
Amounts recognised in the Income Statement in the period	(14.3)	(5.3)
At end of period	74.4	79.8

### 34 Financial instruments (continued)

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

	2019	2018
	£m	£m
At start of period	685.2	692.5
Addition on transition to IFRS 9 – retirement mortgages	105.2	-
Disposal of equity release portfolio to a third party	(122.0)	-
Total gains in Income Statement	81.6	0.3
Loans advanced	33.2	39.7
Redemptions	(59.2)	(47.3)
<b>At end of period</b>	<b>724.0</b>	<b>685.2</b>

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

#### **Equity release and retirement mortgages – principal assumptions**

Principal assumptions underlying the calculation of equity release and retirement mortgages include the following:

##### **Mortality or entry into long term care**

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

##### **Lapses**

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

##### **Expenses**

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

##### **Discount rate**

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

The average discount rate for the portfolio (assumed to be the 15-year point on the yield curve based on average duration at 31 October 2019) was 1.78% (2018: 2.62%).

### 34 Financial instruments (continued)

#### No-negative equity guarantee

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

The property growth and volatility assumed at 31 October 2019 were 3.08% (2018: 3.28%) and 13.0% (2018: 13%) respectively. The value of the no-negative equity guarantee as at 31 October 2019 was £20.7m (2018: £20.4m).

#### Sensitivity analysis

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

	Property price decrease of 1.00%	Volatility increase of 1.00%	Property underperformance decrease of 1.00%	Property price increase of 1.00%	Volatility decrease of 1.00%	Property underperformance increase of 1.00%
	£m	£m	£m	£m	£m	£m
At 31 October 2019	(81.6)	(1.2)	(11.5)	(6.2)	(14.2)	(7.2)
At 31 October 2018	(81.6)	(1.2)	(11.5)	(6.2)	(14.2)	(7.2)

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

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

### 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 2019	Not more than three months	More than three months but not more than one year	More than one year but not more than five years	More than five years	Total	
	£m	£m	£m	£m	£m	
<b>Assets</b>						
Cash and balances held at central banks	321.9	-	-	-	-	321.9
Treasury bills	15.0	-	5.0	16.7	18.8	55.5
Debt securities	3.5	6.0	7.0	71.5	46.9	134.9
Loans and advances to credit institutions	87.4	-	-	-	-	87.4
Loans and advances to customers	67.4	32.6	39.0	292.4	808.8	1,240.2
Investments	6.8	-	-	-	-	6.8
Other assets	10.1	-	-	-	-	10.1
<b>Total financial assets</b>	<b>512.1</b>	<b>38.6</b>	<b>51.0</b>	<b>380.6</b>	<b>874.5</b>	<b>1,856.8</b>
<b>Liabilities</b>						
Deposit from banks	2.5	-	-	70.0	-	72.5
Deposit from customers	165.5	182.4	292.5	395.6	3.5	1,039.5
Derivative financial instruments	0.2	(1.7)	0.5	11.1	71.2	81.3
Other liabilities	5.1	-	-	-	-	5.1
<b>Total financial liabilities</b>	<b>173.3</b>	<b>180.7</b>	<b>293.0</b>	<b>476.7</b>	<b>74.7</b>	<b>1,198.4</b>
<b>Loan commitments liability</b>	<b>0.8</b>	<b>0.5</b>	<b>1.4</b>	<b>98.0</b>	<b>5.8</b>	<b>76.5</b>

### 34 Financial instruments (continued)

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

	Less than 3 months	3 months to 12 months	12 months to 5 years	More than 5 years	Not disclosed	Total
	£ million	£ million	£ million	£ million	£ million	£ million
<b>Assets</b>						
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	71.3	55.3	148.5
Loans and advances to credit institutions	111.9	-	-	-	-	111.9
Loans and advances to customers	51.6	12.9	46.3	289.7	842.1	1,242.6
Investments	6.6	-	-	-	-	6.6
Other assets	5.2					5.2
<b>Total financial assets</b>	<b>347.8</b>	<b>22.2</b>	<b>59.7</b>	<b>368.5</b>	<b>907.4</b>	<b>1,705.6</b>
<b>Liabilities</b>						
Deposit from banks	2.5	-	-	70.0	-	72.5
Deposit from customers	298.9	80.2	284.4	330.4	-	993.9
Derivative financial instruments	-	-	0.3	10.0	98.2	108.5
Other liabilities	8.3	-	-	-	-	8.3
<b>Total financial liabilities</b>	<b>310.7</b>	<b>80.2</b>	<b>284.7</b>	<b>410.4</b>	<b>998.2</b>	<b>1,784.2</b>
<b>Net financial assets</b>	<b>37.1</b>	<b>42.0</b>	<b>275.0</b>	<b>258.1</b>	<b>909.2</b>	<b>921.4</b>

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### 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 2019	Up to three months	Not more than three months	More than three months but not more than six months	More than six months but not more than one year	More than one year but not more than five years	More than five years	Total
	£m	£m	£m	£m	£m	£m	£m
<b>Financial liabilities</b>							
Deposit from banks	72.5	2.5	-	-	71.2	-	73.7
Deposit from customers	1,039.5	165.7	183.1	296.3	411.4	3.8	1,060.3
Derivative financial instruments	81.3	2.5	0.3	4.8	46.3	127.5	181.4
Other liabilities	5.1	5.1	-	-	-	-	5.1
<b>Total financial liabilities</b>	<b>1,198.4</b>	<b>175.8</b>	<b>183.4</b>	<b>301.1</b>	<b>528.9</b>	<b>131.3</b>	<b>1,320.9</b>

As at 31 October 2019	Up to three months	Not more than three months	More than three months but not more than six months	More than six months but not more than one year	More than one year but not more than five years	More than five years	Total
	£m	£m	£m	£m	£m	£m	£m
<b>Financial liabilities</b>							
Deposit from banks	72.5	2.5	-	-	71.7	-	74.2
Deposit from customers	993.9	298.8	80.8	288.2	342.5	-	1,010.3
Derivative financial instruments	108.5	2.5	0.8	4.1	42.6	75.7	125.7
Other liabilities	8.3	8.3	-	-	-	-	8.3
<b>Total financial liabilities</b>	<b>1,183.2</b>	<b>312.1</b>	<b>81.6</b>	<b>292.3</b>	<b>456.8</b>	<b>75.7</b>	<b>1,218.9</b>

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

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

#### g) Foreign currencies

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

## **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.

The primary driver of credit risk within equity release and retirement mortgages and reversionary interests in property is a fall in house prices, which would cause credit losses should house prices fall sufficiently in real terms at the date of redemption.

The primary driver of credit risk within the treasury assets portfolio, which comprises deposits with other banks, gilts and debt securities is counterparty default, meaning the counterparty can no longer repay its obligations. Only instruments issued by counterparties with a minimum rating of BBB- at the point of purchase are held. The Group intends to hold its treasury assets to maturity and is therefore not directly affected by market risk.

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

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

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

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

#### Expected Credit Loss Provisioning

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

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

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

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

#### Key Economic Scenario Assumptions

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

Economic Assumption	Y1 %	Y2 %	Y3 %	Y4 %	Y5 %
UK GDP Growth	1.2	1.7	1.8	1.8	1.8
UK Unemployment Rate	4.0	3.0	4.1	4.3	4.2
% Change in S&P 500 Index <sup>1</sup>	12.0				
% Change in Energy Index	(3.1)	1.8	1.9	1.9	2.0
% Change in Non-Energy Index	0.1	1.6	1.7	1.7	1.8
% Change in Proportion of Downgrades <sup>1</sup>	0.1				

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

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

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

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

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

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



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

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

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

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

The UK government has agreed a flexible extension with the EU in relation to Brexit until the 31 January 2020. The Prime Minister has negotiated a deal with the EU to prevent a disorderly exit and this deal has been approved by Parliament, but the process of turning the deal into legislation has been put on hold until after the general election. The economic forecasts outline that the UK is entering a period of low GDP growth and sustained low unemployment. It is the view of the Group that a higher weighting should be applied to the Neutral scenario which is appropriate in cases where the expectations are of little or no GDP growth. It remains uncertain whether the outcome of Brexit will result in either an orderly or disorderly Brexit and as such it is the view of the Group that equal weightings should be applied to both the Positive and Negative economic scenarios.

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

#### Loans and advances to residential customers

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

	31 October 2019	
	£m	% of total
Fully secured by a first charge on residential property	738.3	100.0
Fair value adjustments	164.5	
Fully secured by a first charge on residential property	751.3	100.0
Fair value adjustments	142.0	

## Notes to the Financial Statements

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

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

#### Residential: risk concentrations

Loan to value (LTV) is one of the main factors used to determine the credit quality of loans secured on residential property along with credit scores. All residential loans and receivables have an LTV of less than 70% when advanced.

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

#### Residential: performance

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

Stage	Description	Credit Score	Gross Loan Balance	ECI Provision
			£m	£m
Stage 1	Satisfactory	>= 676	176.6	-
Stage 2	Watchlist	< = 675	1.9	(0.1)
Stage 3	Default	N/a <sup>1</sup>	-	-
			178.5	
	Less: Loan fee deferral		0.4	
	Provisions for impairment		(0.1)	
Total			178.0	

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

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

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

Stage	Description	Credit Score	Gross Loan Balance	ECI Provision
			£m	£m
Stage 1	Satisfactory	>= 676	104.1	-
Stage 2	Watchlist	< = 675	-	-
Stage 3	Default	N/a <sup>1</sup>	-	-
			104.1	
	Less: Loan fee deferral		0.1	
	Provisions for impairment		-	
Total			104.0	

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

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

#### (a) Credit risk: Commercial lending

##### Commercial: analysis of risk concentration

Loans secured on commercial property are as follows:

	2019		2018	
	£m	%	£m	%
Commercial mortgage	23.3	38.3	35.7	73.8
Development finance	67.5	97.5	62.7	94.4
Investment loans	219.1	376.5	237.7	411.7
Renewable energy	19.4	-	20.7	-
	329.3	512.3	256.8	579.9
Less: Loan fee deferral	(2.0)	-	(2.3)	-
Provisions for impairment	(11.1)	-	(5.1)	-
	316.2	512.3	249.4	579.9

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

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

	2019		2018	
	£m	%	£m	%
Wales	73.2	22.2	83.8	23.5
London - England	123.5	37.6	123.8	34.7
South East & East of England	25.0	7.6	16.2	4.5
Midlands - England	21.2	6.4	31.0	8.7
South West of England	49.5	15.0	68.6	19.2
North West & North East of England	24.2	7.3	19.9	5.6
Scotland	12.7	3.9	13.5	3.8
	339.3	100.0	357.8	100.0

The average loan to value (LTV) in respect of commercial loans is estimated to be 56.1% (2018: 54.2%). LTV analysis has been undertaken by using a combination of external valuations and internal and external desktop reviews which consider the type and quality of security, lease term/tenant as well as geographical location.

£25.5m (2018: £15.8m) of exposures have an LTV of greater than 100%. Of these, £25.2m (2018: £15.4m) are already classified as impaired, leaving £0.3m (2018: £0.4m) of exposures considered to be satisfactory. In these instances, management is satisfied that the cash flows generated by the underlying assets will be sufficient to fully repay the debt over time.

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

## Notes to the Financial Statements

For the year ended 31 October 2019

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

#### Commercial: lending performance

Procedures are in place which grade borrowers in line with the perceived severity of the risk and are designed to identify cases of potential cause for concern to facilitate early risk mitigation or forbearance activity where appropriate. Using this risk grading system, the commercial loan portfolio is classified as follows (figures do not include provisions for loan impairment or unamortised loan fees):

	2019		2018	
	£m	%	£m	%
Stage 1	286.7	87.1	310.3	87.2
Stage 2 – significant increase in credit risk	14.3	4.3	17.1	4.8
Stage 3 – default	28.3	8.6	29.4	8.0
	<b>329.3</b>	<b>100.0</b>	<b>356.8</b>	<b>100.0</b>

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

#### Past due but not impaired

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

#### Exposure by credit rating

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

Risk grade	Description	Stage	CRP Rating	Gross Loan Balance	ECI Provision
				£m	£m
1	Negligible risk	Stage 1	A+	1.4	-
2.1	Minimal risk	Stage 1 or 2	B+	17.9	-
2.2	Low risk	Stage 1 or 2	B	10.9	-
3.1	Fair risk	Stage 1 or 2	B-	65.6	0.2
3.2	Moderate risk	Stage 1 or 2	BB+	174.9	1.4
4.1	Watch	Stage 1 or 2	BB	22.2	0.4
4.2	Enhanced watch	Stage 1 or 2	BB-	8.1	0.1
5	Substandard	Stage 2	BBB	-	-
6	Default	Stage 3	CCC+	24.8	6.5
7	Loss	Stage 3	CCC-	3.5	2.5
<b>Total</b>				<b>329.3</b>	<b>11.1</b>

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

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

Internal risk grade	External credit rating	Stage	Rating	2018 £m	2017 £m
1	Negligible risk	Stage 1	A+	2.2	-
2.1	Minimal risk	Stage 1 or 2	B+	0.4	-
2.2	Low risk	Stage 1 or 2	B	24.2	-
3.1	Fair risk	Stage 1 or 2	B-	111.3	-
3.2	Moderate risk	Stage 1 or 2	BB+	130.8	-
4.1	Watch	Stage 1 or 2	BB	35	-
4.2	Enhanced watch	Stage 1 or 2	BB-	6.4	-
5	Substandard	Stage 2	BBB	17.1	0.2
6	Default	Stage 3	CCC+	25.9	2.5
7	Loss	Stage 3	CCC-	3.5	2.4
<b>Total</b>				<b>259.8</b>	<b>25.1</b>

#### Forbearance

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

#### Credit risk: portfolio buy-to-let lending

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

#### Buy-to-let: analysis of risk concentration

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

	2019		2018	
	Loan balance £m	Unpaid interest £m	Loan balance £m	Unpaid interest £m
Portfolio buy-to-let lending	21.3	30.8	-	-
<b>Total</b>	<b>21.3</b>	<b>30.8</b>	<b>-</b>	<b>-</b>

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

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

	2019		2018	
	£m	£m	£m	£m
Loans secured on buy-to-let property	21.3	100.0	-	-
	<b>21.3</b>	<b>100.0</b>	-	-
Less: Loan fee deferral	(0.1)		-	-
Provisions for impairment	(0.3)		-	-
<b>Total</b>	<b>21.3</b>	<b>100.0</b>	<b>-</b>	<b>-</b>

## Notes to the Financial Statements

For the year ended 31 October 2019

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

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

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

The average loan to value (LTV) in respect of buy-to-let loans is estimated to be 68.5%. LTV analysis has been undertaken by using a combination of external valuations and internal and external desktop reviews which consider the type and quality of security, lease term/tenant as well as geographical location. No exposures have an LTV of greater than 100%.

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

#### Buy-to-let: lending performance

Procedures are in place which grade borrowers in line with the perceived severity of the risk and are designed to identify cases of potential cause for concern to facilitate early risk mitigation or forbearance activity where appropriate. Using this risk grading system, the gross value of the buy-to-let portfolio is classified as follows:

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

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

#### Buy-to-let: lending provisions

Provisions are held against impaired loans as follows:

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

#### Past due but not impaired

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

#### Exposure by credit rating

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

Rating	Rating	Stage	BB+	Total Gross Exposure	LFL provision
3.2	Moderate risk	Stage 1 or 2	BB+	21.3	(0.3)
Total				21.3	(0.3)

## Notes to the Financial Statements

For the year ended 31 October 2019

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

#### (a) Credit risk: Treasury assets

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:

	2019	2018
	£m	£m
UK government and amounts held with central banks	321.9	153.2
Treasury bills	55.5	99.6
Debt securities	134.9	148.5
Loans and advances to credit institutions	87.4	111.9
	599.7	513.2
Provision for impairment	-	-
	599.7	513.2

None of these exposures are past due or impaired.

The following shows the exposures broken down by rating:

	2019	2018
	£m	£m
AAA to AA-	559.9	458.8
A+ to A-	27.2	29.9
BBB+ to BBB-	12.6	20.9
BB+ to BB-	-	3.6
	599.7	513.2

#### Concentration of credit risk

The geographical exposure is as follows:

	2019	2018
	£m	£m
UK	548.2	469.3
Other	51.5	43.9
	599.7	513.2

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

## Notes to the Financial Statements

For the year ended 31 October 2019

### 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.

The maturity analysis of financial assets and liabilities is disclosed in note 34(e) to the financial statements. For insurance contract liabilities, maturity profiles are determined based on estimated timing of net cash outflows from the recognised insurance liabilities.

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

#### 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 2019. The principal risk management tool to mitigate interest rate risk is the use of derivatives to align the interest rate re-pricing profile of assets and liabilities. All of the derivatives used by the Group are interest rate swap contracts of varying maturities and start dates.

The Group's interest rate risk management policy defines the type of derivative transactions that can be undertaken, which are all actioned by the Group's treasury function, and are subject to review and approval at the dealing stage. The Treasurer, who is responsible for treasury matters on a day to day basis, prepares a treasury report for the Board, which includes analysis of interest rate risk exposures.



## Notes to the Financial Statements

For the year ended 31 October 2019

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

#### d) Operational risk

Operational risk is the risk of economic loss from systemic failure, human error and fraud (control failures) or external events, which result in unexpected or indirect loss to the Group. When controls fail to perform, operational risks can cause damage to reputation, have legal or regulatory implications or can lead to financial loss. The Group cannot expect to eliminate all operational risks but by initiating a rigorous control framework and by monitoring and responding to potential risks, the Group is able to manage the risks. Controls include effective segregation of duties, access controls, authorisation and reconciliation procedures, staff education and assessment processes, including the use of internal audit.

#### e) House price risk

House price risk is the risk that arises when there is an adverse mismatch between actual house prices and those implicit in the costing of the Group's equity release and retirement mortgages and reversionary interests, such that the ultimate realisation of the property would not yield the expected return to the Group and could, in certain circumstances, result in a capital loss. The Group mitigates house price risk by monitoring maximum loan to value at inception of the loan and reversionary interests. The reversionary interests are a legacy product which is being run-off over the medium term.

#### *Geographical analysis of loans secured on equity release and retirement mortgages*

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

	2019		2018	
	£m	%	£m	%
Wales	19.3	3.5	18.6	3.4
South East	144.3	26.3	149.9	27.5
South West	62.8	11.4	68.6	12.6
London	57.5	10.5	71.6	13.2
East Anglia	71.9	13.1	62.8	11.5
North West	45.7	8.3	43.6	8.0
West Midlands	31.1	5.7	30.5	5.6
North East	34.3	6.2	19.8	3.6
Yorkshire & Humberside	10.0	1.8	17.7	3.3
East Midlands	17.3	3.2	19.4	3.6
Scotland	29.5	5.4	24.1	4.4
Northern Ireland & Other	25.2	4.6	17.7	3.3
	235.9	100.0	235.5	100.0

#### f) Conduct risk

Conduct risk is the risk that the Group's behaviour results in poor outcomes for customers. The Group is exposed to this risk by virtue of the markets in which it chooses to operate. The Executive Risk Committee has overall responsibility for implementing and monitoring principles, frameworks, policies and limits. The Committee is responsible for managing risk decisions and monitoring risk levels which it reports to the Risk and Conduct Committee.

The Group holds a provision of £nil as at 31 October 2019 (2018: £0.1m).

## Notes to the Financial Statements

For the year ended 31 October 2019

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

#### 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.

### 36 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.

### 37 Shares in Group undertakings

Company	£m
At beginning of year	83.5
Additions	2.5
Reversal of provision	0.5
At end of year	86.5

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 Limited	United Kingdom	Holding company	100%	100%
Julian Hodge Bank Limited	United Kingdom	Banking	100%	100%
Hodge Life Assurance Company Limited	United Kingdom	Life assurance	100%	100%
Carlyle Securities Limited	United Kingdom	Property investment	100%	100%
Carlyle Property Development Company Limited	United Kingdom	Property investment	100%	100%
Sterling House Limited	United Kingdom	Property investment	100%	100%
Wingwest (Fountain Lane) Limited	United Kingdom	Property investment	100%	100%
Hodge Developments (Beaufort Park) Limited	United Kingdom	Property investment	100%	100%
Hodge (Clevedon Estates) Limited	United Kingdom	Property Investment	100%	100%

## Notes to the Financial Statements

For the year ended 31 October 2019

### 38 Subsidiary Audit Exemption

The Carlyle Trust Limited provides a guarantee for the subsidiaries below under s479A, which exempts them from the requirements of the Act relating to audit of its individual accounts for the financial year to 31 October 2019.

Subsidiary Name	Company Number
Hodge Developments (Beaufort Park) Limited	06343749
Wingwest (Fountain Lane) Limited	06127896
Carlyle Securities Limited	00743649
Sterling House Limited	06589142
Hodge (Clevedon Estates) Limited	11209025

### 39 Related parties

The Company has relationships with its parent Company, The Carlyle Trust (Jersey) Limited, fellow subsidiaries of The Carlyle Trust Limited and the Jane Hodge Foundation. All transactions are carried out on an arm's length basis. The company paid dividends to its shareholders during the year ended 31 October 2019 of £3.3m (2018: £3.3m).

The other group related party transactions are disclosed below:

Related Party Name	£m (2019 unless otherwise stated)	
	2019	2018
Jane Hodge Foundation – shareholder of The Carlyle Trust Limited	-	(5.3)
	-	(11.4)

During the year, development costs of £0.3m were recharged to St Aubins Development Company Ltd at cost. This company is a related party as a director of the Company has significant influence over both St Aubins and the Group.

The Group also has a related party liability of £2.5m (2018:£2.5m) with the Jane Hodge Foundation – shareholder of the Carlyle Trust Limited.

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

Related Party Name	2019	2018
	£m	£m
<b>Deposits held by subsidiary</b>		
Julian Hodge Bank Limited	1.1	0.2
<b>Amounts owed from subsidiaries</b>		
Hodge (Clevedon Estates) Limited	-	1.5
Carlyle Property Development Company Limited	0.4	-
<b>Amounts owed to subsidiaries</b>		
Julian Hodge Bank Limited	(3.3)	(0.2)
Reimbursement liability due to The Carlyle Trust Limited	(2.9)	(2.4)
Carlyle Securities Limited	-	(0.1)

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

Key management compensation is as follows:

	£m	
	2019	2018
Short-term employee benefits:	0.7	0.5

## 40 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).

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.

	2019 Unaudited	2018 Unaudited
	£m	£m
Common Equity Tier 1 capital	156.4	168.0
Total risk weighted assets	695.2	751.7
<b>Common Equity Tier 1 capital ratio</b>	<b>22.5%</b>	<b>22.3%</b>
 Total own funds	 156.4	 168.0
Total risk weighted assets	695.2	751.7
<b>Total capital ratio</b>	<b>22.5%</b>	<b>22.3%</b>

### 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 8 to the financial statements.
- Annual turnover (Net Interest Income) and profit before tax: as disclosed in the Income Statement.
- Corporation Tax paid by Julian Hodge Bank Limited: 2019 £0.2m (2018: £0.3m).
- Public subsidies: There were none received in the year.

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

The banking segment's objectives when managing capital are:

- To have sufficient capital to safeguard the Bank's ability to continue as a going concern so that it can continue to provide returns for the shareholder and benefits for other stakeholders;
- To comply with the Bank's capital requirements set out by the PRA in the UK.

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

## 40 Capital risk management (continued)

### 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.

### Pillar 1 capital position

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

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

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