Business review

The following section provides a detailed review of the Group's performance in 2010, including both income statement and balance sheet analyses and looks at some of the key performance indicators (KPIs) that the Board uses to monitor and direct the Group's performance.

Vision and strategy

The Group's vision is "to be the best organisation that our customers do business with", which we aim to achieve by:

- providing members with financial security and long-term value; and
- delivering a strong customer service through engaged and motivated staff.

Fundamental to achieving our vision, is our commitment to remaining a mutual organisation, and specifically a leading independent building society providing competitive products and excellent service across multiple products, brands and distribution channels. All of this is done in order to meet the needs of our members and other customers.

Given our mutual nature, our financial strategy revolves around achieving a balance between value for members, profitability, growth and financial strength. Within this is our target to optimise rather than maximise profits. We look to price our products so that they deliver value to our members and, by being attractive to them, achieve growth for the Group whilst at the same time (since profits are our main source of capital) generating sufficient profits to maintain a strong capital position, and so provide financial security for our members.

This means that we look, as far as is sensible in a competitive marketplace, to provide savings and mortgage products that give long-term value to our members, rather than focus on "Best Buy" products to attract new customers at the expense of existing customers. At the same time we look to minimise our costs without impairing the service we provide to our members. For example, we could cut costs materially by reducing the number of branches and agencies but believe that maintaining a broad network is at the heart of the service we provide to our members.

The Risk management report (pages 35 to 42) sets out the main risks that the Group faces and how we look to manage them. Strategically, we continue to operate in an economy and core markets characterised by a range of short and long-term uncertainties. For example:

- the economic recovery remains fragile and the impact of the government deficit reduction measures is yet to be seen. In particular future developments for interest rates (which directly impact our mortgage and savings customers) and for the level of unemployment (with a direct link to arrears and loan losses) are both highly uncertain;
- the economic conditions, and general socio-economic trends, continue to promote an increasing level of financial crime that the whole industry is experiencing. This means there is a need for constant vigilance and evolution to keep pace with the perpetrators;
- housing and mortgage volumes remain subdued, and these combine with the wider economic conditions to create a real possibility of material future falls in house prices;
- the wholesale funding markets remain extremely sensitive and activity within them sporadic; against this background financial institutions in the UK face material re-financing deadlines in 2011 and 2012. This continues to put pressure on the retail savings market, with many pricing at what we believe are unsustainable levels (i.e. the price paid for savings cannot be fully re-couped from mortgage loans); and
- the fast pace of regulatory change continues, with a raft of new regulation due to come into effect in 2011 and 2012, along with further regulatory reviews to be completed that will deliver even more change. A fundamental change in UK regulatory structures is also imminent.

These uncertainties form the most prominent part of the backdrop against which our strategic and tactical decisions are currently made. The Group's focus is on steering a course through these uncertainties to ensure that it remains a strong and independent building society capable of providing value and service to its members.

It is in this context that the Board assesses the Group's 2010 performance.

Income statement overview

This section looks at our profit before tax on both a statutory and a core operating basis, with commentary that explores the underlying drivers of the Group's performance.

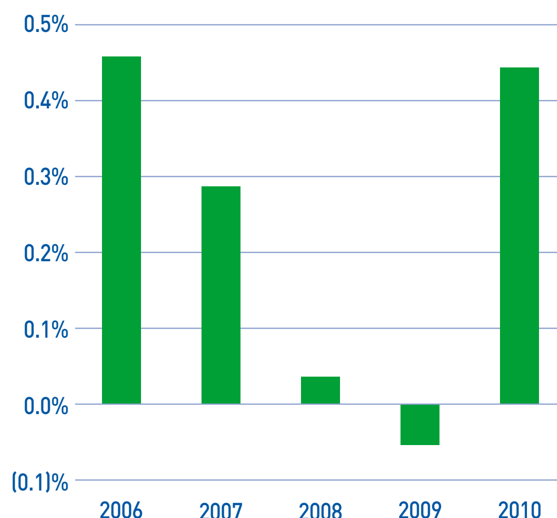
Under both measures 2010 has seen a strong return to profitability by the Group with figures of £115m and £128m respectively against a £12m statutory loss and £8m core operating profit in 2009.

Key Performance Indicator explanation: The Board monitors the Group's performance on both a statutory and a core operating basis because it believes that both add value to their oversight of the Group. Statutory profit before tax is the most commonly used comparative definition of profit and is a key component of our capital. However, it includes a number of items that the Board believes do not reflect the longer-term, sustainable business performance either because they are pure accounting measures (e.g. negative goodwill), are one-off in nature (e.g. integration costs) or are timing differences that reverse over time (e.g. fair value adjustments). The Board therefore uses core operating profit, which excludes these items, to look through to the underlying Group performance.

Statutory profit before tax

	2006 £'m	2007 £'m	2008 £'m	2009 £'m	2010 £'m
Net interest income	165	188	165	148	273
Fair value movements	14	(43)	(29)	(10)	(10)
Profit from sale of assets	-	(2)	(1)	11	15
Other income	32	41	31	31	43
	211	184	166	180	321
Negative goodwill	-	-	3	-	17
	211	184	169	180	338
Management expenses	(117)	(120)	(122)	(131)	(173)
	94	64	47	49	165
Provisions	(16)	(9)	(39)	(61)	(50)
Profit before tax	**78**	**55**	**8**	**(12)**	**115**

Statutory profit before tax as % of mean assets



2010 has seen the Group return to levels of profitability more in line with those achieved before the financial crisis; this is demonstrated by the graph above which shows pre-tax profits measured against mean total assets.

In 2010 statutory pre-tax profits are up by almost £130m to £115m, driven by:

- the inclusion from 1 April 2010 of Chelsea Building Society which, for example, is the main reason why management expenses have risen £42m and other income has risen from £31m to £43m i.e. these increases reflect asset growth;
- a recovery in our net interest income, as some of the suppressing factors present in 2009 (discussed below) reverse out and our post merger management actions began to take effect;
- a one-off profit of £15m from the sale of some of our liquid assets, and a further one-off item (negative goodwill) arising on the merger with the Chelsea; and
- a reduction in our mortgage loss provisions charge of £18m partly offset by an increased provisions charge against other assets.

At the same time our core operating profits, discussed on page 15, rose from £8m to £128m.

The following pages look at each component in more detail.

Business review (continued)

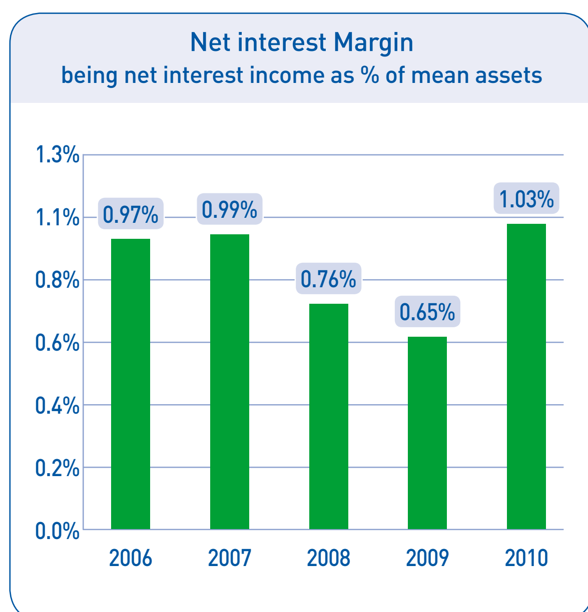
Net interest income

Key Performance Indicator explanation: The Board monitors the Group's net interest margin, a measure that calculates net interest income as a percentage of mean assets. This measure tracks how effective an institution is in earning income on its assets, and in managing the interest paid for its funding. The cheaper they can raise funding, and the more effectively they invest assets, the higher this ratio will be. Because the majority of our assets and liabilities are in the form of mortgage loans to, or savings deposited by, our members, our policy is to optimise rather than maximise this ratio since the product rates that underlie this ratio are our key mechanism for delivering value to our members. As such we have a lower margin than many of our non-mutual peers. The challenge is to achieve the appropriate balance, within a competitive marketplace, between providing value to members, achieving adequate levels of asset growth, taking only sensible levels of risk and making sufficient profits to maintain a strong capital position.

The Group's net interest margin rose to 1.03% in 2010, up from 0.65% in 2009.

The 2009 margin was itself low because we:

- chose to hold abnormally high levels of very low earning liquid assets, which was prudent to ensure we could meet funding maturities in early 2010, and to position the Group for the merger with the Chelsea;
- decided not to pass on all of the bank base rate cuts in 2008-9 to savers, providing them with some protection in this low rate environment but thereby reducing our interest income; and
- focussed, in view of the uncertain economic conditions, on low-risk, low-margin lending, hence reducing earnings from this part of our business.



In 2010 a key focus has been on managing material funding maturities against a background of a highly competitive retail (member) savings market and a wholesale (banks and companies) funding market that continues to be heavily constrained. This included a particular focus on the large portfolio of fixed rate savings products sold, pre-merger, by the Chelsea Building Society in late 2008 and early 2009 at what we consider to be unsustainably high rates of interest. Our policy on these balances has been to look to retain a material proportion at a more sustainable and equitable price level whilst accepting that the remaining balances would move to other institutions. This repositioning process has gone extremely well.

This all meant that:

- for some time we held extremely high levels of liquid assets so that we could be sure of meeting funding maturities (including preparing for managing the Chelsea's fixed-rate savings discussed above) even though this had a material negative impact on our net interest margin in 2009. Because of the progress made with these maturities we have been able to manage the Group's liquidity down from 31.9% as a proportion of liabilities at 31 December 2009 to 24.2% at 30 June 2010 and 21.1% at 31 December 2010. As discussed below this remains a very prudent level of liquidity under the new regime. Had we maintained the previous high level of liquidity we would now be holding, proportionately to our assets, £3.0bn more liquid assets earning very low rates; and
- we are now paying a fair and sustainable, albeit lower, price for the remaining Chelsea balances.

We have also, in common with other lenders, seen an increase in the number of borrowers choosing to remain on our standard variable rate for a period when their initial mortgage product matures, rather than moving immediately to a new product or lender. We expect this to be a temporary trend as borrowers consider their options in uncertain times, but it has provided a further transient boost to our mortgage earnings. At the same time, we increased our new lending in 2010 (from £936m in 2009) to £2,772m. Generally this lending is replacing older, maturing lending that was earning low interest margins (against the cost at which they have to be funded), having been advanced in the somewhat over-heated market conditions of 2006-7. Therefore whilst continuing to offer competitive mortgage products we have nevertheless seen an increase in the margins we earn on our overall mortgage book.

Fair value movements

Key Performance Indicator explanation: The Board monitors the Group's fair value movements in absolute terms. These movements represent adjustments to the value of a number of assets and liabilities to reflect their current market value. However, since the Group generally retains these assets and liabilities to their normal maturity dates (when the full face value is realised) these mark to market adjustments are in effect timing differences, which will in time reverse out.

In 2010 the Group's fair value movements were broadly level with 2009 at £10.5m against £10.3m in 2009, with both figures representing a marked reduction on the levels seen in earlier years. Because these figures represent timing differences the Group's aim is to minimise their year on year impact on our results, and so the 2010 result is considered to be at a comfortable level.

Profit from sale of assets

From time to time the Group will look to sell some of its non-mortgage assets because:

- we are required to periodically sell a proportion of our liquid assets to prove that they remain liquid i.e. can be readily sold on the open market. This is important because these assets are held in low-risk, low-earning investments principally to provide a ready source of funds should we experience an unusually high level of withdrawals from our savings accounts. In 2010 we sold a number of these investments at a profit of just over £15m; and
- in addition there is, from time to time an opportunity to realise an improvement in the underlying market value of an asset without impacting the core business.

By their nature these sources of income are highly variable - whilst the Board monitors and manages them, they are not considered part of our core performance.

Other income

Key Performance Indicator explanation: The Board monitors the Group's other income in absolute terms. This figure principally represents the income we earn from selling non-mortgage and savings products (such as home and contents insurance, investment products and other insurances), combined with that which we earn from a number of smaller business divisions (being our YBS Share Plans and Yorkshire Key Services operations). This measure indicates how successful we have been in:

- providing appropriate and competitively-priced products to our members through our partnerships with other financial institutions; and
- running our smaller business divisions.

In 2010 our other income increased from £31m to £43m, principally due to the inclusion from 1 April 2010 of such income earned by the Chelsea. After taking this into account, and excluding £9m of one-off profits from non-core items in 2007, our other income has been broadly stable over the last five years. In difficult and uncertain economic times the ability to source financial products that our members value, and hence wish to purchase because they meet their investment or insurance needs and all at the right price, is clearly more difficult. We are pleased that our performance has held up so well over the last few years. This is all the more notable given that a significant proportion of this income is linked indirectly to the mortgage market, which itself has shrunk materially in recent years. We remain focussed on sourcing the products that meet our members' needs and on monitoring this income figure, alongside the suitable performance of the products themselves, as evidence of our success in doing this.

Negative goodwill

This item reflects the difference between the deemed purchase price for Chelsea Building Society and the net value of its assets (after they have been adjusted to their "fair value" as discussed on page 16). Although there is no purchase consideration in the case of a merger, it is necessary under accounting rules to calculate one which is deemed to be the theoretical value of the business. The negative goodwill arising on the merger reflects the fact that this theoretical purchase price was lower (i.e. cheaper) than the value of the assets acquired as part of the merger. In accounting terms this item reduced the enlarged Group's opening reserves and then immediately reversed through the income statement, and so had no overall impact on the Group's reserves and its capital position. It does not reflect any element of underlying performance.

Management expenses

The Group continues to focus on its efficiency and effectiveness in how it delivers services to members – a key measure of this is its management expenses ratio.

Key Performance Indicator explanation: The Board monitors the Group's cost efficiency using two measures:

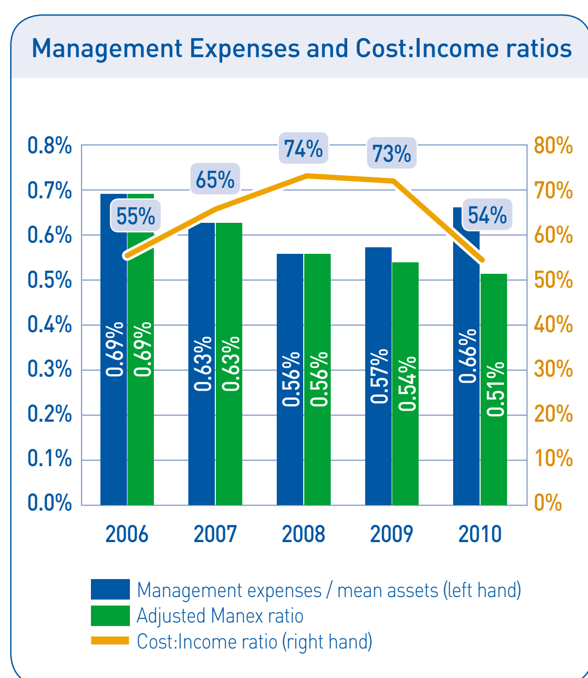
- Management expenses ratio - (management expenses as a percentage of mean assets) looks at how much it costs us to manage every £100 of assets. This provides a broad measurement of how well the Group manages its costs to remain efficient whilst still delivering effective service, and how growth, inflation and efficiency are being balanced. Crudely the lower the ratio the more efficiently an organisation is being managed; and
- Cost:Income ratio – (management expenses as a percentage of total income) looks at the relationship between our income generation and our costs. In some cases an institution may well have higher costs than its peers, but if these costs are generating additional income and hence profits then such a structure makes sense. The lower the ratio the less an institution is spending to generate every £1 of income.

Business review (continued)

The management expenses ratio fell steadily to 2008 and then stabilised before rising sharply in 2010. This increase is due to two merger related factors, namely:

- in 2010 merger-related costs of £10.4m were incurred, including both costs of completing the deal and those incurred in realising the long-term cost savings arising from the merger, and which remain on track for delivery; and
- as the merger took place at 1 April 2010, nine months' worth of costs were incurred for the Chelsea but, being a simple average of the Group's total assets at 31 December 2009 and 2010 the mean asset figure only reflects the effect of six months worth of Chelsea assets.

If these two items are adjusted for (including a similar, merger cost item in the 2009 figures) then our underlying management expenses ratio has continued to improve in 2009 and 2010, ending at 0.51% by 31 December 2010. This reflects a strong underlying performance and the delivery of over £15m of merger related savings in 2010 alone.



The Group's Cost:Income ratio (displayed as a line on the chart, and excluding non-core items) worsened in 2007/8/9 as the economic conditions, the low interest rate environment and management actions to protect the Group's members led to a decline in income levels. Underlying expenses rose, but only marginally. The improvement in overall income levels in 2010 has seen this key ratio return to pre-crisis levels.

Looking forwards, rising inflation and changes to the rate of value added tax combined with the current low-growth environment mean that, even with further merger-related savings due to be realised, maintaining the improvement in this area remains difficult. It remains a key area of focus.

Provisions

Key Performance Indicator explanation: The Board monitors the Group's provisions charge in absolute terms. This measures how far our assets have failed to perform from a credit risk perspective. It includes both actual losses incurred as a result of defaulting borrowers, and our estimate of potential losses on mortgages and other assets that, based on our portfolios' current behaviour, we believe are already impaired (whether or not they are actually in arrears). Whilst clearly heavily influenced by factors such as the wider economy (in particular unemployment levels) and the housing market (in particular house prices) this measure gives the Board a clear view on whether the risks taken on our lending and investments are in line with expectations.

The breakdown of the provisions charge in recent years is as follows:

	2006 £'m	2007 £'m	2008 £'m	2009 £'m	2010 £'m
Provisions against loan portfolios	3.5	5.0	25.0	59.0	40.8
Provisions against impaired investments	-	6.9	-	0.9	5.1
Provisions for other items	12.5	(3.0)	(1.0)	(1.4)	-
Internally generated provisions	**16.0**	**8.9**	**24.0**	**58.5**	**45.9**
FSCS charges	-	-	14.7	2.7	3.6
Total provisions	**16.0**	**8.9**	**38.7**	**61.2**	**49.5**

The main provisions charge, against our residential loan portfolios, fell in 2010 to £41m from £59m in 2009. Whilst not in any way a return to pre-recession levels it is clearly a step in the right direction, and reflects our management of arrears during 2010 as well as wider movements in house prices. The economy and housing markets clearly remain stressed and many are forecasting increased unemployment and falling house prices in 2011, both of which could lead this figure to rise again even with continued firm management of arrears.

Other elements of the provisions charge are related to non-core items:

- impaired investments - as first reported in 2007, the value of our portfolio of structured credit investments was impacted badly by the financial downturn. This loss of value is partly reflected in the fair value movements noted above, and partly in the provisions charge. These provisions relate to historic investments that the Group is no longer active in, and where the remaining portfolio is being managed down, now standing at just £71m or 0.2% of our total assets;
- other items - these adjustments predominantly related to provisions made in 2006 and earlier against potential compensation payments to customers who bought

endowment policies via the Group in the 1990s. Later years have seen a reversal of what turned out to be an over-provision against these items. Again, they related to historic activities in which the Group has not been active for some time; and

- Financial Services Compensation Scheme (FSCS) - since 2008 the Group, along with other building societies, has been paying a material contribution to the FSCS to fund the protection given to depositors in failed institutions (e.g. Bradford & Bingley plc and the Icelandic banks). We continue to believe that the approach to and scale of these charges (in drawing funding disproportionately from generally safer, more heavily retail-funded institutions) is wrong. Nonetheless it represents a real, and most likely ongoing, cost to the Group.

Core operating profit

Clearly a number of the components explored above do not reflect our core operating performance, which is monitored by the Board as shown below. The items reversed out to get to this view of our performance are removed because we do not believe that they reflect the ongoing, underlying performance of the Group. It is important for the Board to have clear sight of this level of performance ignoring shorter-term distortions, be they positive or negative:

	2006 £'m	2007 £'m	2008 £'m	2009 £'m	2010 £'m
Statutory profit before tax	**78**	**55**	**8**	**(12)**	**115**
Reverse out the following items:					
Fair value movements	(14)	43	29	10	10
Sale of assets/ other income	-	(11)	(2)	1	1
Non core provisions:					
• Structured credit	-	7	7	1	5
• FSCS	-	-	15	3	4
• Other liabilities	13	(3)	(1)	(2)	-
Negative goodwill	-	-	(3)	-	(17)
Merger costs	-	-	-	7	10
Core Operating Profit	**77**	**91**	**53**	**8**	**128**

Core operating profit as % of mean assets

In core operating profit terms the Group has returned to the levels of profitability seen before the start of the financial crisis in 2007.

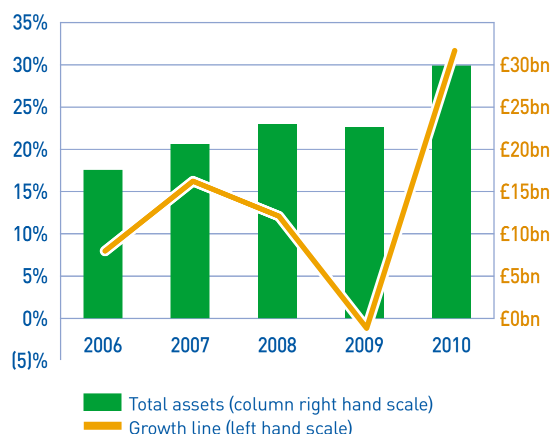
Balance sheet overview

Over the last five years the Group's business has grown materially, through a combination of controlled organic growth and mergers – we are now just over £30bn of assets, up 32% on 2009, and 70% on 2006.

Group Balance Sheet

	2006 £'bn	2007 £'bn	2008 £'bn	2009 £'bn	2010 £'bn
Liquid assets	4.1	4.7	5.3	6.7	5.9
Mortgage loans	13.3	15.4	16.3	15.0	23.4
Other assets	0.2	0.4	1.4	1.0	0.8
Total assets	**17.6**	**20.5**	**23.0**	**22.7**	**30.1**
Retail savings	11.3	12.4	13.7	13.8	21.4
Wholesale funding	4.9	6.6	7.3	7.2	6.3
Other liabilities	0.2	0.2	0.8	0.5	0.7
	16.4	19.2	21.8	21.5	28.4
Remunerated capital	0.3	0.3	0.3	0.3	0.4
Reserves	0.9	1.0	0.9	0.9	1.3
Total liabilities	**17.6**	**20.5**	**23.0**	**22.7**	**30.1**

Total assets (£'bn) and asset growth (%)



The Group grew strongly in 2006-8, with an equivalent annual rate of growth of 12% over these three years. In 2009 the balance sheet was shrunk as both funding and lending markets contracted and the Group looked to ensure that it did not over extend itself involatile markets.

2010 saw the Group's balance sheet grow by 32%, driven by the Chelsea merger. However, this figure covers a more complicated and carefully managed picture of merger-driven growth followed by careful contraction as

unwanted assets and liabilities were shed. The assets actually brought onto the Group's balance sheet at the time of the merger, compared to the Group's balances at 31 December 2009 and 2010 and immediately before the merger (31 March 2010) were as follows:

Group Balance Sheet 2009 to 2010

	31/12 2009	31/03 2010	Chelsea assets added	01/04 2010	31/12 2010
	£'bn	£'bn	£'bn	£'bn	£'bn
Liquid assets	6.7	7.0	3.0	10.0	5.9
Mortgage loans	15.0	14.6	9.2	23.8	23.4
Other assets	1.0	1.2	0.2	1.4	0.8
Total assets	**22.7**	**22.8**	**12.4**	**35.2**	**30.1**
Retail savings	13.8	13.5	9.9	23.4	21.4
Wholesale funding	7.2	7.5	1.7	9.2	6.3
Other liabilities	0.5	0.6	0.4	1.0	0.7
	21.5	21.6	12.0	33.6	28.4
Remunerated capital	0.3	0.3	-	0.3	0.4
Reserves	0.9	0.9	0.4	1.3	1.3
Total liabilities	**22.7**	**22.8**	**12.4**	**35.2**	**30.1**

In the first three months of the year the Group's assets remained flat, albeit with:

- a reduction in mortgage assets as, not unexpectedly, the level of repayments by borrowers outweighed new mortgage lending in what is traditionally a quiet part of the year for new lending;
- a corresponding increase in liquidity as the cash released was retained for future lending; and
- a reduction of £0.3bn in retail savings balances, and a corresponding increase in wholesale funding.

As at 1 April 2010 the merged Group had total assets of £35bn. In the nine months following the merger the Group has focussed, as mentioned above, on managing:

- the large portfolio of fixed-rate savings products inherited from the Chelsea onto more sustainable interest rates and the accompanying, planned, outflow of funds. As a result, retail savings balances shrank by £2.0bn in net terms between the merger date and the end of the year to £21.4bn; and
- a number of wholesale funding maturities, partly offset by new issuance, resulting in a net reduction of £2.9bn in wholesale funding.

This outflow of funds was principally funded out of liquid assets that had been put in place for this reason – so that total liquid assets shrank from £10.0bn to £5.9bn between 1 April and 31 December.

The assets acquired with the Chelsea were subject to a number of significant adjustments to reflect their "fair value" rather than the value at which they were recorded in Chelsea's own records; i.e. as if they had been acquired, individually, by the Yorkshire in standalone transactions. The assets in question, the adjustments made and the fair value at which they came on to our balance sheet, are as follows (for more details see note 42 on pages 108 and 109):

Chelsea Fair Value adjustments

	Chelsea cessation accounts	Fair value adjustments	Take on balances
	£'bn	£'bn	£'bn
Liquid assets	3.0	-	3.0
Mortgage loans	9.4	(0.2)	9.2
Other assets	0.3	(0.1)	0.2
Total assets	**12.7**	**(0.3)**	**12.4**
Retail savings	10.0	(0.1)	9.9
Wholesale funding	1.7	-	1.7
Other liabilities	0.4	-	0.4
	12.1	(0.1)	12.0
Reserves	0.6	(0.2)	0.4
Total liabilities	**12.7**	**(0.3)**	**12.4**

The adjustments fall into a number of categories, including:

- those reflecting the difference between the actual interest rates in place on products or financial instruments (e.g. mortgages, savings and hedge instruments) and what we would have had to pay or could have earned if we were lending/raising money/hedging positions as at 1 April 2010. This price difference has to be shown as a positive or negative adjustment to the underlying mortgage, savings balance or derivative. These adjustments will reverse over time, through the income statement, as the underlying instruments mature;
- the write-off of assets that had no, or reduced, value to the combined group at 1 April 2010 e.g. Chelsea's computer software that was of no value to the combined group because we are integrating the Chelsea business onto the Yorkshire's bespoke

systems. These adjustments reduced reserves on 1 April 2010 but do not have any impact on the income statement thereafter; and

- an adjustment to reflect the amount that we expect to lose, at any point in the future, through borrower defaults. This approach is different to that for our existing mortgage assets where only currently impaired loans can be taken into account. The effect is, provided our estimate of future losses is accurate, that any future losses on these assets will not be reflected in our income statement – it is equivalent to bringing forward future loan loss provisions charges to 1 April 2010. The adjustment in relation to Chelsea mortgages was almost £175m. Although this adversely affects the capital position from 1 April 2010 it then protects the Group's future income statement. This adjustment is in addition to just over £53m of provisions already on the Chelsea's books at the time of the merger, giving a total of over £228m effective protection against future losses on these assets. In the nine months following the merger the actual amount written off against these loans was just £16m.

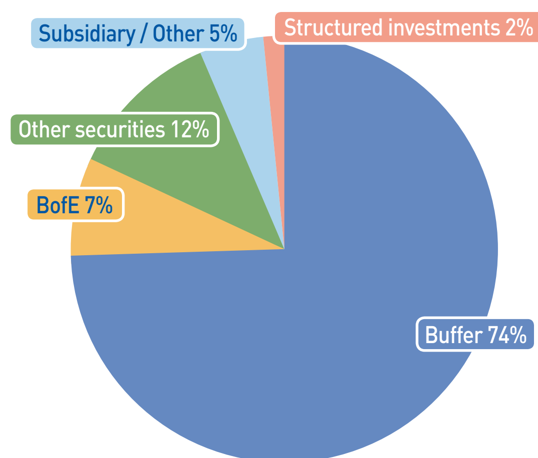
The following sections look in more detail at the principal balance sheet items:

Liquid assets

Key Performance Indicator explanation: The Board monitors the Group's liquidity position in a number of ways, including by continually running potential stress scenarios against our current balance sheet to test that adequate liquidity is in place, and by monitoring the make-up of our funding and liquidity portfolios. The key measure, however, is to monitor the total level of "buffer liquidity" against our regulatory requirement (set by the FSA). Buffer liquidity constitutes cash and investments with the UK government (deposits with the Bank of England or holdings of UK Gilts and similar investments) and with supranational institutions. As such it represents the most liquid and safest form of holding. Our regulatory minimum is set by the FSA, who are currently in the process of reviewing our Internal Liquidity Adequacy Assessment in order to set an Individual Liquidity Guidance figure for the Group. In the meantime the Board is monitoring its liquidity against an interim Individual Liquidity Guidance Limit set by the FSA during 2010.

During 2010, in addition to the planned run down of balances already referred to, the Group continued its progress in moving more of its liquid assets into the highest quality investment categories, as required by the FSA's new liquidity regime. This move also reflects the shift in our funding profile with, in particular, far lower levels of short-dated funding that requires higher liquidity to be held against it. This all means that whilst a higher proportion of our liquid assets are held in these very low earning assets, we can also hold a lower overall level of liquidity. As shown in the table opposite, 75% of our total liquidity is now in this category.

Breakdown of liquid assets as at 31/12/2010



	2009 £bn	2010 £bn
Buffer liquidity	3.2	4.4
BoE Eligible securities	1.1	0.4
Other securities	1.9	0.7
Total core liquidity	**6.2**	**5.5**
Subsidiary / other liquidity	0.4	0.3
Structured investment	0.1	0.1
Total liquid assets	**6.7**	**5.9**

We continue to hold levels of liquidity that are significantly above our interim regulatory requirement.

As previously reported, some years ago the Group, in a controlled and deliberate return-seeking move, invested a small proportion of its liquidity in higher risk, higher yielding treasury investments ("structured investment"). These assets were always less than £200m in value, less than 3% of our total liquidity and less than 1% of total assets. Over the past few years they have been adversely affected by market conditions, resulting in a number of realised losses (i.e. where sold) and reductions in value (where still held). We continue to actively manage these assets and to seek to reduce our exposure, and as at 31 December 2010 this portfolio stands at just £71m or less than 0.25% of total assets.

The difficulties of a number of Eurozone countries have been well publicised in 2010, notably Greece, Ireland, Italy, Portugal and Spain, and in a number of cases rescue schemes have been put in place for these countries. This has raised concerns about the security, from a credit perspective, of loans to financial institutions that are guaranteed by those countries' governments (so-called sovereign risk). The Group has no exposure

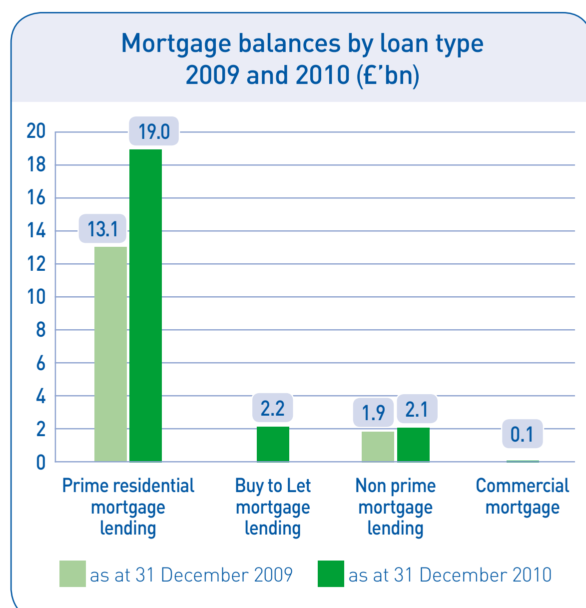
Business review (continued)

to investments issued directly by the governments of any of these countries. The only one of these countries where the Group has an exposure to government-owned or guaranteed institutions is Ireland – where at 31 December 2010 total balances of £216m were outstanding, although £42m of that has since been repaid on its due date. The Group continues to closely monitor these exposures, all of which are senior debt maturing over the next 18 months and which we believe are not impaired.

Mortgage assets and new mortgage lending

With the take-on of the Chelsea we saw a significant shift in the make-up of our mortgage assets since the Chelsea were active in a number of different markets to the Yorkshire Group:

	31 December 2009		31 December 2010	
	£'bn	%	£'bn	%
Prime mortgage lending	13.1	87%	19.0	81%
Buy to Let lending	-	-	2.2	9%
Non prime lending	1.9	13%	2.1	9%
Total residential	**15.0**	**100%**	**23.3**	**99%**
Commercial lending	-	-	0.1	<0.5%
Other lending	-	-	0.0	<0.1%
Total loans	**15.0**	**100%**	**23.4**	**100%**



Our portfolio of prime residential mortgages grew by over £5bn as a result of the merger – and at the end of 2010 it stood at £19bn. As a percentage of our total mortgage loans this is 81%, which is down on 2009 because of the addition of just over £2bn of Chelsea originated Buy-to-Let mortgage loans – a market in which Yorkshire was not previously active, but where we are considering a limited re-entry into new high quality lending.

Meanwhile non prime lending grew with the take-on of Chelsea balances before shrinking back to £2.1bn by the year end, or just 9% of our total portfolio. This is principally lending to borrowers with adverse credit histories or self-certification lending where borrowers are not required to prove their income levels. Both are areas that were prevalent before the financial downturn, where both the Yorkshire and the Chelsea were active to relatively limited degrees and where the Group is completely inactive now. As a result these portfolios are being managed down.

With the merger we took on a small portfolio of commercial loans from the Chelsea, and by the year end had reduced this portfolio by almost 50% to just over £80m. We are not active in this market and do not intend becoming so.

The make-up of our mortgage portfolio, and the potential risks that are contained within it, are monitored closely by the Group across a wide range of characteristics and analyses. These include, for example, considering the geographic profile of the portfolio, its indexed loan-to-value position and its ongoing arrears position.

Taking these in turn:

- the UK economy and housing market is highly regional, and different regions are facing potentially very different economic and housing market conditions in 2011 and beyond. The merger with the Chelsea, as a more southern-focussed society, has meant a re-balancing of the Group's loan portfolios towards London and the South East of England, closer to the national split. Given the stronger performance (both to date and forecast by many commentators) of these regions' housing markets such a shift is likely to be helpful to the Group;

Geographic Distribution	2006	2007	2008	2009	2010
Yorkshire & Humberside	18%	17%	17%	17%	12%
South East	15%	15%	15%	15%	23%
North West	15%	14%	14%	14%	12%
Midlands	11%	11%	11%	12%	12%
Greater London	11%	11%	11%	11%	13%
Scotland	11%	12%	12%	11%	8%
North East	5%	6%	6%	6%	5%
Wales/N. Ireland	6%	6%	6%	6%	5%
South West	5%	5%	5%	5%	7%
East Anglia	3%	3%	3%	3%	3%
	100%	**100%**	**100%**	**100%**	**100%**

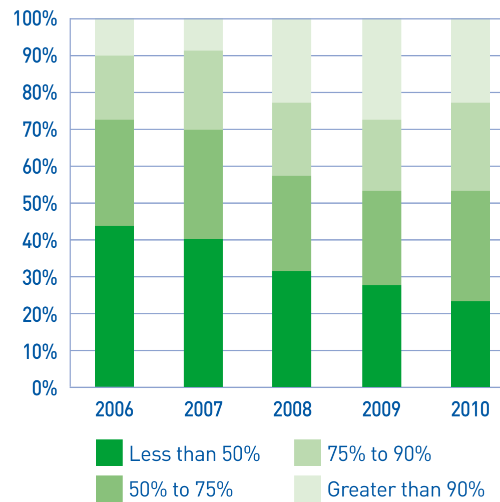
Mortgage assets by region at 31/12/2010

- Yorkshire & Humberside **12%**
- South East **23%**
- North West **12%**
- Midlands **12%**
- Greater London **13%**
- Scotland **8%**
- North East **5%**
- Wales/N. Ireland **5%**
- South West **7%**
- East Anglia **3%**

- an analysis of indexed loan-to-values for a mortgage portfolio provides a broad estimate of the current degree to which borrowers retain equity in their homes, and so how exposed a lender is to making a loss should borrowers default on their loans. The Group has a higher than average proportion of loans in the higher loan-to-value bands, reflecting its focus on the first-time-buyer market and our commitment to helping borrowers at all stages of their home-ownership journey. A combination of the merger with the Chelsea and house price movements during 2010 saw a general improvement in the Group's profile, with fewer borrowers in the highest bracket. This follows a number of years when falling house prices have, inevitably, increased the level of higher loan-to-value loans. The Board remains focussed on this characteristic of the mortgage portfolio through uncertain times.

Indexed loan to value	**2006**	**2007**	**2008**	**2009**	**2010**
Greater then 90%	10%	9%	23%	27%	23%
75% to 90%	17%	21%	19%	19%	23%
50% to 75%	29%	30%	27%	26%	30%
Less than 50%	44%	40%	31%	28%	24%
	100%	**100%**	**100%**	**100%**	**100%**

Indexed loan to value profile



Key Performance Indicator explanation: The Board monitors the Group's arrears performance using a range of different measures and analyses. It does this because the current arrears performance and its trend gives a direct indication of how well borrowers are, or are not, coping with current economic conditions and therefore how exposed the Group may be to borrower defaults and hence loan losses. A range of arrears measures are used because they may each provide a slightly different perspective on current and prospective conditions. However the key measure used by the Board is the number of borrowers whose loan is in arrears by three monthly payments or more.

Loans with payments more than 3 months in arrears as % of total loans

	2006	**2007**	**2008**	**2009**	**2010**
Number of accounts	0.72%	0.95%	1.59%	1.84%	1.84%
Balances outstanding on accounts	0.89%	1.04%	1.99%	2.46%	2.26%

The level of arrears for the Group's loan portfolios has, as previously reported, risen steadily over that last few years as the economic conditions have deteriorated and borrowers have struggled to keep up with their mortgage payments. However, the Group has maintained its arrears below the Council of Mortgage Lenders average for the country as a whole, and based on the latest publically available data (at 31 December 2010) this remains the case. The Group's arrears increased as a result of the merger with the Chelsea, whose equivalent arrears numbers at 31 December 2009 were 2.66% and 2.97%. This meant that as at 30 April 2010 the combined

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group's arrears levels jumped but since then they have reduced to the levels shown above. Overall the 2010 performance has been good, but we remain cautious about the prospects for the UK as a whole in 2011 and beyond, and hence for our borrowers and our resulting arrears. We will continue to seek to balance the financial interests of the membership as a whole in minimising potential losses, and those of individual borrowers who find themselves in financial difficulties.

Key Performance Indicator explanation: The Board monitors the Group's new lending performance across a range of measures, and between different channels and portfolios, with the over-arching metric being net new lending in absolute terms. This figure is used because it provides a measure that includes all portfolios and channels, and measures our effectiveness in gross mortgage lending, the rate at which existing borrowers are redeeming their mortgages and how effective we are being in retaining borrowers whose original loan deals are maturing. As such it gives a good guide to how well we are performing both in terms of offering the type of competitive mortgage products that our customers want, and of meeting our growth aspirations.

In terms of new lending, the Group increased its gross new mortgage lending in 2010 by just under 200% to £2.8bn, back above the level advanced in 2008 and achieving a market share of 2%. This reflects our commitment to be active in the mortgage market, as far as is prudent given the current economic and market conditions. Whilst still below the total levels achieved in 2006/7, for the last months of 2010 we were approaching similar levels of activity.

As mortgage redemptions (relative to the size of our total mortgage book) continued broadly in line with previous years, our net lending for the year improved from a net repayment of £1.2bn in 2009 to a net repayment of £0.8bn. Clearly the Group would like to be achieving positive net mortgage lending, but feels that it is more important to "fund first and lend second", and in raising its funding to ensure that the volume and pricing of that funding is equitable and sustainable. In today's volatile and competitive markets this needs to be managed carefully.

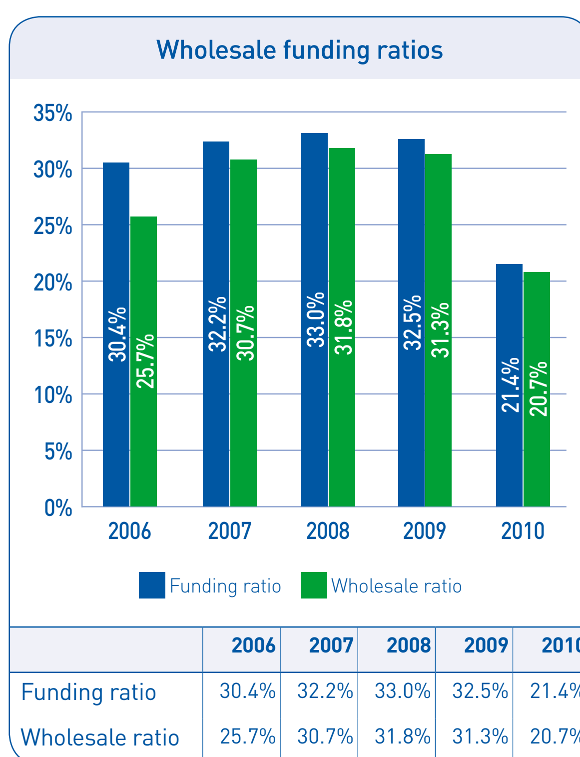
Retail and wholesale funding

During the year the Group saw a material shift in the mix of its funding towards retail savings (i.e. through offering savings products to our members) and away from money raised on wholesale markets. This was a planned move, and the mix is now at a level that the Board feels appropriate in today's markets.

Key Performance Indicator explanation: The Board monitors the Group's relative reliance on wholesale versus retail funding through two measures:

- Funding ratio – which calculates the proportion of total shares and borrowings (excluding offshore deposits held by individuals in Yorkshire Guernsey Limited) that are not in the form of shares. This is a statutory ratio and by law the group must maintain it below 50%; and
- Wholesale ratio – which calculates the proportion of our total funding that is from wholesale sources, in effect from banks and other financial or commercial institutions.

Wholesale funding provides valuable diversity in the Group's funding profile. However, as the events of 2007 and 2008 in particular showed, too great a reliance on these sources can leave institutions exposed to liquidity issues should wholesale markets suddenly contract. The Group's aim is to maintain a sustainable level of wholesale funding without becoming too reliant.



	2006	2007	2008	2009	2010
Funding ratio	30.4%	32.2%	33.0%	32.5%	21.4%
Wholesale ratio	25.7%	30.7%	31.8%	31.3%	20.7%

Retail savings, that is money raised from our members, now constitutes 77% of our total funding. This is clearly sensible in a business whose principal purpose remains the provision of a safe home for members' savings and of residential mortgage loans. At 31 December 2010, 91% of our mortgages were funded from retail savings balances (2009: 92%).

Key Performance Indicator explanation: The Board monitors the Group's retail savings performance by tracking its net retail inflow in absolute terms, being the net amount by which its retail savings balances grow in any period. Any portfolio of retail savings products will, at any point in time, have some products where balances are growing and others where the balances are reducing, reflecting the relative attractiveness of those products against the market. It is, in our view, not a sustainable

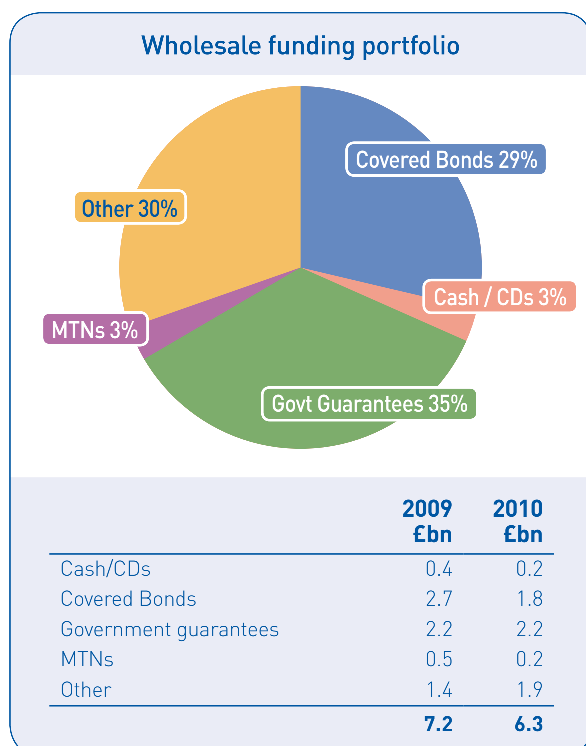
strategy to offer market-leading rates on all savings products at all times, but neither do we look to offer eye-catching introductory rates and then quietly reduce product rates to de minimis levels once the introductory period is past. Instead, we look to compete fairly, offering competitive rates on new products whilst maintaining fair rates on existing balances. This means that, at times when the savings market is overheated, we will inevitably see some outflows on some of our products.

During 2010 the Group's main task was to manage the position inherited from the Chelsea, and in particular the large portfolio of highly priced fixed-rate bonds referred to above. This meant that for the Group as a whole:

- retail savings balances grew by over 54%, or £7.6bn, to £21.4bn in 2010;
- this growth included the addition of £9.9bn of savings balances on merger with the Chelsea;
- the Chelsea balances were managed down by £2.9bn during the last nine months of the year; and
- over the whole year the Yorkshire and Barnsley brands saw net inflow of £0.3bn.

Overall, in what continued to be a highly competitive market that saw a number of players continue to offer what we believe to be unsustainable pricing throughout the year, the Board is satisfied that the 2010 performance represents a prudent approach to managing the Group's funding position.

The Group's wholesale funding portfolio was as follows at the end of the year:



	2009 £bn	2010 £bn
Cash/CDs	0.4	0.2
Covered Bonds	2.7	1.8
Government guarantees	2.2	2.2
MTNs	0.5	0.2
Other	1.4	1.9
	7.2	**6.3**

The Group was pleased to achieve a successful re-entry into the Covered Bond market in September 2010. Looking forward, the Group has a number of significant maturities in 2011 and 2012, and hopes to continue to be active in the market for new issuance.

Key Performance Indicator explanation: A key measure for the Group in monitoring its wholesale funding position is the weighted average maturity of its outstanding funding. This metric provides a measure of how long the Group has funding in place for, since it reflects the average remaining term (weighted by balances) of outstanding wholesale funding. It is important to achieve a balance here – since too long an average maturity suggests a preponderance of more expensive long-term funding, whilst too short an average maturity suggests that the Group will be having to constantly issue and re-issue funding.

The Group's weighted average maturity at 31 December 2010 was 15.6 months. This figure has reduced in recent years as the availability of funding, and particularly longer-term funding, has contracted. However, the Group entered the current market conditions in a very good position and has managed to maintain its average funding maturity at a reasonably high level. As market conditions settle into a new norm we will look to extend this maturity further.

As discussed in previous years' reports, the Group chose to access the Credit Guarantee Scheme and other government funding initiatives available to institutions that satisfy the schemes' strict conditions. We chose to do this because the existence of these schemes itself caused further dislocation of the wholesale funding markets, further reducing the otherwise available funding, and because it provided longer-term funding at commercial rates (allowing us to reduce our levels of shorter-term funding). Not all institutions were able to access these schemes. The funding raised will begin to mature (and therefore need to be repaid) in 2011. The Board has been very careful to plan and manage the Group so as to be sure that these loans can be repaid when due.

Capital

The Group's capital ratios continue to reflect its core strengths, with the two key ratios improving in 2010 from what were already very strong and comparatively high positions.

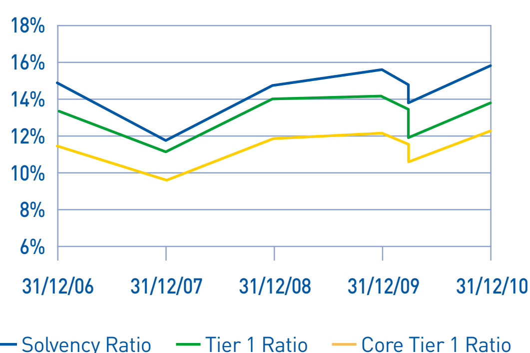
Key Performance Indicator explanation: The Board looks at two key measures to monitor the Group's capital strength, which is important since it represents the money held to protect investors against ever losing any of their money with the Group. The higher these ratios the more capital an institution has in place, relative to the riskiness of its assets, and therefore the stronger its position:

Business review (continued)

- Core Tier 1 ratio – core tier 1 capital represents the very strongest form of capital for any financial institution, and for the Group is essentially its accumulated profits built up over time. The ratio compares this to its assets weighted according to how much risk they carry - all financial institutions, by their very nature, take some degree of risk in investing their assets, but differing assets carry differing degrees of risk; and
- Capital excess – as a part of the Internal Capital Adequacy Assessment Process the FSA sets minimum capital requirements for the Group, based on its view of the Group's own assessment of the risk profile of its assets and wider business activities. The Board monitors closely the degree to which the Group carries capital above this requirement.

The Group's capital resources and ratios are set out in detail in Note 30 to the accounts, but in summary are as follows:

	31/12 2006	31/12 2007	31/12 2008	31/12 2009	31/03 2010	01/04 2010	31/12 2010
Total Capital Resources	1,204	1,120	1,161	1,238	1,246	1,672	1,778
Tier 1 Capital Resources	1,288	1,062	1,104	1,123	1,127	1,451	1,562
Core Tier 1 Capital Resources	937	916	937	964	966	1,288	1,394
RWA	8,100	9,500	7,832	7,927	8,387	12,145	11,205
Tier 1 Ratio	13.5%	11.2%	14.0%	14.2%	13.4%	11.9%	13.9%
Core Tier 1 Ratio	11.6%	9.6%	12.0%	12.2%	11.5%	10.6%	12.4%



Note: The ratio at 31 December 2007 was impacted by the Group's move to the new Basel II regime, and a timing difference between the introduction of certain elements of this regime. In fact, one day later on 1 January 2008 our Solvency ratio was 14.4%, up 2.6%.

During 2010 the Group's capital was reduced, as planned and as indicated in the merger documentation, by the merger with the Chelsea – in effect the "price" that we paid for the merger was a reduction in our capital ratios on 1 April 2010 since the Chelsea's capital position was not as strong as the Yorkshire's. However, by the end of the year the Group has restored its key capital ratios to above those immediately pre-merger, and above the levels at 31 December 2009. This is ahead of our expectations and has been achieved through a combination of planned asset shrinkage post merger (reducing the amount of capital we need in place), and strong profitability which increased the absolute amount of capital we have in place.

Furthermore, our other key ratio, the Capital Excess, remains extremely healthy and ahead of plan. We have in place materially more capital than the FSA considers we need given our size and asset mix.

The Group remains committed to maintaining strong capital ratios as these fundamentally represent security for its membership.

Customer satisfaction measures

Delivering strong customer service is central to our vision and consequently the Board focusses on a number of detailed service measures. These include telephone answering times, ATM availability and general processing speed and accuracy. They provide invaluable feedback on how well we are meeting our members' product and service needs. At the highest level the Board focusses on customer satisfaction and complaints measures as the best reflection of overall service quality.

Key Performance Indicator explanation: The Group looks at a range of customer metrics, with the key ones being:

- Customer satisfaction – which shows the proportion of our customers who say that they are satisfied or more than satisfied with the service they received;
- Net promoter score – which shows the percentage of customers strongly prepared to recommend our products and services to others less those who are not prepared to do so and excluding those who are neutral towards us i.e. it is the net proportion of our customers with a positive perspective on us, and not just the gross number; and
- Complaints – a range of data is monitored including the number and type received, the speed with which complaints are resolved, the proportion that are accepted or rejected, how many are referred to the Financial Ombudsman Service and how many of those are found in our or the customer's favour. The Board also monitors the absolute level of complaints received.

Looking across the period our customer satisfaction measure shows the following picture – a score that is consistently at or above 90%:

As at the end of 2010 our net promoter score (which we have only recently introduced) is 44%, which is extremely pleasing and we believe is significantly better than most financial institutions.

Looking at complaints, the Board reviews an extensive array of data and trends. A key piece of data that started to be available in 2010 was the Financial Ombudsman Service (FOS) complaint overturn rates, which the FOS now publishes bi-annually. These tables show performance in terms of overturn rates relating to each qualifying firm in the finance sector – i.e. the percentage, per firm, of customer complaints sent to the FOS which were overturned in the customer's favour. The latest table - published in Q3 2010 and representing the period 1 January 2010 to 30 June 2010 - quoted the performance of the largest 160 qualifying firms. Yorkshire (including Chelsea) were joint top performers with an FOS overturn rate of only 14% during the reporting period. The Board views this as an excellent achievement - the data is widely recognised as a clear indicator of the fairness of a firm's complaints handling approach. The box below sets this achievement in context by showing a sample of other well-known institutions' results:

FOS Complaints overturn rates for a selection of providers
% of complaints referred to FOS then resolved in favour of consumers 1/1/2010 to 30/6/2010

Top 3 institutions	Clerical Medical Investment Group	14%
	Yorkshire Building Society	14%
	Northern Bank	17%
Other institutions included	Nationwide Building Society	18%
	Santander UK	19%
	Bank of Scotland plc	23%
	Northern Rock	31%
	National Westminster Bank	43%
	Sainsbury's Bank	43%
	Lloyds TSB	45%
	Direct Line Insurance	48%
	Royal Bank of Scotland	50%
	Barclays Bank	61%
	Tesco Personal Finance	65%
	Egg Banking	72%

Staff metrics

The Board places great importance on recruiting and retaining motivated people and recognises the key contribution they make to the Group's continued success.

Key Performance Indicator explanation: The Group looks at two staff metrics on a monthly basis, as well as its periodic, more detailed, staff surveys:

- Turnover – this measures how many of our staff are leaving the organisation. Whilst this inevitably includes a number of retirements and similar leavers, movements in the ratio will give a broad indication of our staff's satisfaction with the Group as an employer. It excludes redundancies since these represent specifically merger-related short-term anomalies; and
- Absenteeism – this measures the percentage of working days lost through sickness and other forms of absenteeism. Generally a lower ratio will suggest a more committed and satisfied workforce.

	2006	2007	2008	2009	2010
Staff turnover	15.2%	18.9%	15.6%	10.7%	15.1%
Staff absenteeism	3.4%	3.1%	3.1%	3.2%	2.8%

In 2010 both measures remain below target i.e. are performing better than target.

Chelsea merger

The Group's merger with the Chelsea and subsequent work on integrating the two societies has been a major part of the Board's, and indeed the whole Group's, focus in 2010. Throughout the process, the Board has closely monitored both the financial impact (embedded in previous sections) and the operational progress of the merger. This includes a detailed integration project review on a monthly basis covering progress and issues on each major workstream, the key risks introduced by any such integration exercise and progress against the clear financial targets (costs and savings) set by the Board. As Iain notes on page 8, the integration is going according to plan and, whilst a material amount of work remains to be completed, is forecast to remain so in both operational and financial terms. The Board remains clearly focussed on monitoring progress in this vital area.

Other business review issues

In common with previous years a number of other areas that might be considered within a Business review are included within other sections of this document, and therefore are not covered separately here. These consist of:

- Corporate responsibility – pages 24 to 27
- Risk management report – pages 35 to 42
- Corporate governance report – pages 43 to 51

Robin Churchouse
Finance Director