# MANCHESTER BUILDING SOCIETY GROUP

# CONDENSED CONSOLIDATED HALF YEARLY FINANCIAL INFORMATION

# 30 JUNE 2018

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## Introduction

The Directors present their Condensed Consolidated Half Yearly Financial Information of the Group for the 6 months ended 30 June 2018.

The Group consists of the Society and its two wholly owned subsidiaries: MBS (Mortgages) Limited and MBS (Property) Limited; further, under the terms of IFRS 10 Consolidated Financial Statements the Group includes the consolidated position of NMB Mortgage Acquisition Company Limited (in liquidation) ("NMB MAC"), where the Group exerts control notwithstanding that it holds no shares in that entity.

## Strategic summary

The Group's strategy since 2013 has been to reduce its risks and conserve regulatory capital through a reduction in the size of its balance sheet. This strategy was necessary because of events that led to a material write-down of the Society's reserves following a change in the accounting treatment of certain financial assets.

As explained in the 2017 Annual Report and Accounts, the Society has insufficient Common Equity Tier 1 ("CET1") capital, a measure of the quality of capital, necessary to return to lending. As a result the Board has continued to explore options, in discussion with the Prudential Regulation Authority ("PRA"), to address the Society's position in the best interests of its members.

During the first half of 2018 the Board continued to look at options to improve the capital position including the pursuit of the Society's legal claim against the previous external auditors, Grant Thornton UK LLP. The High Court judgment was handed down on 2 May 2018 and awarded the Society damages of £336k, which was considerably below the amount claimed. The Society has been granted leave to appeal the decision and that appeal is expected to take place no earlier than mid-January 2019 with the result of the appeal being known some time later. Following the judgment, the High Court awarded interim costs of £2,309k to Grant Thornton. In addition to the interim costs, the Society anticipates that it may have some further liability in respect of Grant Thornton's overall costs which will be determined following a detailed assessment that is expected to take some months. The interim costs, and other costs associated with this legal action, have adversely affected the administrative expenses of the Group and means the Society does not meet its regulatory requirement to hold CET1 capital equal to at least 4.5% of risk weighted assets. The Society continues to discuss and consult with the PRA regarding actions to be taken by the Society to correct this position.

The Group's results incorporate the implementation of IFRS 9 – Financial Instruments from 1 January 2018. This resulted in a reduction to 2018 opening reserves of £0.3m but had a minimal impact on the results for the first 6 months of 2018 as we adopted the transitional arrangements..

As at 30 June 2018 the Society met its Pillar 1 plus Pillar 2A requirement in total capital terms, but did not meet the qualitative standards for the level of CET1 regulatory capital. The latest outlook for the remainder of the year does not significantly change this position. Consequently, the Board considers it is unlikely that the Society will pay the October coupon on the Permanent Interest Bearing Shares ("PIBS") as, in order to conserve capital, such a distribution is prohibited under the Capital Requirements Directive ("CRD IV") article 141.

The Group's results for the period are explained in detail in the sections that follow, along with the principal risks and uncertainties that the Group faces.

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## Business review

The Group recorded a loss after taxation for the 6 months ended 30 June 2018 of £1,629k, compared with a loss for the 6 months ended 30 June 2017 of £698k.

Mortgage assets reduced by 13% since 30 June 2017 and by 6% since the end of 2017 as the Group continued to make no new advances in order to conserve capital through a reduction in balance sheet size.

The Group's net interest income decreased by 7% compared with the same period in 2017. Whilst the level of interest earned on the reducing mortgage book was lower than that of the comparative period in 2017, this was significantly offset by both the lower level of interest paid on retail savings products and the proportionately lower levels of retail funding held in the period. Retail balances at the end of June 2018 were £237m, £11m lower than the position reported at the end of December 2017. The net interest income for the 6 months ended 30 June 2018 included a provision release of £81k relating to remediation work completed in the period. This compares with a release of remediation provisions through interest income of £295k for the equivalent period in 2017 and a £500k release for the full year 2017.

Other operating income for the 6 months ended 30 June 2018 was £612k, compared to £367k for the comparative period in 2017. The increase is mainly due to the £336k of damages awarded to the Society as part of the High Court judgment, as noted in the Directors' Report on page 3, offset by £107k of reduced currency movement gains recorded through operating income. The Group's administrative expenditure was £2,437k (66%) higher than that of the comparative period in 2017. This significant increase relates almost entirely to the interim costs awarded to Grant Thornton following the High Court judgment. Additional professional costs relating to the court case have been offset by a reduction in contractors' fees.

Impairment losses of £245k were recorded in the period in respect of the Group's mortgage and loan books, compared with impairment losses of £1,718k in the first half of 2017. The 2017 losses were principally the result of a charge incurred in respect of the Spanish lifetime portfolio which included a charge in the period of £1,682k driven by a lower Spanish house price inflation forecast. The Spanish lifetime portfolio impairment charge for the first half of 2018 was £112k.

The results for the half year include the full year's charge for the Financial Services Compensation Scheme Levy of £11k. This is offset by the release of £17k from the equivalent provision for the prior scheme year. The net position results in income of £6k for the 6 months ended 30 June 2018.

The Group continues in its efforts to minimise mortgage arrears and to help borrowers in difficulties to resolve their situations, taking a consultative approach with borrowers who experience repayment difficulties and applying forbearance as appropriate. At 30 June 2018 there were 11 mortgage accounts where payments were 12 or more months in arrears (31 December 2017: 14). Outstanding balances on these accounts were £5.8m (31 December 2017: £6.2m), with total arrears of £0.9m (31 December 2017: £0.9m), representing 2.5% of total gross mortgage balances (31 December 2017: 2.3%).

The customer redress exercise in respect of customers affected by the "Bos v Rea" decision, which was disclosed on page 63 of the 2017 Annual Report and Accounts has been completed. The cost of redress for non-compliance resulted in a £79k release from the provision included at 31 December 2017. The movement on this provision during the period is set out in Note 10.

High levels of liquidity have been maintained throughout the period. The Society continues to take a cautious approach to the investment of its liquid funds, having significant balances deposited with the Bank of England and other smaller sums within instantly accessible accounts with a number of UK High Street banks. The small sums held in investment securities as at 31 December 2017 (£39k) redeemed during the first half of 2018 for their full recorded value.

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## Risks and uncertainties

Given the Society does not meet the qualitative standards for the level of CET1 regulatory capital, the requirement for an increase in CET1 capital in order to return to lending, and the assessed prospects for the business and its capital position without such a return, there is a material uncertainty relating to the ability of the Group and Society to continue as a going concern due to the continued run-off of the balance sheet. The Board is assessing a number of options to develop a strategy to address the position of the Group. The immediate focus is on measures to improve the capital position of the Group and, given the shortfall against the qualitative standards for the level of CET1 regulatory capital under CRD IV article 142, a Capital Conservation Plan was submitted to the PRA in October 2016, with updates submitted in April 2017 and September 2017. An updated plan was submitted to the PRA in June 2018 following the Society's CET 1 capital falling below the required 4.5% of Risk Weighted Assets. These documents have been discussed with the PRA and they continue an open dialogue with the Society on future developments.

Every business faces risks as part of its day-to-day operations. The Board's risk management objectives are to seek to minimise the risks that the Group faces, by articulating that it has a low appetite for risk and by deploying a range of risk management policies and procedures within an appropriate control environment in order to achieve such an outcome.

A full explanation of the Board's assessment of the risks and uncertainties that are faced by the Group is set out in the 2017 Annual Report and Accounts on pages 5 to 6.

During 2016, the UK voted in a referendum to leave the European Union ("EU"). The impact of the UK's decision to leave the EU on government policy, the financial markets and the wider economy remains uncertain. With regard to the Group's Spanish lifetime portfolio this introduces additional uncertainty and risk which the Board is monitoring; in particular there is added risk and uncertainty in relation to foreign exchange volatility, property values for the Spanish lifetime portfolio and the behavioral impact on Spanish lifetime mortgage borrowers.

Summarised below are a number of the Group's key risks and uncertainties:

- ***Credit risk:*** The Group is exposed to the risk that it may not receive back in full any sum that has been borrowed (in relation to loans and advances) or any sum that it has deposited with a counterparty (in relation to liquid assets) when such amounts fall due. The Board monitors credit risk, underlying security values and the level of impairment provisions on a monthly basis. Credit risk is more of a consideration in relation to loans and advances than in relation to the Group's liquid assets; the former involve relationships with individuals or small businesses, whilst the latter are far fewer in number,

being restricted to either the Bank of England or UK High Street banks, where credit risk is assessed as being very low.

The assessment of credit risk and the related impairment provisioning is a critical accounting estimate, impacted by judgements relating to customer affordability and the impact of economic circumstances, including the level of interest rates.

The Board's assessment is that the credit risk that the Group faces has not altered since the publication of the 2017 Annual Report and Accounts, with the various loans and mortgage books identified for impairment consideration continuing to perform in a manner similar to that as at 31 December 2017.

- ***Insurance risk:*** Impairment assessments incorporate the insurance risk attaching to the Group's lifetime mortgage contracts, which are euro-denominated. The risk arises from a contractual term within the contract for the Group's lifetime mortgage contract assets which in certain circumstances precludes the Group from pursuing the borrower or their estate for any shortfall on redemption.

- ***Liquidity risk:*** The Group's strategy is to maintain sufficient funds in unencumbered liquid form at all times to ensure that its liabilities can be met as they fall due. Regular stress testing of liquidity is undertaken by separately using 20 week and 3 month time horizons. The Group operates within closely monitored Board-approved liquidity policy limits, which are reviewed on a daily basis by the Group's Finance and Treasury teams, reported to executive management every week and considered by the Board each month. Throughout 2018 the Group has continued to have a significant proportion of its liquid assets deposited with the Bank of England.

- ***Capital risk:*** In order to conserve capital, the Group has continued not to undertake new lending. The Group has also continued to explore ways in which the regulatory capital position could be improved, including the sale of assets. In the medium term, however, the regulatory capital position is dependent on profitable and sustainable growth or new sources of capital.

  The loss in the 6 months ended 30 June 2018 has further reduced CET1 regulatory capital and there continues to be a shortfall against the qualitative standards for the level of CET1 regulatory capital. In accordance with the requirements of CRD IV article 142, the Group submitted a Capital Conservation Plan to the PRA which was presented in October 2016, with updates submitted in April 2017 and September 2017, setting out proposed measures to improve the regulatory capital position. The Board continues to discuss and consult with the PRA on the Capital Conservation Plan and submitted an updated plan in June 2018.

- ***Interest rate risk:*** The Group's mortgage and savings products have different interest rate types and different maturities. This means that the Group is exposed to movements in interest rates. A movement in an external interest rate (e.g. Bank of England Base Rate or LIBOR) does not always affect every mortgage and savings product that the Group holds or does so in a different manner. The Board continues in its intention not to hedge its fixed rate mortgages using interest rate swaps at this time; this position continues to be monitored regularly.

- ***Currency risk:*** The Group faces currency movement risks on its Euro denominated mortgage balances which represent 18% of total mortgage assets as at 30 June 2018. The exchange rate risk arising on these balances is managed and mitigated by transacting exchange rate swaps. The exchange rate risk position is reported to the Asset and Liability Committee ("ALCO") and Board each month.

- ***Economic risk:*** The Group faces the risk that its interest margin can become subjected to the pressure that is brought to bear from being an institution that is primarily funded through retail deposits. Within this market, there is significant competition for attracting retail deposits at sustainable rates of interest.

  The Group is also exposed to movements in the value of residential and commercial property in both its mortgage impairment provision requirements and those property assets held at fair value; the Group's investment property and the Group's head office building. The head office building was last valued in November 2017.

- ***Regulatory Risk:*** The majority of the regulatory requirements that the Group faces are laid down by the PRA and the Financial Conduct Authority ("FCA"). The Group monitors developments in all relevant aspects of financial service regulation and undertakes assessments of the present and future impacts of such. Appropriate actions are taken to strengthen controls and amend the Group's strategy to meet changing regulatory requirements.

  In addition to considering the impact of any non-compliance on the recoverability of loan balances and thus impairment provisioning, the Group considers the conduct risk which arises from having originated regulated loans and having acquired regulated loan portfolios. As is the case for all financial institutions there is a risk that aspects of current or historic business might be considered as not being conducted in accordance with all relevant regulation, or the fair and reasonable treatment of customers.

  Certain activities of the Group, particularly the NMB MAC and the Consumer Loans Company Limited ("CLC") second charge loan portfolios, carry greater levels of conduct risk. The administration of the NMB MAC and CLC portfolios was brought in-house in December 2015 and following that transfer the historic conduct of these portfolios has been reviewed in detail by management.

  As disclosed on page 63 of the 2017 Annual Report and Accounts, following this review, and having incorporated legal advice received, at 31 December 2017 the Group's customer redress programme in relation to NMB MAC and CLC had been completed. The Group continues to hold a customer redress provision of £38k as at 30 June 2018 (30 June 2017: £591k). The remaining provision relates to customers that the Group has yet to successfully contact.

  Although a detailed review of these portfolios has been carried out, there is no judicial certainty in the legal position and there is a risk that further conduct issues or cases of non-compliance with regulations could be identified in the future. As a result the actual results could differ materially from our estimates.

  Provision has been made where the Group is aware of a specific conduct or regulatory issue and can estimate its impact reliably, further details in respect of the Group's consideration of other potential conduct and regulatory issues is provided on page 64 of the 2017 Annual Report and Accounts.

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**Other Matters**

**Board and staff changes**

On 27 April 2018, P.A. Lynch, previously Interim Chief Executive, was appointed as Chief Executive.

On 1 July 2018, J. Lincoln stepped down from the non-Board role of Interim Finance Director and was appointed as a Non-executive Director. Also at that time, M.A. Winterbottom was

appointed as Finance Director. Both of these Board appointments are subject to regulatory approval.

Save for these changes, the Officers as at 30 June 2018 remain unaltered from those disclosed at 31 December 2017 on page 60 of the 2017 Annual Report and Accounts.

## Going Concern

The directors consider that it is appropriate for the accounts to be prepared on a going concern basis of accounting as fully explained in Note 1.2 on pages 14 to 15, which sets out the risks and uncertainties assessed as part of the preparation of the accounts.

## Forward-looking statements

Within the half yearly information comments are made about future events, which the Board believes to be reasonable. As these statements are based on the Group's current view of the UK and Spanish economies, financial markets and regulation, the Board can give no assurances that the markets will develop in the way that is drafted and actual outcomes may differ to those that are anticipated.

The Group does not undertake to update any of the statements that it has made about future events prior to the reporting of the full year results.

## Approval of interim financial statements

The Condensed Consolidated Half Yearly Financial Information was approved by the Board of Directors on 29 August 2018.

## STATEMENT OF DIRECTORS' RESPONSIBILITIES IN RESPECT OF THE CONDENSED CONSOLIDATED HALF YEARLY FINANCIAL INFORMATION

The directors confirm that, to the best of their knowledge:

- The condensed set of consolidated accounts has been prepared in accordance with IAS 34 *Interim Financial Reporting*, as adopted by the European Union.
- The half yearly accounts include the information required by the Financial Conduct Authority Disclosure and Transparency Rules (DTR 4.2.7 and DTR 4.2.8)

The results for the half year ended 30 June 2018 and those comparable figures for the half year ended 30 June 2017 are unaudited. The figures for the year ended 2017 are extracted from the 2017 Annual Report and Accounts, prepared in accordance with IFRS as adopted in the EU, on which the Independent Auditors gave an unqualified opinion but did include an emphasis of matter in relation to the existence of a material uncertainty which may cast significant doubt about the Group's ability to continue as a going concern. Further details in relation to this are provided in Note 1.2 on pages 14 to 15.

The Directors are responsible for the maintenance and integrity of information on the Society's website. Copies of the 2017 Annual Report & Accounts and this Half Yearly Financial Information may be found at: www.themanchester.co.uk/Aboutus/FinancialInformation

The Board of Directors responsible for the half yearly accounts are listed below:

| | |
|---|---|
| H.F. Baines | Vice Chairman |
| I.A. Dewar | Non-Executive Director |
| J. Lincoln | Non-Executive Director |
| D.A. Harding | Chairman |
| P.A. Lynch | Chief Executive |
| F.B. Smith | Non-Executive Director |
| M.A. Winterbottom | Finance Director |

Signed on behalf of the Board of Directors

D.A. Harding
Chairman
29 August 2018

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

| | Note | Unaudited 6 months to 30 Jun 18 £000 | Unaudited 6 months to 30 Jun 17 £000 | Audited 12 months to 31 Dec 17 £000 |
|---|---|---|---|---|
| Interest receivable and similar income | | 5,526 | 6,266 | 12,181 |
| Interest expense and similar charges | | (1,359) | (1,774) | (3,162) |
| Net interest income | | 4,167 | 4,492 | 9,019 |
| Other operating income | | 612 | 367 | 650 |
| Other operating charges | | (38) | (43) | (90) |
| Net gain on financial assets designated at fair value through profit and loss | | 1 | 1 | 1 |
| Total operating income | | 4,742 | 4,817 | 9,580 |
| Administrative expenses and depreciation | | (6,132) | (3,695) | (7,955) |
| Operating (loss)/profit before impairment and provisions | | (1,390) | 1,122 | 1,625 |
| Impairment losses | *7* | (245) | (1,718) | (2,376) |
| Financial Services Compensation Scheme levy | *10* | 6 | (102) | (29) |
| Loss for the period before taxation | | (1,629) | (698) | (780) |
| Income tax expense | *4* | - | - | - |
| Loss for the period | | (1,629) | (698) | (780) |

## CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

**Unaudited 6 months to 30 June 2018**

| | Retained earnings | Subscribed capital | PPDS | Total |
|---|---|---|---|---|
| | £000 | £000 | £000 | £000 |
| Closing Balance at 31 December 2017 | (10,023) | 9,788 | 17,461 | 17,226 |
| Expected Credit Loss adjustment to 1 January 2018 reserves in relation to implementation of IFRS 9 | (299) | - | - | (299) |
| Opening Balance at 1 January 2018 under IFRS 9 | (10,322) | 9,788 | 17,461 | 16,927 |
| Transactions with equity holders - interest on PIBS | - | - | - | - |
| Tax credit re: interest paid to PIBS holders | - | - | - | - |
| Loss and total comprehensive expense for the period | (1,629) | - | - | (1,629) |
| Balance at 30 June 2018 | (11,951) | 9,788 | 17,461 | 15,298 |

**Unaudited 6 months to 30 June 2017**

| | Retained earnings | Subscribed capital | PPDS | Total |
|---|---|---|---|---|
| | £000 | £000 | £000 | £000 |
| Balance at 1 January 2017 | (9,243) | 9,788 | 17,461 | 18,006 |
| Transactions with equity holders - interest on PIBS | - | - | - | - |
| Tax credit re: interest paid to PIBS holders | - | - | - | - |
| Loss and total comprehensive expense for the period | (698) | - | - | (698) |
| Balance at 30 June 2017 | (9,941) | 9,788 | 17,461 | 17,308 |

**Audited 12 months to 31 December 2017**

| | Retained earnings | Subscribed capital | PPDS | Total |
|---|---|---|---|---|
| | £000 | £000 | £000 | £000 |
| Balance at 1 January 2017 | (9,243) | 9,788 | 17,461 | 18,006 |
| Transactions with equity holders - interest on PIBS | - | - | - | - |
| Tax credit re: interest paid to PIBS holders | - | - | - | - |
| Loss and total comprehensive expense for the period | (780) | - | - | (780) |
| Balance at 31 December 2017 | (10,023) | 9,788 | 17,461 | 17,226 |

## CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

| | Note | Unaudited 30 Jun 18 £000 | Unaudited 30 Jun 17 £000 | Audited 31 Dec 17 £000 |
|---|---|---|---|---|
| **Assets** | | | | |
| Liquid assets | 5 | 45,055 | 56,092 | 43,981 |
| Derivative financial instruments | | 102 | 14 | 280 |
| Loans and advances to customers | 6 | 235,256 | 270,518 | 250,821 |
| Property, plant and equipment | | 6,008 | 5,791 | 6,112 |
| Investment property | | 571 | 654 | 691 |
| Current tax assets | | - | - | - |
| Deferred tax assets | 8 | - | - | - |
| Other assets | | 2,435 | 3,244 | 2,306 |
| Total assets | | 289,427 | 336,313 | 304,191 |

| | Note | Unaudited 30 Jun 18 £000 | Unaudited 30 Jun 17 £000 | Audited 31 Dec 17 £000 |
|---|---|---|---|---|
| **Liabilities** | | | | |
| Due to members | | 236,975 | 276,863 | 247,628 |
| Deposits from banks and others | 9 | 16,086 | 19,512 | 17,858 |
| Derivative financial instruments | | 320 | 1,058 | 192 |
| Other liabilities | | 1,484 | 1,511 | 1,845 |
| Provisions for liabilities and charges | 10 | 64 | 861 | 242 |
| Subordinated liabilities | 11 | 14,200 | 14,200 | 14,200 |
| Subscribed capital | 12 | 5,000 | 5,000 | 5,000 |
| Total liabilities | | 274,129 | 319,005 | 286,965 |
| **Equity** | | | | |
| Retained earnings | | (11,951) | (9,941) | (10,023) |
| Subscribed capital | 12 | 9,788 | 9,788 | 9,788 |
| Profit participating deferred shares | 13 | 17,461 | 17,461 | 17,461 |
| Total equity | | 15,298 | 17,308 | 17,226 |
| Total equity and liabilities | | 289,427 | 336,313 | 304,191 |

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

| | Unaudited 6 months to 30 Jun 18 £000 | Unaudited 6 months to 30 Jun 17 £000 | Audited 12 months to 31 Dec 17 £000 |
|---|---|---|---|
| Net cash flows from/ (used in) operating activities | 1,089 | (25,978) | (37,799) |
| Net cash flows from/ (used in) investing activities | 28 | 219 | (73) |
| Net cash flows (used in)/ from financing activities | - | - | - |
| Net increase/ (decrease) in cash and cash equivalents | 1,117 | (25,759) | (37,872) |
| | | | |
| Net increase/(decrease) in cash and cash equivalents | 1,117 | (25,759) | (37,872) |
| Cash and cash equivalents at the start of the period | 43,932 | 81,804 | 81,804 |
| Cash and cash equivalents at the end of the period | 45,049 | 56,045 | 43,932 |

## 1. Basis of preparation and significant accounting policies

### 1.1 Basis of preparation

This half yearly financial information for the 6 months ended 30 June 2018 has been prepared in accordance with both the Financial Conduct Authority's Disclosure and Transparency Rules and IAS 34 *Interim Financial Reporting*, as adopted by the EU. This financial information should be read in conjunction with the 2017 Annual Report and Accounts.

The half yearly financial information set out above does not constitute Accounts within the meaning of the Building Societies Act 1986.

The financial information for the 12 months to 31 December 2017 has been extracted from the 2017 Annual Report and Accounts, prepared in accordance with IFRS as adopted in the EU. In relation to these accounts, the opinion of the Independent Auditors was unqualified but did include an emphasis of matter in relation to the existence of a material uncertainty which may cast significant doubt about the Group's ability to continue as a going concern. Further details in relation to this are provided in Note 1.2 below.

The half yearly financial information for the 6 months ended 30 June 2018 and the 6 months ended 30 June 2017 are unaudited.

### 1.2 Basis of preparation: going concern

The Group's interim financial statements for the 6 months ended 30 June 2018 have been prepared on a going concern basis as explained below.

The long term continuing operation of the Society and the Group is dependent on successfully being able to return to lending to grow the balance sheet in order to improve profitability and rebuild regulatory capital. At present the Society has insufficient capital to return to lending and continues to manage a long term run-off of the balance sheet.

As at 30 June 2018 the Society met its Pillar 1 plus Pillar 2A requirement in total capital terms, but continued to have a shortfall against the qualitative standards for the level of CET1 regulatory capital. The Society as required by CRD IV article 142 submitted a Capital Conservation Plan to the PRA in October 2016 as a result of this shortfall, with updates in April 2017 and September 2017 setting out proposed measures to improve the regulatory capital position. A new plan was submitted to the PRA in June 2018 following the Society's CET 1 capital falling below the required 4.5% of Risk Weighted Assets.

The plan shows the impact of a continued run off of the balance sheet on the Society's regulatory capital position. In addition, as part of this plan the Board, in close dialogue with the PRA, considered a number of options which individually or in combination aim to address the Society's position to enable it to meet capital requirements and improve the quality of its regulatory capital.

Following the submission of the plan, no action has been taken by the regulators in response to the Society's failure to meet the requirement to hold CET 1 capital in excess of 4.5% of risk weighted assets. The Board continues to track the Society's performance against this plan.

The Board expects to continue to discuss and consult with the PRA over the remainder of the year. The preferred options to improve the regulatory capital position may involve third

parties and as such carry execution risk. At present the outcome and timing of this regulatory process is uncertain.

Although the above represents material uncertainties which may cast significant doubt about the Society's and Group's ability to continue as a going concern in the longer term, in the Board's opinion the going concern basis is appropriate.

In order to satisfy themselves that the Society and Group have adequate resources to continue to operate for the foreseeable future as a going concern, the directors have taken into account the following:

- The Group's underlying financial performance and projections;
- The Group's current level of liquidity;
- The Group's financial position as at 30 June 2018;
- The Group's financial projections of income, expenditure, assets, liabilities, liquidity and regulatory capital, including sensitivity analysis. These projections, based on a managed run-off of the balance sheet without a return to lending, indicate that the underlying operations of the Group may not be profitable in the short to medium term. In the medium term it is likely that the net interest margin will be insufficient to cover operating costs and loan impairment charges, resulting in operating losses;
- The ongoing legal claim against and prospects of recovery from Grant Thornton UK LLP, the previous external auditors;
- The challenge of meeting the CET1 regulatory capital requirements and the measures available to the Society to improve the regulatory capital position;
- The regulator's response to the plan submitted in June 2018;
- Ongoing discussions with the PRA and other stakeholders regarding the development of a plan to address the Society's position and its strategic direction;
- The operational risks faced by the Society to develop and deliver the strategic plans;
- The Group's principal risks and uncertainties as set out on pages 5 to 7.

Should there be a material stress event in the economy or to financial markets that adversely impacts the Society, or the current options available to the Society are shown not to be viable, then there is less certainty as to the going concern position of the Society.

Having due regard to these matters and after taking into consideration the material uncertainties above, the Board continues to adopt the going concern basis of accounting in preparing the financial statements.

### 1.3 Basis of preparation: accounting policies

The half yearly financial information has been prepared consistently with the accounting policies described on pages 25 to 30 of the 2017 Annual Report and Accounts. One new accounting standard adopted during the period and which has had a significant impact on the Group's results reported for the 6 months ended 30 June 2018 is *IFRS 9 – Financial Instruments*; which has replaced most of IAS 39 – Financial Instruments: Recognition and Measurement.

The new classification and measurement rules have not changed the way in which management accounts for financial instruments before impairment. Appropriate classification and measurement is determined through the review of business models and whether the contractual terms of a financial asset give rise to cash flows that are solely payments of principal and interest ("SPPI") on the principal amount outstanding.

The most significant impact on the Group is in respect of the measurement of impairment of financial assets. Under IFRS 9, impairment is based on expected credit losses ("ECL") rather than the methodology the Group previously adopted under IAS 39 which was based upon

incurred credit losses. The ECL impairment provisioning under IFRS 9 includes the requirement to include more forward-looking information in order to establish expected credit losses, and also to consider multiple economic scenarios.

At initial recognition, an ECL provision is required for default events in the next 12 months whilst, following a significant increase in credit risk, a lifetime ECL is required. The review of credit risk and the calculation of ECL are required to be unbiased and probability weighted, and should include all available relevant information, with assessments of current conditions and forecasts of future economic conditions. As a result the recognition and measurement of impairment is more forward looking than is the case under IAS 39.

The Group is now required to perform a staging assessment of each financial instrument. The three stages are as follows:

• Stage 1: Loans where there has been no significant deterioration in credit risk since initial recognition of the loan by the Society

• Stage 2: Loans where there has been a significant increase in credit risk since initial recognition of the loan by the Society

• Stage 3: Loans which are deemed to be "credit impaired" (and therefore in default)

The increase on the Group's loan loss provisions on adoption of IFRS 9 as at 1 January 2018 was £0.3m which is included within the financial statements as a reduction in reserves.

The impairment charge for the 6 months to 30 June 2018 under IFRS 9 is in line with the charge which would have been recognised under IAS 39.

With the exception of the adoption of IFRS 9, the Group expects that the accounting policies that will be applied at the time of compiling the 2018 Annual Report and Accounts will be materially the same as for the 2017 Annual Report and Accounts.

The Group has noted that there are a number of further new accounting standards that are not effective for the period commencing 1 January 2018, but which are likely to be adopted over the coming years. None of these is likely to have a material impact on the Group.

## 2. Fair values of financial assets and liabilities

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between knowledgeable, willing market participants at the measurement date.

The following methods and assumptions have been applied in determining the fair value of the financial instruments in these reports:

i. The fair value of the Permanent Interest Bearing Shares which are classified as liabilities (see Note 12) is based on the market price for those instruments. This liability is grouped into the fair value hierarchy under level 1, as set out below.

ii. The fair value of derivatives and investment securities are calculated by utilising internal valuation models using a discounted cash flow model based on a current yield curve appropriate for the remaining term to maturity. External market data is used within these internal valuation models. Derivatives are held for economic purposes. Investment securities are designated at fair value through profit and loss. Movements in the valuations of derivatives and investment securities are treated as fair value through profit and loss, and these financial assets and liabilities are grouped into the fair value hierarchy under level 2, as set out below.

iii. The fair value of loans and advances to customers at a variable rate of interest is assumed to approximate to their carrying amounts. The fair value of loans and advances at a fixed rate of interest is estimated by internal valuation models. External market data is used within these internal valuation models. These financial assets are grouped into the fair value hierarchy under level 2, as set out below.

iv. All other financial assets and liabilities are held at amortised cost.

The Group has disclosed within these financial statements all the assets and liabilities for which fair values are required.

The fair value measurement basis used is as follows:

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

Level 2 Valuation techniques where all inputs are taken from observable market data, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

Level 3 Valuation techniques where significant inputs are not based on observable market data. None of the Groups financial assets or liabilities are valued using this technique.

A comparison between the carrying values and fair values of the Society's financial assets and liabilities is shown in the following table:

| | 30 June 2018 | | 30 June 2017 | | 31 December 2017 | |
|---|---|---|---|---|---|---|
| | Carrying Value £000 | Fair Value £000 | Carrying Value £000 | Fair Value £000 | Carrying Value £000 | Fair Value £000 |
| **Financial assets** | | | | | | |
| Cash and balances with the Bank of England | 34,989 | 34,989 | 44,046 | 44,046 | 32,911 | 32,911 |
| Loans and advances to credit institutions | 10,066 | 10,066 | 12,003 | 12,003 | 11,031 | 11,031 |
| Investment securities | - | - | 43 | 43 | 39 | 39 |
| Derivative financial instruments | 102 | 102 | 14 | 14 | 280 | 280 |
| Loans and advances to customers | 235,256 | 224,856 | 270,518 | 259,636 | 250,821 | 240,216 |
| | 280,413 | 270,013 | 326,624 | 315,742 | 295,082 | 284,477 |
| **Financial liabilities** | | | | | | |
| Due to members | 236,975 | 236,968 | 276,863 | 276,883 | 247,628 | 247,624 |
| Other deposits | 16,086 | 16,086 | 19,512 | 19,512 | 17,858 | 17,858 |
| Derivative financial instruments | 320 | 320 | 1,058 | 1,058 | 192 | 192 |
| Other borrowed funds | 14,200 | 14,200 | 14,200 | 14,200 | 14,200 | 14,200 |
| Subscribed capital | 5,000 | 1,225 | 5,000 | 1,356 | 5,000 | 1,350 |
| | 272,581 | 268,799 | 316,633 | 313,009 | 284,878 | 281,224 |

## 3. Segmental information

The Group's results are predominantly derived from the Society's principal operations. The Group's other income streams are not sufficiently material to require segmental reporting

## 4. Income tax

| | Unaudited<br>30 Jun 18<br>£000 | Unaudited<br>30 Jun 17<br>£000 | Audited<br>31 Dec 17<br>£000 |
|---|---|---|---|
| Results for the year before tax | (1,629) | (698) | (780) |
| Tax rate | 19.00% | 19.25% | 19.25% |
| Expected tax credit | (310) | (134) | (150) |
| Adjustments for non-deductible items | 7 | 6 | 14 |
| Income not taxable | - | - | (78) |
| Deferred tax movement closing rate / average rate difference | - | - | 33 |
| Current year losses for which no deferred tax asset recognised | 399 | 241 | 452 |
| Profits of year covered by brought forward losses in respect of which no deferred tax asset recognised | - | - | (85) |
| Decrease in deferred tax asset recognised | - | - | (186) |
| Fixed asset timing differences for which no deferred tax asset recognised | (96) | (113) | - |
| Actual tax expense | - | - | - |

## 5. Liquid assets

| | Unaudited<br>30 Jun 18<br>£000 | Unaudited<br>30 Jun 17<br>£000 | Audited<br>31 Dec 17<br>£000 |
|---|---|---|---|
| Cash and balances with the Bank of England | 34,989 | 44,046 | 32,911 |
| Loans and advances to credit institutions | 10,066 | 12,003 | 11,031 |
| Investment securities | - | 43 | 39 |
| | 45,055 | 56,092 | 43,981 |

## 6. Loans and advances to customers

| | Unaudited<br>30 Jun 18<br>£000 | Unaudited<br>30 Jun 17<br>£000 | Audited<br>31 Dec 17<br>£000 |
|---|---|---|---|
| Fully secured on residential property | 214,923 | 245,808 | 228,674 |
| Fully secured on land | 19,525 | 23,569 | 21,085 |
| Other loans | 808 | 1,141 | 1,062 |
| | 235,256 | 270,518 | 250,821 |

## 7. Impairment losses

| | Unaudited 30 Jun 18 £000 | Unaudited 30 Jun 17 £000 | Audited 31 Dec 17 £000 |
|---|---|---|---|
| Impairment losses on loans and advances to customers | 245 | 1,718 | 2,789 |
| Reversal of previous impairment on Property, Plant and Equipment | - | - | (413) |
| | 245 | 1,718 | 2,376 |

| | Unaudited 30 Jun 18 £000 | Unaudited 30 Jun 17 £000 | Audited 31 Dec 17 £000 |
|---|---|---|---|
| Impairment provision on loans and advances to customers, at the end of the period: | | | |
| Loans fully secured on residential property | 19,518 | 18,501 | 19,165 |
| Other loans | 4,317 | 4,674 | 4,136 |
| Total | 23,835 | 23,175 | 23,301 |

The June 2018 impairment provisions include an adjustment to the 1 January 2018 impairment provisions, which changes the provision measurement from compliance with the old Accounting Standard, *IAS 39 – Financial Instruments: Recognition and Measurement*, to compliance with the requirements of *IFRS 9 – Financial Instruments*, the replacement Accounting Standard. IFRS 9 was adopted from January 2018 and resulted in an increase of £0.3m in impairment provisions, with an equivalent reduction in reserves at that time. Further details on the adoption of IFRS 9 are included in Note 1.3.

## 8. Deferred tax assets

| | Unaudited 30 Jun 18 £000 | Unaudited 30 Jun 17 £000 | Audited 31 Dec 17 £000 |
|---|---|---|---|
| Tax losses | 1 | 2 | 1 |
| Deferred tax movement on timing differences on derivative contracts | 30 | 24 | 38 |
| Accelerated tax depreciation | (31) | (26) | (39) |
| Other provisions | - | - | - |
| | - | - | - |

## 9. Deposits from banks and others

| | Unaudited 30 Jun 18 £000 | Unaudited 30 Jun 17 £000 | Audited 31 Dec 17 £000 |
|---|---|---|---|
| Other deposits | 16,086 | 19,512 | 17,858 |

## 10. Provisions for liabilities and charges

| FSCS levy | Unaudited 6 months to 30 Jun 18 £000 | Unaudited 6 months to 30 Jun 17 £000 | Audited 12 months to 31 Dec 17 £000 |
|---|---|---|---|
| At start of period | 31 | 68 | 68 |
| (Release)/charge for the period | (6) | 102 | 29 |
| Provision utilised | - | - | (66) |
| At end of period | 25 | 170 | 31 |

| Customer redress | Unaudited 6 months to 30 Jun 18 £000 | Unaudited 6 months to 30 Jun 17 £000 | Audited 12 months to 31 Dec 17 £000 |
|---|---|---|---|
| At start of period | 111 | 1,690 | 1,690 |
| Transferred from/(to) other liabilities/ impairment provision | - | - | (91) |
| Release) for the period | (2) | (330) | (500) |
| Provision utilised | (71) | (769) | (988) |
| At end of period | 38 | 591 | 111 |

| Other | Unaudited 6 months to 30 Jun 18 £000 | Unaudited 6 months to 30 Jun 17 £000 | Audited 12 months to 31 Dec 17 £000 |
|---|---|---|---|
| At start of period | 100 | 100 | 100 |
| Release for the period | (79) | - | - |
| Provision utilised | (20) | - | - |
| At end of period | 1 | 100 | 100 |
| **Total provisions for liabilities and charges at the end of the period** | 64 | 861 | 242 |

(i) Financial Services Compensation Scheme ("FSCS levy")

The Society's provision for FSCS charges arises from its operation as a UK deposit taker. The FSCS levy consists of two parts- a management expenses levy, which covers the interest cost of running the scheme, and a capital levy to cover the cost of the compensation paid, net of any recoveries.

The expected management expenses levy for the FSCS scheme year 2017-18 had been provided at the end of 2017. The provision release for the half year to 30 June 2018 is in respect of a reduction in the expected management expenses levy for the FSCS scheme year 2018-19. This charge represents the expected full cost of the FSCS levy for the financial year.

No provision is made for scheme years beyond these periods. The levy is paid during the third quarter each year and the Society does not expect to recover any sums paid.

(ii) Customer redress provision

The customer redress provision is held in relation to a customer redress exercise in respect of instances of non-compliance with the CCA within the NMB MAC and CLC second charge portfolios. As noted on page 63 of the 2017 Annual Report and Accounts, this redress exercise was completed in 2017. Attempts to contact some customers have been unsuccessful to date, and the £38k provision is retained at 30 June 2018 in relation to these customers.

(iii) Other provision

The other provision relates to the result of the BoS v Rea decision, which is detailed on page 63 of the 2017 Annual Report and Accounts. The remediation exercise in relation to this provision was completed during the first 6 months of 2018. The £1k provision that remains relates to a small number of customers which the Society has, so far, been unable to contact.

## 11. Subordinated liabilities

| | Unaudited 30 Jun 18 £000 | Unaudited 30 Jun 17 £000 | Audited 31 Dec 17 £000 |
|---|---|---|---|
| Loan (repay 2022) interest: 3 month LIBOR + 1.75% | 5,000 | 5,000 | 5,000 |
| Loan (repay 2023) interest: 3 month LIBOR + 2.45% | 4,200 | 4,200 | 4,200 |
| Loan (repay 2032) interest: 6.70% | 5,000 | 5,000 | 5,000 |
| | 14,200 | 14,200 | 14,200 |

## 12. Subscribed capital

The Society has two tranches of PIBS in issue. The first tranche was issued in 1999 and is remunerated at 8.00% and the other was issued in 2005 and is remunerated at 6.75%. The two tranches are accounted for differently as they are subject to differing legal arrangements. Both tranches of PIBS are unsecured and rank pari passu with each other. In priority terms, the PIBS holders rank behind the Society's depositing members, its wholesale counterparties and all subordinated note holders. PIBS coupons are non-cumulative.

| Classified as a liability: | Unaudited 30 Jun 18 £000 | Unaudited 30 Jun 17 £000 | Audited 31 Dec 17 £000 |
|---|---|---|---|
| 8.00% Permanent Interest Bearing Shares | 5,000 | 5,000 | 5,000 |
| Total | 5,000 | 5,000 | 5,000 |

| Classified as equity: | Unaudited 30 Jun 18 £000 | Unaudited 30 Jun 17 £000 | Audited 31 Dec 17 £000 |
|---|---|---|---|
| 6.75% Permanent Interest Bearing Shares | 9,788 | 9,788 | 9,788 |
| Total | 9,788 | 9,788 | 9,788 |

## 13. Profit Participating Deferred Shares

| | Unaudited 30 Jun 18 £000 | Unaudited 30 Jun 17 £000 | Audited 31 Dec 17 £000 |
|---|---|---|---|
| Nominal value – proceeds received | 18,000 | 18,000 | 18,000 |
| Less: issue costs | (539) | (539) | (539) |
| Total | 17,461 | 17,461 | 17,461 |

The shares were issued in April 2013, are unsecured and rank pari passu with any other deferred shares comprising Common Equity Tier 1 capital issued or to be issued by the Society and rank behind any other deferred shares of the Society in issue not comprising Common Equity Tier 1 capital, including the Society's 1999 and 2005 PIBS.

The PPDS holders rank behind the Society's depositing members, its wholesale counterparties and all subordinated note holders.

The terms of the PPDS allow the Board, at its sole discretion, to declare a dividend of up to 30% of the Society's post tax profits.  Dividends are non-cumulative.

## 14. Capital

The Board manages capital within the regulatory limits set by the PRA.

The Group calculates and reports its regulatory capital on a "Total Group" basis with the regulatory capital group being made up of the Society, MBS (Mortgages) Limited and MBS (Property) Limited.

| | Unaudited 6 months to 30 Jun 18 Total Group £000 | Unaudited 6 months to 30 Jun 17 Total Group £000 | Audited 12 months to 31 Dec 17 Total Group £000 |
|---|---|---|---|
| **Tier 1 Capital** | | | |
| Common Equity Tier 1 Capital (CET1) | | | |
| Accumulated Losses | (11,952) | (9,941) | (10,023) |
| IFRS 9 Transitional Arrangements | 285 | - | - |
| Profit Participating Deferred Shares | 17,461 | 17,461 | 17,461 |
| Total CET1 Capital | 5,794 | 7,520 | 7,438 |
| Other Tier 1 Capital | | | |
| Permanent Interest Bearing Shares | | | |
| -Nominal balance | 14,788 | 14,788 | 14,788 |
| -Amortisation | (8,873) | (7,394) | (7,394) |
| Net Permanent Interest Bearing Shares | 5,915 | 7,394 | 7,394 |
| **Total Tier 1 Capital** | 11,709 | 14,914 | 14,832 |
| **Tier 2 Capital** | | | |
| Subordinated Debt | | | |
| -Nominal balance | 14,200 | 14,200 | 14,200 |
| -Amortisation | (4,657) | (2,895) | (3,399) |
| Net Subordinated Debt | 9,543 | 11,305 | 10,801 |
| Collective Provisions | 441 | 401 | 431 |
| Permanent Interest Bearing Shares | 8,873 | 7,394 | 7,394 |
| **Total Tier 2 Capital** | 18,857 | 19,100 | 18,626 |
| **Total Regulatory Capital** | 30,566 | 34,014 | 33,458 |

Since the start of 2018 Total Regulatory Capital under CRD IV has decreased by £2,892k from £33,458k to £30,566k.

The decrease results from ongoing operations, made up as follows:

- the retained loss of the regulatory capital group for the half year of £1,629k;
- the 1 January 2018 reduction in reserves of £299k in relation to the implementation of IFRS 9;
- the offsetting adjustment of £(285)k regarding the transitional rules covering the implementation of IFRS 9;

- amortisation out of Tier 2 capital of an additional portion of Subordinated debt which now has less than five years to its maturity date, amounting to £758k in the half year;
- the continued grandfathering of Subordinated debt out of Tier 2 capital over a 9 year period, amounting to £500k in the half year;
- an increase in collective provisions of £10k;

As at 30 June 2018 the Society met its Pillar 1 plus Pillar 2A requirement in total capital terms, but continued to have a shortfall against the qualitative standards for the level of CET1 regulatory capital. The Society as required by CRD IV article 142 submitted a Capital Conservation Plan to the PRA in October 2016 as a result of this shortfall, with updates in April 2017 and September 2017 setting out proposed measures to improve the regulatory capital position. A new plan was submitted to the PRA in June 2018 following the Society's CET 1 capital falling below the required 4.5% of Risk Weighted Assets. These documents have been discussed with the PRA and they continue an open dialogue with the Society on future developments.

## 15. Related party transactions

The Group is controlled by Manchester Building Society and consists of the Society and its two wholly owned subsidiaries: MBS (Mortgages) Ltd and MBS (Property) Ltd. The Group also exerts control over NMB MAC notwithstanding that it holds no shares in that entity. The Society continued to provide loan funding to its subsidiaries during the half year ended 30 June 2018 in a manner similar to that disclosed in the 2017 Annual Report and Accounts. Accordingly, transactions with these related parties are entered into in the normal course of business; related party transactions, for the half year to 30 June 2018 are similar in nature to those for the year ended 31 December 2017.

On 27 April 2018, P.A. Lynch, previously Interim Chief Executive, was appointed as Chief Executive. On 1 July 2018, J. Lincoln stepped down from the non-Board role of Interim Finance Director and was appointed as a Non-executive Director. Also at that time, M.A. Winterbottom was appointed as Finance Director. Both of these Board appointments are subject to regulatory approval.

Save for these changes, the Officers as at 30 June 2018 remain unaltered from those disclosed at 31 December 2017 on page 60 of the 2017 Annual Report and Accounts.

Where the services of key management personnel are provided by entities controlled by them, then transactions with these entities are approved by the Remuneration and Nominations Committee.

## 16. Financial commitments

There is no material change to the Group's financial commitments from the position reported in the 2017 Annual Report and Accounts

## 17. Contingent liabilities and assets

(i) Contingent liabilities

Given the high level of scrutiny regarding financial institutions' treatment of customers and business conduct from regulatory bodies and other sources there is a risk that certain aspects of the Group's current or historic business, including, amongst other things, CCA regulated loans, may be determined by the FCA and other regulatory bodies or the courts as, in their opinion, not being conducted in accordance with applicable laws or regulations, or fair and reasonable treatment.

As detailed in the Regulatory risk section on page 7 and in Note 10, provision has been made where the Group is aware of a specific conduct issue and can estimate its impact reliably.

As disclosed on page 64 of the 2017 Annual Report and Accounts there is a risk that other aspects of the Group's business might be considered as not having been conducted in accordance with all relevant regulation, or the fair and reasonable treatment of customers. It is also not possible to rule out the possibility of other instances of non-compliance with CCA or other regulations which have not been identified. No provisions against these risks are included in these accounts.

As noted in the Directors' Report on page 3, the High Court judgment resulting from the Society's legal claim against its former external auditors, Grant Thornton UK LLP, has resulted in Grant Thornton being awarded £2,309k interim costs. While the Society has been granted leave to appeal the decision, there remains the potential for a final costs determination that may require the Society to pay a further sum to Grant Thornton. The amount of such an award is not known at this time.

(ii) Contingent assets

The Group's claim against Grant Thornton UK LLP, as detailed in section (i) above, may result in further damages being awarded to the Society upon appeal. The likelihood and amount of any potential award are not known at this time. It is expected that the appeal will be heard no earlier than mid-January 2019, with the judgment known some time later.

## 18. Events after the end of the reporting period

There have been no events occurring after the end of the reporting period that would have a material impact upon the results reported.

## 19. Other Ratios

| | Unaudited 6 months to 30 Jun 18 % | Unaudited 6 months to 30 Jun 17 % | Audited 12 months to 31 Dec 17 % |
|---|---|---|---|
| Gross capital as a percentage of shares and borrowings | 13.63 | 12.32 | 13.72 |
| Liquid funds as a percentage of shares and borrowings | 17.80 | 18.93 | 16.57 |
| Loss after tax as a percentage of mean total assets *(expressed on an annualised basis)* | (1.10) | (0.39) | (0.23) |
| Group management expenses as a percentage of mean total assets *(expressed on an annualised basis)* | 4.13 | 2.06 | 2.32 |
| Leverage ratio | 3.70 | 4.11 | 4.49 |

The definitions for the above ratios are explained in detail on page 65 of the 2017 Annual Report and Accounts.

The Society has utilised available transitional arrangements in relation to the impact of adopting IFRS 9 on regulatory capital and the figures above reflect these arrangements. Had the transitional arrangements not been adopted, the leverage ratio would have been 3.61%.