Local banking for Britain

TSB

"During 2016 TSB continued to make great progress in its mission to bring more competition to UK banking."

Paul Pester, Chief Executive Officer, TSB

TSB Banking Group plc
Annual Report and Accounts 2016

Our performance in 2016 provides clear evidence that TSB continues to deliver on its strategy of bringing more competition to UK banking.

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Strategic report

Summary results

Summary balance sheet

	2016 £ million	2015 £ million	Change %
Loans and advances to customers	**29,419.1**	26,398.1	11.4
Other assets	**7,776.6**	5,219.9	49.0
Total assets	**37,195.7**	31,618.0	17.6
Customer deposits	**29,383.8**	25,874.2	13.6
Other liabilities	**5,946.9**	3,997.5	48.8
Shareholder's equity	**1,865.0**	1,746.3	6.8
Total equity and liabilities	**37,195.7**	31,618.0	17.6

Summary statutory income statement

	2016 £ million	2015 £ million	Change %
Net interest income	**853.8**	765.3	11.6
Other income	**150.2**	125.4	19.8
Total income	**1,004.0**	890.7	12.7
Operating expenses	**(734.7)**	(740.8)	(0.8)
Impairment	**(87.3)**	(82.3)	6.1
Statutory profit before taxation	**182.0**	67.6	169.2
Taxation	**(54.2)**	21.2	
Statutory profit for the year	**127.8**	88.8	43.9

Segmental analysis of management basis profit before taxation

	2016 £ million	2015 £ million	Change %
Franchise	**64.6**	40.3	60.3
Mortgage Enhancement	**46.2**	63.2	(26.9)
Whistletree Loans	**66.9**	2.2	
Management profit before taxation	**177.7**	105.7	68.1
Gain on sale of share in Visa Europe	**32.5**	–	
Other one-off items(1)	**(30.4)**	(30.7)	(1.0)
Banking volatility(2)	**2.2**	(7.4)	
Statutory profit before taxation	**182.0**	67.6	169.2

Key performance indicators

Operational (explained in the context of our strategy on page 7)			
Mortgage gross new lending (£ million)	**6,592.5**	4,831.3	36.5%
Share of new personal bank account gross flow(3)	**6.4%**	6.8%	(0.4)pp
Customer advocacy – Net Promoter Score (NPS)(4)	**23**	16	7
Financial			
Loan to deposit ratio	**100.1%**	102.0%	(1.9)pp
Common Equity Tier 1 Capital ratio	**18.4%**	17.8%	0.6pp
Leverage ratio (fully loaded)	**4.8%**	5.2%	(0.4)pp
Group banking net interest margin(5)	**3.09%**	3.51%	(42)bps
Asset quality ratio (AQR)(6)	**0.31%**	0.37%	(6)bps

(1) Other one off items primarily reflect costs associated with restructuring the branch network.
(2) Banking volatility reflects gains and losses on derivatives, hedge accounting ineffectiveness, and volatility associated with share schemes.
(3) Source: CACI Current and Savings Account Market Database (CSDB) which includes current, packaged, youth, student and basic bank accounts, and new account openings excluding account upgrades. Data presented on a 2 month lag.
(4) NPS is based on the question "On a scale of 0-10, where 0 is not at all likely and 10 is extremely likely, how likely is it that you would recommend TSB to a friend or colleague?" NPS is the percentage of TSB customers who score 9-10 after subtracting the percentage who score 0-6. Calculated as a 12 month rolling average.
(5) Management basis net interest income divided by average loans and advances to customers, gross of impairment allowance.
(6) Impairment charge on loans and advances to customers divided by average loans and advances to customers, gross of impairment allowance.

Chief Executive Officer's statement

During 2016 TSB continued to deliver on its mission to bring more competition to UK banking. It's now three years since we set out to bring a different sort of banking to the UK – the sort of banking that customers tell us they want and we believe they deserve. In 2016 we continued to receive strong endorsement for our straightforward approach to local banking as TSB was voted Britain's most recommended high street bank,[1] we exceeded our target of attracting more than 6% of all new and switching bank accounts in the UK for the third year in a row, and we achieved the lending growth target we set ourselves at our 2014 IPO three years early.

Financial summary

Customer advocacy and trust in TSB has translated into strong balance sheet growth. During 2016 customer deposit balances increased by £3.5 billion (13.6%) to £29.4 billion. This provided funding to support one of our strategic pillars of helping more customers to borrow well, with total loan balances increasing by £3.0 billion (11.4%) to £29.4 billion – this was driven by a £4.0 billion increase in Franchise loan balances partially offset by a reduction in the Mortgage Enhancement and Whistletree portfolios of £1.0 billion. The success of our strategy is also evident in the strong profit growth in 2016. On a statutory basis, profit before taxation was £182.0 million, an increase of £114.4 million (169.2%) compared to 2015. This was primarily driven by three factors:

- an increase in profits earned by the Franchise business of £24.3 million (60.3%) to £64.6 million reflecting, amongst other things, the success of the TSB mortgage broker service in generating growth in the mortgage portfolio;
- a £64.7 million increase in profits from the Whistletree portfolio, which reflects a full year of earnings following the portfolio's acquisition in December 2015; and
- a £32.5 million non-recurring gain on the sale of our share in Visa Europe following its acquisition by Visa Inc.

Partially offsetting these increases, profit before taxation from the Mortgage Enhancement portfolio decreased by £17.0 million, reflecting the expected repayment of loans in this closed portfolio. On a management basis, which excludes certain items of a one-off nature, such as the gain on the disposal of our Visa Europe share, profit before taxation increased by 68.1% to £177.7 million. This is the basis of presentation used by management to assess the underlying performance of the business.

Our growth strategy

Since launching TSB back on to high streets across Britain just over three years ago in September 2013, our three strategic pillars have remained the same: to provide great banking to more people; to help more people borrow well with TSB; and to provide the kind of banking people tell us they want and we believe they deserve.

During 2016, we made significant progress on all three as summarised below and as explained further in the context of Board approved key performance indicators on page 7.

Providing great banking to more people

When we relaunched TSB in September 2013 we set ourselves the aspiration to grow our market share of bank accounts by consistently attracting more than 6% of all new and switching bank accounts over a five year period. In 2016 we again exceeded our target, with 6.4% of all customers switching banks or opening a new account choosing TSB.

Helping more people to borrow well with TSB

In 2016 customer lending grew by 11.4% to £29.4 billion, meaning that in the third quarter we achieved our June 2014 IPO target of growing customer lending by 40% to 50% over a five year period, three years early. Growth in customer lending was supported by our mortgage offering with Franchise mortgage balances increasing by 21.0% to £22.9 billion. This growth was driven by the continued success of TSB's award winning mortgage broker service which delivered a 5 star service[2] for the second year, attracting £6.8 billion of applications and generating £5.1 billion of advances, 63.5% higher than in 2015. Following on from developments in 2015 to make personal unsecured loans available to non bank account customers through our branch network, we extended this offering through our digital channels from Q3 2016. Unsecured lending balances remained broadly flat year on year and represent an area of focus in 2017. Our ambitions to help more people borrow are evidenced by improvements in both the proportion of good quality lending and reductions in the volume and proportion of impaired exposures as outlined on pages 88 and 89 and are further supported by the average mortgage loan to value which remains low at 42%.

Providing the kind of banking experience people want and deserve

In 2016 we continued to invest in training, in our branch network and in our digital services with the aim of providing our customers with excellent levels of service however and wherever they choose to bank with us. We were delighted to launch the first of our new, purpose-built, flagship branches in Birmingham and Aberdeen towards the end of 2016. The results of these investments continue to be recognised. Customers are more willing than ever before to recommend TSB to friends and family with the Bank's Net Promoter Score, our measure of advocacy, increasing to 23 from 16 at the start of the year. Independent research company, BDRC, confirmed TSB as Britain's Most Recommended High Street Bank for 2016 while, in KPMG Nunwood's UK Customer Experience Excellence ranking, TSB climbed 84 places to become the highest ranked high street bank in the UK. While we are proud of our continued progress in 2016, there is more to be achieved in realising our ambitions to provide the kind of banking experience people want and we believe they deserve.

(1) Source: Independent benchmark study (covering all major banks) conducted by BDRC Continental; sample 15,000 UK consumers, March 2016.
(2) Source: TSB was awarded a 5 Star service award for mortgages at the Financial Advisor Services Awards 2016.

Chief Executive Officer's statement (continued)

Outlook – delivering through uncertainty

TSB remains one of the most strongly capitalised banks in the UK and, with a healthy liquidity reserve, is well positioned to weather economic uncertainty or shocks. While we continue to be confident in the strength of the UK economy, we are mindful of the challenges ahead. Most commentators predict that economic and market conditions are likely to remain uncertain for a range of reasons, including the UK's exit from the EU and as the form and impact of this takes time to become clear. Interest rates are also predicted to remain at historic low levels, placing pressure on net interest margins for all banks.

Whilst we expect to continue to grow TSB in a responsible and sustainable way during 2017, the prevailing low interest rates, the contractual increase of more than £100 million in outsourcing fees we pay to Lloyds Banking Group (LBG), and the continued roll-off of the Mortgage Enhancement and Whistletree portfolios will, we expect, lead to a significant reduction in our profit before tax in 2017.

Looking forward, TSB's ability to make banking better for all UK consumers will be accelerated as we continue to invest in migrating our banking platform (the 'IT Migration Programme') from the one provided by LBG to a new state-of-the-art platform designed and built with the help of our shareholder, Sabadell. The new platform should reduce TSB's costs considerably with an expectation that the increase in LBG outsourcing costs, referred to above, will be reversed in future years. The new platform will also provide opportunities for TSB to become more innovative and agile in responding to our customers' evolving banking requirements. We expect to unveil the new platform fully to our customers towards the end of 2017 but they will begin to experience it through the launch of our new mobile banking app in Q1 2017. This IT Migration Programme is, of course, of such scale and strategic importance that it does not come without delivery and operational risks, as described further on page 9. These risks are being overseen by the Audit Committee on behalf of the Board as described on page 34.

Helping local communities to thrive

In 2016 TSB reinforced its commitment to help local communities by announcing, in May 2016, a partnership with Trinity Mirror, Pride of Britain and Pride of Sport. These awards celebrate ordinary people who do extraordinary things for the benefit of their local communities. Further, our partners in branches and offices continued to work with a good cause or charity in their local community and, since the launch of our new communities strategy in February 2015, £1.35 million has been donated to over 900 local causes. In addition to these fundraising activities, TSB encourages partners to spend a day, when they would normally be working, in their community supporting a local good cause.

Bringing more competition to UK retail banking

Whilst we at TSB continue to do our bit to bring more competition to UK banking and ultimately make banking better for all UK consumers, we, alone, can't break the stranglehold the big banks have on the market. We continue to urge the competition authorities and policy makers to do their bit to bring the full force of competition to bear on the market. We continue to call for a market where:

- all bank customers know what they pay for the banking services they use – through the introduction of a standard format monthly bill;
- all customers, including overdraft users, are able to switch banks easily – through the introduction of a credit passport; and
- where all customers are aware of their right to switch banks – through the regular promotion of an enhanced switching service.

We believe the introduction of these simple measures will fundamentally improve competition and change the culture of UK banks to serve customers on their terms. TSB will continue to work closely with Government and regulators in an attempt to bring the full force of competition to bear on the UK banking market.

Conclusion

Our performance in 2016 provides clear evidence that TSB continues to deliver on its strategy of bringing more competition to UK banking. Central to the success of our strategy is our customer focus and the commitment and energy that our partners bring to serving our customers every day. I am proud that our partners' commitment to providing the highest standards of customer service has been widely recognised, with TSB rated as the best high street bank for customer service. I thank all our partners for their continued drive and passion.

Looking forward, TSB is well placed to continue to thrive despite a potentially uncertain economic environment. Our ability to bring better banking to UK consumers will be enhanced by the delivery of our new IT platform. We remain confident that TSB is an attractive long-term home for customers – and one that is increasingly distinct from other banks.

Paul Pester
Chief Executive Officer

How we make money – our business model

A transparent and straightforward local banking business model

At TSB we believe that bringing more competition to UK banking will ultimately make banking better for all UK consumers. We are doing this by building the sort of bank that customers have told us they want: a transparent and straightforward bank that supports local economic growth and helps local people help themselves. We call this 'Local Banking for Britain'.

Banking is based on the effective evaluation of risks, ensuring an appropriate return is earned for taking them. The overall level of risk we are willing to take, our 'risk appetite', is determined by our Board, and robust systems and practices are in place to support TSB Group operating in line with these predetermined parameters. This helps protect both our customers' and the shareholder's interests.

Our business model is simple

We use the funds from savings and bank account customers primarily to fund loans to personal and small business customers. The amount of income we earn from lending the funds exceeds the interest we pay on the deposits. We aim to preserve this margin and to manage the potential impact on income and reserves from changes in interest rates through the appropriate use of derivatives.

We subtract any charges including operating costs, impairment and tax expenses to arrive at our profit. The Board then decides whether this is used to pay dividends or reinvested in the business. The execution of this business model requires the taking of certain risks and we take actions to mitigate all of them.

Components of our Business model	Description	Further information	
		Review of our performance	Financial statements
Sources of funding	Money deposited by customers into their bank and savings accounts provides the majority of the funds we use to support lending to customers. We also raise funds from other sources, including wholesale funding markets and equity invested by the shareholder.	Page 15	Page 62
Loans	Funds deposited with TSB are used to support lending to customers who wish to borrow. A portion of funds are held in reserve, in the form of a liquidity portfolio, to meet any unexpected funding requirements.	Page 18	Page 66
Income	We earn income in the form of interest that we receive on the loans we make to customers and we pay interest to savings and bank account customers on the money they deposit with us. We also earn other income in the form of fees and charges for the provision of other banking services and commissions from the sale of certain products such as general insurance.	Page 20	Page 76
Charges	Running a bank with 5 million customers comes with overheads. Charges we incur include the costs of paying our 8,296 TSB partners, running our branches, investing in our business and paying for advertising and marketing. Occasionally, our customers are unable to repay the money they borrow from us; this is also a cost to the bank in the form of our impairment charge. Finally, TSB Group pays tax to Her Majesty's Revenue and Customs (HMRC).	Page 21	Page 78
Profits and returns to the shareholder	The Board reviews TSB Group's performance. It decides whether profits are put aside for future investment in the business, for protection against the uncertainties that TSB Group faces, or returned to the shareholder in the form of dividends. Currently, all returns are being reinvested in the business.	Page 22	Page 83

Our strategy and key performance indicators

Strategic priority	2016 performance	Key performance indicator

Provide great banking to more people

Strategic priority	2016 performance	Key performance indicator
Grow market share of bank accounts by consistently taking a greater than 6% share of gross flow over a five year period.	• TSB continued to exceed its 6% flow target, with 6.4% of all customers switching or opening a new account choosing TSB during 2016. • In addition to the strong performance of the Classic Plus account, more customers are choosing TSB for their savings. During 2016, deposits grew by 13.6% to £29.4 billion reflecting customers' continued trust in TSB.	**Share of personal bank account gross flow (%)[1]** **2016**: **6.4%** / **2015**: 6.8% **Share of PCA stock (%)** **2016**: **4.5%** / **2015**: 4.4%

Help more people borrow well

Strategic priority	2016 performance	Key performance indicator
Grow Franchise customer lending by 40% to 50% over a five year period from IPO.	• Balance sheet growth continues to remain strong with total customer lending balances up 11.4% to £29.4 billion in the year. • Mortgage gross lending continues to increase. The mortgage intermediary channel, launched in January 2015 continues to perform well and has seen £5.1 billion of mortgage loan completions advanced through this channel in 2016. • Franchise customer loan balances have increased by 18.8%, helping to achieve the target to grow customer balances by 40-50% within 5 years of the IPO, three years early. • Impaired loans as a percentage of gross loan balances improved to 0.47% at December 2016 compared with 0.60% a year earlier.	**Mortgages gross lending (£m)** **2016**: **6,592.5** / **2015**: 4,831.3 **Unsecured asset growth (£m)** **2016**: **36.0** / **2015**: (29.7)

Provide the kind of banking experience people want and deserve

Strategic priority	2016 performance	Key performance indicator
Deploy TSB's strong digital capability. Build greater consideration of the TSB brand. Deliver a differentiated customer experience through our partners.	• More customers continue to recommend TSB to friends and family with TSB Bank plc's (the Bank's) Net Promoter Score increasing by 7 points year on year to 23. • TSB was confirmed as Britain's most recommended high street bank for 2016 by independent research company BDRC. • TSB climbed 84 places in KPMG Nunwood's 2016 UK Customer Experience Excellence ranking – becoming the highest ranked high street bank in the UK. • During 2016, TSB announced a partnership with Trinity Mirror, Pride of Britain and Pride of Sport. The awards celebrate ordinary people who do extraordinary things and reinforces TSB's commitment to local communities. • During 2016, an IT Migration Programme commenced which is designed to support the exit from the existing banking platform, provided under a transitional outsourcing arrangement with LBG, to a new platform provided by Sabadell. The new platform is expected to present opportunities to develop and launch new products and services more quickly so that TSB Group can be more agile in responding to customers' evolving banking requirements.	**Customer advocacy (Net Promoter Score)[2]** **2016**: **23** / **2015**: 16 **Digital penetration of new PCA customers (%)** **2016**: **88.7** / **2015**: 85.4

(1) Source: CACI Current and Savings Account Market Database (CSDB) which includes current, packaged, youth, student and basic bank accounts, and new account openings excluding account upgrades. Data presented on a 2 month lag.
(2) NPS is based on the question "On a scale of 0-10, where 0 is not at all likely and 10 is extremely likely, how likely is it that you would recommend TSB to a friend or colleague?" NPS is the percentage of TSB customers who score 9-10 after subtracting the percentage who score 0-6. Calculated as a 12 month rolling average.

Risk management in TSB

TSB Group's business model and strategy requires a careful assessment and acceptance of a number of risks. A strong and robust approach to risk management exists which is designed to support business strategy, mitigate risks, and seeks to protect the interests of customers, partners, and our shareholder. There are five strategic and business drivers that provide the context for risk management in TSB Group.

Part of an international group, undertaking a major migration	TSB Group has been part of the Sabadell Group since June 2015, and work is progressing to migrate to the Sabadell banking platform.
Growing quickly in a challenging environment	TSB Group is a growing challenger bank with a clear strategy that leverages a transparent and straightforward business model.
Promote competition in the market	TSB Group's strategy is clear: to bring more competition to UK banking and provide a different kind of banking experience that customers want and deserve.
Reliant on a competitor for outsourced services	Information technology and associated banking services are supplied to TSB Group by LBG under Transitional Service Agreements (TSAs). This reliance should only hold until migration is completed in late 2017.
Running the bank	TSB Group faces risks that arise from the normal course of business. These risks could impact how TSB Group operates and potentially results in loss caused by inadequate or failed internal processes, people, or systems, or from external events.

As described in the Chief Executive Officer's statement, TSB Group has commenced an IT Migration Programme to migrate its banking platform to one provided by Sabadell. Given the size and scale of this Programme, the key risks associated with this Programme are considered in our review of principal risks and uncertainties below.

Risk culture

TSB Group's risk culture is aligned to its principle of partnership and delivering the right outcomes for customers and other stakeholders. The risk culture in TSB Group encourages all partners to be accountable for risk both in terms of what they do and how they do it. All partners in TSB Group are responsible for indentifying, assessing and managing risks within their area of responsibility, supported by clear escalation and reporting of risk to senior management and the Board. TSB Group's risk culture is supported by having the strong foundations of a clear risk strategy and risk appetite, effective governance structure and risk management frameworks, reinforced by TSB Group's approach to remuneration for all partners.

Risk appetite

TSB Group defines risk appetite as the amount and type of risk that it is prepared to accept or tolerate. Within each planning cycle, the Board approves TSB Group's risk appetite and strategy. Through clear and consistent communication, the Board aims to ensure that senior management operates within risk appetite through risk policies that either limit or, where appropriate, prohibit activities, relationships and situations that could be detrimental to the risk profile of TSB Group.

Risk management and governance

The risk management framework sets out TSB Group's approach to the management of risk. It sets the accountabilities for the management and control of risks, oversight activities and independent assurance. TSB Group's risk management activities are organised across three lines of defence. This is designed to enable accountabilities and responsibilities to be clearly understood and to establish independent oversight and assurance processes.

First line of defence: Functions that own and manage risks	As the first line of defence, operational business units and management have ownership and primary responsibility and accountability for directly assessing, controlling and mitigating risks. They establish controls to oversee compliance with TSB Group's policies and risk appetite.
Second line of defence: Function that controls and oversees risks	The second line of defence consists of TSB Group's Risk function. The Risk function monitors and facilitates the implementation of effective risk management policies and practices, and assists risk owners in reporting risk related information in TSB Group. The second line also provides independent oversight and challenge of risk decisions taken within the first line.
Third line of defence: Internal function that provides independent assurance	TSB Group's Internal Audit function forms the third line of defence and provides independent and objective assessment of the risk management activities of both the first and second lines. Internal Audit reports on the effectiveness of TSB Group's risk management activities to the Board and senior management.

Risk management in TSB (continued)

TSB Group's risk committees are responsible for providing oversight of the effectiveness of the risk management framework set out by the Board. Additionally, they monitor and challenge risk exposures and take appropriate action to monitor the acceptability of TSB Group's overall risk profile. All committees within the governance structure are responsible for ensuring that a risk and control environment is established within its area of authority, with clear reporting lines established through the Bank Executive Committee and the Board Risk Committee, and ultimately to the Board. Further information on TSB Group's committee governance is set out in the Corporate governance statement on pages 24 to 31.

Stress testing

TSB Group uses stress and scenario testing to assess and support the business strategy. This allows senior management and the Board to assess the impact of adverse scenarios and take appropriate management actions if required. Such testing includes stress tests for capital and liquidity regulatory submissions, the Internal Capital Adequacy Assessment Process (ICAAP), the Internal Liquidity Adequacy Assessment Process (ILAAP) and Recovery and Resolution planning. In addition, TSB Group's stress testing also covers adverse situations in the wider macroeconomic environment, market risk sensitivities, financial market disruption, and operational risks. TSB Group also conducts reverse stress tests which subject strategic plans to extreme events that may cause TSB Group to fail. All outputs are subject to a robust governance process prior to Board approval.

Indentifying material and emerging risks

The process to identify, measure and control risk is fully embedded in TSB Group's risk management framework. TSB Group is exposed to a number of material risks and uncertainties that arise from its business model and strategy.

The top risks and uncertainties faced by TSB Group reflect the five strategic and business model drivers outlined on the previous page. These are described in more detail below, along with steps TSB Group has taken to mitigate the impact of the risk.

<table>
<tr><th colspan="2">Part of an international group, undertaking a major migration</th></tr>
<tr><td>Migration risks;
Becoming an integrated part of Sabadell</td><td>As described in the Chief Executive Officer's statement, the IT Migration Programme to enable TSB to exit the existing IT and operational service arrangements provided by LBG and migrate to Sabadell's banking platform is a key strategic imperative which should reduce TSB's costs considerably and enable TSB to become more innovative and agile.

Key risks arising from such a large scale IT Migration Programme include potential impacts to customers and their banking experience, execution and delivery risks and the risk of diversion of management focus from other strategic initiatives to focus on the delivery of the IT Migration Programme.

In mitigation, many partners in TSB Group and Sabadell are experienced in delivering large scale change and migration projects and are fully aware of the risks that arise in such projects.

A full cross-entity change and migration programme and governance structure has been established, with representatives from every part of TSB Group, to monitor and mitigate the risks and potential distractions that such a material change programme can have while delivering a growth strategy.

As described on page 37, the Audit Committee oversees the management of the IT Migration Programme risks and the internal controls and risk management systems adopted by the Programme.</td></tr>
</table>

Risk management in TSB (continued)

Growing quickly in a challenging environment	
Financial risks; Managing the balance sheet for sustainable growth	It is essential that TSB Group has a stable and diverse funding profile and retains sufficient liquidity to manage its financial risks. TSB Group's banking model is based on customer deposits as its primary source of funding to support lending activities and help more people to borrow well. To mitigate against potential funding shortfalls, TSB Group makes use of wholesale funding facilities, such as the issuance of debt securities backed by secured mortgages and the Bank of England's Term Funding Scheme (TFS), within the limits set in the Board approved risk appetite. TSB Group is funded and capitalised to support its strategy for organic growth and inorganic expansion. With continuing growth, regular stress testing forms part of the process which seeks to ensure that TSB Group remains adequately funded.
Lending risks; Helping more people to borrow well	TSB Group adopts decision making processes and systems geared to provide affordable lending, based on individual needs and circumstances at the time of application. This approach helps customers borrow well and limits the risks associated with non-repayment. To assist with this, TSB Group's risk appetite, which has been set for controlled growth, has measures and limits in place to act as a mechanism to prevent the bank and its customers from overreaching their ability to manage their borrowing. These measures include loan-to-income ratios, limits on interest only mortgage lending and maximum loan-to-value thresholds. Risk appetite metrics apply to all acquisition channels including the Mortgage Intermediary channel. For non-organic growth, such as the acquisition of the Whistletree assets in 2015, TSB Group undertakes a robust due diligence process. This helps establish that any potential acquisition of an existing lending portfolio conforms to TSB's appetite for risk and its overall risk profile. For all of its lending portfolios, TSB Group understands that occasionally customer circumstances change which could impact their ability to pay back borrowings. In these situations, TSB Group works with its customers to improve their position by offering various treatment strategies and support.
Market risks; Managing market risks	Market risk occurs in the form of a reduction or increase in earnings, value or reserves caused by changes in the prices of financial instruments and rates. In addition, market risk can arise as a result of changes in customer behaviour, which may affect the maturity profiles of TSB Group's assets and liabilities. TSB Group aims to optimise the value of its business by preserving its margins and managing market risk positions that arise through the natural course of business. TSB Group's primary market risk consists of exposure to changes in interest rates. This includes the risk that assets and liabilities have a maturity mismatch, or re-price at different times to each other, exposing TSB Group's earnings or reserves to fluctuations as interest rates vary. TSB Group is also exposed to the following types of interest rate risk: basis risk; bond spread risk; optionality risk arising from certain product features; behavioural risk; and margin compression. TSB Group holds derivative financial instruments in the normal course of its banking business for interest rate risk management and margin stabilisation purposes. The hedge effectiveness of these derivatives is monitored regularly.
Industry risks; Regulatory, structural and legislative	As a challenger bank operating in an ever-changing environment it is important for TSB Group to respond to industry developments in a way that doesn't adversely impact on its customers, strategy or partners. TSB Group regularly reviews and responds to future industry changes including technology advances, regulatory developments, and shifts in the political agenda. This includes developments such as the Senior Managers Regime and FCA Conduct Rules, the implementation of the Financial Services (Banking Reform) Act 2013, enhanced digital services such as mobile payment services and a new mobile application.

Risk management in TSB (continued)

Promoting competition	
Competition risks; Competing in a challenging environment	TSB Group operates in a challenging UK retail banking market and is fully aware of the competition it faces from other banks, large and small, and other financial services models such as peer-to-peer lending. TSB Group's ability to react and to lead in market developments is one of the major benefits of moving to the agile operating system offered by Sabadell. In due course, this will allow TSB Group to design, develop and deploy new products and services at a greater pace than it is currently able to.

Reliant on a competitor for outsourced services	
Supplier risk; Managing the contractual relationship with LBG	The main supplier, under the Transitional Services Agreement (TSA), to TSB Group for its IT platform and other banking services is a key competitor, LBG. The relationship between TSB Group and LBG is carefully managed through robust governance arrangements as specified in the TSA contracts. The completion of an agreement with a Sabadell Group company to provide the new IT platform to TSB Group will transition these outsourcing arrangements from a key competitor to a Sabadell Group company.

Running the bank	
Conduct and customer risks; Delivering fair outcomes for our customers	TSB Group's approach to conduct enables it to deliver the basics of banking whilst delivering compelling value propositions for customers that set it apart from the competition. To deliver this sustainably, TSB Group seeks to establish that good conduct and an appreciation of the conduct risks the bank faces underpin everything it does. To achieve this, TSB Group continually invests in the pre-requisites of good conduct: • having the right people; • doing the right things; • in the right way for our customers; and • continually assessing that we are achieving this aim. TSB Group's products, services and channels are designed, monitored and managed to provide value over time and to meet our customers' requirements. By holding to this approach and responding to the feedback we receive from customers, partners, regulators and wider industry commentators, TSB Group can both deliver fair outcomes for its customers and build sustainable value. TSB Group remains mindful of the risks to its customers posed by the IT Migration Programme and has taken the necessary steps to mitigate against these risks.
Financial and cyber-crime; Protecting TSB Group and its customers	TSB Group and its customers face continued threat from fraud and financial crime, whether from telephone scams, money laundering, or online from hacking or malicious emails. TSB Group takes seriously its duties to protect customers, partners and itself from fraud and financial crime, including cyber-crime. TSB Group partners regularly undertake an education and awareness programme with the aim that partners understand their roles and responsibilities. TSB Group monitor the threats faced by TSB Group and its customers, the methods used by criminals and how to report any suspicious activity. TSB Group makes use of robust technology to identify and prevent suspicious activity through the use of transaction monitoring systems and other prevention systems. In managing this risk, TSB Group is reliant on the robustness of its main IT service provider, LBG, particularly with regards to IT security and protection against cyber crime. TSB Group is committed to making customers' banking experience as safe as possible. Along with the steps outlined above, TSB Group also provides information and steps that customers can take themselves to stay safe, through an online Security Centre, which is available online at: http://www.tsb.co.uk/security/.

Risk management in TSB (continued)

Running the bank (continued)	
Operational risks; Managing the stability, resilience and capability of day-to-day banking activities	In its day to day business activities, TSB Group undertakes activities that create operational risk which could result in a loss. TSB Group uses a framework for managing its operational risk, with controls to prevent, detect and mitigate against the consequences of operational risk events. Examples of operational risks faced by TSB Group include: • IT systems: risk of cyber attacks, outages or other loss of resilience which leads to a disruption in day-to-day banking activities; • People: TSB Group faces a number of people risks which could impact on the day-to-day operation of services; • Change: not managing change to maintain a stable working and banking environment and failure to limit the impact on customers and partners during the change cycle; and • Third party suppliers: risk of service disruption caused by the failure of a third party supplier or service provider. TSB Group has processes and systems to respond quickly to customer issues arising from these risks. We regularly review the operational risks and any potential impact that they may have and we take action to mitigate and control them.

TSB Group also monitors emerging risks. These are new, unforeseen, or evolving risks where the probability and impact is uncertain. In assessing emerging risks, TSB Group considers the likelihood of the relevant risk materialising and the potential impact on its business strategy, customers, partners and shareholder, taking opinion from across the three lines of defence. TSB Group uses this assessment as part of the business planning process.

Evaluating emerging risks	
Strategic delivery risk	Operating in a competitive UK retail banking sector, with a low interest rate outlook, could impact TSB Group's growth strategy and objectives. With the support of a prudent risk appetite and governance processes, products and services continue to evolve to drive forward the growth agenda. This includes increased use of digital technology and improved online services.
Changes to UK regulatory, legislative and public policy	Due to the nature of the financial services industry, TSB Group faces a complex legal and regulatory environment. TSB Group monitors forthcoming legal and regulatory changes and continues to invest in its people and IT systems with the aim that standards are met and maintained. All legal and regulatory changes faced by TSB are managed through an effective governance and oversight framework.
Global trends	Political uncertainty could have an impact on TSB Group's business, customers and shareholder and this is continuously monitored to assess the potential impacts. Prolonged economic and political uncertainty following the Brexit vote could have an impact on TSB's strategy and customers. Risks associated with Brexit have been indentified and are controlled at a business level.
The UK leaving the European Union	TSB Group continues to monitor developments regarding the UK's withdrawal from the European Union. Potential impacts have been included in TSB Group's business planning and stress test scenarios.
FinTech and technological developments	The combined risks of FinTech and other technological advances are a threat to the traditional value chain and ways in which all banks currently operate and service customers. TSB Group carefully considers these risks in its business planning and, in parallel to migrating onto an agile banking platform, is exploring how it continues to bring more competition to UK banking as technology and traditional value chains evolve.
Cyber risk	Cyber risk continues to grow across all industry sectors as organisations take advantage of digital technologies. TSB Group protects against, and constantly monitors, emerging cyber risk to establish that robust controls exist in protecting our organisation, customers and partners.

Risk management in TSB (continued)

Going concern

The Directors recognise their responsibility to make an assessment of TSB Group's ability to continue as a going concern for a period of at least twelve months from the date the financial statements are approved. As noted on page 42, the Directors consider that it is appropriate to adopt the going concern basis in preparing the consolidated financial statements.

Viability statement

As more fully explained in the Corporate governance statement on page 24, the Directors consider that it is appropriate to voluntarily adopt the principles of the UK Corporate Governance Code issued by the Financial Reporting Council (FRC) which includes provisions that require the Directors to:

- carry out a robust assessment of the principal risks facing the company;
- explain how they have assessed the prospects of the company, over what period, and why they consider that period to be appropriate; and
- state whether they have a reasonable expectation that the Company and TSB Group will be able to continue in operation and meet their liabilities, taking account of their current position and principal risks, over this period.

Robust assessment of risks

The Chief Risk Officer presents a regular analysis of the principal risks arising from TSB Group's business model, strategy and the external economic and competitive environment to the Board Risk Committee. The Directors receive a regular report from the Chief Risk Officer to enable them to monitor the principal risks, and changes to them, in the context of the Board approved risk appetite. Further information on the principal risks and uncertainties are set out on pages 8 to 12.

Period of viability assessment

Guidance from the Financial Reporting Council states that the period assessed under the viability statement should be significantly longer than 12 months from the date of approval of the financial statements, which is the period over which going concern is assessed.

For TSB Group, the Directors have assessed viability to December 2020. The assessment has been made over this period as it is consistent with the period over which TSB Group's medium term strategic and financial plan is prepared, the period over which key capital and leverage ratios are forecast and the period over which regulatory and internal stress testing of these profit, capital and funding forecasts are carried out.

Approach to assessing viability and going concern

The Directors' assessment of viability is integrated into the existing approach to the going concern assessment. In making the viability assessment, the Directors have considered a wide range of information relating to present and future conditions, including future projections of profitability, capital requirements, capability, resources and funding. In addition, the Directors have assessed the top and emerging risks that could threaten TSB Group's future prospects and business model more broadly and the monitoring and mitigation activities around them.

Viability assessment

The viability assessment is based on TSB Group having sufficient liquidity and capital, and includes consideration of its funding and capital plans and the ILAAP and ICAAP approved by the Board and submitted to the Prudential Regulatory Authority (PRA). The Directors confirm that:

- they have carried out a robust assessment of the principal risks facing TSB Group, including those that would threaten its business model, future performance, solvency or liquidity; and
- in light of TSB Group's capital and funding resources (pages 15 to 17) they have a reasonable expectation that TSB Group will be able to continue in operation and meet its liabilities as they fall due in the period to December 2020.

Review of our performance in 2016

TSB Group's performance is presented on a statutory basis prepared using accounting policies described on page 56.

Review of performance in 2016
The review of our performance in 2016 is structured in a manner consistent with the key elements of TSB Group's business model explained on page 6.

Balance sheet, funding and capital

Business model component	Analysis	2016 £ million	2015 £ million
Customer deposits		**29,383.8**	25,874.2
Non customer funding		**4,763.0**	3,301.7
Funding resources		**34,146.8**	29,175.9
Shareholder's equity		**1,865.0**	1,746.3
Sources of funding	Page 15	**36,011.8**	30,922.2
Other liabilities		**1,183.9**	695.8
Total equity and liabilities		**37,195.7**	31,618.0
Loans and adv to customers	Page 18	**29,419.1**	26,398.1
Liquidity portfolio	Page 18	**5,571.4**	3,782.3
Other assets		**2,205.2**	1,437.6
Total assets		**37,195.7**	31,618.0
Loan to deposit ratio		**100.1%**	102.0%
Common Equity Tier 1 Capital ratio		**18.4%**	17.8%

Total sources of funding increased by £5.1 billion primarily driven by strong customer deposit net inflow as more customers trust TSB with their savings.

The increased funding supported TSB Group's strategic aim to help more people borrow well, funding a £3.0 billion increase in customer loan balances.

Income statement profitability (statutory basis)

		2016 £ million	2015 £ million
Net interest income	Page 20	**853.8**	765.3
Other income	Page 20	**150.2**	125.4
Operating expenses	Page 21	**(734.7)**	(740.8)
Impairment	Page 21	**(87.3)**	(82.3)
Statutory profit before tax		**182.0**	67.6
Taxation	Page 21	**(54.2)**	21.2
Statutory profit for the year		**127.8**	88.8

On a statutory basis, profit before tax increased by 169.2% to £182.0 million reflecting:

- the effect of the inclusion of a full year of earnings from the Whistletree Loans purchased in December 2015;
- increased net interest income from a larger and growing Franchise loan book; and
- the recognition of a one off gain of £32.5 million on the sale of TSB's Visa Europe share.

Segmental results
Profit performance is further analysed on a segmental basis, consistent with how TSB Group is organised, managed and reported internally.

The segmental results, as presented on a management basis, exclude certain volatile and one-off items which enables management to assess TSB Group's underlying financial performance.

By Segment	2016 £ million	2015 £ million
Franchise	**64.6**	40.3
Mortgage Enhancement	**46.2**	63.2
Whistletree Loans	**66.9**	2.2
Management profit before tax	**177.7**	105.7
Gain on sale of share in Visa Europe	**32.5**	–
Other one-off items	**(30.4)**	(30.7)
Banking volatility	**2.2**	(7.4)
Statutory profit before tax	**182.0**	67.6

Profit before tax, on a management basis, increased by 68.1% to £177.7 million, primarily driven by the inclusion of a full year of earnings from the Whistletree Loans purchased in December 2015.

The Segments reported internally are as follow:

- *Franchise* comprises the retail banking business carried out in the UK which offers a broad range of retail financial services including current accounts, savings products, personal loans, credit cards and mortgages.

- *Mortgage Enhancement* is a separate portfolio of mortgage assets which was assigned to TSB Group with effect from 28 February 2014. This segment was established in response to a review by the Office of Fair Trading of the effect on competition of the divestment of TSB and is designed to enhance TSB Group's profitability by over £230 million.

- *Whistletree Loans* is a separate portfolio of former Northern Rock mortgages and unsecured loans which was acquired with effect from 7 December 2015 and which at 31 December 2016 had total customer loan balances of £2.5 billion.

Sources of funding

Money deposited by customers into their bank and savings accounts provides the majority of the funds we use to support lending to customers. We also raise funds from other sources, including wholesale funding markets and equity invested by the shareholder.

	2016 £ million	2015 £ million	Change %
Customer deposits	**29,383.8**	25,874.2	13.6
Non-customer funding:			
Repurchase agreements	**1,409.6**	–	
Debt securities in issue	**2,940.1**	2,899.6	1.4
Subordinated liabilities	**413.3**	402.1	2.8
Non customer funding	**4,763.0**	3,301.7	44.3
Funding resources	**34,146.8**	29,175.9	17.0
Shareholder's equity	**1,865.0**	1,746.3	6.8
Total sources of funding	**36,011.8**	30,922.2	16.5

Sources of funding

Total sources of funding increased by 16.5% to £36.0 billion primarily reflecting a 13.6% increase in customer deposits. This growth reflected strong inflows in TSB's fixed and variable rate cash ISAs and continued growth in bank account balances. Bank account balance growth was supported by the ongoing success of the 'Classic Plus' account which contributed to TSB Group opening 6.4% of all new and switching personal banks accounts in the UK during 2016.

Non customer funding increased by 44.3% to £4,763.0 million reflecting the following developments:

- In March 2016 £750 million of funding was raised under an 18 month repurchase agreement facility collateralised using retained notes issued by Duncan Funding 2015-1 plc.
- In May 2016, TSB Group completed its second public residential mortgage backed securitisation (Duncan Funding 2016-1 plc). This securitised Franchise mortgages and raised £555.6 million, with £2,294.4 million of AAA/Aaa rated retained notes available to be used as security against future funding requirements.
- Partially offsetting these funding sources, the drawn balance from the Cape securitisation facility provided by Lloyds Bank plc reduced during 2016 by £441.0 million to £1,914.3 million. The balance of this facility is aligned to the outstanding balance on the Mortgage Enhancement portfolio. The reduction in the funding facility reflects the ongoing repayment of the outstanding loans balances.
- The £1.0 billion unsecured funding facility held by the Group from Sabadell expired on 31 December 2016. No amounts were drawn against this facility.

In addition, in August 2016, the Bank of England announced the Term Funding Scheme which provides four year term funding to banks at rates close to the Base Rate. TSB has joined the scheme and is able to access the funds when required.

Cost of funding resources

The cost of customer deposits remained constant at 0.66% in 2016 (2015: 0.66%). While average savings deposit costs also remained constant at 0.72% (2015: 0.72%), the cost of new fixed rate ISA deposits in 2016 increased reflecting a competitive market, offset by the lower cost of existing variable rate deposits following the Base Rate reduction in August 2016. Average bank account interest rates decreased from 0.54% to 0.53% due to growth in non-interest bearing balances.

Capital resources

The capital position of TSB Group remains strong with a Common Equity Tier 1 (CET1) Capital ratio of 18.4% and a leverage ratio of 4.8% and is sufficient to support the delivery of TSB Group's growth strategy. The movement in the year primarily reflects profits earned during 2016.

Sources of funding (continued)

Capital resources

	At 31 Dec 2016 £ million	At 31 Dec 2015 £ million
Shareholder's equity per balance sheet	**1,865.0**	1,746.3
Excess of expected losses over impairment provisions	**(73.5)**	(72.1)
Cash flow reserve regulatory adjustment	**(0.4)**	0.9
Prudent valuation prudential filter adjustment	**(3.1)**	(1.6)
Intangible assets	**(2.6)**	(1.0)
Common Equity Tier 1/Total Tier 1 capital (fully loaded*)	**1,785.4**	1,672.5
Tier 2 capital (fully loaded*)	**383.9**	383.5
Total capital resources (fully loaded*)	**2,169.3**	2,056.0
Risk-weighted assets	**9,681.7**	9,376.2
Common Equity Tier 1/Total Tier 1 capital ratio (fully loaded*)	**18.4%**	17.8%
Total Capital ratio (fully loaded*)	**22.4%**	21.9%

* TSB Group's capital is reported on a fully loaded basis. TSB Group's capital is compliant with Capital Requirements Regulation (CRR) and not subject to transitional adjustments.

The movements in CET 1/ Total Tier 1, Tier 2 and Total Capital in the year are shown below:

	CET 1/ Total Tier 1 £ million	Tier 2 £ million	Total resources £ million
At 31 December 2015	**1,672.5**	**383.5**	**2,056.0**
Profit attributable to ordinary shareholder	**127.8**	**–**	**127.8**
Change in excess of expected losses over impairment provisions	**(1.4)**	**–**	**(1.4)**
Change in excess of default provision over default expected loss	**–**	**(0.1)**	**(0.1)**
Movement in other comprehensive income	**(9.1)**	**–**	**(9.1)**
Movement in other reserves	**–**	**–**	**–**
Change in intangible assets	**(1.6)**	**–**	**(1.6)**
Movement in tier 2 subordinated liabilities	**–**	**0.5**	**0.5**
Cash flow hedging reserve regulatory adjustment	**(1.3)**	**–**	**(1.3)**
Movement in prudent valuation prudential filter adjustment	**(1.5)**	**–**	**(1.5)**
At 31 December 2016	**1,785.4**	**383.9**	**2,169.3**

CET 1/ Total Tier 1 capital increased by £112.9 million during 2016 primarily due to attributable profit of £127.8 million for the year. This increase was partly offset by a decrease in other comprehensive income of £9.1 million.

Risk-weighted assets (CRD IV)

	At 31 Dec 2016 £ million	At 31 Dec 2015 £ million
Risk type analysis of risk-weighted assets:		
Franchise standardised approach	**828.5**	828.4
Franchise IRB approach	**5,453.3**	4,913.4
Total Franchise	**6,281.8**	5,741.8
Mortgage Enhancement standardised approach	**654.2**	802.4
Whistletree Loans standardised approach	**1,131.3**	1,363.6
Total credit risk	**8,067.3**	7,907.8
Operational risk	**1,407.8**	1,416.4
Counterparty risk	**206.6**	52.0
Total risk-weighted assets	**9,681.7**	9,376.2

During 2016 RWAs increased by £305.5 million (3.3%) due to growth in TSB's Franchise Mortgage book and balances held with other institutions. This was partly offset by the expected decreases in the Mortgage Enhancement and Whistletree portfolios.

Sources of funding (continued)

Leverage ratio

The leverage ratio measure is defined as the ratio of Tier 1 capital to total exposure. This is intended to complement the risk based capital requirements with a simple, non-risk based 'backstop' measure. TSB Group calculates its leverage ratio based on the exposure measure in the revised Basel III leverage ratio framework published in January 2014 and adopted in the Capital Requirements Regulation (CRR) and the CRR definition of Tier 1. The Basel Committee has proposed that final adjustments to the definition and calibration of the leverage ratio are carried out in 2017, with a view to migrating to a Pillar 1 treatment in 2018. TSB Group continues to monitor Basel III developments and their adoption in the CRD IV framework.

	At 31 Dec 2016 £ million	At 31 Dec 2015 £ million
Total Tier 1 Capital for leverage ratio (fully loaded)	**1,785.4**	1,672.5
Exposures for leverage ratio		
Total statutory balance sheet assets	**37,195.7**	31,618.0
Removal of accounting value for derivatives	**(247.5)**	(90.5)
Exposure value for derivatives and securities financing transactions	**(80.7)**	(129.8)
Off-balance sheet	**798.3**	709.7
Other regulatory adjustments	**(79.6)**	(73.8)
Total exposures	**37,586.2**	32,033.6
Leverage ratio	**4.8%**	5.2%

The leverage ratio of 4.8% exceeds the Basel Committee's proposed minimum of 3%, applicable from 2018.

Loans

Funds deposited with TSB are used to support lending to customers who wish to borrow. A portion of funds are held in reserve, in the form of a liquidity portfolio, to meet any unexpected funding requirements.

Loans and advances to customers	2016 £ million	2015 £ million	Change %
Franchise - secured	**22,867.9**	18,904.9	21.0
Franchise - unsecured and business banking	**2,222.4**	2,214.5	0.4
Mortgage Enhancement	**1,848.9**	2,272.3	(18.6)
Whistletree Loans	**2,479.9**	3,006.4	(17.5)
Total loans and advances to customers	**29,419.1**	26,398.1	11.4
Liquidity portfolio			
Balances at central banks[(1)]	**3,473.1**	2,541.9	36.6
Gilts (available-for-sale)[(2)]	**1,872.8**	1,240.4	51.0
Supranational and development bank bonds (available-for-sale)	**225.5**	–	
Total liquidity portfolio	**5,571.4**	3,782.3	47.3

(1) Balances at central banks are combined with other cash balances and mandatory reserve deposits of £225.2 million (2015: £213.7 million) when shown on TSB Group's consolidated balance sheet on page 58.
(2) Of which £663.8 million (2015: £nil) were sold under repurchase agreements but not derecognised from TSB Group's consolidated balance sheet (see note 5 to the consolidated financial statements on page 64).

Loans and advances to customers

Loans to customers increased by 11.4% to £29.4 billion driven by strong growth in Franchise secured lending, partially offset by the ongoing and expected repayment of the Mortgage Enhancement and Whistletree Loans portfolios.

The growth in Franchise secured loans reflected the continued success of TSB's mortgage broker service where £6.8 billion of applications represented an increase of 23.4% on 2015.

Liquidity portfolio

The Group's liquidity portfolio comprises highly liquid assets, primarily cash deposits at the Bank of England, UK Gilts and supranational and development bank bonds available and immediately accessible to meet potential cash outflows. The liquidity portfolio increased by 47.3% to £5.6 billion at December 2016 driven by increased funding provided by the growth of customer deposits in excess of the increase in lending to customers during 2016.

TSB Group's liquidity position is managed centrally by TSB Group's Treasury function and is available for deployment at immediate notice, subject to complying with regulatory requirements, and is a key component of TSB Group's liquidity management process. A key regulatory measure of liquidity adequacy is the Liquidity Coverage Ratio (LCR). This is designed to promote the short term resilience of TSB Bank's liquidity risk profile and is regularly monitored and forecast alongside other cash flow and liquidity ratios. At 31 December 2016, the LCR was 171.0% (2015: 145.2%). This compares to the minimum regulatory requirement of 80% set by the PRA, which will increase to 100% from 1 January 2018.

Interest rates earned on loans

In 2016, the average rate earned on Franchise loans reduced from 3.76% to 3.45%. This was due to the greater proportion of mortgages relative to higher margin unsecured loans, the impact of competition which continued to weigh on new business and refinance rates, and the reduction in variable and tracker rates following the reduction in Base Rate during 2016. The average rate earned on Franchise mortgages reduced from 2.70% to 2.64%. Lower rates were earned on the fixed rate portion of the portfolio reflecting lower funding costs and increased competition in the market. Yields on unsecured lending decreased from 12.21% to 11.34% reflecting growth in 0% balance transfer promotional offers and competition within the unsecured lending market.

Loans (continued)

TSB Group manages the quantity of assets that have been used to support wholesale funding activities. The table below summarises the extent to which assets have been encumbered. The increase in amounts encumbered with counterparties other than central banks during 2016 reflects issuance of further TSB Group securitisation programmes.

Encumbered assets

		Other Assets				
		Assets positioned at	Assets not positioned at central banks			
	Assets encumbered with counterparties other than central banks £ million	central banks (pre-positioned plus encumbered) £ million	Readily available for encumbrance £ million	Capable of being encumbered £ million	Unencumbered-cannot be used £ million	Total Assets
Cash and balances with central banks	**–**	**3,524.1**	**–**	**–**	**174.2**	**3,698.3**
Loans and advances to credit institutions	**550.0** (1)	**–**	**–**	**–**	**0.4**	**550.4**
Loans and advances to customers	**4,243.8** (2)	**7,766.6**	**2,851.8**	**12,712.4**	**1,844.5**	**29,419.1**
Available-for-sale financial assets	**663.8** (3)	**–**	**1,434.5**	**–**	**5.2**	**2,103.5**
Other assets – cash collateral	**557.0** (4)	**–**	**–**	**–**	**867.4**	**1,424.4**
Total – December 2016	**6,014.6**	**11,290.7**	**4,286.3**	**12,712.4**	**2,891.7**	**37,195.7**
Total – December 2015	3,777.0	11,717.2	2,694.1	10,303.9	3,125.8	31,618.0

(1) Cash held on deposit by the securitisation subsidiaries (Cape Funding No.1 plc, Duncan Funding 2015-1 plc and Duncan Funding 2016-1 plc) and deposits secured due to market transactions.
(2) Mortgage loans encumbered in support of external securitisation notes issued by Cape Funding No.1 plc, Duncan Funding 2015-1 plc and Duncan Funding 2016-1 plc and mortgage loans supporting retained issuance under Duncan Funding 2015-1 plc sold under repurchase agreements.
(3) Gilts sold under repurchase agreements.
(4) Cash collateral placed with counterparties in respect of TSB Group's derivative financial liabilities.

Income

We earn income in the form of interest that we receive on the loans we make to customers and we pay interest to savings and bank account customers on the money they deposit with us. We also earn other income in the form of fees and charges for the provision of other banking services and commissions from the sale of certain products such as general insurance.

Net interest income

	2016 £ million	2015 £ million	Change %
Franchise	**737.0**	704.3	4.6
Mortgage Enhancement	**52.5**	73.7	(28.8)
Whistletree Loans	**77.3**	3.3	
Management basis net interest income	**866.8**	781.3	10.9
Net interest income on derivatives not in hedge relationships*	**(13.0)**	(16.0)	(18.8)
Statutory net interest income	**853.8**	765.3	11.6

* Included in Management basis net interest income but is recognised in other income for statutory purposes.

Segmental margins	2016 %	2015 %	Change Bps
Group banking net interest margin	**3.09%**	3.51%	(42)bps
Franchise banking net interest margin	**3.17%**	3.61%	(44)bps
Mortgage Enhancement banking net interest margin	**2.56%**	2.90%	(34)bps
Whistletree banking net interest margin	**2.82%**	–	282bps

Net interest income increased by 11.6% to £853.8 million, primarily reflecting a full year of interest earned on the Whistletree Loans and higher earnings due to the growth in the Franchise segment.

The increase in Franchise net interest income was predominantly driven by the 21.0% growth in mortgage balances reflecting the success of TSB Group's mortgage broker service. However this was partially offset by a 44bps reduction in net interest margin, due to lower swap rates following the UK's decision to leave the EU and the subsequent Bank of England rate reduction to 0.25%, combined with increased competition in unsecured lending driving down yields.

Mortgage Enhancement net interest income decreased by 28.8% primarily due to the ongoing and expected repayment of balances on this closed book.

Other income

	2016 £ million	2015 £ million	Change %
Franchise	**114.2**	129.7	(12.0)
Mortgage Enhancement	**(6.3)**	(10.4)	39.4
Whistletree Loans	**(5.9)**	(1.1)	
Management basis other income	**102.0**	118.2	(13.7)
Net interest income on derivatives not in hedge relationships*	**13.0**	16.0	(18.8)
Gain on sale of share in Visa Europe	**32.5**	–	
Banking volatility	**1.7**	(8.8)	
Other one off items	**1.0**	–	
Statutory other income	**150.2**	125.4	19.8

* Included in Management basis net interest income but is recognised in other income for statutory purposes.

Other income increased by 19.8% to £150.2 million reflecting the recognition of a one-off gain of £32.5 million from the sale of TSB Group's share in Visa Europe.

Excluding the gain on the sale of TSB Group's share in Visa Europe, banking volatility and other one off items, comprising gains on the disposal of properties associated with the restructuring of the branch network, management basis other income decreased by 13.7% to £102.0 million reflecting the previously reported effect of market reforms to interchange fee income and the introduction of 'cash back' on contactless payments on the Classic Plus current account, introduced in 2016.

Charges

Running a bank with 5 million customers comes with overheads. Charges we incur include the costs of paying our TSB partners, running our branches, investing in our business and paying for advertising and marketing. Occasionally, our customers are unable to repay the money they borrow from us; this is also a cost to the bank in the form of our impairment charge. Finally, TSB Group pays tax to Her Majesty's Revenue and Customs (HMRC).

Operating expenses

	2016 £ million	2015 £ million	Change %
TSB partner related costs	**353.2**	343.4	2.9
Regulatory and professional costs	**26.0**	36.2	(28.2)
Operational and IT costs	**37.5**	30.9	21.4
Marketing costs	**57.1**	54.7	4.4
Property costs	**95.1**	95.6	(0.5)
Investment costs	**33.5**	56.7	(40.9)
Transitional Service Agreement (TSA) costs	**91.8**	85.4	7.5
Other	**9.6**	8.6	11.6
Management basis operating expenses excluding one off items	**703.8**	711.5	(1.1)
Other one-off items	**31.4**	30.8	1.9
Banking volatility	**(0.5)**	(1.5)	
Statutory operating expenses	**734.7**	740.8	(0.8)

Operating expenses were broadly unchanged at £734.7 million reflecting the ongoing strategic focus on cost management. The key developments in 2016 were:

- Regulatory and professional costs decreased by £10.2 million reflecting a lower market-wide cost for the FSCS levy.
- Investment expenditure decreased by £23.2 million as TSB Group scaled back on projects to prioritise migration activity.
- Partially offsetting these decreases, operational and IT costs increased by £6.6 million and the TSA charge from LBG increased by £6.4 million due to inflation, increased business volumes and a reduction in contractual discounts.
- Costs considered to be of a one-off nature and excluded from the internally reported management basis results remained stable at £31.4 million and primarily reflected costs associated with restructuring the branch network.

Impairment charge

	2016 £ million	2015 £ million	Change %
Mortgages	**7.5**	2.0	275.0
Personal unsecured	**74.7**	79.0	(5.4)
Business banking	**0.6**	1.2	(50.0)
Total Franchise	**82.8**	82.2	0.7
Mortgage Enhancement	–	0.1	
Whistletree Loans	**4.5**	–	
Total impairment charge	**87.3**	82.3	6.1
Asset quality ratio	**0.31%**	0.37%	(6)bps

The impairment charge increased by 6.1% to £87.3 million primarily reflecting the impact of a full year of impairment losses incurred in the Whistletree Loans portfolio. The Franchise personal unsecured portfolio decreased by 5.4% due in part to sustained favourable economic conditions. This was partially offset by an increase in the secured impairment charge during 2016 increasing provision coverage levels.

Taxation

The tax charge of £54.2 million (2015: tax credit of £21.2 million) reflects an effective tax rate of 29.8%. This is slightly higher than the applied UK corporation tax rate of 28% in 2016 and is primarily driven by the non deductibility of certain costs, including property and restructuring costs. The applied tax rate of 28% comprises the 20% average UK corporation tax rate and the 8% bank surcharge applicable on taxable profits in excess of £25 million from January 2016.

The tax credit in 2015 reflects the net effect on the carrying value of deferred tax assets from changes to UK corporation tax rates substantively enacted last year and temporary differences arising following HMRC's determination of the tax transfer value of the Mortgage Enhancement portfolio. Excluding these items, the effective tax rate in 2015 was 26.2%. This was higher than the average UK corporation tax rate of 20.25% in 2015, reflecting the non deductibility of Sabadell transaction related and other costs.

A reconciliation of the tax charge to that which would have resulted from using the UK corporation tax rate is set out in note 19 to the consolidated financial statements.

Profits and returns to the shareholder

The Board reviews TSB Group's performance. It decides whether profits are put aside for future investment in the business, for protection against the uncertainties that TSB Group faces, or returned to the shareholder in the form of dividends. Currently all returns are being reinvested in the business.

TSB Group's Executive Committee and Board review the results and consider performance across three segments: Franchise; Mortgage Enhancement; and Whistletree Loans.

Year ended 31 December 2016	Franchise £ million	Mortgage Enhancement £ million	Whistletree Loans £ million	Total £ million
Net interest income	**737.0**	**52.5**	**77.3**	**866.8**
Other income/(expense)	**114.2**	**(6.3)**	**(5.9)**	**102.0**
Total income	**851.2**	**46.2**	**71.4**	**968.8**
Operating expenses	**(703.8)**	–	–	**(703.8)**
Impairment	**(82.8)**	–	**(4.5)**	**(87.3)**
Management basis profit before taxation (excluding one off items)	**64.6**	**46.2**	**66.9**	**177.7**
Gain on sale of share in Visa Europe				**32.5**
Other one-off items				**(30.4)**
Banking volatility				**2.2**
Statutory profit before taxation				**182.0**
Year ended 31 December 2015				
Net interest income	704.3	73.7	3.3	781.3
Other income/(expense)	129.7	(10.4)	(1.1)	118.2
Total income	834.0	63.3	2.2	899.5
Operating expenses	(711.5)	–	–	(711.5)
Impairment	(82.2)	(0.1)	–	(82.3)
Management basis profit before taxation	40.3	63.2	2.2	105.7
One-off items				(30.7)
Banking volatility				(7.4)
Statutory profit before taxation				67.6

Key balance sheet items at 31 December 2016	£ million	£ million	£ million	£ million
Loans and advances to customers	**25,090.3**	**1,848.9**	**2,479.9**	**29,419.1**
Customer deposits	**29,383.8**	–	–	**29,383.8**
Key balance sheet items at 31 December 2015				
Loans and advances to customers	21,119.4	2,272.3	3,006.4	26,398.1
Customer deposits	25,874.2	–	–	25,874.2

Franchise management basis profit before taxation increased by 60.3% to £64.6 million during 2016 as a result of strong secured lending performance through our broker service and ongoing focus on cost management.

Mortgage Enhancement management basis profit before taxation decreased by 26.9% to £46.2 million due to the expected run-off of this mortgage portfolio. The Whistletree Loans segment has had a full year of income statement impact following its transfer in December 2015 resulting in a contribution to management basis before tax of £66.9 million.

Other one off items excluded from the management basis results of £30.4 million (2015: £30.7 million) primarily reflect costs associated with restructuring the branch network and in 2015 included Sabadell transaction related costs.

Strategic report on pages 3 to 22 approved, by order of the Board:

Susan Crichton
Company Secretary, 25 January 2017

Corporate governance statement

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How the business is managed

The design and operation of a robust Corporate Governance Framework appropriate for a bank of TSB's scale and ambition is critical to meeting the needs of all our stakeholders. The Corporate Governance Framework encompasses TSB Banking Group plc (the Company), TSB Bank plc (the Bank) and any other subsidiaries of the Company from time to time (together TSB Group or TSB). Each Director of the Company also serves as a Director of the Bank. Will Samuel is the Chairman of the Boards of both the Company and the Bank. The Board of the Company (the Board) as a whole is collectively responsible to the shareholder for promoting the long term success of the Company by directing the Company's affairs. The Corporate Governance Framework is designed to assist the Board, the Board of the Bank and the Chief Executive Officer in discharging their duties by ensuring an appropriate scheme of delegation. This is achieved through:

- Board authorities which set out the basis for delegation of authorities from the Board and the Board of the Bank to Board committees and to the Chief Executive Officer; and
- Delegated executive authorities through which the Chief Executive Officer delegates aspects of his own authority to other senior executives and sets out the support provided to him by the Executive Committees.

The corporate governance structure is supported by the Internal Control and Governance Framework as outlined on page 30. An important principle, applied throughout the Company's governance framework, is that the delegation of executive authority is to the individual office holders (who may in turn delegate aspects of their authority to others). Executive Committees may be established to support the individuals in exercising their delegated authorities but the committees do not separately hold any delegated authority in their own right. This approach of individual accountability is aligned to the principles of the Senior Managers' Regime, which was fully implemented by TSB during the course of 2016.

Whilst the Bank continues to operate as a ring-fenced UK bank it is also part of a wider group (the Sabadell Group) and is required to adhere to relevant Sabadell Group policies, in addition to any relevant obligations imposed by Sabadell Group's regulators, the Bank of Spain and the European Central Bank.

To assist with this Sabadell operates three information sharing and co-ordination committees which seek to ensure that TSB Group policies and processes are aligned to those of the Sabadell Group where it is appropriate to do so. Certain members of the Bank Executive Committee are also appointed as members of these committees.

Although the Company no longer has shares with a premium listing on the London Stock Exchange, the Board has committed to voluntarily adopt the principles of the UK Corporate Governance Code 2016 (the Code), where it is appropriate to do so as a wholly owned subsidiary of Sabadell. A copy of the Code is available at www.frc.org.uk.

The following aspects of the Code are not considered appropriate for TSB:

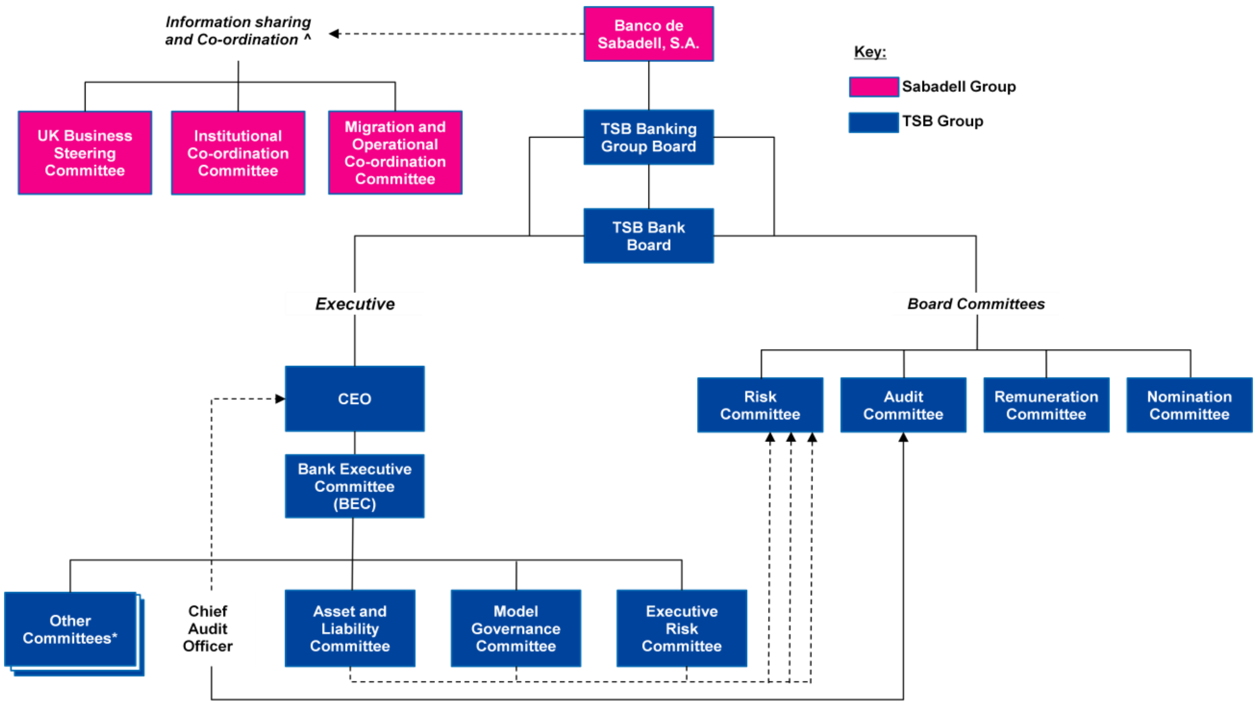
- All Directors should be subject to annual election by shareholders (B.7.1 and B.7.2).
- Provisions relating to the proportion of Independent Non-executive Directors who are members of the Nomination, Audit and Remuneration Committees (B.2.1 / C.3.1 / D.2.1).
- Provisions relating to dialogue with shareholders (E.1) and constructive use of General Meetings (E.2).

In addition, Directors appointed at the nomination of Sabadell have not been appointed for a specified term as recommended by the Code (B.2.3). Finally, until the appointment of Graeme Hardie on 19 October 2016 as an additional Independent Non-executive Director, less than half the Board (excluding the Chairman) was comprised of Non-executive Directors considered by the Board to be independent. From the date of Graeme Hardie's appointment, the composition of the Board is aligned with the Code (B.1.2).

How the business is managed (continued)

The Corporate Governance Framework is reviewed at least annually by the Board to establish that governance arrangements are and remain effective.

The Company is a wholly owned subsidiary of Sabadell. The diagram below sets out the framework of Board and Executive Committees.



^ The information sharing and co-ordination committees are Sabadell Group Committees. Membership of these committees includes TSB Group Executives.

* Product Pricing Committee, Executive Product and Sales Process Governance Committee, Spend Wise Committee, Disclosure Committee, and Credit Risk Committee.

The role and responsibility of the Board

The Board's full responsibilities are set out in the matters reserved for the Board which are summarised below.

(i) Strategy

- Approving TSB Group's strategy and long term objectives and ensuring that rigorous and robust processes are in place to monitor organisational compliance with the agreed strategy and risk appetite and in accordance with all applicable laws and regulations;
- Determining Board structure, size and composition for the Company and Bank, succession planning for members of the Company and Bank Boards and committees, determining the roles of Chairman, Senior Independent Director, Non-executive Directors, Chief Executive Officer and Executive Directors;
- Approving the high level framework of Board delegations;
- Approving TSB Group principles and high level governance and health, safety and fire policies and noting funding, liquidity and accounting policies;
- Approving new TSB Group contracts where the cost impact exceeds £10 million and renewal of existing contracts where the cost impact exceeds £20 million;
- Approving the acquisition or disposal of assets by the Company or any subsidiary of the Company, where the consideration exceeds £10 million; and
- Approving material changes to TSB Group corporate and organisational structure, including changes to the Company's listing status or its status as a plc.

How the business is managed (continued)

(ii) Risk

- Approval of the TSB Group's strategy and long term objectives and review of delivery of that strategy;
- Ensuring that rigorous and robust processes are in place to monitor organisational compliance with the agreed strategy and risk appetite and with all applicable laws and regulations; and
- Reviewing the effectiveness of the Company's and Bank's risk management and internal control systems.

(iii) Shareholder communications

- Approving financial statements and annual report and accounts;
- Approving TSB Group's dividend policy; and
- Approving the resolutions and associated documentation for the shareholder at a general meeting.

In accordance with the Company's articles of association, Sabadell is empowered to determine that certain matters reserved to the Board of the Company also require approval by Sabadell.

Role of Directors

There is a clear division of responsibility between the Chairman and Chief Executive Officer, approved by the Board.

(i) Chairman

The Chairman is responsible for leadership of the Board and Bank Board and is pivotal in creating the conditions for overall Board and individual Director effectiveness. The Chairman's key accountabilities are as follows:

- Building an effective Board with complementary skills and experience;
- Running the Board and setting its agenda;
- Ensuring the Board members receive accurate, timely and clear information;
- Managing the Board and encouraging a culture of openness and debate;
- Ensuring effective communication with the shareholder;
- Encouraging active engagement by all Board members;
- Holding meetings with the Non-executive Directors without the Executive Directors present;
- Demonstrating effective leadership; and
- Upholding the highest standards of integrity, probity and corporate governance.

(ii) Chief Executive Officer

The Chief Executive Officer is responsible for running the business and has the following key responsibilities and accountabilities:

- Leading the formulation of TSB Group's strategy;
- Co-ordinating activities to implement strategy and for managing the business in accordance with TSB Group's risk appetite and business plan approved by the Board;
- Making decisions in all matters affecting the operations, performance and strategy of the business, with the exception of those matters reserved to the Board or specifically delegated by the Board to its committees;
- Establishing, maintaining and implementing the risk management and funding and liquidity frameworks in line with Board approved risk appetite;
- The continuing review of the organisational structure of TSB Group and recommendations for changes to optimise the adequacy and use of resources; and
- Setting the tone at the top in relation to culture, ethos and corporate social responsibility.

Other than matters expressly reserved to the Chief Executive Officer, authority can be delegated to the respective Functional Heads (Bank Executive Committee members), jointly or severally.

(iii) Non-executive Directors

The role of the Non-executive Directors includes the following key elements:

- Providing constructive challenge to management and helping to develop strategy;
- Scrutinising the performance of management in meeting agreed goals and objectives and monitoring the reporting of performance;
- Satisfying themselves on the integrity of financial information and that financial controls and risk management systems are robust and defensible; and
- Determining appropriate levels of remuneration for Executive Directors and having a prime role in appointing and, where necessary, removing Executive Directors and in succession planning.

How the business is managed (continued)

(iv) Senior Independent Director

The Senior Independent Director's role is defined as follows:

- Acting as a sounding board for the Chairman and to serve as an intermediary for the other Directors when necessary;
- Being available to the shareholder if it has concerns which cannot otherwise be resolved;
- Chairing meetings in the absence of the Chairman; and
- Reviewing the Chairman's performance.

Board membership and composition

As at the date of this report the Board has nine members and is comprised as follows:

Non-executive Chairman:	Will Samuel (independent on appointment)
Executive Directors:	
Chief Executive Officer	Paul Pester
Chief Financial Officer	Ralph Coates
Independent Non-executive Directors:	Dame Sandra Dawson (Senior Independent Director)
	Graeme Hardie
	Sandy Kinney
	Polly Williams
Non-executive Directors:	Miquel Montes
	Tomás Varela

Full biographical details including their skills and experience are shown on pages 50 to 53. The letters of appointment for Non-executive Directors are available at the Company's registered office.

Ralph Coates joined the Board as Chief Financial Officer on 1 July 2016. Graeme Hardie joined the Board as an Independent Non-executive Director on 19 October 2016.

Board Committees

Certain responsibilities of the Board and Board of the Bank are delegated to committees of the Board to assist the Board and Board of the Bank in carrying out their functions. The Risk Committee (chaired by Sandy Kinney) oversees the management of the risks TSB Group faces, the Audit Committee (chaired by Polly Williams) oversees financial reporting and internal control, the Nomination Committee (chaired by Will Samuel) leads the process for appointments to the Board, and succession planning for the Board and Bank Executive Committee, and the Remuneration Committee (chaired by Dame Sandra Dawson), formulates TSB Group Remuneration Policy and supports the ongoing delivery of sustainable performance. The Audit and Nomination Committees have each prepared reports which include a full discussion on their role, structure and composition. Each of the Board Committee's terms of reference are available at www.tsb.co.uk.

How the business is managed (continued)

Meeting attendance

The table below sets out the attendance of Directors at Board meetings and the attendance of Committee members at the relevant Committee meetings during the year.

Name of Director	Board meetings attended	Audit Committee meetings attended	Risk Committee meetings attended	Nomination Committee meetings attended	Remuneration Committee meetings attended
Number of meetings held	**15**	**8**	**6**	**5**	**9**
Will Samuel	15 out of 15	-	-	5 out of 5	-
Paul Pester (iii)	14 out of 15	-	-	-	-
Darren Pope (i) (iii)	7 out of 8	-	-	-	-
Ralph Coates (ii)	7 out of 7	-	-	-	-
Dame Sandra Dawson (iii)	14 out of 15	-	-	5 out of 5	9 out of 9
Graeme Hardie (iii) (iv)	2 out of 2	1 out of 2	1 out of 1	-	-
Sandy Kinney (iii)	14 out of 15	8 out of 8	6 out of 6	-	-
Polly Williams (iii)	12 out of 15	8 out of 8	6 out of 6	-	9 out of 9
Miquel Montes (iii)	15 out of 15	-	-	5 out of 5	8 out of 9
Tomás Varela	15 out of 15	8 out of 8	6 out of 6	-	-

(i) Resigned from the Board on 1 July 2016.
(ii) Appointed to the Board on 1 July 2016.
(iii) Directors not able to attend meetings due to longstanding prior commitments or illness, provided comments to the relevant Chair on matters to be discussed at the relevant meeting.
(iv) Appointed to the Board on 19 October 2016.

Board development

Graeme Hardie will complete a comprehensive induction programme following his appointment to the Board as an Independent Non-executive Director. Additionally, Non-executive Directors are given the opportunity to request additional training in order that they are fully comfortable with their role within the Board and to enable them to be able to contribute to the operation of the Board and the long-term success of the Company in the fullest manner possible.

In addition, 'deep-dive' educational sessions are regularly held to allow Non-executive Directors to explore key strategic and risk issues outside of the time constraints of a formal Board meeting. A number of such sessions, run by relevant members of the Bank Executive Committee, were held during 2016 and covered topics including the Market Abuse Regulations, Information and Cyber Security, Secured and Unsecured Portfolio Risks, and Property Risk. The Company Secretarial team, on behalf of the Chairman, maintains a schedule of all external training sessions and conferences attended by the Directors during the year.

How the business is managed (continued)

Board effectiveness

The review of Board effectiveness for 2016 was run internally by way of a self-assessment questionnaire. It was led by Dame Sandra Dawson in her role as Senior Independent Non-executive Director and managed by the Company Secretarial team. The questionnaire was circulated to the Board together with selected members of the executive team who regularly attend Board meetings. The questionnaire required qualitative rather than quantitative responses to bring a richness to the evaluation. The Company Secretarial team analysed responses and judged them using a rating system aligned to the Company's wider partner performance framework. The results of the review concluded that the Board's performance continued to be effective, whilst identifying areas where it could be developed further.

The Board's Audit, Risk and Remuneration Committees have also conducted a review of their effectiveness during 2016. Each committee agreed a questionnaire which was circulated to committee members and other members of the executive team who regularly attend committee meetings. The results were analysed by the Company Secretarial team, discussed with the chair of the relevant Board committee and actions agreed by the committees for the coming year.

Independence

The Board has considered whether there are any relationships or circumstances which could appear to affect the Independent Non-executive Directors' judgement. No Independent Non-executive Director, or member of their immediate family, has ever had a material relationship with TSB Group nor receives additional remuneration apart from Director fees. The Independent Non-executive Directors do not participate in TSB Group's pension schemes nor do they participate in TSB Group's share schemes. No Independent Non-executive Directors serve as Directors of any companies or affiliates in which any other Director is also a Director. Miquel Montes and Tomás Varela are members of Sabadell's Executive Committee and for that reason are not considered to be independent. They do not receive any fees from TSB Group.

Management of conflicts of interest

Each Director has a duty under the Companies Act 2006 to avoid a situation in which they have, or may have, a direct or indirect interest that conflicts, or might conflict, with the interests of the Company. This duty is in addition to the existing duty that Directors owe to the Company to disclose to the Board any interest in a transaction or arrangement under consideration by the Company. If Directors become aware of any situation which may give rise to a conflict of interest they must inform the rest of the Board immediately and the Board is then permitted under the articles of association to authorise such conflict. This information is recorded in the Company's register of conflicts together with the date on which authorisation was given. In addition, Directors are asked to certify, on an annual basis, that the information contained in the register is correct.

Save as set out below in relation to Miquel Montes and Tomás Varela, there are no potential conflicts of interest between any duties owed by the Directors to the Company and their private interests or other duties.

As Executive members of Sabadell, Miquel Montes and Tomás Varela will have a conflict of interest in circumstances where the interests of TSB Group and the wider Sabadell Group are not, or may not be, aligned. This conflict was authorised by the Board on 22 July 2015.

How the business is managed (continued)

Reappointment of Directors

The Board considers that all Directors continue to be effective, committed to their roles and have sufficient time available to perform their duties. All Non-executive Directors, with the exception of Miquel Montes and Tomás Varela (being the Directors appointed at the nomination of Sabadell), have been appointed for an initial three year term and their continued appointment thereafter will be considered by the Board at the end of this initial period of office. As the Company is part of the Sabadell Group it is not considered necessary for Directors to seek annual re-election or for the Directors appointed at the nomination of Sabadell to be appointed for a specified term.

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Company Secretary and independent professional advice

The Company Secretary, Susan Crichton, is responsible to the Board for ensuring compliance with corporate governance requirements. The Board has access to her individually and collectively. As well as the support of the Company Secretary, any Director may take independent professional advice at the Company's expense in the furtherance of their duties, where considered necessary.

Evaluation of internal controls procedures

The Board has carried out an assessment of the effectiveness of the Company's risk management and internal control systems. The Audit Committee report explains the process in more detail on page 36.

External auditor

PricewaterhouseCoopers LLP (PwC) have expressed their willingness to continue as the Company's auditor. As outlined in the Audit Committee report on page 38, resolutions proposing their reappointment for 2017 and to authorise the Directors to determine their remuneration will be proposed at the 2017 Annual General Meeting, as recommended by the Audit Committee.

Principal accountant fees and services

An analysis of fees for professional services provided by PwC, the Company's external auditor is set out in note 16 to TSB Group's consolidated financial statements on page 79.

Internal Control and Governance Framework

An explanation of the Bank Executive Committee and its sub-committees is set out below.

(i) Bank Executive Committee

Chaired by the Chief Executive Officer, the Bank Executive Committee is TSB Group's principal executive committee. The Bank Executive Committee collectively supports the Chief Executive Officer in developing and implementing TSB Group's strategy, monitoring business performance and agreeing any actions that are required to manage issues that affect TSB Group. Consideration is given to the interests of all stakeholders, including customers, the shareholder and partners.

All members of the Bank Executive Committee report to the Chief Executive Officer. In addition, the Chief Risk Officer has a reporting line to the Chair of the Board Risk Committee. To protect the independence of Internal Audit, the Chief Audit Officer's primary reporting line is to the Chair of the Audit Committee with a secondary line reporting to the Chief Executive Officer. The Chief Audit Officer also has a reporting line to the Group Chief Audit Officer of Sabadell.

Bank Executive Committee Sub-Committees

(i) Executive Risk Committee

Chaired by the Chief Risk Officer, the Executive Risk Committee reviews and recommends overall risk appetite, including its allocation within TSB Group. The Executive Risk Committee provides oversight to assure the effective operation of governance, risk and control frameworks across TSB Group. The Executive Risk Committee also regularly reviews aggregate risk exposures, concentrations of risk and risk versus reward returns and ensures that appropriate action is taken where risk positions are considered inappropriate.

(ii) Model Governance Committee

Chaired by the Chief Financial Officer, the Model Governance Committee approves, monitors and reviews material risk models across TSB Group. This is the Board's designated model governance committee and the Chief Financial Officer is the designated Board member attending.

How the business is managed (continued)

(iii) Product Pricing Committee

The Product Pricing Committee is chaired by the Products Director and is responsible for reviewing and approving pricing strategy and any decisions in relation to the pricing of TSB Group's products. The Product Pricing Committee provides oversight over the management of the relevant categories of risk, including conduct risk, associated with product pricing strategies.

(iv) Asset and Liability Committee

Chaired by the Chief Financial Officer, the Asset and Liability Committee is responsible for the strategic management of TSB Group's balance sheet and the risk management framework for all treasury risks. These risks are principally market, liquidity, capital, counterparty credit and earnings volatility.

(v) Spend Wise Committee

Chaired by the Chief Operating Officer, the Spend Wise Committee is responsible for TSB Group's expenditure. The Spend Wise Committee aims to ensure that TSB Group spends efficiently and reviews cost budgets and forecasts to ensure that they support the delivery of TSB Group's strategy. The Spend Wise Committee also considers requests for expenditure that are outside of forecast and budgets before they are spent, together with the review of budgeted expenditure over a set limit to ensure such requests represent value for money.

(vi) Disclosure Committee

Chaired by the Chief Financial Officer, the Disclosure Committee is responsible for identifying inside information and determining how and when TSB Group should disclose that information in accordance with its obligations to the Sabadell Group and holders of the Company's listed debt.

(vii) Executive Product and Sales Process Governance Committee

Chaired by the Products Director, the Executive Product and Sales Process Governance Committee is responsible for ensuring effective execution of the five key stages of the product lifecycle, providing strategic and senior oversight to identify, measure, monitor and control risks associated with product and sales process activities.

(viii) Credit Risk Committee

Chaired by the Chief Risk Officer, the Credit Risk Committee is responsible for overseeing management of TSB Group's credit risk profile. These responsibilities include the management of TSB Group's risk appetite metrics, approving credit policy and strategy changes in line with the Chief Risk Officer's delegated authority and other matters escalated to it.

By order of the Board

Susan Crichton

Company Secretary, 25 January 2017

Nomination Committee report

Chairman's introduction
All the Nomination Committee members are Non-executive Directors. The Committee is authorised by the Board to keep the composition of the Board under review and to lead the process for appointments to the Board, Board Committees and the chairmanship of those Committees. It is responsible for keeping the structure, size and composition of the Board under regular review, and for making recommendations to the Board with regard to any changes necessary. The Committee also considers succession planning for the Board, taking into account the skills and expertise that will be needed in the future.

The members of the Nomination Committee are as follows:

- Will Samuel (Chairman);
- Dame Sandra Dawson; and
- Miquel Montes.

The Nomination Committee met five times during the year.

Recruitment of Directors and Senior Management
Darren Pope resigned as Chief Financial Officer on 1 July 2016. A thorough search for his successor was undertaken using the services of an external search firm and the Committee met to discuss potential candidates. On 26 January 2016 the Nomination Committee recommended to the Board the appointment of Ralph Coates as Chief Financial Officer and Executive Director. This recommendation was endorsed by the Board and, following regulatory approval, Ralph was appointed Chief Financial Officer and Executive Director of TSB on 1 July 2016.

Early in 2016, the Committee agreed that following the resignation of Stuart Sinclair at the end of November 2015, it was necessary to appoint an additional Independent Non-executive Director to enhance the Board's collective retail banking experience. Following an extensive search supported by MWM Consulting (who have no other connection with TSB Group), the Committee met on 4 August 2016 and recommended to the Board the appointment of Graeme Hardie as an Independent Non-executive Director. Following acknowledgement by the Bank of England of the intended appointment, Graeme was appointed as a Director of TSB on 19 October 2016. Following subsequent consideration by the Committee and recommendation to the Board, Graeme was appointed as a member of the Risk and Audit Committees of the Board on 8 November 2016.

As part of its work, the Nomination Committee also has responsibility for succession planning of TSB's senior management. After Neeta Atkar had indicated her intention to resign from her role as Chief Risk Officer of TSB, the Committee met to discuss potential candidates with support from a specialist executive search firm. Following consideration, the Committee confirmed that it was supportive of the candidacy of Iain Laing for the role of TSB Chief Risk Officer. Iain was appointed as TSB's Chief Risk Officer with effect from 1 January 2017.

Diversity
TSB is committed to fair and consistent treatment of all partners regardless of their personal characteristics, which include gender, ethnicity, religion, sexual orientation, transgender status, disability, nationality or age, as further detailed on page 40. The Board has adopted this approach to diversity and has regard to it when considering Board candidates. The Board diversity policy promotes and affirms our aspiration to meet and exceed the target of 25% of Board positions being held by women, as set out by Lord Davies. We currently have 33% women on the Board; although this may change over time as the Board is refreshed and new appointments are made. Additionally, three of the four Board Committees are chaired by women. In identifying candidates for future appointments, the Committee will consider the balance of skills, knowledge, experience and diversity required on the Board for a particular appointment.

The percentage of women in senior management positions is set out on page 40.

The Chairman's other significant interests
During the year I resigned as Chairman and Non-executive Director of Ecclesiastical Insurance Group plc on 16 March 2016 and Howden Joinery Group plc on 5 May 2016. Following these changes, I had no other significant commitments. With effect from 1 January 2017, I have accepted a new appointment as Chairman and Non-executive Director of Tilney Bestinvest Group Limited, subject to FCA approval. I will also chair the Remuneration and Nomination Committees of this company.

Will Samuel

Will Samuel
Chairman, 25 January 2017

Audit Committee report

Chair's introduction

In my introductory remarks in the 2015 Annual Report and Accounts I explained that TSB has no obligation to include an Audit Committee report in our Annual Report and Accounts but that we do so voluntarily. This reflects our transparency and the importance placed on the role of the Audit Committee. I will ensure that I and the Committee are held to account and that its activities continue to be reported in a straightforward and transparent manner.

I am a chartered accountant and spent a number of years as an Audit Partner at KPMG. As well as my TSB Board role, I am a Non-executive Director of Jupiter Fund Management plc, Daiwa Capital Markets Europe Ltd and XP Power Ltd. I have been chair of the Committee throughout 2016 and have been ably supported by my fellow Non-executive Directors Sandy Kinney and Tomás Varela during that period. I am pleased to welcome Graeme Hardie, who has broad UK retail banking experience, as a member of the Committee following his appointment to the Board as an Independent Non-executive Director on 19 October 2016. Biographies of the members of the Committee can be found on pages 50 to 53. All Non-executive Directors, including the Chairman, of TSB Group have a standing invitation to attend meetings of the Committee.

The report that follows describes the Committee's responsibilities and its activities during 2016. Consistent with last year, it describes the matters reviewed by the Committee in assessing the transparency and integrity of TSB Group's financial reporting, explains the Committee's work in assessing the effectiveness of TSB Group's internal controls and risk management framework and the activities undertaken to monitor the work and priorities of the Internal Audit function. Additionally, it reflects the work of the Committee to provide oversight, on behalf of the Board, of the management of risks associated with the IT Migration Programme (as detailed on page 9).

In discharging its responsibilities during 2016, the Committee has sought to develop a transparent and open framework of review and challenge of management's key judgements. External audit provides a key role in this challenge process and the Committee has satisfied itself as to the effectiveness and independence of the external auditor during 2016.

As outlined in my report in the 2015 Annual Report and Accounts, the Committee has taken particular interest in the following matters during 2016:

- maintaining an effective control framework during a period of rapid growth and when management are preparing for the migration to the Sabadell banking platform;
- understanding the consequences for TSB Group's control framework resulting from the IT Migration Programme; and
- overseeing TSB Group's readiness for IFRS 9 *'Financial Instruments'* and, in particular, compliance with the new financial asset impairment requirements of this new accounting standard.

While I expect the Committee's focus to evolve during 2017, it will crucially continue to be centred around the same strategic developments outlined above.

Polly Williams
Chair, Audit Committee, 25 January 2017

Audit Committee report (continued)

Membership and operation of the Committee
The Committee currently comprises three Independent Non-executive Directors (Polly Williams, Sandy Kinney and Graeme Hardie) and one Non-executive Director (Tomás Varela), each with recent, relevant experience in finance or banking. All members of the Committee are also currently members of the Board Risk Committee.

Committee meetings are attended by members of the Bank Executive Committee including the Chief Executive Officer, Chief Financial Officer, Chief Risk Officer, Chief Audit Officer, and General Counsel. The external auditor, PwC, attends each meeting of the Committee which includes a private session with the Non-executive Directors, without the presence of Bank Executive Committee members, other than the Chief Audit Officer.

I report to the Board after each Committee meeting on the main matters discussed so that all Directors are informed on the activity of the Committee. I am available to all Directors for discussion of any matters in more detail and maintain regular dialogue outside Committee meetings with the Bank Executive Committee members, particularly the Chief Executive Officer, Chief Financial Officer, Chief Operating Officer and Chief Audit Officer, and also with the lead and engagement partners of the external auditor. The Committee met eight times during 2016 and has allocated its time to reflect the priorities of TSB Group.

Audit Committee responsibilities and activity in 2016
The Committee is responsible for ensuring that a straightforward and transparent culture exists to ensure that TSB Group operates within the Board approved risk appetite for financial reporting, internal control and whistleblowing. Specifically, the Audit Committee is responsible for reviewing and reporting to the Board on:

- Financial statements and related financial reporting;
- Internal controls and risk management systems;
- Adequacy of whistleblowing arrangements;
- Performance and effectiveness of the Internal Audit function;
- Effectiveness of the relationship with the external auditors; and
- TSB's IT Migration Programme.

Financial statements and related financial reporting
The Committee is responsible for review and challenge of TSB Group's interim and annual financial statements including the significant financial reporting estimates and judgements which they contain. During 2016, the Committee has considered the following matters:

(i) The consistency and appropriateness of, and any changes to, significant accounting policies
The Committee has considered and accepted management's review of TSB Group's accounting policies which remain unchanged from those adopted in 2015.

The Committee has also received reports from management on TSB Group's readiness to comply with the provisions of IFRS 9 '*Financial Instruments*' which comes in to force with effect from 1 January 2018. The Committee has also reviewed the appropriateness of the disclosures at note 12 to the consolidated financial statements on pages 73 to 75 in relation to TSB Group's approach to, and implementation of, IFRS 9.

(ii) The methods used to account for significant transactions
The Committee has reviewed and supported proposals from management on the accounting for the potential exit from the transitional outsourcing arrangements with LBG and migration to Sabadell's IT platform.

(iii) Viability and going concern assessments
The Committee has considered management's approach to, and the conclusions of, the assessment of TSB Group's ability to remain a going concern. The Committee considered and supported management's conclusion that it remained appropriate to adopt the going concern basis in preparing the consolidated financial statements. The Committee also considered management's approach to, and the conclusions of the assessment of TSB viability. In particular the Committee considered and supported the approach adopted by management in determining the period over which viability was assessed. The results of the viability assessment are set out on page 13.

(iv) Review of annual report – fair, balanced and understandable
The Committee considered management's approach to, and governance arrangements over, the preparation of this annual report and recommended to the Board that, taken as a whole, it was considered to be fair, balanced and understandable. The approach and results of the assessment are set out in the Directors' report (page 42).

Audit Committee report (continued)

(v) Whether TSB Group has made appropriate estimates and judgements

The Committee has reviewed the nature, basis for and the appropriateness of the estimates and judgements proposed by management in the financial statements. The table below summarises the position reflected in TSB Group's financial statements for the year ended 31 December 2016. After challenge, the Committee supported management's proposals.

Significant accounting judgements and estimates	Audit Committee considerations	Financial statement reference
Impairment provisioning	At 31 December 2016, TSB Group's allowance for impairment losses was £73.7 million. Determining the adequacy of provisions against the loan portfolio requires judgement in assessing the level of incurred losses in the loan portfolio and future cash flows expected from impaired loans. During 2016, the Committee reviewed regular reports from management on provisioning including management's adjustments to modelled outcomes. These reports assessed the adequacy of historic provisions against subsequent recoveries, reviewed management's governance arrangements over provisioning adequacy and in particular the governance over impairment models and benchmarked TSB Group's metrics against other banks. At 31 December 2016, the impairment provisions included £25.3 million of management's adjustments to modelled outcomes. A key focus of the Committee during the year was an assessment of the level and rationale for such adjustments. The Committee challenged reports prepared by management to support these adjustments, and management's plans to amend, where appropriate, the relevant models to minimise future adjustments. The Committee concluded that a robust governance framework existed to monitor provisioning adequacy and that the assumptions and judgements applied by management were appropriate.	Note 10 (page 69)
Customer remediation provision	Conduct issues are a key focus of the banking industry. Notwithstanding the indemnity given by LBG, TSB Group retains the primary liability for alleged misconduct to its customers. At 31 December 2016, TSB Group carried provisions of £10.8 million (2015: £14.5 million), which was materially covered by a corresponding asset in respect of an indemnity provided by Lloyds Bank plc, primarily in respect of alleged mis-selling of added value current accounts and compensation for alleged breaches of the Consumer Credit Act. The Committee reviewed a report from management setting out the approach undertaken to assess any liability for alleged conduct issues. This included assessing themes and volumes of customer complaints received by TSB Group. The Committee was satisfied that the provisions, recovery under the indemnity and related disclosures in the financial statements were appropriate.	Note 32 (page 100)
Recoverability of deferred tax assets	At 31 December 2016, TSB Group's deferred tax assets of £99.6 million primarily reflected unutilised temporary differences arising from the transfer in 2013 of customer balances to TSB Group from LBG entities. Continued recognition of this asset requires judgement in assessing the availability of future taxable profits to absorb these temporary differences. The Committee considered reports from management and concluded that sufficient taxable profits are forecast against which the full temporary difference is expected to be utilised. The Committee agreed with management's judgement that, based on TSB Group's forecast taxable profits, continued recognition in full of the deferred tax asset remained appropriate.	Note 20 (page 82)

Audit Committee report (continued)

IT Migration Programme accounting	In the third quarter of 2016, TSB Bank plc and its ultimate parent company, Banco Sabadell, confirmed a set of arrangements between themselves which restricts the aggregate financial exposure of the IT Migration Programme to TSB Bank plc to a maximum of £15 million. As a consequence, TSB Group have deferred £37.0 million of IT Migration Programme costs incurred to date as a prepayment of charges for services from a Sabadell Group company that will crystallise on the completion of the migration from the existing LBG platform. The Committee assessed a report from management setting out the approach for accounting for the IT Migration Programme and the effect of the Funding Agreement. The Committee was satisfied that the accounting treatment was appropriate.	Note 29 (page 98)
Effective interest rate methodology	At 31 December 2016, TSB Group carried an asset of £15.0 million in respect of the deferred recognition, for accounting purposes, of bonus interest payable on certain savings products and an asset of £35.9 million in respect of the premium paid on acquisition of the Whistletree Loans portfolio. Determining the carrying value of these assets requires management to estimate the expected repayment profile of the respective savings balances and Whistletree loan balances. The Committee reviewed reports from management during the year summarising their approach to estimating the expected repayment profile of the portfolios. With respect to the savings portfolio this included consideration of the effect of new pricing on existing customer behaviour, developments in the industry, and an assessment of customers' future behaviour in the current low interest rate environment. The Committee was satisfied that the carrying value of the assets and the associated income recognition was appropriate.	Note 1 (page 62)
Valuation of investment in Visa Inc. convertible preferred stock	In June 2016, TSB Group received Visa Inc. convertible preferred stock as partial consideration for the sale of its share in Visa Europe to Visa Inc. At 31 December 2016, TSB Group's investment was recognised as an available-for-sale asset at its fair value of £5.2 million. Determining the fair value of this investment requires management judgement as the preferred stock is not transferrable and conversion is subject to reduction to reflect potential litigation losses incurred by Visa. The Committee considered a report from management setting out the approach adopted given the uncertainty as to the extent of any future litigation losses and was satisfied that the fair value recognised was appropriate.	Note 11 (page 70)
Fair value of financial instruments carried at amortised cost	The fair value of financial instruments that are carried on the balance sheet at amortised cost are required to be disclosed. As quoted prices are not available for TSB Group's amortised cost financial instruments, estimating their fair value requires judgement. The Committee reviewed a report from management summarising the methodology adopted, including the key inputs and judgements required in estimating fair value at 31 December 2016. The Committee concluded that the approach adopted and the fair values disclosed were appropriate.	Notes 6 and 12 (pages 64 and 71)

Internal controls and risk management systems

The Committee is responsible for reviewing the adequacy and effectiveness of TSB Group's internal controls and risk management systems and reporting on that review. As described in the review of the principal risks and uncertainties, on page 9, TSB Group has a significant dependency on LBG for the provision of banking services and the effective operation of related controls under the TSA. The Committee includes these controls within the scope of its review. In undertaking that review the Committee considered the following specific matters:

- Ongoing monitoring reports of the effectiveness of TSB Group's internal control and risk management systems;
- A review which concluded that TSB Group's internal financial control framework is operating effectively;
- Regular management information on the activity of Internal Audit; and
- The review of matters arising from a Type 2 International Standard on Assurance Engagements (ISAE) 3402 controls report from LBG.

On the basis of this work, the Committee was satisfied that TSB Group's internal controls and risk management systems operated effectively during 2016. The key elements of the management of risk within the business and the effective system for internal controls are set out within the corporate governance statement (see page 30).

Audit Committee report (continued)

IT Migration Programme (the Programme)

TSB is preparing for the transfer from the existing IT and operational services provided by LBG to one provided by companies within the Sabadell Group and other third party suppliers.

The Committee has been requested by the Board to oversee the management of the Programme risks as they affect the delivery of the Programme and its objectives and oversight the internal controls and risk management systems adopted by the Programme.

The Committee receives regular reports from management which monitor both the progress of the Programme against a defined and pre-approved delivery plan and the management of the associated Programme risks. The Programme management team have held a number of 'deep-dive' reviews with the Board and the Committee on areas such as the customer journeys through migration and the end state operating model. In addition, there are robust second and third lines assurance plans in place to support the Programme. These reviews focus on both the key risks and key decision points of the Programme. These, along with third party reviews, provide additional insights to the Committee on the effectiveness of the Programme's risk management processes.

Adequacy of whistleblowing arrangements

The Committee oversees the adequacy of TSB Group's whistleblowing arrangements, ensuring that they are proportionate and enable partners and contractors to raise concerns, in confidence, about possible wrongdoing in financial reporting or other matters. In 2016, the Committee considered a report on the whistleblowing arrangements within TSB Group and an overview of instances of whistleblowing. The report concluded that there is awareness of whistleblowing processes and procedures within TSB Group and that there were no matters that would suggest these are not operating effectively. The report further concluded that there were no areas of concern or trends identified and that appropriate action had been taken with the small number of cases reported.

Performance and effectiveness of the Internal Audit function

The Committee is responsible for monitoring the performance and effectiveness of Internal Audit. During 2016, the Committee carried out this responsibility by:

- Reviewing and approving the remit of Internal Audit, in line with the Chartered Institute of Internal Auditors July 2013 'Recommendations for Effective Internal Audit in the Financial Services Sector';
- Reviewing and approving the 2016 Internal Audit plans in line with TSB Group's strategy, ensuring these had appropriate coverage of the business (including the IT Migration Programme) and were flexible and focused on significant risk activities in 2016 and had the flexibility to respond to important events that may arise, e.g. migration and assurance over inorganic growth opportunities;
- Receiving regular reports from the Chief Audit Officer on the range of Internal Audit activities undertaken in 2016 and monitoring activities resulting from Internal Audit reports;
- Approving the Internal Audit budget, including for using subject matter expertise where appropriate, to deliver the audit plan;
- Reviewing the interaction between Internal Audit and the Risk function;
- Reviewing the interaction between Internal Audit and the external auditor; and
- Confirming that Internal Audit makes independent assessments of TSB Group's control framework but is fully informed by management's and the Risk function's reporting and views on risks and controls.

Audit Committee report (continued)

Effectiveness of the relationship with the external auditor

The Committee is responsible for the effectiveness of TSB Group's relationship with its external auditor and for assessing their independence and objectivity. During 2016 the Committee discharged this responsibility by:

- Agreeing the terms of the audit engagement letter and reviewing and approving the audit fee proposal. Fees paid to the external auditor are set out in note 16 to the consolidated financial statements on page 79;
- Reviewing and challenging the external auditor's audit strategy and their consideration of significant and elevated audit risks to ensure TSB Group's circumstances are appropriately reflected;
- Receiving reports from the external auditor covering management's estimates and judgements;
- Reviewing the outcomes of the Financial Reporting Council's Audit Quality Review inspection reports as they relate to PwC and potential considerations for TSB Group's audit;
- Considering the approach to obtaining independent assurance over outsourced controls;
- Performing a formal review of the audit service through the use of interviews with the Chair of the Audit Committee, Chief Financial Officer and Chief Risk Officer and PwC colleagues who are independent of the TSB audit engagement; and
- Ensuring compliance with policy governing the use of the external auditor for non-audit services to safeguard their objectivity and independence (see page 79 for fees paid to the external auditor).

The Committee is mindful of the requirement under EU legislation, effective for TSB Group for the financial year ending 31 December 2017, to tender TSB Group's external audit, at a minimum, every 10 years and is reviewing this requirement having regard to the wider Sabadell external audit relationship.

PwC has held the position of external auditor of TSB Bank plc since 1997 and of the Company since its incorporation, both as part of the wider historical LBG audit relationship. The Committee has taken into account the knowledge and experience that PwC has of TSB Group's business and the need to align with the broader Sabadell Group wide audit arrangements. Consequently, the Committee has recommended to the Board that the re-appointment of PwC for the audit of the 2017 financial statements is put to the shareholder along with a resolution for the Committee to set the remuneration and terms of engagement of the Company's auditor. Allan McGrath was the senior statutory auditor who will rotate off the engagement following the conclusion of the audit of the 2016 financial statements. The process to confirm his replacement is nearing completion.

Polly Williams
Chair, Audit Committee, 25 January 2017

Directors' report

Introduction

The Directors of TSB Banking Group plc (the Company) present their report and consolidated financial statements for the year ended 31 December 2016, in accordance with section 415 of the Companies Act 2006.

The information set out on pages 3 to 22 and, in particular, the following cross-referenced material, is incorporated into this Directors' report:

- The corporate governance statement (pages 23 to 32);
- Likely future developments in TSB Group's business (page 5); and
- Statement of Directors' responsibilities (page 54).

Results and dividends

The consolidated balance sheet can be found on page 58 and the consolidated statement of comprehensive income is on page 59. The Directors do not currently propose to pay a dividend.

Directors

The Directors who served during the period under review or from the date of their appointment are:

Will Samuel	
Dame Sandra Dawson	
Graeme Hardie	*(appointed 19 October 2016)*
Sandy Kinney	
Miquel Montes	
Paul Pester	
Darren Pope	*(resigned 1 July 2016)*
Ralph Coates	*(appointed 1 July 2016)*
Tomás Varela	
Polly Williams	

The biographies of TSB Group's Directors appear on pages 50 to 53.

The Company's articles of association (the Articles) give the Directors power to appoint and replace Directors. Under the terms of reference of the Nomination Committee, any appointment must be recommended by it for approval by the Board of Directors. Directors can also be appointed or removed from office by written notice provided to the Company by Sabadell as the sole shareholder.

Power of Directors

The Directors are responsible for managing the business of the Company and may exercise all the powers of the Company so long as the Articles or applicable legislation do not stipulate that any such powers must be exercised by the members.

Directors' indemnities

Each of the Directors have the benefit of a deed of indemnity which constitutes a 'qualifying third party indemnity provision'. This indemnification for Directors provided by the Company has been arranged in accordance with the Articles and the Companies Act 2006. With the exception of Tomás Varela, Miquel Montes, Ralph Coates and Graeme Hardie, the indemnities were in place throughout 2016. The indemnities for Tomás Varela and Miquel Montes were executed on 17 February 2016, whilst the indemnity for Ralph Coates was executed on 28 July 2016 and the indemnity for Graeme Hardie was executed on 8 November 2016. Each of the indemnities remain in force at the date of signing these financial statements and are available for inspection at the Company's registered office.

Directors' emoluments waiver

Miquel Montes and Tomás Varela do not receive a fee as Non-executive Directors of the Company. None of the other Directors, save for the Chairman who waived his entitlement to the fee for membership of the Nomination Committee, have waived their emoluments during the period under review, nor have they agreed to waive future emoluments.

Directors' report (continued)

Share capital
At 25 January 2017 the total issued share capital with voting rights consisted of 500,000,000 ordinary shares of £0.01 each. The total issued share capital is held by Banco de Sabadell, S.A.

Future developments
The development of TSB Group is set out in the context of the Board's strategy on page 5.

Employee information
One of the things TSB is most proud of is the collaborative and engaging culture it has built across the organisation. A key element of creating this environment is striving for an inclusive culture. TSB achieves this through its industry-leading diversity network, 'Inclusion'. This aims to help every partner achieve their potential, focusing on three key themes: personal progression, work-life balance, and an inclusive culture. Executive sponsorship of each of the key audiences of disability, gender, ethnic diversity, LGBT, and 'New to TSB' further embeds TSB's approach in this area.

People with disabilities are treated fairly and can compete on equal terms for career progression. TSB's Partners with Disabilities policy is designed to inform partners of the support available to those with disabilities and how to access this support. Covering a range of areas, this policy is designed to ensure that all of our policies – from our TSB Partner Employment Policy to our Harassment Policy – are inclusive of partners with disabilities. Partners can, for example, go to the Workplace Adjustments section of the policy to see how to request a workplace adjustment assessment if they need any reasonable adjustments. Additionally, information can be found on how TSB is a level 2 Disability Confident employer, a scheme that sees TSB commit to offer an interview to disabled people who meet the minimum criteria for a job. TSB is also a member of the Business Disability Forum.

Gender balance of partners is a key priority to ensure that TSB recruits from the widest resource pool and appoints the best person for each role. There is particular focus on achieving this balance for the more senior roles, with 42% of senior management, 23% of the Bank Executive Committee and 33% of the Board being female.

In September 2016, TSB signed up to the HMT Women in Finance charter. Helen Rose, Chief Operating Officer, is the executive sponsor for gender equality in TSB. As part of TSB's commitment to gender balance, it has created an aspirational range of 45%-55% for the proportion of senior management roles in TSB held by women. In 2017, TSB will begin publishing its progress towards this long term aspirational range annually in the HMT Women in Finance charter. In April 2016, TSB was also named in The Times Top 50 Employers for Women 2016 as a leader of workplace gender equality.

TSB has policies that enable partners to work flexibly, including working compressed hours, flexible hours and job sharing to meet personal commitments.

A culture of lifelong learning continues to be embedded within the organisation. Every partner is encouraged to have a personal development plan which they review regularly with their line manager. Partners who are new to TSB are given an induction, 'Welcome to TSB'. The 'TSB Academy' guides partners through all of the learning and development that is available, and a mentoring scheme encourages informal learning at all levels of experience.

Furthermore, all partners in TSB, both customer facing and non customer facing, have gone through a transformational behavioural programme in the last 18 months called 'The TSB Experience'. TSB designed and created the programme with the aim of providing better banking to customers. Its partners are what differentiates TSB, and how they behave with customers and with each other will create an experience people want and deserve.

A range of services are also in place to support the wellbeing of partners. An Employee Assistance Programme gives all partners free access to confidential counselling and professional advice and an Occupational Health service allows line managers to refer partners for medical assessments, to ensure support is available to facilitate partner recovery.

'The Link', a forum formed of partners across all levels, gathers and builds on partner feedback and enables meaningful dialogue between partners and the Executive leadership. There are five regional Link Groups covering Britain, made up of partners from every part of the business. The outputs from every meeting are presented to the Bank Executive Committee to help inform TSB's activity and strategic outlook.

Directors' report (continued)

Employee information (continued)
Partner engagement is, and has always been, positive at TSB. Partner feedback is received through an annual Partner Experience survey, undertaken in September. For this year's survey, for the first time, we partnered with Great Place to Work with 73% of our partners participating. Our overall Great Place to Work trust index score was 72% (2% above the minimum threshold score of 70% to be accredited as a Best Workplace). In respect of TSB specific questions, our partners provided a positive overall result of 78%. TSB has also partnered with Best Companies for the first time and the outcome of that survey will be available later in the year.

Collaboration is also encouraged through the recognition and celebration of partner contribution. This is demonstrated in the 'Say Thank You' scheme which gives partners the opportunity to recognise the contribution of fellow partners who demonstrate TSB's values.

In May 2016, TSB announced a new partnership with Pride of Britain and Pride of Sport – celebrating ordinary people who do extraordinary things in their local communities. This partnership aligns with TSB values, in particular TSB's support for local people helping local people. Nominations for the Pride of Britain and Pride of Sport Awards were accepted in all TSB branches.

As part of this, TSB created the Pride of Britain 'TSB Community Partner Award' – aimed at celebrating the very special people, whether an individual or group, who have worked together in partnership as a force for good in their local community to improve the lives of people around them. TSB created its own 'Pride of TSB' to recognise the extraordinary TSB partners who are making a real difference to the lives of people around them.

Political donations and expenditure
No amounts were given for political purposes during the year.

Financial risk management and hedging policies
Details of the use of financial instruments, together with risk management disclosures can be found in the Managing financial risk section of the financial statements on pages 86 to 95.

Post balance sheet event
There are no significant events affecting TSB Group that have arisen between 31 December 2016 and the date of this report that require disclosure, save for the matter disclosed in note 35 to the consolidated financial statements on page 101.

Research and development activities
TSB Group develops new products and services during the ordinary course of business.

Overseas branches
TSB Group does not have any branches outside of the United Kingdom.

Corporate headquarters and registered office
The Corporate headquarters and registered office address for TSB Banking Group plc is 20 Gresham Street, London, EC2V 7JE. Telephone: +44 (0)20 7003 9000. Website: www.tsb.co.uk.

Disclosure of information to external auditor
In accordance with the provisions of the Companies Act 2006, the Directors serving at the date of approval of this report confirm that, so far as each Director is aware, there is no relevant audit information of which the Company's auditors are unaware and each Director has taken all the steps that he or she ought to have taken as a Director in order to make himself or herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

Directors' report (continued)

Going concern

The Directors recognise their responsibility to make an assessment of TSB Group's ability to continue as a going concern, for a period of at least twelve months from the date the financial statements are approved. As set out on page 13, the Directors assessment of going concern is integrated with that of the assessment of the viability of TSB Group. The Directors are satisfied that adequate funding and liquidity resources will be in place to allow the financial statements to continue being prepared on a going concern basis and are not aware of any material uncertainties that may cast significant doubt upon TSB Group's ability to continue as a going concern.

Fair, balanced and understandable

The Board has ultimate responsibility for reviewing and approving the annual report. In adopting the principles of the UK Corporate Governance Code, the Directors confirm that they consider that the annual report, taken as a whole, is fair, balanced and understandable and provides the information necessary for the shareholder to assess the Company's position and performance, business model and strategy. When arriving at this conclusion the Board was assisted by a number of processes including:

- The annual report is drafted and comprehensively reviewed by appropriate senior management with overall co-ordination by the Financial Controller;
- An extensive verification process is undertaken to ensure factual accuracy, with third party review by legal advisers; and
- The final draft is reviewed widely by Bank partners of varying degrees of seniority and from a broad range of Bank functions, the Bank Executive Committee and the Audit Committee prior to consideration by the Board.

By order of the Board

Susan Crichton
Company Secretary, 25 January 2017
Registered in England and Wales
Company Number 08871766

Remuneration review 2016

TSB's remuneration is designed to be simple and fair, putting great customer service at the heart of what we do. Our reward philosophy, and the reward practices that underpin it, were established at IPO in 2014 and remain fundamentally unchanged.

The aim of our remuneration policy remains to provide competitive remuneration aligned to the delivery of our strategic goals of providing great banking to more people, helping more people to borrow well and providing the kind of banking experience people want and deserve. It is designed to attract and retain talented individuals; to promote TSB's values; to generate sustainable business performance, while taking into account effective risk management and acceptable conduct; and, given the particular challenges of 2016 and 2017, to focus on the successful delivery of the IT Migration Programme put in place following TSB's acquisition by Sabadell.

Overview of TSB remuneration structures

Our remuneration is structured into three main elements: competitive fixed pay, the TSB Award (short term incentive) for all partners and the Sustainable Performance Award (SPA) (long term incentive) for our more senior partners.

As stated in our 2015 Remuneration Report, during the delivery of TSB's IT Migration Programme through to the end of 2017, a small number of senior partners will receive Sabadell Integration Awards (SIA). These partners have critical roles to play in achieving successful migration and in delivering the IT Migration Programme. SIAs will vest only to the extent that key migration objectives are met, whilst ensuring the underlying sustainability of the business.

The SPA and SIA have significant deferral requirements of up to seven years, in line with regulation. 70% of these awards are delivered for the CEO in Sabadell shares, with holding requirements on the shares post vesting. These features mean strong alignment with the long term, sustainable nature of our business and with the experience of all shareholders in the Sabadell Group.

2016 Business Performance and its impact on remuneration

During 2016, TSB continued to deliver on its mission to bring more competition to UK banking. In 2016 TSB was rated Britain's most recommended high street bank, the target to open more than 6% of all new and switching bank accounts in the UK was exceeded for the third year in a row and our 2014 IPO lending growth target was delivered three years early.

Last year saw us all but complete the build of our new, state-of-the art, banking platform which we look forward to unveiling to customers towards the end of 2017. This will enable us to offer more products and services to our customers in the future and accelerate our efforts to bring more competition to UK banking. It will also help TSB to reduce its costs considerably whilst providing opportunities to become more innovative and agile.

This very strong performance of the TSB core business and the progress being made with the IT Migration Programme is reflected in variable remuneration outcomes for all TSB partners who meet their individual 2016 performance objectives and in the Remuneration Committee's decisions in respect of the CEO, as detailed later in this report, and other senior partners. This has been a year of strong performance and reward outcomes reflect that fact.

Rewarding TSB partners

TSB's employee engagement survey allows the Remuneration Committee to gain insights into partners' perspectives on reward and reward outcomes. In our 2016 survey for example, some 65% responded favourably to the statement "I feel I receive a fair share of the profits made by this organisation". TSB's level of favourable response was higher than the two relevant external benchmarks, one being Financial Services companies participating in this same survey and the other being participating companies identified as Large Best Workplaces.

In August 2016 TSB became an accredited Living Wage employer. This makes us one of a pioneering group of around 3,000 employers, big and small, who are voluntarily choosing to pay at least the real Living Wage. The real Living Wage is independently calculated based on what employees and their families need to be paid to get by. The minimums of the 2017 TSB national and London pay scales coming into effect from 1 April 2017, have been set at a level which will exceed the new real Living Wage rates announced on 31 October 2016.

The Remuneration Committee was also pleased to approve, based on business performance, a 2016 TSB Award costing over £28 million, a higher budget than for the 2015 performance year. The TSB Award recognises the collective effort made by all partners to deliver business success. All TSB partners, from the CEO to front line staff, who have an 'On Track' performance rating, will receive 12.5% of their relevant basic salary as a TSB Award in March 2017. Our 'Pioneers' - our outstanding performers - will receive up to double that. Given the shape of our workforce, the majority of our Pioneers are in front line roles, directly serving our customers and making a difference in the local communities where they work.

Wider partner remuneration and annual TSB Award outcomes are matters the Committee continues to take into account when making decisions on executive pay.

Remuneration review 2016 (continued)

Meeting our Obligations

TSB's remuneration policy continues to meet regulatory requirements. As reported last year, TSB now applies a 2:1 variable to fixed pay cap post the Sabadell acquisition in line with approvals granted to Banco Sabadell by its shareholders. In practice, the use of the 2:1 cap, rather than the 1:1 cap, is limited to a small number of senior partners who are participants in the Sabadell Integration Award.

Following the publication of the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) Policy Statements in June 2015 which finalised changes to their Remuneration Codes, TSB moved to comply with the new requirements on variable remuneration. The Remuneration Committee approved the necessary adjustments to the Sustainable Performance Award (SPA) and Sabadell Integration Award (SIA) whilst maintaining the fundamental scheme designs.

For any SPA or SIA grant in respect of the 2016 performance year and beyond, the vesting arrangements for Senior Managers (in effect, the Bank Executive Committee members) have been amended. For these partners, the SPA tranches will now vest pro rata over the five years from the third to the seventh year post award subject to the achievement of the relevant performance conditions. For any SIA which vests, a portion will vest upfront, with the remainder also subject to vesting pro-rata from the third to the seventh year post award. For other Material Risk Takers, the existing SPA and SIA scheme design already met the new deferral requirements and vesting arrangements therefore remain unchanged.

The need to extend clawback for up to ten years post vesting if required is now reflected in TSB's clawback stipulations. The holding period post vesting, currently six months, which applies to the share elements of variable remuneration for Senior Managers, will increase to 12 months from 1 January 2017 in line with EBA requirements under CRD IV.

TSB has also noted and made relevant changes to its policies to reflect the PRA's required approach to buyouts for Material Risk Takers, which came into effect from 1 January 2017.

TSB Remuneration Policy overview

The table below summarises the key components of TSB's remuneration.

Fixed pay	TSB aims to provide market competitive fixed pay, taking account of relevant market benchmarks, the complexity of each role and the individual's performance. It includes: • Basic salary: Typically reviewed annually, taking account of general market movements and performance of TSB and the individual. • Pension: Participation in TSB's defined contribution scheme. Senior partners may alternatively receive a cash allowance of equivalent value (after taking into account TSB's need to pay national insurance on a cash payment) in lieu of a pension contribution. • Benefits: Benefits include private medical insurance, life assurance, provision of a car (or alternatively a cash car allowance) and funded participation in TSB's flexible benefits scheme. Other benefits may be provided where appropriate (e.g. relocation allowances). • Role based allowance: This is received only by the CEO to reflect the change in his role following the acquisition of TSB by Banco Sabadell in 2015.
TSB Award	The TSB award is an annual incentive plan for all partners determined on the same terms for everyone. It rewards the achievement of annual business and personal performance targets, including customer service targets, and aligns all partners to common goals. An 'on-target' award level of 10% of basic salary applies to all. Awards are made only if certain 'gateways', including risk, profitability and individual conduct are satisfied and corporate performance targets are met. Further detail on the performance measures is provided below.

Remuneration review 2016 (continued)

TSB Remuneration Policy overview (continued)

Sustainable Performance Award (SPA)	The SPA is a discretionary long term incentive arrangement designed to reward sustained business performance over time. Awards are funded subject to there being sufficient profit and the pool is determined based on assessment of corporate performance measures. Individual awards are then determined by reference to personal performance and are denominated in a mix of cash and shares (proportions vary depending on seniority). Awards are deferred in line with regulatory requirements and vest only to the extent that continuing capital and liquidity, risk and return on equity vesting conditions are met. Vesting of awards made to Senior Managers from the 2016 performance year is between years 3 and 7 post award whilst for other Material Risk Takers vesting remains between years 1 and 5 post award.
Sabadell Integration Award (SIA)	SIAs have been and will be made only to a small number of senior partners responsible for the critical objectives of achieving the migration of TSB onto the Sabadell platforms and the delivery of TSB's IT Migration programme. The SIA runs from 2015 to 2017. Awards vest to the extent that stretching performance targets are achieved and a large portion of any award that vests is subject to deferral. The deferred portion of awards made from the 2016 performance year onwards are paid to Senior Managers from the third to seventh anniversary post award whilst for other Material Risk Takers payout is between the first and fifth anniversary post award.

Taken as a whole, we believe TSB Group's remuneration package remains balanced and competitive, driving sustainable long-term growth.

The Remuneration Committee does not expect any significant changes to remuneration policy for 2017.

TSB Award

All eligible partners, from the CEO to front-line branch staff, participate in the TSB Award which is structured to pay the same percentage of basic salary, depending on corporate and individual performance, to those with the same performance rating.

The core TSB Award can vary between 0% and 15% of basic salary. Awards are subject to the discretion of the Remuneration Committee based on consideration of outcomes against corporate targets. At 'on target' corporate and individual performance we aim to deliver an award of 10% of basic salary which may be increased to 15% if warranted by corporate achievement of stretch targets. Individuals with an exceptional performance rating of 'Pioneer' could be given a higher award, with a maximum of two times the core award. This means the highest award possible could be 30% of basic salary for a partner with a 'Pioneer' performance rating. A zero award is possible if corporate performance and/ or individual performance merit that result.

The final level of the TSB Award is determined by the Remuneration Committee as follows:

- Assessment as to whether profitability and risk management threshold gateways have been satisfied at a corporate level and consideration of the affordability of the proposed TSB Award spend.
- Assessment of corporate performance against pre-determined Key Performance Indicators (KPIs), which include customer outcomes, financial resilience metrics and achievement of strategic business objectives to determine the overall award size and funding for the year.
- Assessment of individual performance to (i) ensure all individuals have met minimum performance criteria to be eligible for the award and (ii) identify any exceptional performance in the year which may warrant an enhanced 'Pioneer' award.

The pre-determined KPIs used to assist in deciding the overall award size for 2016 were set under the following corporate priorities:

Remuneration review 2016 (continued)

TSB Award (continued)

- **Customer Outcomes (50% weighting)** –Targets were set relating to:
  - Customer satisfaction measured by a Net Promoter Score;
  - Customer advice measured through a sales fair outcomes assessment; and
  - Customer service based on how well we deal with customer complaints.

- **Financial Resilience (25% weighting)** - A profit target was set.

- **Strategic Delivery (25% weighting)** –Targets were set relating to:
  - Personal Current Account (PCA) market share flow;
  - Franchise Asset Growth; and
  - The Delivery of the Migration Programme.

Sustainable Performance Award (SPA)

SPA awards are restricted to more senior partners, broadly the Bank Executive Committee, their direct reports and a limited number of other senior roles.

The face value of a SPA grant may vary between 0% and 100% of basic salary. 'On target' awards vary by seniority, but for Bank Executive Committee members would be 62.5% of basic salary. Exceptional corporate and individual performance may result in a higher award but no grant will exceed 100% of basic salary. A zero award can be made if corporate and/or individual performance merit that result.

The final level for SPA Awards is determined by the Remuneration Committee as follows:

- Assessment as to whether profitability and risk management threshold gateways have been satisfied at a corporate level and consideration of the affordability of the SPA grants after paying any TSB Awards.
- Assessment of corporate performance against pre-determined KPIs, which include customer outcomes, financial resilience metrics and achievement of strategic business objectives, to determine the SPA pool size.
- Assessment of individual performance to determine individual award levels.

The pre-determined KPIs used to assist in deciding the core award pool size for 2016 were set under the same strategic priorities as for the TSB Award, detailed above. Two further targets were set for the SPA under the heading of Financial Resilience and related to the management of operating costs and achievement of a balanced funding plan.

2016 SPA Awards will be made following the publication of TSB Group's results (i.e. in Q1 2017) and will vest in five annual tranches, if the vesting conditions are met, from the third anniversary of the award for Senior Managers (broadly members of the Bank Executive Committee) and from the first anniversary of the award for other eligible partners.

Sustainable performance release conditions

Each tranche is released subject to satisfactory individual conduct and performance if the sustainable performance conditions have been met at each vesting date. These conditions are as follows:

- Capital and Liquidity: No significant breach of Board risk appetite in the year.
- Regulatory and Compliance: No material regulatory issues and a satisfactory internal control environment in the year.
- Sustained financial performance: Performance against a pre-determined financial target (Cumulative Return on Equity) has been achieved.

The testing of the metrics will determine, subject to the Remuneration Committee's discretion, the extent to which a tranche vests. The vesting may be reduced, ultimately to zero, depending on the testing outcome and Remuneration Committee discretion.

Sabadell Integration Award (SIA)

Awards under the SIA are time limited and no awards under this scheme will be made beyond the 2017 performance year. The SIA is designed to support the delivery of the migration of TSB onto the Sabadell platforms and the wider TSB IT Migration Programme. The Remuneration Committee made SIA grants to a limited number of senior partners in 2016 and will consider grants in 2017 for those identified as eligible to participate in the SIA for that year. The Remuneration Committee also determines the performance targets that need to be met for SIA awards to vest.

Remuneration review 2016 (continued)

Sabadell Integration Award (SIA) (continued)

For the SIAs granted in 2016, awards vested dependent upon TSB Group achieving its management profit and operating cost targets for the year and the Remuneration Committee being satisfied that the delivery of the IT Migration Programme is progressing to plan. Once vested, for most participants, a portion of the award is delivered immediately and the balance is deferred. Testing of the corporate objectives ensures individual objectives have not been met at the expense of TSB Group's sustainable financial performance. The Remuneration Committee ensures any payments under the SIA are affordable.

At an individual level personal objectives were set relating to key IT Migration Programme targets for 2016. Account was also taken of individual 2016 performance against TSB Group's risk, culture and conduct requirements prior to determining whether the SIA grant should vest.

Consideration of risk

In designing the remuneration structure, careful consideration has been given to supporting and promoting sound and effective risk management. For example:

- Risk profile and behaviours are a key gateway that must be satisfied for any of the incentive awards to pay out. Incentive pools and awards may be adjusted, including to zero, in the event of any material breaches.
- All elements of variable remuneration for Material Risk Takers are subject to malus and clawback provisions in line with regulatory requirements.
- Risk based adjustments to variable reward outcomes at a collective and individual level are considered and, where appropriate, applied.
- A significant portion of variable remuneration is deferred. For example, for the CEO at least 60% of variable remuneration in respect of 2016 will be deferred and released over a seven year period post award.

Highest paid Director – 2016 remuneration disclosure

The table below sets out 2015 and 2016 total remuneration for TSB Group's CEO, Paul Pester, the highest paid Director.

The Remuneration Committee recognises there has been a large increase in the CEO's total remuneration package for 2016 compared to 2015. This increase is driven by three issues, as follows:

- The 2016 figures include, for the first time, a full year of basic salary at £900,000 and of a role based allowance of £200,000, introduced after the Sabadell acquisition, both of which commenced from 1 July 2015.
- The gradual vesting of annual SPA awards. The 2014 and 2015 awards vest in five tranches from the first year after award to the extent performance targets have been achieved. 2016 figures reflect the vesting of tranches from both the 2014 and 2015 SPA grants, whilst the 2015 figures included only the first tranche of the 2014 SPA grant. Over time, the number of SPA tranches vesting shown in this table could build up to five, reflecting awards made over five calendar years.
- Most importantly, the vesting of half the 2015 Sabadell Integration Award (SIA) already disclosed in last year's Remuneration Report, but which remained subject to 2016 performance conditions and 100% of the 2016 SIA award. The remaining half of the 2015 SIA and any 2017 SIA granted will vest at the end of 2017 to the extent performance conditions are met.

Over 80% of 2016 variable pay is therefore related to progress with the IT Migration Programme put in place following TSB's acquisition by Sabadell. The Board has assessed that progress with this major programme of work is going well and that TSB is where it had hoped to be in delivering it at the end of 2016. There will be no SIA awards made beyond the end of the 2017 performance year.

The SPA and SIA are subject to significant deferral requirements and the CEO will have to wait for a number of years before receiving the whole of the SIAs detailed below. The 2014 and 2015 SPA awards vest in five tranches over five years, whilst the SIA awards vest 40% up front with the 60% deferred not vesting in full for seven years. Awards are made to the CEO, 30% in cash and 70% in Sabadell shares, retaining strong alignment with the experience of shareholders in the Sabadell Group. Final payments under the 2016 SIA will not be made until 2024 and during this extended deferral period malus and clawback requirements continue to apply.

Remuneration review 2016 (continued)

The CEO's total variable remuneration for 2016 meets the regulatory requirement of being no more than twice fixed pay. Permission for the use of the 2:1 ratio has previously been granted to Sabadell by its shareholders.

CEO Remuneration	2016 £	2015 £ [1]
Basic salary [2]	**900,000**	800,000
Role based allowance[3]	**200,000**	100,000
Benefits [4]	**45,500**	43,426
Pension [5]	**167,267**	160,000
Fixed Pay	**1,312,767**	**1,103,426**
TSB Award	**112,500**	100,000
2014 SPA – Vesting of Tranches 1 (2015) and 2 (2016)[6]	**118,450**	123,444
2015 SPA – Vesting of Tranche 1 [6]	**145,796**	–
2015 SIA Partial Vesting [7]	**383,673**	–
2016 SIA [7]	**1,600,000**	–
Variable Remuneration	**2,360,419**	**223,444**
Total Remuneration (audited)	**3,673,186**	**1,326,870**

Notes

(1) 2015 figures represent relevant remuneration for the full year as stated in TSB's 2015 Remuneration Report updated to take account of the actual vesting value of Tranche 1 of the 2014 SPA as explained at note (6) below.
(2) The basic salary for 1 January to 31 December 2016 was £900,000, last changed with effect from 1 July 2015.
(3) The role based allowance for 1 January to 31 December 2016 was £200,000, as set from 1 July 2015.
(4) Benefits include the taxable value of all benefits received, which included a car allowance and a flexible benefits allowance set annually at 4% of basic salary.
(5) Pension represents the value of the pension allowance provided, which has been paid as cash.
(6) The values shown in respect of the SPA grants for 2014 and 2015 represent, in turn:
    a. The value at vesting of the first tranche of the 2014 SPA grant for the performance period 1 January – 31 December 2015 (2015 column).
    b. The vesting of the second tranche of the 2014 SPA grant for the performance period 1 January – 31 December 2016 (2016 column). 100% of this tranche of the award was approved for vesting after the testing of the performance conditions.
    c. The vesting of the first tranche of the 2015 SPA grant for the performance period 1 January – 31 December 2016. 100% of this tranche of the award was approved for vesting after the testing of the performance conditions.

    The value of the award at (a) shown in the table is the actual value of this award at vesting on 9 March 2016. The vesting value differs from that shown in the 2015 Remuneration Report because its publication pre-dated the vesting date and the value of the share element therefore had to be estimated. Relevant variable and total remuneration figures for 2015 have been adjusted accordingly.

    Vesting of the awards at (b) and (c) will take place on or around 9 March 2017. Since these awards are partially in Sabadell shares and the future Sabadell share price is not known the value shown has been estimated using the three day average of the Sabadell share price and Euro/Sterling exchange rate as at 31 December 2016. These awards were made in a mix of cash and shares, with the cash portion of the award at (b) being £37,800 and of the award at (c) being £45,600.
(7) 50% of the 2015 SIA award and 100% of the 2016 SIA were due to be tested, at end December 2016 for achievement of the performance conditions. As a result, 100% of these awards have been approved for vesting. Release will be subject to the deferral requirements explained earlier in this report. The values shown here are the cash (£120,000) and Sabadell shares value of the 2015 SIA and the cash value of the 2016 SIA as at 31 December 2016. The value of the Sabadell share element of the 2015 SIA has been calculated using the approach applied to the SPA awards as explained in note (6) given these shares will actually finally vest on or around 9 March 2017.
(8) Paul Pester has been awarded a 2016 SPA grant with a face value of £810,000. He is also eligible to be considered for a 2017 Sabadell Integration Award. These awards remain subject to performance conditions and will vest only to the extent that they are met. Any amounts that do vest will be disclosed at the appropriate point in future reports.
(9) As disclosed in our Directors' Remuneration Report (DRR) for 2014, Paul Pester holds a legacy 2014 LTIP award granted by LBG prior to TSB listing. This share-based award lapsed on a time pro-rated basis when LBG ceased to hold a majority of shares in TSB Group. Participants were treated by LBG as 'good leavers'. To reflect the impact of the pro-rating, TSB Group made a broadly equivalent share-based 'substitution award' to those impacted such that no individual would be either materially advantaged or disadvantaged as a result of the listing. Legacy awards remain under the governance of LBG and its Remuneration Committee. Substitution awards will vest close to the same vesting dates as the LBG awards they replace. Any LBG 2014 LTIP award which vests in 2017 will be at the discretion of LBG and its Remuneration Committee. Vesting of the relevant TSB Substitution Award is determined by the TSB Remuneration Committee based on a balanced scorecard of TSB performance measures.
(10) Paul Pester exercised share options and received shares under long term incentive schemes in 2016, as was the case in 2015.

Remuneration review 2016 (continued)

Consideration by the Directors of matters relating to Directors' remuneration

The Board entrusts the Remuneration Committee with responsibility for remuneration policy and its ongoing appropriateness and relevance. Policy is considered regularly by the Remuneration Committee, taking account of changes in regulation and the wider market. In formulating and reviewing policy independent advice is sought and considered. In particular, the sustainability of the policies and their risk impact are carefully reviewed. The Bank's Remuneration Policy is formally reviewed at least annually and, once approved by the Remuneration Committee, is reviewed and approved by the Board. The effectiveness of the remuneration policy and its application are reviewed formally by the Risk function annually. The Remuneration Committee considers the Risk function's report following that review and tracks and monitors any recommended actions.

The Remuneration Committee's full terms of reference are kept under regular review. These can be found on our corporate website at http://www.tsb.co.uk/investors/people/.

The Board Remuneration Committee is chaired by Dame Sandra Dawson and the other committee members are Polly Williams, who also chairs the Board Audit Committee, and Miquel Montes. Sandy Kinney, Chair of the Board Risk Committee, attends meetings of the Remuneration Committee from time to time to ensure alignment between the work of the Remuneration Committee and the Risk Committee. Remuneration Committee meetings are also attended by the Company Chairman, the CEO, the CFO, the HR Director, the CRO, and the Director of Performance and Reward to provide input on their specialist areas. The Company Secretary acts as the secretary to the Remuneration Committee. None of these additional attendees participates in the discussion of issues directly affecting their own remuneration.

The Remuneration Committee appointed Deloitte LLP (Deloitte) to provide independent advice on remuneration matters following a presentation to the Remuneration Committee members in 2014. The Remuneration Committee reviewed Deloitte's work during 2016 and decided to continue with Deloitte's appointment. Deloitte is a member of the Remuneration Consultants Group and, as such, voluntarily operates under the code of conduct in relation to executive remuneration consulting in the UK. Deloitte has provided independent advice on matters under consideration by the Remuneration Committee including compliance with regulations, advice on market trends and data, remuneration policy and implementation of remuneration arrangements. The Remuneration Committee is satisfied the advice it has received has been objective and independent.

Deloitte also provided advice on share plans, wider remuneration matters, taxation and financial matters and other miscellaneous consulting and assurance services. In addition, management received external advice, including market data and legal counsel, from a number of other providers which is not considered to be material in assisting the Remuneration Committee to consider Directors' remuneration.

Directors' biographies

Will Samuel
Chairman

Skills and background
Will was appointed as Non-executive Chairman on 7 March 2014. Having worked over 35 years in merchant banking and corporate finance, he brings a wealth of expertise of the banking sector and regulatory environment to his role as Chairman of TSB.

Will began his career at Coopers & Lybrand where he qualified as a Chartered Accountant. In 1977, Will joined Schroders in the Investment Management Division and worked in a variety of roles. In 1986, he was appointed a Director of Schroders plc as the Group Managing Director of Investment Banking. Schroders subsequently sold its investment banking business to become Schroder Salomon Smith Barney (SSSB) in 2000 and Will served as Co-Chief Executive Officer at SSSB until 2003, when he was appointed Vice Chairman, European Investment Bank of Citigroup Inc.

Will joined Lazard & Co in 2004 as Vice Chairman and was appointed a Senior Advisor from 2011. In January 2012, Will was appointed Senior Advisor to the Financial Services Authority and, subsequently, Senior Advisor to the Prudential Regulation Authority, stepping down prior to his appointment as Non-executive Chairman of TSB.

Will has held other Non-executive Directorships including Chairman of Howdens Joinery Group (formerly MFI Furniture Group), Chairman of Ecclesiastical Insurance Group, Chairman of H P Bulmer plc, Deputy Chairman of Inchcape plc, and Non-executive Director of the Edinburgh Investment Trust plc. Will was Trustee and Honorary Treasurer of International Alert, a charitable peace building non-governmental organisation, from 2009 to 2014.

Will is a Fellow of the Institute of Chartered Accountants in England and Wales and has a First Class Honours Degree in Chemistry from Durham University and a Degree in Mathematics from the Open University.

Current external appointments
Chairman, Non-executive Director and Chairman of the Remuneration and Nomination Committees of Tilney Bestinvest Group Limited (with effect from 1 January 2017, subject to regulatory approval from the FCA).

Committee membership
Nomination Committee (Chair)

Professor Dame Sandra Dawson
Senior Independent Non-executive Director

Skills and background
Dame Sandra joined the Board on 16 May 2014. She brings a wealth of experience and knowledge gained through a broad range of activities including research, education and financial services in commercial, public and charitable bodies. Former Non-executive Directorships include Barclays Bank plc, JP Morgan Fleming Claverhouse Investment Trust plc, the Financial Services Authority and Oxfam.

Dame Sandra was KPMG Professor of Management Studies at Cambridge Judge Business School from 1995 to 2013, Director of the School from 1995 to 2006 and Master of Sidney Sussex College Cambridge from 1999 to 2009. She was previously at Imperial College, University of London ultimately as Professor of Organisational Behaviour.

Current external appointments
- Non-executive Director, Winton Capital Group
- Trustee/Non-executive Director, Institute for Government
- Chairman of the Executive Committee and Trustee, Social Science Research Council USA
- Trustee, American University of Sharjah

Committee membership
- Remuneration Committee (Chair)
- Nomination Committee

Directors' biographies (continued)

Graeme Hardie
Independent Non-executive Director

Skills and background
Graeme was appointed to the Board on 19 October 2016. He has broad experience in the financial services sector, which includes extensive retail banking experience as well as various Non-executive Director roles. Graeme spent 27 years in various roles at Royal Bank of Scotland, ultimately working as Managing Director for Retail Banking at NatWest, where he led the post-acquisition change programme. After this, he became Executive Director of Retail Banking at Abbey National Bank, with responsibility for all retail financial services activities. He then spent four years as Senior Advisor to the CEO at the Financial Services Authority before moving to Non-executive Director roles, including membership of the Boards of Co-operative Bank and Metro Bank.

Committee membership
- Audit Committee
- Risk Committee

Alexandra Kinney Pritchard (Sandy Kinney)
Independent Non-executive Director

Skills and background
Alexandra (Sandy) was appointed to the Board on 16 May 2014. She has had a distinguished career across the financial services industry. Prior to joining TSB she had been Non-executive Director at Irish Life and Permanent TSB, Skipton Building Society and the FSCS. Sandy is an accountant and was previously a Senior Partner at PricewaterhouseCoopers LLP (Head of European Strategic Performance Improvement).

Current external appointments
- Non-executive Director, MBNA Ltd.

Committee membership
- Risk Committee (Chair)
- Audit Committee

Polly Williams
Independent Non-executive Director

Skills and background
Polly was appointed to the Board on 16 May 2014. She is a chartered accountant and a former Partner at KPMG LLP. She resigned from her partnership in 2003 and since then has held a number of Non-executive Directorship roles, including at Worldspreads Group plc, APS Financial Limited, Z Group plc, National Counties Building Society (as Chairman) and Scotiabank Ireland Limited.

Current external appointments
- Non-executive Director, Jupiter Fund Management plc
- Non-executive Director, Daiwa Capital Markets Europe Ltd
- Trustee of the Guide Dogs for the Blind Association
- Non-executive Director, XP Power Ltd

Committee membership
- Audit Committee (Chair)
- Risk Committee
- Remuneration Committee

Directors' biographies (continued)

Miquel Montes
Non-executive Director

Skills and background
Miquel was appointed to the Board on 30 June 2015. He is General Manager and Chief Operations and Corporate Development Officer of Sabadell, which he joined in 2001. He has extensive retail banking experience having held senior positions at Deutsche Bank, Banco Atlántico and Banca Catalana in the 21 years prior to joining Sabadell.

Currently, Miquel leads Sabadell's human resources, technology, innovation, operations, organisation and efficiency functions. In addition, he is responsible for Sabadell's corporate development function and is a member of Sabadell's Executive Committee. He is an academic adviser at ESADE Business School and holds a Global Executive MBA from ESADE and an MBA from Georgetown University (McDonough School of Business - School of Foreign Services).

Current external appointments
- President of Solvia

Committee membership
- Remuneration Committee
- Nomination Committee

Tomás Varela
Non-executive Director

Skills and background
Tomás was appointed to the Board on 30 June 2015. He is General Manager and Group Chief Financial Officer of Sabadell, which he joined in 1992. Over 24 years he has developed his career at Sabadell, having previously held different managerial positions in the insurance sector at Allianz (Spain) and as an auditor at Price Waterhouse (a legacy firm of PwC) over a 10 year period.

In his current role, Tomás's responsibilities include financial reporting, asset and liability management, funding structure, economic analysis, accounting and financial management, capital management, short, medium and long term financial planning, cost management, M&A financial structure and investor relations. He is a member of Sabadell's Executive Committee.

Tomás is a Certified Public Accountant and Certified Insurance Broker. He holds a B.Sc. in Economics from the University of Barcelona and an MBA in International Business from the European University (Barcelona).

Committee membership
- Audit Committee
- Risk Committee

Directors' biographies (continued)

Paul Pester
Chief Executive Officer

Skills and background
Paul was appointed as an Executive Director of the Company on 31 January 2014. Having joined LBG in 2010 he was appointed Chief Executive Officer of the Verde programme in 2011 through which he led the development and establishment of the new TSB within LBG. In 2013, Paul was appointed as Chief Executive Officer of TSB Bank plc and led the launch of the bank, its separation from LBG and listing on the London Stock Exchange. Prior to this Paul spent six years as the Group Chief Executive Officer at Virgin Money and two years working at Santander UK where he led the acquisition of Bradford & Bingley and the subsequent integration of Abbey, Alliance & Leicester and Bradford & Bingley to create a single UK business. His early career was spent in management consultancy, principally at McKinsey & Company.

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Ralph Coates
Chief Financial Officer

Skills and background
Ralph was appointed to the Board on 1 July 2016. He qualified as a Chartered Accountant with PricewaterhouseCoopers (PwC) in South Africa, and subsequently spent four years in PwC's London office in the Transaction Services division, focusing on M&A in the retail sector.

In 2004, Ralph joined Barclays Bank in London, becoming Finance Director for the UK Retail & Business Bank in 2011.

Prior to joining TSB, Ralph was the Finance Director at the Bank of England supporting its strategic transformation and the delivery of its policy agenda.

Statement of Directors' responsibilities

The Directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared TSB Group and Company financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of TSB Group and the Company and of the profit or loss of the TSB Group for that period. In preparing these financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether applicable IFRSs as adopted by the European Union have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company and TSB Group will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company and TSB Group's transactions and disclose with reasonable accuracy at any time the financial position of the Company and TSB Group and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Company and TSB Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are responsible for the maintenance and integrity of the Bank's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Financial statements

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Alignment with TSB Group's business model

The presentation of TSB Group's consolidated financial statements aligns with the execution of its strategy, its business model and the management of the financial risk to which it is exposed. As such the consolidated financial statements are structured around the key elements of TSB Group's business model as explained on page 6.

Basis of preparation

These consolidated financial statements of TSB Banking Group plc (TSB Group) comprise the results of TSB Banking Group plc consolidated with those of its subsidiaries, including TSB Bank plc. Details of subsidiary undertakings are provided in note 4 to the Company financial statements on page 108. These consolidated financial statements have been prepared in accordance with the Companies Act 2006 and with International Financial Reporting Standards (IFRS), as adopted by the European Union (EU). IFRS comprises accounting standards prefixed IFRS, issued by the International Accounting Standards Board (IASB) and those prefixed IAS, issued by the IASB's predecessor body, as well as interpretations issued by the IFRS Interpretations Committee (IFRS IC) and its predecessor body. TSB Group has taken advantage of relaxations in hedge accounting requirements in the EU endorsed version of IAS 39 *Financial Instruments: Recognition and Measurement* adopted by the EU which are not available in the version issued by the IASB.

The consolidated financial statements have been prepared under the historical cost convention as modified by financial assets and financial liabilities, including derivative contracts at fair value through profit or loss and available-for-sale financial assets. The Directors consider that it is appropriate to continue to adopt the going concern basis in preparing the consolidated financial statements.

Accounting policies

The significant accounting policies used in the preparation of the consolidated financial statements are presented in a manner consistent with TSB Group's business model and are therefore included in the relevant sections of the consolidated financial statements. In addition, the following accounting policies relate to the consolidated financial statements taken as a whole.

Consolidation - Subsidiaries are all entities (including special purpose entities) over which TSB Group has control. TSB Group controls an entity when it is exposed to, or has rights to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. Such power, generally but not exclusively, accompanies a shareholding of more than half of the voting rights. Subsidiaries are fully consolidated from the date on which control is transferred to TSB Group and are deconsolidated from the date that control ceases. Inter-company transactions, balances and unrealised gains and losses on transactions between TSB Group companies are eliminated.

Foreign currency translation - Foreign currency transactions are translated using the exchange rates prevailing at the dates of the transactions. Monetary items denominated in foreign currencies are translated at the rate prevailing at the balance sheet date. Foreign exchange gains and losses resulting from the restatement and settlement of such transactions are recognised in other operating income/expenses in the income statement.

Critical accounting estimates and judgements

The preparation of financial statements in accordance with IFRS requires management to make judgements, estimates and assumptions in applying the accounting policies that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The significant judgements made by management in applying accounting policies and the key sources of estimation uncertainty in these consolidated financial statements, which together are deemed critical to the results and financial position, are presented within the components of TSB Group's business model as shown in the table below. These areas are discussed in detail by the Audit Committee as set out on pages 35 and 36 of the corporate governance statement.

Critical accounting estimates and judgements	reference
Effective interest rate methodology	Note 1
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Consolidated balance sheet

as at 31 December 2016

	Note	2016 £ million	2015 £ million
Assets			
Cash and balances at central banks		**3,698.3**	2,755.6
Financial assets held for trading:			
Equity instruments	18	**8.7**	5.3
Trading derivative assets	27	**143.2**	47.9
Available-for-sale financial assets	11	**2,103.5**	1,262.8
Loans and receivables:			
Loans and advances to credit institutions	9	**550.4**	311.4
Reverse repurchase agreements with credit institutions		–	20.3
Loans and advances to customers	7	**29,419.1**	26,398.1
Fair value adjustments for portfolio hedged risk		**0.8**	4.1
Hedging derivative assets	27	**104.3**	42.6
Items in course of collection from banks		**213.8**	163.0
Current tax assets		**–**	5.0
Deferred tax assets	20	**99.6**	121.1
Property, plant and equipment	30	**168.3**	161.1
Other assets	31	**685.7**	319.7
Total assets		**37,195.7**	31,618.0
Liabilities			
Financial liabilities held for trading:			
Trading derivative liabilities	27	**97.7**	43.5
Financial liabilities at amortised cost:			
Deposits from credit institutions	2	**49.6**	0.8
Repurchase agreements with credit institutions	5	**751.0**	–
Repurchase agreements with non credit institutions	5	**658.6**	–
Customer deposits	1	**29,383.8**	25,874.2
Debt securities in issue	3	**2,940.1**	2,899.6
Subordinated liabilities	4	**413.3**	402.1
Fair value adjustments for portfolio hedged risk		**70.7**	41.5
Hedging derivative liabilities	27	**529.1**	239.8
Current tax liabilities		**14.7**	–
Items in course of transmission to banks		**176.1**	152.3
Other liabilities	32	**246.0**	217.9
Total liabilities		**35,330.7**	29,871.7
Equity			
Share capital	22	**5.0**	5.0
Share premium	22	**965.1**	965.1
Merger reserve	22	**616.5**	616.5
Capital reorganisation reserve	22	**(1,311.6)**	(1,311.6)
Capital reserve	22	**410.0**	410.0
Retained profits	22	**1,173.7**	1,045.9
Valuation adjustments:			
Available-for-sale reserve	22	**5.9**	16.3
Cash flow hedging reserve	22	**0.4**	(0.9)
Shareholder's equity		**1,865.0**	1,746.3
Total equity and liabilities		**37,195.7**	31,618.0

The accompanying notes are an integral part of the consolidated financial statements. The consolidated financial statements on pages 56 to 101 were approved by the Board of Directors on 25 January 2017 and signed on its behalf by:

Paul Pester
Chief Executive Officer

Ralph Coates
Chief Financial Officer

Consolidated statement of comprehensive income

for the year ended 31 December 2016

	Note	2016 £ million	2015 £ million
Income statement:			
Interest and similar income	13	**1,097.7**	967.2
Interest and similar expense	13	**(243.9)**	(201.9)
Net interest income	13	**853.8**	765.3
Fee and commission income	14	**197.5**	198.8
Fee and commission expense	14	**(97.3)**	(81.8)
Net fee and commission income	14	**100.2**	117.0
Other operating income	15	**50.0**	8.4
Other income		**150.2**	125.4
Total income		**1,004.0**	890.7
Total operating expenses	16	**(734.7)**	(740.8)
Operating profit before impairment losses and taxation		**269.3**	149.9
Impairment losses on loans and advances to customers	10	**(87.3)**	(82.3)
Profit before taxation		**182.0**	67.6
Taxation	19	**(54.2)**	21.2
Profit for the year	22	**127.8**	88.8
Other comprehensive (expense)/income:			
Items that may be subsequently reclassified to profit or loss:			
Change in available-for-sale reserve			
Change in fair value		**(14.4)**	22.1
Taxation thereon	20	**4.0**	(6.2)
	22	**(10.4)**	15.9
Change in cash flow hedging reserve			
Change in the fair value of derivatives in cash flow hedges		**48.6**	14.4
Transfers to the income statement		**(47.5)**	(15.1)
Taxation thereon	20	**0.2**	(0.2)
	22	**1.3**	(0.9)
Other comprehensive (expense)/income for the year, net of taxation		**(9.1)**	15.0
Total comprehensive income for the year		**118.7**	103.8

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated statement of changes in equity

for the year ended 31 December 2016

	Share capital £ million	Share premium £ million	Merger reserve £ million	Capital reorg-anisation reserve £ million	Capital reserve £ million	Available-for-sale reserve £ million	Cash flow hedging reserve £ million	Retained profit £ million	Total equity £ million
Balance at 1 January 2015	5.0	965.1	616.5	(1,311.6)	410.0	0.4	–	949.0	1,634.4
Comprehensive income:									
Profit for the year	–	–	–	–	–	–	–	88.8	88.8
Other comprehensive income/(expense)	–	–	–	–	–	15.9	(0.9)	–	15.0
Total comprehensive income	–	–	–	–	–	15.9	(0.9)	88.8	103.8
Transactions with owners:									
Movement in shares held by trusts	–	–	–	–	–	–	–	9.1	9.1
Reclassification of equity settled share schemes to cash settled	–	–	–	–	–	–	–	(3.1)	(3.1)
Value of partner services	–	–	–	–	–	–	–	2.1	2.1
Total transactions with owners	–	–	–	–	–	–	–	8.1	8.1
Balance at 31 December 2015	5.0	965.1	616.5	(1,311.6)	410.0	16.3	(0.9)	1,045.9	1,746.3
Balance at 1 January 2016	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**16.3**	**(0.9)**	**1,045.9**	**1,746.3**
Comprehensive income/(expense):									
Profit for the year	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**127.8**	**127.8**
Other comprehensive (expense)/income	**–**	**–**	**–**	**–**	**–**	**(10.4)**	**1.3**	**–**	**(9.1)**
Total comprehensive income	**–**	**–**	**–**	**–**	**–**	**(10.4)**	**1.3**	**127.8**	**118.7**
Balance at 31 December 2016	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**5.9**	**0.4**	**1,173.7**	**1,865.0**

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated cash flow statement

for the year ended 31 December 2016

	Note	2016 £ million	2015 £ million
Cash flows from operating activities			
Profit before taxation		**182.0**	67.6
Adjustments for:			
Change in operating assets	33	**(3,920.6)**	(2,270.5)
Change in operating liabilities	33	**3,990.2**	1,478.1
Non-cash and other items	33	**76.2**	142.1
Taxation paid		**(8.7)**	(8.5)
Net cash provided by/(used in) operating activities		**319.1**	(591.2)
Cash flows from investing activities			
Purchase of property, plant and equipment		**(35.9)**	(39.7)
Purchase of financial assets		**(779.2)**	(3,969.6)
Interest received on financial assets		**53.7**	32.8
Proceeds on disposal of equity assets		**25.3**	–
Maturity/(Issue) of reverse repurchase agreements		**20.3**	(20.3)
Interest received on reverse repurchase agreements		**2.2**	–
Purchase of Sabadell shares		**(5.2)**	(7.1)
Disposal of shares held by trusts		**–**	7.6
Net cash used in investing activities		**(718.8)**	(3,996.3)
Cash flows from financing activities			
Proceeds from debt securities issued		**553.7**	2,873.7
Repayment of debt securities in issue		**(557.4)**	–
Interest paid on debt securities		**(40.6)**	(0.3)
Interest paid on subordinated liabilities		**(22.1)**	(22.1)
Proceeds from /(Repayment of) repurchase agreements		**1,408.6**	(32.5)
Interest paid on repurchase agreements		**(9.5)**	(0.4)
Net cash provided by financing activities		**1,332.7**	2,818.4
Change in cash and cash equivalents		**933.0**	(1,769.1)
Cash and cash equivalents at 1 January	33	**2,714.7**	4,483.8
Cash and cash equivalents at 31 December		**3,647.7**	2,714.7

The accompanying notes are an integral part of the consolidated financial statements.

Notes to the consolidated financial statements

Sources of funding

Money deposited by customers into their bank and savings accounts provides the majority of the funds we use to support lending to customers. We also raise funds from other sources, including wholesale funding markets, that diversify our funding profile and our shareholder also provides some funding in the form of equity in the business.

Accounting policies relevant to sources of funding

(a) Financial liabilities

Financial liabilities is the term used to describe TSB Group's deposits and funding. It includes customer deposits, deposits from credit institutions, debt securities in issue, subordinated liabilities, items in the course of transmission to banks and derivative financial liabilities (see accounting policy (j) under Managing financial risk).

Financial liabilities which are not derivatives are measured at amortised cost. Issues of financial liabilities measured at amortised cost are recognised on settlement date. A financial liability is derecognised from the balance sheet when TSB Group has discharged its obligations, the contract is cancelled or the contract expires.

Borrowings (which include deposits from credit institutions, customer deposits, debt securities in issue and subordinated liabilities) are recognised initially at fair value, being their issue proceeds net of transaction costs incurred. These instruments are subsequently stated at amortised cost using the effective interest method.

1. Customer deposits

	2016 £ million	2015 £ million
Bank accounts	**9,938.8**	8,699.0
Instant access saving deposits	**15,221.4**	13,823.5
Deposits with agreed maturity	**4,209.6**	3,323.4
Deposits redeemable at notice	**26.0**	34.8
Valuation adjustments	**(12.0)**	(6.5)
Total customer deposits	**29,383.8**	25,874.2

At 31 December 2016 £2,766.2 million (2015: £1,338.4 million) of customer deposits had a residual maturity of greater than one year. Valuation adjustments primarily reflect effective interest rate (EIR) asset balances, as explained below, and micro fair value hedge adjustments.

Significant judgements and estimates – effective interest rate methodology

TSB Group uses the EIR method to determine the recognition of interest expense on customer deposits. At 31 December 2016, TSB Group had deferred, for accounting purposes, £15.0 million of interest expense in respect of bonus interest on certain savings products (2015: £8.0 million). This amount will be recognised as interest expense over the expected remaining life of the relevant savings balances. The assessment of this period requires management judgement including the extent to which recent historical repayment behaviour is indicative of future expected behaviour.

2. Deposits from credit institutions

	2016 £ million	2015 £ million
Deposits from credit institutions	**49.6**	0.8
Total deposits from credit institutions	**49.6**	0.8

At 31 December 2016 and 2015, all balances have a contractual residual maturity of less than one year.

Notes to the consolidated financial statements

Sources of funding (continued)

3. Debt securities in issue

	Balance at 1 Jan 2016 £ million	Issues/ (Repayments) £ million	Exchange rate adjustments £ million	Balance at 31 Dec 2016 £ million
Debt securities issued in an EU Member State requiring filing of a prospectus:				
Duncan Funding 2015-1 plc	**544.3**	**(65.0)**	**35.6**	**514.9**
Duncan Funding 2016-1 plc	**–**	**500.2**	**10.7**	**510.9**
Debt securities issued in an EU Member State not requiring filing of a prospectus	**2,355.3**	**(437.0)**	**(4.0)**	**1,914.3**
Total debt securities in issue	**2,899.6**	**(1.8)**	**42.3**	**2,940.1**

	Balance at 1 Jan 2015 £ million	Issues/ (Repayments) £ million	Exchange rate adjustments £ million	Balance at 31 Dec 2015 £ million
Debt securities issued in an EU Member State requiring filing of a prospectus:				
Duncan Funding 2015-1 plc	–	536.7	7.6	544.3
Duncan Funding 2016-1 plc	–	–	–	–
Debt securities issued in an EU Member State not requiring filing of a prospectus	10.0	2,339.0	6.3	2,355.3
Total debt securities in issue	10.0	2,875.7	13.9	2,899.6

	Date of issue	Amount 31 Dec 2016 £ million	Amount 31 Dec 2015 £ million	Interest rate at 31 Dec 2016	Maturity date	Issue currency	Target of offering
Issuing entity							
Cape Funding No. 1 plc	05/2014	**1,914.3**	2,355.3	0.99769%	12/2018	GBR	Institutional
Duncan Funding 2015-1 plc	11/2015	**259.0**	324.1	1.07063%	09/2020	GBR	Institutional
Duncan Funding 2015-1 plc	11/2015	**255.9**	220.2	0.16400%	09/2020	EUR	Institutional
Duncan Funding 2016-1 plc	05/2016	**115.2**	–	0.08900%	04/2021	EUR	Institutional
Duncan Funding 2016-1 plc	05/2016	**395.7**	–	1.17100%	04/2021	GBR	Institutional
Total debt securities in issue		**2,940.1**	2,899.6				

4. Subordinated liabilities

	2016 £ million	2015 £ million
Fixed/floating rate reset callable subordinated Tier 2 notes due May 2026	**383.8**	383.5
Accrued interest	**3.4**	3.4
Fair value hedge accounting adjustments	**26.1**	15.2
Total subordinated liabilities	**413.3**	402.1

TSB Banking Group plc (the Company) issued, in 2014, £385.0 million of fixed/floating rate reset callable subordinated Tier 2 notes at an issue price of 99.493% of the principal amount. The notes pay interest at a rate of 5.75% per annum, payable semi-annually in arrears until 6 May 2021 at which time the interest rate becomes 3 month LIBOR plus 3.43% per annum payable quarterly in arrears. The Company has the option to redeem these notes on 6 May 2021 and quarterly thereafter, subject to approval of the Prudential Regulatory Authority.

Sources of funding (continued)

5. Repurchase agreements

During 2016, TSB Group entered into repurchase agreements which transferred legal title of certain assets (comprising gilts and retained notes issued under TSB Group's securitisation programmes) in return for cash, together with an agreement to repurchase the assets at a later date and at a predetermined price. The securitisation notes are supported by mortgage loans (see note 7). The gilts and mortgage loans were not derecognised from TSB Group's consolidated balance sheet as substantially all of the rewards, including interest income, and risks, including credit and interest rate risks, are retained by TSB Group. In all cases, the transferee has the right to sell or repledge the gilts and retained notes concerned, subject to delivering the securities at the repurchase date.

The table below presents the carrying values of the transferred gilts and the associated repurchase agreement liabilities. The associated liabilities represent TSB Group's obligation to repurchase the transferred assets.

	Carrying amount of transferred assets 2016 £ million	Carrying amount of associated liabilities 2016 £ million	Carrying amount of transferred assets 2015 £ million	Carrying amount of associated liabilities 2015 £ million
Repurchase agreements with credit institutions	**932.4**	**751.0**	–	–
Repurchase agreements with non credit institutions	**663.8**	**658.6**	–	–
Repurchase agreements	**1,596.2**	**1,409.6**	–	–

6. Fair value of financial liabilities

The following table summarises the carrying values and fair values of financial liabilities presented on TSB Group's balance sheet. The fair values presented in the table are at a specific date and may be significantly different from the amount which will actually be paid on the maturity or settlement date.

		2016		2015	
	Note	Carrying value £ million	Fair value £ million	Carrying value £ million	Fair value £ million
Financial liabilities					
Customer deposits	1	**29,383.8**	**29,451.5**	25,874.2	25,954.8
Repurchase agreements	5	**1,409.6**	**1,417.1**	–	–
Debt securities in issue	3	**2,940.1**	**2,950.2**	2,899.6	3,031.4
Subordinated liabilities	4	**413.3**	**403.4**	402.1	412.4
Trading derivative liabilities	27	**97.7**	**97.7**	43.5	43.5
Hedging derivative liabilities	27	**529.1**	**529.1**	239.8	239.8

The carrying amount of deposits from credit institutions and items in course of transmission to banks is a reasonable approximation of fair value. Fair value is the price that would be paid to transfer a liability (or sell an asset) in an orderly transaction between market participants at the measurement date. The fair values of TSB Group's financial liabilities that traded in active markets are based on current offer prices. For those instruments which do not have an active market, fair values have been determined using valuation techniques which include reference to recent arm's length transactions, or reference to other instruments with characteristics similar to those of the instruments held by TSB Group. Valuation techniques used include discounted cash flow analysis and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by TSB Group. Derivative financial instruments are the only financial liabilities of TSB Group that are carried at fair value.

Valuation hierarchy of financial liabilities

Financial liabilities carried at fair value, or for which fair values are disclosed, have been classified into three levels according to the quality and reliability of information used to determine the fair values.

Level 1 - Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2 - Level 2 valuations are those where quoted market prices are not available, for example where the instrument is traded in a market that is not considered to be active or valuation techniques are used to determine fair value and where these techniques use inputs that are based significantly on observable market data.

Level 3 - Level 3 portfolios are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data.

Notes to the consolidated financial statements

Sources of funding (continued)

6. Fair value of financial liabilities (continued)

The table below analyses the fair values of TSB Group's financial liabilities.

	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2016					
Customer deposits	**–**	**29,451.5**	**–**	**29,451.5**	**29,383.8**
Repurchase agreements	**–**	**1,471.1**	**–**	**1,471.1**	**1,409.6**
Debt securities in issue	**1,035.8**	**1,914.4**	**–**	**2,950.2**	**2,940.1**
Subordinated liabilities	**–**	**403.4**	**–**	**403.4**	**413.3**
Trading derivative liabilities	**–**	**97.7**	**–**	**97.7**	**97.7**
Hedging derivative liabilities	**–**	**529.1**	**–**	**529.1**	**529.1**
At 31 December 2015					
Customer deposits	–	25,954.8	–	25,954.8	25,874.2
Debt securities in issue	625.4	2,406.0	–	3,031.4	2,899.6
Subordinated liabilities	–	412.4	–	412.4	402.1
Trading derivative liabilities	–	43.5	–	43.5	43.5
Hedging derivative liabilities	–	239.8	–	239.8	239.8

The fair value of deposits repayable on demand is considered to be equal to their carrying value. The fair value for all other customer deposits is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities. TSB Group's subordinated liabilities and derivative financial liabilities, which comprise interest rate swaps, are primarily valued using discounted cash flows where the most significant input is interest yield curves developed from publicly quoted rates and by reference to instruments with similar risk characteristics as the instruments held by TSB Group.

Notes to the consolidated financial statements

Loans

Funds deposited with TSB Group are primarily used to support lending to customers. TSB Group lends money to customers using different products, including mortgages, credit cards, unsecured personal loans and overdrafts. A portion of the funds are held in reserve – we call that our liquidity portfolio, which enables TSB Group to meet unexpected future funding requirements.

Accounting policies relevant to loans

(b) Financial assets

'Financial assets' is the term used to describe TSB Group's loans to customers and other institutions. It includes loans and advances to customers, loans and advances to credit institutions, available-for-sale financial assets, cash and balances with central banks, items in course of collection from banks and derivative financial assets (see accounting policy (j) under Managing financial risk).

On initial recognition, financial assets which are not derivatives are classified as loans and receivables or available-for-sale financial assets. Purchases and sales of financial assets and liabilities are recognised on trade date, being the date that TSB Group is committed to purchase or sell an asset.

Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when TSB Group has transferred its contractual right to receive the cash flows from the assets and either:

- Substantially all of the risks and rewards of ownership have been transferred; or
- TSB Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

(i) Loans and receivables

Loans and receivables include loans and advances to customers, loans and advances to credit institutions and other eligible assets. Loans and advances are initially recognised when cash is advanced to the borrower at fair value inclusive of transaction costs or, for other eligible assets, their fair value at the date of acquisition. Financial assets classified as loans and receivables are accounted for at amortised cost using the effective interest method less provision for impairment.

Where TSB Group enters into securitisation transactions to finance certain loans and advances to customers using a structured entity funded by the issue of debt, these loans and advances continue to be recognised by TSB Group together with a corresponding liability for the funding where TSB Group retains control of the structured entity.

(ii) Available-for-sale financial assets

TSB Group classifies financial assets as available-for-sale when the instruments are not derivatives and are not held for trading purposes or otherwise designated at fair value through profit or loss, or at amortised cost. Available-for-sale investments are held at fair value with gains and losses arising from changes in fair value recognised in other comprehensive income. Interest is calculated using the effective interest method and is recognised in the income statement in net interest income. On disposal, the cumulative gain or loss previously recognised in other comprehensive income is recognised in the income statement.

(iii) Repurchase agreements

Financial instruments sold under a repurchase agreement, under which substantially all the risks and rewards of ownership are retained by TSB Group, continue to be recognised on the balance sheet and the sale proceeds are recognised as a financial liability. The difference between the sale and repurchase price is recognised over the life of the agreement as interest expense using the effective interest method.

Loans (continued)

(c) Impairment of financial assets

(i) Accounted for at amortised cost

At each balance sheet date TSB Group assesses whether, as a result of one or more events occurring after initial recognition, there is objective evidence that a financial asset or group of financial assets has become impaired.

If there is objective evidence that an impairment loss has been incurred, an allowance is established which is calculated as the difference between the balance sheet carrying value of the asset and the present value of estimated future cash flows discounted at that asset's original EIR. If an asset has a variable interest rate, the discount rate used for measuring the impairment loss is the current EIR.

Subsequent to the recognition of an impairment loss on a financial asset or a group of financial assets, interest income continues to be recognised on an EIR basis, on the asset's carrying value net of impairment provisions. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, such as an improvement in the borrower's credit rating, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

(ii) Collective basis

Impairment allowances for portfolios of homogenous loans such as residential mortgages, personal loans and credit card balances, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis.

(iii) Homogenous groups of loans

Impairment is assessed on a collective basis for homogenous groups of loans that are not considered individually impaired. The asset is included in a group of financial assets with similar credit risk characteristics and collectively assessed for impairment.

The criteria that TSB Group uses to determine that there is objective evidence of an impairment loss may include:

- Delinquency in contractual payments of principal and/or interest;
- Indications that the borrower or group of borrowers is experiencing significant financial difficulty;
- Restructuring of debt to reduce the burden on the borrower;
- Breach of loan covenants or conditions; and
- Initiation of bankruptcy or individual voluntary arrangement proceedings.

In respect of TSB Group's secured mortgage portfolios, the impairment allowance is calculated based on a definition of impaired loans which are those six months or more in arrears (or in certain cases where the borrower is bankrupt or is in possession). The estimated cash flows are calculated based on historical experience and are dependent on estimates of the expected value of collateral which takes into account expected future movements in house prices, less costs to sell.

For unsecured personal lending portfolios, the impairment trigger is generally when the balance is two or more instalments in arrears or where the customer has exhibited one or more of the impairment characteristics set out above. While the trigger is based on the payment performance or circumstances of each individual asset, the assessment of future cash flows uses historical experience of cohorts of similar portfolios such that the assessment is considered to be collective. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the cohort and historical loss experience for similar assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. The methodology and assumptions used for estimating future cash flows are reviewed regularly by TSB Group to reduce any differences between loss estimates and actual loss experience.

(iv) Write-offs

A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery (as a result of the customer's insolvency, ceasing to trade or other reason) and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the statement of comprehensive income.

Notes to the consolidated financial statements

Loans (continued)

7. Loans and advances to customers

	2016 £ million	2015 £ million
Commercial credit	**158.8**	186.8
Secured loans – Franchise	**22,806.0**	18,823.3
Secured loans – Mortgage Enhancement	**1,843.4**	2,267.4
Secured loans – Whistletree Loans	**2,389.6**	2,911.4
Unsecured loans - Whistletree Loans	**72.2**	92.6
Other term loans	**1,227.2**	1,220.2
Receivable on demand	**829.3**	796.5
Impaired assets	**140.0**	159.0
Other valuation adjustments	**26.3**	12.1
Gross loans and advances to customers	**29,492.8**	26,469.3
Allowance for impairment losses (note 10)	**(73.7)**	(71.2)
Loans and advances to customers	**29,419.1**	26,398.1

At 31 December 2016 £26,851.8 million of loans and advances to customers (2015: £23,992.2 million) had a contractual residual maturity of greater than one year. Other valuation adjustments reflect effective interest rate asset balances and micro fair value hedge adjustments.

Loans and advances to customers include loans securitised under TSB Group's securitisation programmes, the majority of which have been sold to bankruptcy remote structured entities. As the structured entities are funded by the issue of debt on terms whereby the majority of the risks and rewards of the portfolio are retained by TSB Group, the structured entities are consolidated fully and all of these loans are retained on TSB Group's balance sheet, with the related notes in issue included within debt securities in issue.

TSB Group's securitisation programmes, together with the balances of the advances subject to these arrangements and the carrying value of the notes in issue at 31 December, are listed below.

	31 December 2016		31 December 2015	
	Loans and advances securitised[(1)] £ million	Liability £ million	Loans and advances securitised[(1)] £ million	Liability £ million
Cape Funding No. 1 plc	**2,243.8**	**2,341.1**	2,701.2	2,805.1
Duncan Funding 2015-1 plc	**1,773.3**	**1,879.1**	2,026.5	2,086.1
Duncan Funding 2016-1 plc	**3,079.7**	**3,244.8**	–	–
	7,096.8	**7,465.0**	4,727.7	4,891.2
Less held by TSB Group		**(4,524.9)**		(1,991.6)
Total securitisation notes (note 3)		**2,940.1**		2,899.6

(1) Due to the nature of the securitisation programmes, cash arising from mortgage repayments will be retained for periods of time before being invested in replacement mortgage assets or being distributed to note holders.

Cash deposits of £530.5 million (2015: £302.5 million) held by TSB Group are restricted in use to repayment of the debt securities issued by the structured entities and other legal obligations.

TSB Group recognises the full liabilities associated with its securitisation programmes within debt securities in issue, although the obligations of TSB Group are limited to the cash flows generated from the underlying assets. TSB Group could be required to provide additional support to the Cape Funding securitisation programme to maintain the credit ratings of the debt securities issued in the form of increased cash reserves and the holding of subordinated notes. Further, the Cape Funding programme allows TSB Group to repurchase assets should they become credit impaired, and TSB Group has voluntarily offered to repurchase £16.2 million of such assets during 2016 (2015: £17.4 million). TSB Group has also voluntarily offered to repurchase £4.8 million of assets (that are not credit impaired) from the Cape Funding securitisation programme during 2016 (2015: £3.4 million).

Notes to the consolidated financial statements

Loans (continued)

8. Commitments arising from the banking business

In the normal course of business, TSB Group provides commitments to lend to its customers as presented below.

	2016 £ million	2015 £ million
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Mortgage offers made	**1,489.8**	1,740.0
Credit cards	**2,695.4**	2,760.2
Other	**1,091.8**	806.3
Total commitments	**5,277.0**	5,306.5

Of the amounts shown above, £1,778.3 million (2015: £1,740.0 million) was irrevocable. All commitments to lend to customers shown in the table above have a contractual maturity of less than one year.

9. Loans and advances to credit institutions

	2016 £ million	2015 £ million
Other accounts	**530.9**	310.1
Deposits secured due to market transactions	**19.5**	1.3
Total loans and advances to credit institutions	**550.4**	311.4

At 31 December 2016 £196.3 million of loans and advances to credit institutions (2015: £137.6 million) had a contractual residual maturity of greater than one year.

Loans and advances to credit institutions includes cash deposits of £530.5 million (2015: £302.5 million) held by securitisation entities Cape Funding No.1 plc, Duncan Funding 2015-1 plc and Duncan Funding 2016-1 plc.

10. Allowance for impairment losses on loans and receivables

	Specific coverage determined individually £ million	Specific coverage determined collectively £ million	Incurred but not reported coverage £ million	Total £ million
At 1 January 2015	1.4	61.6	23.1	86.1
Movements reflected in the income statement	2.3	85.6	(5.6)	82.3
Movements not reflected in the income statement:				
Utilisations	(2.6)	(111.7)	–	(114.3)
Other movements	–	17.1	–	17.1
At 31 December 2015	**1.1**	**52.6**	**17.5**	**71.2**
Movements reflected in the income statement	**0.5**	**84.3**	**2.5**	**87.3**
Movements not reflected in the income statement:				
Utilisations	**(1.0)**	**(100.9)**	**–**	**(101.9)**
Other movements	**–**	**17.1**	**–**	**17.1**
At 31 December 2016	**0.6**	**53.1**	**20.0**	**73.7**

Included in total allowance for loans and advances to customers is £53.7 million (2015: £53.7 million) relating to lending that was determined to be impaired.

Notes to the consolidated financial statements

Loans (continued)

Significant judgements and estimates – impairment provisioning

The allowance for impairment losses is management's best estimate of losses incurred in the portfolio at the balance sheet date. At 31 December 2016 TSB Group recognised an impairment allowance against loans and advances to customers of £73.7 million (2015: £71.2 million).

The impairment allowance is subject to estimation uncertainty and in particular is sensitive to changes in economic and credit conditions, including the interdependency of house prices, unemployment rates, interest rates, borrowers' behaviour, and consumer bankruptcy trends. It is inherently difficult to estimate how changes in one or more of these factors might impact the impairment allowance. However, given the relative size of the mortgage portfolio, a key variable is house prices which determine the collateral value supporting loans in such portfolios. The value of this collateral is estimated by applying changes in house price indices to the original assessed value of the property. If average house prices had been 10% lower than those estimated at 31 December 2016, the allowance for impairment losses would have been approximately £8.0 million higher (2015: £7.3 million higher, adjusted to reflect revised analysis).

The adequacy of the provision is estimated using models which use a variety of inputs, including recent historical experience to estimate the level of incurred losses in the portfolio. In certain circumstances adjustments are made to the modelled outcomes to reflect where, in management's judgement, the modelled outcomes are not sufficiently sensitive to current economic conditions. At 31 December 2016, the impairment allowance included £25.4 million of post model adjustments (2015: £18.4 million).

11. Available-for-sale financial assets

	2016 £ million	2015 £ million
UK Gilts	**1,872.8**	1,240.4
Supranational and development bank bonds	**225.5**	–
Visa Inc. convertible preferred stock	**5.2**	–
Investment in Visa Europe	**–**	22.4
Total available-for-sale financial assets	**2,103.5**	1,262.8

At 31 December 2016 UK gilts with a carrying value of £663.8 million (2015: £nil) were subject to repurchase agreements (note 5). At 31 December 2016 and 2015 all of the available-for-sale financial assets had a contractual maturity of greater than one year.

Significant judgements and estimates – valuation of investment in Visa Inc. convertible preferred stock

In June 2016, TSB Group received Visa Inc. convertible preferred stock as partial consideration for the sale of its share in Visa Europe to Visa Inc. At 31 December 2016, TSB Group's investment was recognised as an available-for-sale asset at its fair value of £5.2 million. The key inputs to the valuation are the conversion rate of the preferred stock to Visa Inc. common stock, the fair value of Visa Inc. common stock and the US Dollar to Sterling exchange rate. Determining the fair value of this investment requires management judgement as the preferred stock is not transferrable and conversion to Visa Inc. common stock is subject to reduction to reflect potential litigation losses incurred by Visa.

The most significant unobservable input to the valuation is an estimate of potential litigation losses which could reduce the conversion rate of the preferred stock. The potential fair value of TSB Group's investment in Visa Inc. convertible preferred stock could be up to £15.6 million greater if no reductions were assumed in the conversion of the preferred stock and there were no restrictions on transferability.

Loans (continued)

12. Fair value of financial assets

The following table summarises the carrying values of financial assets presented on TSB Group's consolidated balance sheet. The fair values presented in the table are at a specific date and may be significantly different from the amount which will actually be received on the maturity or settlement date.

		2016		2015	
	Note	Carrying value £ million	Fair value £ million	Carrying value £ million	Fair value £ million
Financial assets					
Loans and advances to customers	7	**29,419.1**	**29,464.7**	26,398.1	26,380.9
Available-for-sale financial assets	11	**2,103.5**	**2,103.5**	1,262.8	1,262.8
Trading derivative assets	27	**143.2**	**143.2**	47.9	47.9
Hedging derivative assets	27	**104.3**	**104.3**	42.6	42.6
Equity instruments	18	**8.7**	**8.7**	5.3	5.3

The carrying amount of cash and balances at central banks; items in course of collection from banks; and loans and advances to credit institutions is a reasonable approximation of fair value.

Valuation hierarchy of financial assets carried at amortised cost

The table below analyses the fair values of financial assets carried at amortised cost and for which fair value is disclosed.

	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
Loans and advances to customers	**–**	**–**	**29,464.7**	**29,464.7**	**29,419.1**
At 31 December 2016	**–**	**–**	**29,464.7**	**29,464.7**	**29,419.1**
At 31 December 2015	–	–	26,380.9	26,380.9	26,398.1

TSB Group provides loans at both fixed and variable rates. Fair value is principally estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by TSB Group and other financial institutions. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period.

Valuation hierarchy of financial assets carried at fair value

The table below analyses the fair values of the financial assets of TSB Group which are carried at fair value.

	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2016					
Available-for-sale financial assets	**2,098.3**	**–**	**5.2**	**2,103.5**	**2,103.5**
Trading derivative assets	**–**	**143.2**	**–**	**143.2**	**143.2**
Hedging derivative assets	**–**	**104.3**	**–**	**104.3**	**104.3**
Equity instruments	**8.7**	**–**	**–**	**8.7**	**8.7**
Total	**2,107.0**	**247.5**	**5.2**	**2,359.7**	**2,359.7**
At 31 December 2015					
Available-for-sale financial assets	1,240.4	–	22.4	1,262.8	1,262.8
Trading derivative assets	–	47.9	–	47.9	47.9
Hedging derivative assets	–	42.6	–	42.6	42.6
Equity instruments	5.3	–	–	5.3	5.3
Total	1,245.7	90.5	22.4	1,358.6	1,358.6

Loans (continued)

12. Fair value of financial assets (continued)

Level 3 financial assets	2016 £ million	2015 £ million
Balance at 1 January	**22.4**	–
Disposal of share in Visa Europe	**(22.4)**	–
Acquisition of Visa Inc. convertible preferred stock	**4.5**	–
Gains recognised in ‘changes in fair value’ in other comprehensive income	**0.7**	22.4
Balance at 31 December	**5.2**	22.4

During 2016, TSB Group disposed of its share in Visa Europe for consideration comprising a combination of upfront and deferred cash of £28.0 million and the receipt of Visa Inc. convertible preferred stock valued at £4.5 million at the date of initial recognition. This resulted in a gain on disposal of £32.5 million that is recognised in other operating income in the income statement (see note 15).

Available-for-sale gilts and supranational and development bank bonds are valued using quoted market prices and are therefore classified as Level 1 assets. The only Level 3 financial asset carried at fair value at 31 December 2016 is the available-for-sale investment in Visa Inc. convertible preferred stock. A description of the valuation approach and the key unobservable inputs to the valuation are explained on page 70. Derivative financial assets are primarily interest rate swaps and are valued using a discounted cash flow model where the most significant input is interest yield curves which are developed from publicly quoted rates.

Notes to the consolidated financial statements

Loans (continued)

IFRS 9 *Financial Instruments*

In July 2014, the IASB issued IFRS 9 *Financial Instruments*, which replaces IAS 39 *Financial Instruments: Recognition and Measurement*. IFRS 9 fundamentally changes the way financial instruments are accounted for and includes requirements in three areas; classification and measurement of financial assets and liabilities, impairment of financial assets, and hedge accounting. IFRS 9 was endorsed by the EU in November 2016 and will be applied by TSB Group from its mandatory application date of 1 January 2018. The classification and measurement and impairment requirements will be applied retrospectively by adjusting the opening balance sheet at 1 January 2018; there is no requirement to restate comparative period amounts.

1. Overview of the requirements of IFRS 9

- *Classification and measurement* **-** The classification and measurement of financial assets will depend on how these are managed (the business model) and their contractual cash flow characteristics. The classification of the financial asset determines whether it is measured at amortised cost, fair value through other comprehensive income (FVOCI) or fair value through profit or loss (FVPL). The requirements for the classification of financial liabilities, as they currently apply to TSB Group, remain unchanged.

  The majority of TSB Group's financial assets are loans and advances to customers currently classified as loans and receivables and held at amortised cost. TSB Group conducted an assessment of potential changes in the classification and measurement of financial assets as at 31 December 2015. Based on this assessment, and reflecting TSB Group's straightforward local banking business model, TSB Group does not expect there to be significant changes to the classification or measurement of its financial assets.

- *Impairment* **-** The impairment requirements of IFRS 9 apply to financial assets measured at amortised cost and FVOCI. At initial recognition, an impairment allowance is required for expected credit losses (ECL) resulting from default events expected within the next 12 months (12 month ECL). In the event of a significant increase in credit risk, allowance is required for ECL resulting from default events expected over the estimated life of the financial instrument (lifetime ECL). IFRS 9 requires the financial asset to be allocated to one of three 'stages' as follows:

  - Stage 1 - Financial assets which have not experienced a significant increase in credit risk since they were originated. Recognition of a 12 month ECL is required. Interest income on stage 1 financial assets is calculated on the gross carrying amount of the financial asset;
  - Stage 2 – Financial assets which have experienced a significant increase in credit risk. For financial assets in stage 2, recognition of a lifetime ECL impairment allowance is required. Interest income on stage 2 financial assets is calculated on the gross carrying amount of the financial asset; and
  - Stage 3 - Financial assets which have experienced one of more events that have had a detrimental impact on the estimated future cash flows and are considered to be credit impaired. Like stage 2, recognition of a lifetime expected ECL impairment allowance is required. However, interest income on stage 3 loans is calculated on the financial asset balance net of impairment allowance.

  The assessment of whether credit risk has increased significantly since initial recognition is performed for each reporting period. This is achieved by considering the change in the probability of default occurring over the remaining life of the financial instrument.

  The assessment of credit risk and the estimation of ECL should be unbiased and probability-weighted, and should incorporate all available information which is relevant to the assessment. This should include reasonable and supportable forecasts of economic conditions at the reporting date.

  As a result, the recognition and measurement of impairment is intended to be more forward looking than under the IAS 39 incurred loss model and the resulting impairment charge is expected to be more volatile. The application of IFRS 9 is also expected to result in an increase in the total level of impairment allowances. This is because all financial assets will be assessed for at least 12 month ECL and the population of financial assets to which lifetime ECL applies is likely to be larger than the population for which there is objective evidence of impairment in accordance with IAS 39.

- *Hedge accounting* - IFRS 9 does not explicitly address the macro hedge accounting that is undertaken by TSB Group and includes an accounting policy choice to continue applying the hedge accounting requirements of IAS 39, which TSB Group expects to exercise. The revised hedge accounting disclosures required by the related amendments to IFRS 7 *Financial Instruments: Disclosures* will be implemented on transition to IFRS 9 in 2018.

Notes to the consolidated financial statements

Loans (continued)

IFRS 9 *Financial Instruments* (continued)

2. Overview of TSB Group's preparations to implement IFRS 9

Within TSB Group, a joint Finance and Risk IFRS 9 Implementation Programme (the Programme) has been preparing for the implementation of IFRS 9 since 2014. The Programme is co-sponsored by the TSB Group Chief Financial Officer and Chief Risk Officer and a Steering Committee has been established comprising senior management from Finance, Risk and other functional experts when required. The Programme has developed risk modelling methodologies for the calculation of impairment, defined TSB Group accounting policies and is designing data systems and process requirements. The Programme's focus in 2017 will evolve from design and build to testing and operational readiness which will support a period of parallel run and the refinement of key model parameters and policy decisions.

TSB Group will present a quantification of the potential impact of IFRS 9 on the consolidated financial statements once it is practicable to provide a reliable estimate. This is expected to be no later than in the 2017 Annual Report and Accounts.

3. Comparison of TSB Group's existing IAS 39 accounting policies with IFRS 9

The accounting policies and critical accounting estimates and judgements for the impairment of loans and advances (in accordance with IAS 39) are set out on pages 66, 67 and 70. The equivalent policies for financial assets at amortised cost and at FVOCI (in accordance with IFRS 9) are being developed as described below.

- *Definition of default*

  TSB Group currently intends to align as far as possible the IFRS 9 and regulatory definitions of default, the definition of credit impaired and the definition of non-performing exposure. This will result in loans that are more than 90 days past due, or considered by management as unlikely to pay their obligations in full without realisation of collateral, being considered as in default for IFRS 9. TSB Group does not expect to rebut the presumption in IFRS 9 that loans which are more than 90 days past due are in default.

- *Stage 1*

  Under IFRS 9, financial assets which are not considered to have significantly increased in credit risk have loss allowances measured at an amount equal to 12 months ECL. This 12 month time horizon will be equal to (in respect of TSB Group's mortgage loan portfolios) or longer than (in respect of TSB Group's unsecured and business banking portfolios) the period estimated under IAS 39. This is expected to result in IFRS 9 allowances being larger that those calculated in accordance with IAS 39.

- *Stage 2*

  Financial assets are considered to be in stage 2 when their credit risk has increased significantly since initial recognition. This is likely to result in an increased allowance relative to IAS 39 as the result of the recognition of lifetime ECL for populations that are not currently considered to be credit impaired under IAS 39.

  The main factor that will be considered by TSB Group is an increase in the residual lifetime Probability of Default (PD) since initial recognition. As a secondary assessment criterion, financial assets that are in forbearance but not in default are expected to have experienced significant increase in credit risk and will be in stage 2. As a backstop, TSB Group does not expect to rebut the presumption in IFRS 9 that all financial assets that are more than 30 days past due have experienced a significant increase in credit risk.

  The assessment as to when a financial asset has experienced a significant increase in residual PD requires the application of management judgement. TSB Group is in the process of assessing the thresholds using factors that are relevant to TSB Group's internal credit risk management strategies.

  In respect of loans, TSB Group does not plan to use the practical expedient available in IFRS 9 which permits low credit risk loans (i.e. those considered investment grade) to remain in stage 1 without an assessment of significant increase ('low credit risk exemption'). In respect of TSB Group's investment grade debt securities, TSB Group expects to take advantage of the low credit risk exemption and categorise these financial assets as stage 1.

- *Stage 3*

  Financial assets will be included in stage 3 when there is objective evidence of credit impairment. Under IFRS 9, TSB Group expects to assess stage 3 loans by considering the relevant objective evidence. This will primarily be whether contractual payments of either principal or interest are past due for more than 90 days, the debtor is assessed as unlikely to pay, or the loan is otherwise considered to be in default.

Loans (continued)

IFRS 9 *Financial Instruments* (continued)

- *Write-off of financial assets*
  TSB Group's policy on the write-off of loans and advances included on page 67 is expected to remain unchanged.

- *Modified financial assets and derecognition*
  IFRS 9 requires that, where the contractual cash flows of a financial asset have been renegotiated or modified and the financial asset was not derecognised, its gross carrying amount is recalculated as the present value of the modified contractual cash flows, discounted at the original effective interest rate. The contractual terms of a TSB Group loan may be modified for a number of reasons, but which are primarily due to customers being granted a concession due to their financial difficulty and the loan being considered in forbearance. TSB Group therefore expects that customer treatments identified as entry to forbearance will result in loans being considered as modified under IFRS 9. The current derecognition accounting policy as described on page 66 will remain unchanged under IFRS 9.

4. Methodologies applied to measure 12-month and lifetime expected credit losses

ECLs are calculated using three main components:
- a probability of default (PD);
- a loss given default (LGD); and
- the exposure at default (EAD).

For accounting purposes, the 12 month and lifetime PDs represent the probability of a default occurring over the next 12 months or the lifetime of the financial instruments, respectively, based on conditions existing at the balance sheet date and future economic conditions that affect credit risk. The LGD represents losses expected on default, taking into account the mitigating effect of collateral, its expected value when realised and the time value of money. The EAD represents the expected balance at default, taking into account the repayment of principal and interest from the balance sheet date to the default event together with any expected drawdown of a committed facility.

The 12 month ECL is calculated by multiplying the 12 month PD, LGD and EAD. Lifetime ECL is calculated using the lifetime PD, and the appropriate LGD and EAD based on the modelled remaining behavioural life of the financial asset.

TSB Group plans to base the ECL calculations on the systems used to calculate regulatory expected losses. This is considered to be most efficient given similarities in the calculations. However, certain adjustments are required to the Basel risk components (PD, LGD, and EAD) to meet IFRS 9 requirements. The main adjustments necessary to Basel risk components are explained in the table below:

Model	Regulatory capital models	IFRS 9 models
Probability of Default	• Through the cycle (represents long-run averaged throughout a full economic cycle). • The definition of default includes a backstop of more than 90 days past due, although this has been modified to more than 180 days past due for mortgages.	• Forward in time (based on current conditions, adjusted to take into account estimates of future economic conditions). • Definition of default for IFRS 9 will use a quantitative threshold of more than 90 days past due for all portfolios.
Exposure at default	• Cannot be lower than current balance.	• Amortisation and expected prepayments captured for term products.
Loss given default	• Downturn LGD (consistent losses expected to be suffered during a severe but plausible economic downturn). • Regulatory floors may apply to mitigate risk of underestimating downturn LGD due to lack of historical data. • Discounted using the cost of capital. • All collection costs included.	• Expected LGD (based on estimate of LGD including the expected impact of future economic conditions such as changes in value of collateral). • No floors. • Discounted using the original effective interest rate of the loan. • Only costs associated with obtaining/selling collateral included.
Other		• Discounted back from point of default to balance sheet date.

The measurement of ECL will also require the use of multiple economic scenarios to calculate a probability weighted forward looking estimate. TSB Group is continuing to refine the approach to, and governance over, the selection of appropriate forward looking economic scenarios. Considerations include the number of scenarios to be used, and assessing the probability weightings applied to each scenario. Transfers between stages will capture the effects of the application of these probability weighted forward-looking macroeconomic variables.

Notes to the consolidated financial statements

Income

We earn income in the form of interest that we receive on the loans we make to customers and we pay interest to savings and bank account customers on the money they deposit with us and to providers of other forms of funding. We also earn other income in the form of fees and charges from the provision of banking services and commissions from the sale of certain third party products such as general insurance.

Accounting policies relevant to income

(d) Interest income and expense

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments using the EIR method. The EIR method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense. The EIR is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability.

The effective interest rate is calculated on initial recognition of the financial asset or liability, estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts paid or received by TSB Group that are an integral part of the overall return, direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument and all other premiums or discounts. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss (see accounting policy (c) on impairment of financial assets).

(e) Fees and commission income and expense

Fees and commissions which are not an integral part of the EIR are generally recognised when the service has been provided.

13. Net interest income

	2016 £ million	2015 £ million
Interest and similar income		
Cash and balances at central banks	**11.0**	18.4
Available-for-sale financial assets	**28.9**	17.5
Loans and advances to credit institutions	**3.4**	0.9
Derivative financial instruments	**(8.9)**	25.8
Loans and advances to customers	**1,063.3**	904.6
Total interest and similar income	**1,097.7**	967.2
Interest and similar expense		
Deposits from credit institutions	**(0.2)**	(0.1)
Repurchase agreements	**(10.3)**	–
Customer deposits	**(174.0)**	(172.1)
Debt securities in issue	**(37.0)**	(7.3)
Subordinated liabilities	**(22.4)**	(22.4)
Total interest and similar expense	**(243.9)**	(201.9)
Net interest income	**853.8**	765.3

Included within interest and similar income is £9.5 million (2015: £8.7 million) in respect of impaired financial assets.

Notes to the consolidated financial statements

Income (continued)

14. Net fee and commission income

	2016 £ million	2015 £ million
Fee and commission income		
Bank accounts	**89.6**	93.9
Credit and debit card fee income	**62.5**	61.6
Insurance commission income	**21.0**	21.9
Other	**24.4**	21.4
Total fee and commission income	**197.5**	198.8
Fee and commission expense		
Bank accounts	**(74.4)**	(62.4)
Credit and debit card fee expense	**(8.8)**	(6.5)
Other	**(14.1)**	(12.9)
Total fee and commission expense	**(97.3)**	(81.8)
Net fee and commission income	**100.2**	117.0

Fees and commissions which are an integral part of the EIR are recognised in net interest income.

15. Other operating income

	2016 £ million	2015 £ million
Fair value movement on instruments held at fair value through profit or loss	**15.2**	7.2
Rent receivable	**1.3**	1.2
Gain on sale of share in Visa Europe	**32.5**	–
Other income	**1.0**	–
Total other operating income	**50.0**	8.4

Notes to the consolidated financial statements

Charges

Running a bank with 5 million customers comes with overheads. Charges we incur include the costs of paying our TSB partners, running our branches, investing in our business and paying for advertising and marketing. Occasionally, our customers' circumstances change and they are unable to repay the money they borrow from us causing us to incur impairment losses. Finally, TSB Group pays tax to HMRC on the profits we earn.

Accounting policies relevant to recognising charges

(f) Pensions and other post-retirement benefits

TSB Group operates defined contribution pension plans under which fixed contributions are paid. The costs of TSB Group's defined contribution plans are charged to the income statement, as an operating expense, in the period in which they fall due.

(g) Share-based compensation

TSB Group operates a number of cash settled share-based compensation plans, in respect of services received from certain of its partners. The total expense is recognised over the vesting period, which is the period over which all of the specified vesting conditions are to be satisfied. A corresponding credit is recognised as a liability. In addition, in some circumstances employees may provide services in advance of the grant date and therefore liability is estimated for the purposes of recognising the expense during the period between service commencement period and grant date.

At the end of each reporting period, the fair value of the liability is measured with any changes in fair value recognised in operating expenses.

(h) Taxation

Current corporation tax which is payable on taxable profits is recognised as an expense in the period in which the profits arise.

Deferred tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements.

Deferred tax is determined using tax rates that have been enacted or substantively enacted by the balance sheet date that are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised.

Deferred and current tax assets and liabilities are offset when they arise in the same tax reporting group and where there is both a legal right of offset and the intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

Notes to the consolidated financial statements

Charges (continued)

16. Operating expenses

	2016 £ million	2015* £ million
Staff costs		
Wages and salaries	**254.0**	246.7
Social security costs	**28.0**	28.0
Other pension costs	**31.9**	31.7
Share-based payments	**3.4**	4.8
Other staff costs	**62.0**	50.4
Total staff costs	**379.3**	361.6
Premises and equipment expenses		
Rent	**33.6**	34.5
Rates	**16.0**	15.6
Other	**36.7**	32.8
Total premises and equipment expenses	**86.3**	82.9
Other expenses		
Transitional Services Agreement (TSA) costs	**91.8**	85.4
Professional fees	**21.3**	35.3
Advertising and promotion	**59.1**	57.4
Financial Services Compensation Scheme (FSCS) levy	**6.2**	14.2
Other	**67.6**	83.4
Total other expenses	**246.0**	275.7
Depreciation (note 30)	**23.1**	20.6
Total operating expenses	**734.7**	740.8

The monthly average number of employees on a headcount basis during the year was 8,296 (2015: 8,620), all of whom were employed in the UK. Included in staff costs is remuneration paid to key management personnel as set out in note 29(i) on page 97. Included in other expenses are fees paid to TSB Group's auditors as set out in the table below:

Auditor remuneration	2016 £ million	2015 £ million
Fee for the audit of the financial statements of TSB Banking Group plc	**0.1**	0.1
Fee for the audit of TSB Group's subsidiaries	**1.7**	1.0
Non audit fees	**0.4**	0.1
Total fees payable to TSB Group's auditors	**2.2**	1.2

The 2016 fee for the audit of TSB Group's subsidiaries includes audit related services performed during the year to support the Sabadell interim audit and accelerated audit procedures relating to TSB Group's IFRS 9 programme.

17. Directors' emoluments

The remuneration of the Directors during the year was as follows:

	2016 £ 000	2015 £ 000
Aggregate remuneration paid to Directors in respect of qualifying services	**2,884**	2,871
Aggregate cash received under long-term incentive arrangements	**1,803**	715
Total	**4,687**	3,586

Details of the highest paid Director are set out on pages 47 and 48 in the Remuneration review. The table below presents the number of Directors who:

	2016 Number	2015 Number
Exercised share options	**2**	3
Received shares under long term incentive schemes	**1**	2
Accrued pension benefits under defined contribution pension schemes	**–**	1

Notes to the consolidated financial statements

Charges (continued)

18. Share-based payments

Operating expenses include the following in respect of TSB Group's share-based compensation schemes:

	2016 £ million	2015 £ million
Cash settled schemes	**3.4**	3.1
Equity settled schemes	**–**	2.4
	3.4	5.5

During 2016, TSB Group introduced two new schemes - a Sharesave and a Sharematch scheme, both of which provide all TSB Group partners with the opportunity to own shares in Sabadell. These replaced the previous Sharesave and Sharematch schemes which terminated upon the acquisition of TSB Group by Sabadell during 2015. TSB Group continues to operate the Sustainable Performance Award (SPA) scheme and Substitution Award scheme for more senior partners. As all share-based compensation schemes in operation during 2016 involve an award of, or options over, Sabadell shares, these arrangements are accounted for as cash settled share-based payment arrangements resulting in the recognition of a liability.

Sustainable Performance Award (SPA) scheme

During 2016, 2,700,434 Sabadell shares, with a fair value of £3.0 million at 31 December 2016, were awarded to certain senior partners under the SPA scheme.

Sharesave scheme

In August 2016, a Sharesave scheme commenced. Eligible partners chose to enter into a contract to save up to £500 per month and, at the maturity date, three years from the start of the savings contract, have the option to use these savings within six months to acquire shares in Sabadell at £0.7768, being a 20% discount to the average closing price and Sterling/Euro exchange rate on the date of the Sharesave invitation. Alternatively, eligible partners may take the accumulated savings balance as a cash payment. Following the acquisition by Sabadell in 2015, the TSB Sharesave scheme that was established in 2014 terminated. partners were able to use savings accumulated to the date of termination to exercise their options. Movements in the number of Sharesave options outstanding are set out below:

	2016		2015	
	Number of options (Sabadell) (000's)	**Weighted average exercise price (pence)**	Number of options (TSB Banking Group plc) (000's)	Weighted average exercise price (pence)
Outstanding at 1 January	**–**	**–**	6,301	–
Granted	**14,213**	**77.68**	–	225.48
Exercised	**–**	**–**	(1,830)	–
Forfeited	**(116)**	**77.68**	(4,360)	225.48
Cancelled	**(123)**	**77.68**	(111)	225.48
Outstanding at 31 December	**13,974**	**77.68**	–	225.48
Exercisable at 31 December	**–**	**–**	–	–

The remaining contractual life of the options outstanding at 31 December 2016 was two years and nine months. At 31 December 2016, the fair value of the options granted during 2016, determined using a Black Scholes option pricing model, was 29.7 pence and a liability of £0.3 million was recognised on the consolidated balance sheet. The weighted average TSB share price at the date of exercise in 2015 was £3.40.

Share incentive plan (SIP) – matching shares

In September 2016, a Sharematch scheme commenced. TSB Group undertook to match Sabadell shares purchased by partners, up to the value of £30 per month, which are being held in trust for a mandatory period of three years on the TSB partners' behalf. If a partner leaves TSB Group within the three year holding period under anything other than 'good' leaver status, all of the matching shares are forfeited. Similarly, if partners sell their purchased shares within three years, their matching shares are forfeited. Following the acquisition by Sabadell in 2015, the former TSB SIP scheme, established in 2014, terminated and was replaced with the new scheme. Partners matching and free shares were released from the trust and transferred to the partner.

At 31 December 2016 £8.7 million (2015: £5.3 million) of Sabadell shares were held for the purpose of TSB Group's share-based payment schemes and carried as equity instruments held for trading on the consolidated balance sheet.

In 2015, a credit of £0.7 million related to LBG schemes was included in operating expenses.

Notes to the consolidated financial statements

Charges (continued)

19. Taxation

	2016 £ million	2015 £ million
UK corporation tax		
Current tax on profit for the year	**(28.6)**	(0.1)
Adjustments in respect of prior year	**0.1**	1.9
Current tax (charge)/credit	**(28.5)**	1.8
Deferred tax (note 20)		
Origination and reversal of temporary differences:		
Deferred tax on business transfers	**(24.5)**	(10.9)
Changes in UK corporation tax rates	**(1.3)**	32.3
Deferred tax on pension	**0.2**	(0.2)
Accelerated capital allowances	**0.2**	(1.1)
Other	**(0.3)**	(0.7)
Deferred tax (charge)/credit	**(25.7)**	19.4
Taxation (charge)/credit	**(54.2)**	21.2

The change in UK corporation tax rates in 2016 reflected the effect of the enactment of the Finance Act 2016 which included legislation to reduce the main rate of UK corporation tax from 18% to 17% from 1 April 2020. The effect of this change resulted in the recognition of a deferred tax charge of £1.3 million and a corresponding reduction in the deferred tax asset at 31 December 2016.

The change in UK corporation tax rates in 2015 primarily reflects the effect of the enactment of the Finance (No. 2) Act 2015 which included legislation introducing the 8% bank surcharge effective from 1 January 2016, applicable to taxable profits in excess of £25 million per annum. It also included legislation to reduce the main rate of corporation tax from 20% to 19% from 1 April 2017 and to 18% from 1 April 2020 (which has now been superseded by the Finance Act 2016). The net effect of these changes resulted in the recognition of a deferred tax credit of £32.1 million and corresponding increase in the deferred tax asset at 31 December 2015. A further £0.2 million reflects the application of the average corporation tax rate for the year to temporary differences reversing during the year.

A reconciliation of the charge that would result from applying the UK corporation tax rate to profit before taxation to the actual taxation charge for the year is presented below:

	2016 £ million	2015 £ million
Profit before taxation	**182.0**	67.6
Taxation charge at applied UK corporation tax rate of 28.0% (2015: 20.25%)	**(51.0)**	(13.7)
Factors affecting charge:		
Disallowed costs	**(4.0)**	(6.1)
Changes to UK corporation tax rates	**(1.3)**	32.3
Taxable profits not subject to 8% bank surcharge	**2.0**	–
Deferred tax asset arising from business transfers	**–**	6.8
Adjustments in respect of prior years	**0.1**	1.9
Taxation (charge)/credit	**(54.2)**	21.2

The applied UK corporation tax rate of 28.0% for 2016 includes the 8% bank surcharge on profits in excess of £25 million that was effective from 1 January 2016 together with the average UK corporation tax rate of 20%.

Disallowed costs primarily reflect certain recurring property and restructuring costs. Changes to UK corporation tax rates reflect the deferred tax charge, and corresponding reduction in the deferred tax asset balance, arising from the effect of the Finance Act 2016 which reduces the UK corporation tax rate from 18% to 17% from 1 April 2020. Offsetting these, is the effect of the non applicability of the bank surcharge to the first £25 million of taxable profits.

Notes to the consolidated financial statements

Charges (continued)

20. Deferred tax assets

The movement in deferred tax assets is as follows:

	2016 £ million	2015 £ million
At 1 January	**121.1**	108.1
Income statement charge (note 19)	**(25.7)**	19.4
Amounts credited/(charged) to equity:		
Movements in cash flow hedging reserve	**0.2**	(0.2)
Movements in available-for-sale reserve	**4.0**	(6.2)
At 31 December	**99.6**	121.1

Deferred tax assets are comprised as follows:

	2016 £ million	2015 £ million
Deferred tax impact of business transfers	**102.0**	127.8
Pension and other post-retirement benefits	**–**	(0.2)
Revaluations of available-for-sale financial assets	**(2.3)**	(6.2)
Cash flow hedging reserve	**–**	(0.2)
Other temporary differences	**(0.1)**	(0.1)
Total deferred tax assets	**99.6**	121.1

Significant judgements and estimates - recoverability of deferred tax assets

At 31 December 2016, TSB Group recognised deferred tax assets of £99.6 million, primarily comprising £99.5 million in respect of temporary differences arising from the transfer of customer accounts during 2013 and £2.5 million in respect of temporary differences arising from the Mortgage Enhancement portfolio, offset by £2.3 million of a deferred tax liability arising from changes in the fair value of financial assets held as available-for-sale.

The valuation and assessment of the recovery of the deferred tax asset requires judgement as to the amount and timing of future taxable profits. TSB Group's expectations of the level of future taxable profits takes into account the Board approved medium term plan and associated risk factors including future economic outlook and regulatory change. Based on this, management have concluded it remains appropriate to recognise the deferred tax asset in full.

Notes to the consolidated financial statements

Profits and returns to the shareholder

The Board reviews TSB Group's performance. It decides whether profits are put aside for future investment in the business, for protection against the uncertainties that TSB Group faces, or returned to the shareholder in the form of dividends. Currently all returns are being reinvested in the business.

Accounting policies relevant to profits and returns to the shareholder

(i) Share capital

Shares are classified as equity instruments when there is no contractual obligation to deliver cash or other assets to another entity on terms that may be unfavourable. Ordinary shares are classified as equity.

21 Segmental analysis

The presentation of segmental information is consistent with internal reporting provided to the Bank Executive Committee which is considered to be the 'chief operating decision maker'. The segmental results are presented on a management basis, which excludes certain volatile and non-recurring items and is the basis reviewed by the Bank Executive Committee. TSB Group's reportable segments have been identified as Franchise, Mortgage Enhancement and Whistletree Loans reflecting its organisational and management structures.

- *Franchise* comprises the retail banking business carried out in the UK which offers a broad range of retail financial services including current accounts, savings products, personal loans, credit cards and mortgages.
- *Mortgage Enhancement* is a separate portfolio of mortgage assets which was assigned to TSB Group with effect from 28 February 2014. This segment was established in response to a review by the Office of Fair Trading of the effect on competition of the divestment of TSB which is designed to enhance TSB Group's profitability by over £230 million.
- *Whistletree Loans* is a separate portfolio of former Northern Rock mortgages and unsecured loans which was acquired with effect from 7 December 2015 and which at 31 December 2016 had total customer loan balances of £2.5 billion.

The Bank Executive Committee's review includes consideration of each segment's net interest income and consequently the interest income and expense for each reportable segment is presented on a net basis.

	Franchise £ million	Mortgage Enhancement £ million	Whistletree Loans £ million	Total £ million
Year ended 31 December 2016				
Net interest income	737.0	52.5	77.3	866.8
Other income	114.2	(6.3)	(5.9)	102.0
Total income	851.2	46.2	71.4	968.8
Operating expenses	(703.8)	–	–	(703.8)
Impairment	(82.8)	–	(4.5)	(87.3)
Management basis profit before taxation	64.6	46.2	66.9	177.7
Losses on derivatives and hedge accounting				(5.6)
Derivative fair value unwind				8.1
Volatility from share schemes				(0.3)
Gain on sale of share in Visa Europe				32.5
Other one off costs				(30.4)
Statutory profit before taxation				182.0
Taxation				(54.2)
Statutory profit for the year				127.8

At 31 December 2016				
Segment loans and advances to customers	25,090.3	1,848.9	2,479.9	29,419.1
Segment customer deposits	29,383.8	–	–	29,383.8

Notes to the consolidated financial statements

Profits and returns to the shareholder (continued)

21. Segmental analysis (continued)

	Franchise £ million	Mortgage Enhancement £ million	Whistletree Loans £ million	Total £ million
Year ended 31 December 2015				
Net interest income	704.3	73.7	3.3	781.3
Other income	129.7	(10.4)	(1.1)	118.2
Total income	834.0	63.3	2.2	899.5
Operating expenses	(711.5)	–	–	(711.5)
Impairment	(82.2)	(0.1)	–	(82.3)
Management basis profit before taxation	40.3	63.2	2.2	105.7
Losses on derivatives and hedge accounting				(1.9)
Derivative fair value unwind				(5.1)
Volatility from share schemes				(0.4)
Other one off costs				(30.7)
Statutory profit before taxation				67.6
Taxation				21.2
Statutory profit for the year				88.8
At 31 December 2015				
Segment loans and advances to customers	**21,119.4**	**2,272.3**	**3,006.4**	**26,398.1**
Segment customer deposits	**25,874.2**	**–**	**–**	**25,874.2**

The table below presents a reconciliation from the management basis profit to the statutory results.

	Management basis £ million	Reclass of NII on trading derivatives £ million	Loss on derivatives and hedge accounting £ million	Derivative fair value unwind £ million	Volatility from share schemes £ million	Gain on sale of share in Visa Europe £ million	Other one off (costs)/ income £ million	Statutory basis £ million
Year ended 31 December 2016								
Net interest income	**866.8**	**(13.0)**	**–**	**–**	**–**		**–**	**853.8**
Other income	**102.0**	**13.0**	**(5.6)**	**8.1**	**(0.8)**	**32.5**	**1.0**	**150.2**
Total income	**968.8**	**–**	**(5.6)**	**8.1**	**(0.8)**	**32.5**	**1.0**	**1,004.0**
Operating expenses	**(703.8)**	**–**	**–**	**–**	**0.5**	**–**	**(31.4)**	**(734.7)**
Impairment	**(87.3)**	**–**	**–**	**–**	**–**	**–**	**–**	**(87.3)**
Profit before taxation	**177.7**	**–**	**(5.6)**	**8.1**	**(0.3)**	**32.5**	**(30.4)**	**182.0**
Year ended 31 December 2015								
Net interest income	781.3	(16.0)	–	–	–	–	–	765.3
Other income	118.2	16.0	(1.9)	(5.1)	(1.8)	–	–	125.4
Total income	899.5	–	(1.9)	(5.1)	(1.8)	–	–	890.7
Operating expenses	(711.5)	–	–	–	1.4	–	(30.7)	(740.8)
Impairment	(82.3)	–	–	–	–	–	–	(82.3)
Profit before taxation	105.7	–	(1.9)	(5.1)	(0.4)	–	(30.7)	67.6

Notes to the consolidated financial statements

Profits and returns to the shareholder (continued)

22. Shareholder's equity

	Share capital £ million	Share premium £ million	Merger reserve £ million	Capital reorg-anisation reserve £ million	Capital reserve £ million	Available-for-sale reserve £ million	Cash flow hedging reserve £ million	Retained profits £ million
Balance at 1 January 2015	5.0	965.1	616.5	(1,311.6)	410.0	0.4	–	949.0
Movement in shares held by trusts	–	–	–	–	–	–	–	9.1
Reclassification of equity settled share schemes to cash settled	–	–	–	–	–	–	–	(3.1)
Value of partner services	–	–	–	–	–	–	–	2.1
Net movement in available-for-sale reserve	–	–	–	–	–	15.9	–	–
Net movement in cash flow hedging reserve	–	–	–	–	–	–	(0.9)	–
Profit for the year	–	–	–	–	–		–	88.8
At 31 December 2015	5.0	965.1	616.5	(1,311.6)	410.0	16.3	(0.9)	1,045.9
Balance at 1 January 2016	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**16.3**	**(0.9)**	**1,045.9**
Net movement in available-for-sale reserve	**–**	**–**	**–**	**–**	**–**	**(10.4)**	**–**	**–**
Net movement in cash flow hedging reserve	**–**	**–**	**–**	**–**	**–**	**–**	**1.3**	**–**
Profit for the year	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**127.8**
At 31 December 2016	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**5.9**	**0.4**	**1,173.7**

In 2014 TSB Banking Group plc was incorporated with 50,000 ordinary £1 shares. During 2014, this increased to 500.0 million one pence ordinary shares as a result of the following:

- a 100 for 1 share split.
- a share issuance of 50 million one pence ordinary shares in exchange for the acquisition of the entire share capital of TSB Bank plc. The issuance was recorded at the carrying amount of the net assets of TSB Bank plc at the date of acquisition and resulted in a transfer to the share premium reserve of a minimum amount required by the Companies Act 2016. The difference between the amount transferred to share capital and share premium and the carrying amount of the net assets of TSB Bank plc was transferred to the merger reserve.
- a share issuance of 445.0 million one pence ordinary shares at a premium of £0.4394 per share to its then immediate parent company, Lloyds Bank plc, for cash proceeds of £200.0 million.

At 31 December 2016, TSB Banking Group plc had in issue 500.0 million (2015: 500.0 million) one pence ordinary shares authorised, allotted and fully paid up.

The capital reserve represents a capital contribution received in 2013 from a then parent company.

The available-for-sale reserve represents the unrealised change in the fair value of available-for-sale investments since initial recognition.

The cash flow hedging reserve represents the cumulative gains and losses on effective cash flow hedging instruments that will be recycled to the income statement when the hedged transactions affect profit or loss.

Notes to the consolidated financial statements

Managing financial risk

Financial instruments are fundamental to TSB Group's activities and, as a consequence, the risks associated with financial instruments represent a significant component of the risks faced by TSB. The primary risks affecting TSB Group through its use of financial instruments are: credit risk; funding and liquidity risk; and market risk. A summary of TSB Group's use of financial instruments and information about the management of these risks is presented below.

Accounting policies relevant to managing financial risk

(j) Derivative financial instruments and hedge accounting

All derivative financial instruments are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow as appropriate. Derivatives are carried on the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative.

Changes in the fair value of any derivative instrument are recognised immediately in the income statement.

Fair value is the exit price from the perspective of market participants who hold the asset or owe the liability at the measurement date.

The method of recognising the movements in the fair value of derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged.

Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of such instruments. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item and the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge relationship in offsetting changes in the fair value of the hedged risk. In its application of the hedge accounting policy, TSB Group follows the requirements of the EU – endorsed version of IAS 39 *Financial Instruments: Recognition and Measurement* adopted by the EU which are not available in the version issued by the IASB. The effectiveness of the hedging relationship is tested both at inception and throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its documented objective, hedge accounting is discontinued. TSB Group designates certain derivatives as either hedges of the fair value of recognised assets or liabilities (fair value hedges) or hedges of highly probable future cash flows attributable to recognised assets or liabilities (cash flow hedges).

Fair value hedges

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. If the hedge no longer meets the criteria for hedge accounting, changes in the fair value of the hedged item attributable to the hedged risk are no longer recognised in the income statement. The cumulative adjustment that has been made to the carrying amount of the hedged item is amortised to the income statement using a straight line method over the period to maturity.

Cash flow hedges

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income in the cash flow hedging reserve. The gain or loss relating to the ineffective portion is recognised immediately in the income statement. Amounts accumulated in equity are reclassified to the income statement in the periods in which the hedged item affects profit or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised in the income statement when the previously hedged cash flow is ultimately recognised in the income statement.

Managing financial risk (continued)

23. Measurement basis of financial instruments

The following tables analyse the carrying amounts of financial instruments by category.

At 31 December 2016	Held for trading £ million	Available-for- sale £ million	Held at amortised cost £ million	Designated as hedging instruments £ million	Loans and receivables £ million	Total £ million
Financial liabilities						
Derivative financial liabilities	**97.7**	**–**	**–**	**529.1**	**–**	**626.8**
Deposits:						
Deposits from credit institutions	**–**	**–**	**49.6**	**–**	**–**	**49.6**
Repurchase agreements with credit institutions	**–**	**–**	**751.0**	**–**	**–**	**751.0**
Repurchase agreements with non credit institutions	**–**	**–**	**658.6**	**–**	**–**	**658.6**
Customer deposits	**–**	**–**	**29,383.8**	**–**	**–**	**29,383.8**
Debt securities in issue	**–**	**–**	**2,940.1**	**–**	**–**	**2,940.1**
Subordinated liabilities	**–**	**–**	**413.3**	**–**	**–**	**413.3**
Items in course of transmission to banks	**–**	**–**	**176.1**	**–**	**–**	**176.1**
Total financial liabilities	**97.7**	**–**	**34,372.5**	**529.1**	**–**	**34,999.3**
Financial assets						
Cash and balances at central banks	**–**	**–**	**3,698.3**	**–**	**–**	**3,698.3**
Derivative financial assets	**143.2**	**–**	**–**	**104.3**	**–**	**247.5**
Equity instruments	**8.7**	**–**	**–**	**–**	**–**	**8.7**
Available-for-sale financial assets						
Gilts, supranational and development bank bonds	**–**	**2,098.3**	**–**	**–**	**–**	**2,098.3**
Equity instruments	**–**	**5.2**	**–**	**–**	**–**	**5.2**
Loans and receivables:						
Loans and advances to credit institutions	**–**	**–**	**–**	**–**	**550.4**	**550.4**
Loans and advances to customers	**–**	**–**	**–**	**–**	**29,419.1**	**29,419.1**
Items in course of collection from banks	**–**	**–**	**213.8**	**–**	**–**	**213.8**
Total financial assets	**151.9**	**2,103.5**	**3,912.1**	**104.3**	**29,969.5**	**36,241.3**

At 31 December 2015	Held for trading £ million	Available-for- sale £ million	Held at amortised cost £ million	Designated as hedging instruments £ million	Loans and receivables £ million	Total £ million
Financial liabilities						
Derivative financial liabilities	43.5	–	–	239.8	–	283.3
Deposits:						
Deposits from credit institutions	–	–	0.8	–	–	0.8
Customer deposits	–	–	25,874.2	–	–	25,874.2
Debt securities in issue	–	–	2,899.6	–	–	2,899.6
Subordinated liabilities	–	–	402.1	–	–	402.1
Items in course of transmission to banks	–	–	152.3	–	–	152.3
Total financial liabilities	43.5	–	29,329.0	239.8	–	29,612.3
Financial assets						
Cash and balances at central banks	–	–	2,755.6	–	–	2,755.6
Derivative financial assets	47.9	–	–	42.6	–	90.5
Equity instruments	5.3	–	–	–	–	5.3
Available-for-sale financial assets:						
Gilts	–	1,240.4	–	–	–	1,240.4
Equity instruments	–	22.4	–	–	–	22.4
Loans and receivables:						
Loans and advances to credit institutions	–	–	–	–	311.4	311.4
Reverse repurchase agreements with credit institutions	–	–	–	–	20.3	20.3
Loans and advances to customers	–	–	–	–	26,398.1	26,398.1
Items in course of collection from banks	–	–	163.0	–	–	163.0
Total financial assets	53.2	1,262.8	2,918.6	42.6	26,729.8	31,007.0

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Credit risk

Credit risk is the risk of financial loss if a customer or counterparty to a financial instrument fails to meet its contractual obligations. Credit risk appetite is set at Board level and is described and reported through a suite of metrics devised from a combination of accounting and credit portfolio performance measures, and includes the use of various credit risk rating systems to measure the credit risk of loans and advances to customers and banks at a counterparty level using three components: (i) the probability of default by the counterparty on its contractual obligations; (ii) the exposure to the counterparty at default; and (iii) the likely loss ratio on the defaulted obligations, the loss given default. TSB Group uses a range of approaches to mitigate credit risk, including internal control policies, obtaining collateral, using master netting agreements and other credit risk transfers, such as asset sales. TSB Group's credit risk exposure, which arises primarily in the United Kingdom, is set out below.

(i) Maximum credit exposure

The maximum credit risk exposure in the event of other parties failing to perform their obligations is presented below. No account is taken of any collateral held and the maximum exposure to loss is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions, their contractual nominal amounts.

	2016 £ million	2015 £ million
Loans and advances to customers [1]	**29,419.1**	26,398.1
Loans and advances to credit institutions	**550.4**	311.4
Reverse repurchase agreements with credit institutions	**–**	20.3
Available-for-sale financial assets [2]	**2,098.3**	1,240.4
Items in course of collection from banks	**213.8**	163.0
Derivative financial assets	**247.5**	90.5
	32,529.1	28,223.7
Lending commitments – revocable	**3,498.7**	3,566.5
Lending commitments – irrevocable	**1,778.3**	1,740.0
Maximum credit risk exposure	**37,806.1**	33,530.2

(1) Amounts shown are net of related impairment allowances.
(2) 2016 includes gilts and supranational and development bank bonds. 2015 includes only gilts.

(ii) Credit quality of assets

Loans and receivables

The analysis of lending between mortgages and other loans and advances to customers has been presented based upon the type of exposure.

	Loans and advances to customers			Other loans and receivables[1]
At 31 December 2016	Mortgages £ million	Unsecured lending and business banking £ million	Total £ million	£ million
Neither past due nor impaired	**26,645.3**	**2,254.6**	**28,899.9**	**550.4**
Past due but not impaired	**417.1**	**35.8**	**452.9**	**–**
Impaired – no provision required	**57.9**	**–**	**57.9**	**–**
Impaired - provision held	**31.8**	**50.3**	**82.1**	**–**
Gross loans and receivables	**27,152.1**	**2,340.7**	**29,492.8**	**550.4**
Allowance for impairment losses (note 10)	**(28.0)**	**(45.7)**	**(73.7)**	**–**
Net loans and receivables	**27,124.1**	**2,295.0**	**29,419.1**	**550.4**
At 31 December 2015				
Neither past due nor impaired	23,525.9	2,256.2	25,782.1	331.7
Past due but not impaired	485.3	42.9	528.2	–
Impaired - no provision required	57.7	–	57.7	–
Impaired - provision held	41.3	60.0	101.3	–
Gross loans and receivables	24,110.2	2,359.1	26,469.3	331.7
Allowance for impairment losses (note 10)	(19.1)	(52.1)	(71.2)	–
Net loans and receivables	24,091.1	2,307.0	26,398.1	331.7

(1) Other loans and receivables comprise loans and advances to credit institutions and for 2015 also include reverse repurchase agreements with credit institutions.

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Credit risk (continued)

Loans and receivables which are neither past due nor impaired

	Loans and advances to customers			Other loans and receivables
31 December 2016	**Mortgages £ million**	**Unsecured lending and business banking £ million**	**Total £ million**	**£ million**
Good quality	**26,605.2**	**1,964.6**	**28,569.8**	**550.4**
Satisfactory quality	**33.0**	**237.0**	**270.0**	**–**
Lower quality	**2.9**	**25.5**	**28.4**	**–**
Below standard, but not impaired	**4.2**	**27.5**	**31.7**	**–**
Total loans and receivables which are neither past due nor impaired	**26,645.3**	**2,254.6**	**28,899.9**	**550.4**
31 December 2015				
Good quality	23,460.2	1,909.0	25,369.2	331.7
Satisfactory quality	57.7	284.6	342.3	–
Lower quality	3.6	31.5	35.1	–
Below standard, but not impaired	4.4	31.1	35.5	–
Total loans and receivables which are neither past due nor impaired	23,525.9	2,256.2	25,782.1	331.7

The above classifications reflect expected recovery levels as well as probabilities of default assessed using internal rating models. Good quality lending includes all the lower assessed default probabilities and all loans with low expected losses in the event of a default, with other categories reflecting progressively higher risks and lower expected recoveries.

Available-for-sale financial assets include gilts and supranational and development bank bonds rated at least AA.

Loans and receivables which are past due but not impaired

	Loans and advances to customers			Other loans and receivable
31 December 2016	**Mortgages £ million**	**Unsecured lending and business banking £ million**	**Total £ million**	**£ million**
0-30 days	**180.1**	**21.3**	**201.4**	**–**
30-60 days	**83.6**	**7.1**	**90.7**	**–**
60-90 days	**55.7**	**0.1**	**55.8**	**–**
90-180 days	**66.6**	**0.3**	**66.9**	**–**
Over 180 days	**31.1**	**7.0**	**38.1**	**–**
Total loans and receivables which are past due but not impaired	**417.1**	**35.8**	**452.9**	**–**
31 December 2015				
0-30 days	202.3	15.2	217.5	–
30-60 days	92.6	17.0	109.6	–
60-90 days	56.7	0.4	57.1	–
90-180 days	83.2	0.9	84.1	–
Over 180 days	50.5	9.4	59.9	–
Total loans and receivables which are past due but not impaired	485.3	42.9	528.2	–

A financial asset is past due if a counterparty has failed to make a payment when contractually due.

An analysis of derivative assets is presented in note 27.

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Credit risk (continued)

(iii) Collateral held as security for financial assets

TSB Group holds collateral against loans and advances to customers in the form of mortgages over residential property and second charges over business assets, including commercial and residential property.

Mortgages

An analysis by loan-to-value (LTV) ratio of TSB Group's residential mortgage lending is presented below. The value of collateral used in determining the LTV ratios has been estimated based upon the last actual valuation, adjusted to take into account subsequent movements in house prices.

31 December 2016	Neither past due nor impaired £ million	Past due but not impaired £ million	Impaired £ million	Gross £ million
Less than 70%	**19,671.7**	**275.5**	**58.1**	**20,005.3**
70% to 80%	**4,020.8**	**65.2**	**11.8**	**4,097.8**
80% to 90%	**2,215.1**	**42.0**	**8.8**	**2,265.9**
90% to 100%	**651.9**	**23.5**	**7.1**	**682.5**
Greater than 100%	**85.8**	**10.9**	**3.9**	**100.6**
Total mortgages	**26,645.3**	**417.1**	**89.7**	**27,152.1**
31 December 2015				
Less than 70%	17,715.2	276.6	64.5	18,056.3
70% to 80%	3,261.4	86.5	13.1	3,361.0
80% to 90%	1,798.5	68.6	8.3	1,875.4
90% to 100%	638.7	36.1	8.4	683.2
Greater than 100%	112.1	17.5	4.7	134.3
Total mortgages	23,525.9	485.3	99.0	24,110.2

Unsecured lending and business banking

At 31 December 2016, unimpaired unsecured and business banking lending amounted to £2,290.4 million (2015: £2,299.1 million). At 31 December 2016, impaired unsecured and business banking lending amounted to £4.6 million (2015: £23.0 million), net of an impairment allowance of £45.7 million (2015: £37.0 million). Non-mortgage retail lending is unsecured, with no collateral held in respect of retail credit cards, overdrafts, or unsecured personal loans.

For business banking lending, collateral primarily consists of second charges over commercial and residential property. Where collateral is held, lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on any collateral provided. Collateral values are assessed at the time of loan origination and reassessed if there is observable evidence of distress of the borrower. At 31 December 2016, credit risk is mitigated by collateral held totalling £137.7 million (2015: £158.1 million).

(iv) Collateral repossessed

	2016 £ million	2015 £ million
Residential property	**3.7**	4.4
Total collateral repossessed	**3.7**	4.4

TSB Group does not take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations.

(v) Forbearance

TSB Group operates a number of schemes to assist borrowers who are experiencing financial difficulties. Forbearance solutions may offer relief in the form of reductions to contractual payments, and for customers who have longer term financial difficulties, term extensions and 'repair' approaches such as capitalisation of arrears. At 31 December 2016, total forborne loans were £371.1 million (2015: £351.3 million), of which £67.0 million (2015: £78.0 million) were impaired. At 31 December 2016, the allowance for loan losses held in respect of forborne loans was £15.3 million (2015: £15.7 million).

Notes to the consolidated financial statements

Managing financial risk (continued)

25. Funding and liquidity risk

Definition and exposure

Liquidity risk is the risk that TSB Group, although solvent, does not have available sufficient financial resources to enable it to meet its obligations as they fall due. Funding risk is the risk that TSB Group does not have stable sources of funding in the medium and long term to enable it to meet its financial obligations, such as payments or collateral calls, as they fall due, either at all or only at excessive cost. Liquidity exposure represents the mismatch of potential outflows in any future period measured against expected inflows. Liquidity risk is managed, monitored and measured from both an internal and regulatory perspective.

Sources of funding

TSB Group's funding and liquidity position is underpinned by its significant customer deposit base. The deposit base is made up of customer current and savings accounts which, although mostly repayable on demand, have historically provided a stable source of funding. TSB Group has also diversified its funding base by raising wholesale term funding during 2016. Further information regarding sources of funding is available on pages 15 to 17. At 31 December 2016, TSB Group's primary liquidity portfolio totalled £5,571.4 million (2015: £3,782.3 million). This comprised £3,473.1 million (2015: £2,541.9 million) held on deposit with the Bank of England, a £1,872.8 million (2015: £1,240.4 million) portfolio of UK gilts (of which £663.8 million had been sold under repurchase agreements – see note 5) and £225.5 million (2015: £nil) of supranational and development bank bonds. TSB Group also uses wholesale facilities and the Term Funding Scheme.

Risk appetite

The funding and liquidity risk appetite for TSB Group is set and approved annually by the Board. Risk is reported against this appetite through various metrics to enable TSB Group to manage the funding and liquidity position. The risk appetite is established under a liquidity risk management framework designed with the aim that TSB Group has sufficient financial resources of appropriate quality for its funding profile.

Measurement and monitoring

A series of measures are used across TSB Group to monitor both short term and long term liquidity. Liquidity is measured on a daily basis and reported internally. Daily liquidity reporting is supplemented by early warning indicators and a Liquidity Contingency Plan. Monthly reporting procedures are in place to update and inform senior management. All liquidity policies and procedures are subject to periodic independent internal oversight.

Notes to the consolidated financial statements

Managing financial risk (continued)

25. Funding and liquidity risk (continued)

The table below presents the contractual residual maturities of the assets and liabilities on the balance sheet:

At 31 December 2016	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Liabilities						
Deposits from credit institutions	**49.6**	**–**	**–**	**–**	**–**	**49.6**
Repurchase agreements with credit institutions	**1.0**	**–**	**750.0**	**–**	**–**	**751.0**
Repurchase agreements with non credit institutions	**658.6**	**–**	**–**	**–**	**–**	**658.6**
Customer deposits	**25,296.7**	**266.2**	**1,054.7**	**2,766.2**	**–**	**29,383.8**
Debt securities in issue	**–**	**159.9**	**507.9**	**2,272.3**	**–**	**2,940.1**
Subordinated liabilities	**26.1**	**3.4**	**–**	**–**	**383.8**	**413.3**
Items in course of transmission to banks	**176.1**	**–**	**–**	**–**	**–**	**176.1**
Trading derivative liabilities	**0.1**	**0.4**	**14.1**	**77.7**	**5.4**	**97.7**
Hedging derivative liabilities	**–**	**–**	**0.4**	**9.3**	**519.4**	**529.1**
Other liabilities (1)	**227.1**	**0.4**	**(1.5)**	**16.3**	**89.1**	**331.4**
Total liabilities	**26,435.3**	**430.3**	**2,325.6**	**5,141.8**	**997.7**	**35,330.7**

(1) Other liabilities comprises current tax liabilities, fair value adjustments for portfolio hedged risk and other liabilities.

Assets						
Loans and receivables:						
Loans and advances to credit institutions	**19.9**	**334.2**	**–**	**196.3**	**–**	**550.4**
Loans and advances to customers	**1,194.5**	**272.0**	**1,229.7**	**5,609.7**	**21,113.2**	**29,419.1**
Available-for-sale financial assets	**–**	**–**	**–**	**–**	**2,103.5**	**2,103.5**
Items in course of collection from banks	**213.8**	**–**	**–**	**–**	**–**	**213.8**
Trading derivative assets	**0.4**	**0.7**	**8.2**	**110.4**	**23.5**	**143.2**
Hedging derivative assets	**–**	**(0.4)**	**–**	**84.9**	**19.8**	**104.3**
Other assets (2)	**4,329.3**	**–**	**19.7**	**79.8**	**232.6**	**4,661.4**
Total assets	**5,759.9**	**606.5**	**1,257.6**	**6,081.1**	**23,492.6**	**37,195.7**

(2) Other assets comprises cash and balances at central banks, equity instruments, fair value adjustments for portfolio hedged risk, property, plant and equipment, deferred tax assets and other assets.

At 31 December 2015	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Liabilities						
Deposits from credit institutions	0.6	0.2	–	–	–	0.8
Customer deposits	22,621.9	456.1	1,457.8	1,338.4	–	25,874.2
Debt securities in issue	–	103.0	466.9	2,329.7	–	2,899.6
Subordinated liabilities	–	1.9	–	–	400.2	402.1
Items in course of transmission to banks	152.3	–	–	–	–	152.3
Trading derivative liabilities	0.1	0.6	5.4	33.2	4.2	43.5
Hedging derivative liabilities	–	–	0.1	3.2	236.5	239.8
Other liabilities	195.9	0.3	–	–	63.2	259.4
Total liabilities	22,970.8	562.1	1,930.2	3,704.5	704.1	29,871.7

Assets						
Loans and receivables:						
Loans and advances to credit institutions	8.9	164.9	–	137.6	–	311.4
Reverse repurchase agreements with credit institutions	–	–	20.3	–	–	20.3
Loans and advances to customers	1,016.8	249.7	1,139.4	5,218.2	18,774.0	26,398.1
Available-for-sale financial assets	–	–	–	–	1,262.8	1,262.8
Items in course of collection from banks	163.0	–	–	–	–	163.0
Trading derivative assets	0.6	0.8	9.2	37.0	0.3	47.9
Hedging derivative assets	–	0.3	1.3	24.9	16.1	42.6
Other assets	3,032.0	–	25.2	101.0	213.7	3,371.9
Total assets	4,221.3	415.7	1,195.4	5,518.7	20,266.9	31,618.0

Notes to the consolidated financial statements

Managing financial risk (continued)

25. Funding and liquidity risk (continued)

Contractual maturities for financial liabilities form an important source of information for the management of liquidity risk. The table below analyses financial liabilities by relevant contractual maturity grouping on an undiscounted future cash flow basis based on the remaining period at the balance sheet date.

At 31 December 2016	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Financial liabilities						
Deposits from credit institutions	**49.6**	**–**	**–**	**–**	**–**	**49.6**
Repurchase agreements with credit institutions	**–**	**2.9**	**756.8**	**–**	**–**	**759.7**
Repurchase agreements with non credit institutions	**658.6**	**–**	**–**	**–**	**–**	**658.6**
Customer deposits	**25,292.9**	**218.0**	**1,126.7**	**2,887.7**	**–**	**29,525.3**
Debt securities in issue	**–**	**163.6**	**526.8**	**2,297.1**	**–**	**2,987.5**
Subordinated liabilities	**–**	**–**	**22.1**	**462.5**	**–**	**484.6**
Items in course of transmission to banks	**176.1**	**–**	**–**	**–**	**–**	**176.1**
Total non-derivative financial liabilities	**26,177.2**	**384.5**	**2,432.4**	**5,647.3**	**–**	**34,641.4**
Gross settled derivative - outflows	**31.4**	**24.7**	**191.1**	**715.1**	**472.1**	**1,434.4**
Gross settled derivative - inflows	**(18.6)**	**(10.7)**	**(80.3)**	**(501.9)**	**(213.6)**	**(825.1)**
Total financial liabilities	**26,190.0**	**398.5**	**2,543.2**	**5,860.5**	**258.5**	**35,250.7**

At 31 December 2015	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Financial liabilities						
Deposits from credit institutions	0.8	–	–	–	–	0.8
Customer deposits	22,648.2	451.1	1,482.5	1,379.7	–	25,961.5
Debt securities in issue	–	107.8	489.8	2,376.8	–	2,974.4
Subordinated liabilities	–	–	22.1	88.6	396.1	506.8
Items in course of transmission to banks	152.3	–	–	–	–	152.3
Total non-derivative financial liabilities	22,801.3	558.9	1,994.4	3,845.1	396.1	29,595.8
Gross settled derivative - outflows	6.6	21.1	102.7	563.3	374.7	1,068.4
Gross settled derivative - inflows	(4.3)	(12.4)	(52.5)	(452.2)	(230.7)	(752.1)
Total financial liabilities	22,803.6	567.6	2,044.6	3,956.2	540.1	29,912.1

26. Capital resources

TSB Group seeks to maintain a strong capital base which meets both its regulatory requirements and supports the growth of the business, even under stressed conditions. The table below presents TSB Group's regulatory capital resources.

	2016 £ million	2015 £ million
Shareholder's equity	**1,865.0**	1,746.3
Regulatory deductions	**(79.6)**	(73.8)
Common Equity Tier 1/Total Tier 1 capital	**1,785.4**	1,672.5
Tier 2 capital	**383.9**	383.5
Total capital resources	**2,169.3**	2,056.0

Further information on capital resources is available on pages 15 to 17 in the review of our performance in 2016.

Notes to the consolidated financial statements

Managing financial risk (continued)

27. Market risk

Definition and exposure
Market risk is the risk of a reduction in earnings, value or reserves caused by changes in the prices of financial instruments. In addition, market risk can arise as a result of changes in customer behaviour, which may affect the maturity profiles of TSB Group's assets and liabilities. TSB Group's market risk consists primarily of exposure to changes in interest rates, including the margin between customer and market rates. This includes the potential impact on earnings and value that could occur when, if rates fall, liabilities cannot be re-priced as quickly or by as much as assets.

Management and measurement
Risk exposure across TSB Group is monitored monthly using, primarily, net interest income and earnings sensitivity. This methodology considers all re-pricing mismatches in the current balance sheet and calculates the change in net interest income that would result from a set of defined interest rate shocks. A limit structure exists to ensure that risks stemming from residual positions or from changes in assumptions about customer behaviour remain within TSB Group's risk appetite.

A 12 month view of the sensitivity of net interest income is calculated on the basis of TSB Group's current consolidated balance sheet with re-pricing dates adjusted according to behavioural assumptions. At 31 December 2016, the projected change in 12 month net interest income in response to an immediate parallel shift in all relevant interest rates, market and administered, would be an increase of £9.4 million (2015: £4.6 million) from a 25bps increase in rates, and a decrease of £19.7 million (2015: £10.5 million) from a 25bps decrease. The measure assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount and does not take into account potential management actions.

Derivative financial instruments
TSB Group holds derivative financial instruments in the normal course of its banking business for interest rate risk management and margin stabilisation purposes. Derivatives are recognised at fair value on TSB Group's consolidated balance sheet. The fair values and notional amounts of derivative instruments are presented in the following table:

	2016			2015		
	Contract/ notional amount £ million	Assets fair value £ million	Liabilities fair value £ million	Contract/ notional amount £ million	Assets fair value £ million	Liabilities fair value £ million
Interest rate swaps	**19,722.5**	**139.9**	**(97.7)**	14,180.4	47.9	(43.5)
Equity options	**8.7**	**3.3**	**–**	–	–	–
Trading derivative instruments	**19,731.2**	**143.2**	**(97.7)**	14,180.4	47.9	(43.5)
Designated as micro fair value hedges	**845.0**	**26.3**	**(1.1)**	737.0	16.3	(0.2)
Designated as macro fair value hedges	**4,673.7**	**21.7**	**(528.0)**	3,355.5	15.2	(238.6)
Designated as cash flow hedges	**372.1**	**56.3**	**–**	2,003.0	11.1	(1.0)
Hedging derivative instruments	**5,890.8**	**104.3**	**(529.1)**	6,095.5	42.6	(239.8)
Total derivative instruments	**25,622.0**	**247.5**	**(626.8)**	20,275.9	90.5	(283.3)

Derivative assets of £238.6 million (2015: £78.3 million) are expected to be recovered after more than one year. Derivative liabilities of £611.8 million (2015: £277.1 million) are expected to be settled after more than one year.

Fair value hedges
TSB Group designates certain of its fixed rate customer loans, debt securities, customer deposits and subordinated debt in fair value hedge accounting relationships. During the year losses of £40.8 million (2015: £7.9 million) were recognised on derivatives in hedge accounting relationships and gains of £37.6 million (2015: £7.2 million) were recognised on the hedged items attributable to the hedged interest rate risk.

Notes to the consolidated financial statements

Managing financial risk (continued)

27. Market risk (continued)

Cash flow hedges

TSB Group uses cash flow hedge accounting relationships for interest rate and foreign exchange risk and designates certain of its base rate mortgages and debt securities in issue in qualifying cash flow hedge accounting relationships. The following tables present the periods when TSB Group's hedged cash flows are expected to occur and when they will affect income for designated cash flow hedges.

At 31 December 2016	Less than 1 year £ million	1-2 years £ million	2-3 years £ million	3-4 years £ million	4-5 years £ million	5-10 years £ million	Total £ million
Hedged forecast cash flows expected to occur:							
Forecast receivable cash flows	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Forecast payable cash flows	**(37.1)**	**(33.8)**	**(30.9)**	**(273.6)**	**–**	**–**	**(375.4)**
Hedged forecast cash flows affect profit or loss:							
Forecast receivable cash flows	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Forecast payable cash flows	**(0.6)**	**(0.7)**	**(1.0)**	**(1.0)**	**–**	**–**	**(3.3)**

At 31 December 2015	Less than 1 year £ million	1-2 years £ million	2-3 years £ million	3-4 years £ million	4-5 years £ million	5-10 years £ million	Total £ million
Hedged forecast cash flows expected to occur:							
Forecast receivable cash flows	4.6	5.5	–	–	–	–	10.1
Forecast payable cash flows	(0.9)	(0.8)	(1.3)	(2.0)	(223.1)	–	(228.1)
Hedged forecast cash flows affect profit or loss:							
Forecast receivable cash flows	4.6	4.9	–	–	–	–	9.5
Forecast payable cash flows	(0.8)	(0.8)	(1.3)	(2.1)	(1.9)	–	(6.9)

During the year, gains of £47.0 million (2015: £9.3 million) were transferred from the cash flow hedging reserve to other operating income and gains of £0.5 million (2015: £5.8 million) were transferred to net interest income. Gains of £3.6 million (2015: losses of £3.5 million) were recognised in other operating income in respect of ineffectiveness arising from cash flow hedges. During 2015 and 2016 there were no transactions for which cash flow hedge accounting had to be ceased as a result of the highly probable cash flows no longer being expected to occur.

Offsetting financial assets and financial liabilities

The following information relates to financial assets and liabilities which have not been set off but for which TSB Group has enforceable master netting agreements in place with counterparties.

				Related amounts where set off in the balance sheet is not permitted		
At 31 December 2016	Gross amounts £ million	Amounts offset £ million	Net amounts reported on the balance sheet £ million	Related financial instrument amounts not offset £ million	Cash collateral received/ pledged £ million	Potential net amount £ million
Derivative financial assets	**247.5**	–	**247.5**	**(187.9)**	**(3.3)**	**56.3**
Total	**247.5**	–	**247.5**	**(187.9)**	**(3.3)**	**56.3**
Derivative financial liabilities	**(626.8)**	–	**(626.8)**	**187.9**	**438.9**	**–**
Total	**(626.8)**	–	**(626.8)**	**187.9**	**438.9**	**–**
At 31 December 2015						
Derivative financial assets	90.5	–	90.5	(83.0)	–	7.5
Total	90.5	–	90.5	(83.0)	–	7.5
Derivative financial liabilities	(283.3)	–	(283.3)	83.0	200.3	–
Total	(283.3)	–	(283.3)	83.0	200.3	–

Notes to the consolidated financial statements

Other important disclosures

Accounting policies relevant to this section

(k) Provisions and contingent liabilities
Provisions are recognised in respect of present obligations arising from past events where it is probable that outflows of resources will be required to settle the obligations and they can be reliably estimated.

Contingent liabilities are possible obligations whose existence depends on the outcome of uncertain future events or those present obligations where the outflows of resources are uncertain or cannot be measured reliably. Contingent liabilities are not recognised in the financial statements but are disclosed unless they are remote.

Contingent assets are possible assets that arise from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within TSB Group's control. These are disclosed where an inflow of economic benefits is probable, and are recognised only when it is virtually certain that an inflow of economic benefits will arise.

(l) Property, plant and equipment
Property, plant and equipment are recognised at cost less accumulated depreciation. Cost includes the original purchase price of the assets and the costs attributable to bringing the asset into working condition for its intended use. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows:

Premises (excluding land):
- Freehold/long and short leasehold premises: shorter of 50 years or the remaining period of the lease.
- Leasehold improvements: shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease.

Equipment:
- Fixtures and furnishings: 0-10 years.
- Other equipment and motor vehicles: 2-8 years.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than its recoverable amount it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use.

(m) Operating leases
The leases entered into by TSB Group as lessee are primarily operating leases. Operating lease rentals payable are charged to the income statement on a straight-line basis over the period of the lease. When an operating lease is terminated before the end of the lease period, any payment made to the lessor by way of penalty is recognised as an expense in the period of termination.

Notes to the consolidated financial statements

Other important disclosures (continued)

28. Contingent liabilities

(i) The Financial Services Compensation Scheme (FSCS)
The FSCS is the UK's independent statutory compensation fund of last resort for customers of authorised financial services firms and pays compensation if a firm is unable or likely to be unable to pay claims against it. The FSCS is funded by levies on the authorised financial services industry. Each deposit-taking institution contributes towards the FSCS levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year, which runs from 1 April to 31 March.

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. Although the substantial majority of the remaining loan balance is expected to be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets, any shortfall and interest cost will be funded by deposit-taking participants of the FSCS. During 2016, the FSCS invoiced a third annual levy in respect of expected shortfalls in the repayment of the principal balance of the loan.

During 2016, TSB Group has paid, as required, its share of the 2015/16 interest and the 2016/17 capital elements of the levy and accrued for its share of the 2016/17 interest element, payable in September 2017.

The amount of future compensation costs levies payable by TSB Group depends on a number of factors including participation in the market at 31 December, the level of protected deposits and the population of deposit-taking participants and any shortfall in the repayment of the loan from HM Treasury.

(ii) Legal and regulatory matters
During the ordinary course of business, TSB Group is subject to other threatened and actual legal proceedings (which may include class action lawsuits brought on behalf of customers and other third parties), regulatory investigations, regulatory challenges and enforcement actions. All such material matters are periodically reassessed, with the assistance of external professional advisers where appropriate, to determine the likelihood of TSB Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required to settle the obligation at the relevant balance sheet date. In some cases it will not be possible to form a view, either because the facts are unclear or because further time is needed to properly assess the merits of the case and no provisions are held against such matters. However, TSB Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position, operations or cash flows.

29. Related party transactions

TSB Group's related parties include key management personnel, Sabadell and other Sabadell Group companies.

(i) Key management personnel
Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of TSB Group which is the Board and Executive Committee. The compensation paid or payable to key management personnel is shown in the table below.

	2016 £ 000	2015 £ 000
Short term employee benefits	**7,144**	6,581
Post-employment benefits	**880**	907
Other long term benefits	**1,340**	1,127
Share-based payments	**2,430**	2,113
Payments for loss of office	**14**	143
Total	**11,808**	10,871

Other important disclosures (continued)

29. Related party transactions (continued)

The tables below detail, on an aggregated basis, related party transactions, balances outstanding at the year end and related income and expense in respect of key management personnel.

	2016 £ 000	2015 £ 000
Loans		
At 1 January	**262**	247
Advances (includes key management personnel appointed during the year)	**254**	112
Interest charged during the year	**8**	8
Repayments (includes key management personnel who resigned during the year)	**(313)**	(105)
At 31 December	**211**	262

The loans attracted interest at customer rates and were made in the ordinary course of business. No provisions have been recognised in respect of loans given to key management personnel (2015: £nil).

	2016 £ 000	2015 £ 000
Deposits		
At 1 January	**1,161**	736
Deposits (includes key management personnel appointed during the year)	**3,567**	8,578
Interest expense on deposits	**1**	6
Repayments (includes key management personnel who resigned during the year)	**(3,910)**	(8,159)
At 31 December	**819**	1,161

All deposits placed by key management personnel are at customer rates and were made in the ordinary course of business.

(ii) Transactions and balances with Sabadell Group companies
On 8 October 2015, TSB Group established a £1.0 billion unsecured funding facility from Sabadell. At 31 December 2016, this facility lapsed with no amounts having been drawn against the facility. Fee expenses of £2.5 million (2015: £0.4 million) were recognised in respect of non-utilisation fees payable on this facility to Sabadell of which £0.2 million is payable at 31 December 2016 (2015: £0.2 million).

Sabadell acted as a Joint Lead Manager in relation to TSB Group's first public residential mortgage backed securitisation (Duncan Funding 2015-1 plc), issued on 12 November 2015, and received no fee for the services provided. Sabadell was also appointed as a Joint Lead Manager in relation to a second public residential mortgage backed securitisation (Duncan Funding 2016-1 plc), issued on 27 May 2016, and received a fee of £0.3 million for the services provided to TSB Group.

On 25 August 2016, TSB Group purchased options from Sabadell to acquire 11.2 million Sabadell shares at an exercise price of 77.68p in order to hedge the risk associated with the TSB Sharesave scheme. A premium of £3.6 million was paid to acquire the options and at 31 December 2016, the options had a fair value of £3.3 million.

In the third quarter of 2016, TSB Bank plc and its ultimate parent company, Banco Sabadell, confirmed a set of arrangements between themselves which restricts the aggregate financial exposure of the IT Migration Programme to TSB Bank plc to a maximum of £15 million. As a consequence, TSB Group deferred £37.0 million of IT Migration Programme costs incurred to date as a prepayment of charges for services from a Sabadell Group company that will crystallise on the completion of the migration from the existing LBG platform.

Notes to the consolidated financial statements

Other important disclosures (continued)

30. Property, plant and equipment

	Premises £ million	Equipment £ million	Total £ million
Cost			
At 1 January 2015	166.7	83.9	250.6
Additions	26.4	8.1	34.5
Write-offs	(3.8)	(1.4)	(5.2)
At 31 December 2015	**189.3**	**90.6**	**279.9**
Additions	**28.2**	**7.7**	**35.9**
Disposals	**(2.1)**	**(0.6)**	**(2.7)**
Write-offs	**(5.0)**	**(3.2)**	**(8.2)**
At 31 December 2016	**210.4**	**94.5**	**304.9**
Accumulated depreciation			
At 1 January 2015	56.2	45.2	101.4
Depreciation charge for the year (note 16)	13.0	7.6	20.6
Write-offs	(2.3)	(0.9)	(3.2)
At 31 December 2015	**66.9**	**51.9**	**118.8**
Depreciation charge for the year (note 16)	**14.9**	**8.2**	**23.1**
Disposals	**(0.4)**	**(0.3)**	**(0.7)**
Write-offs	**(2.4)**	**(2.2)**	**(4.6)**
At 31 December 2016	**79.0**	**57.6**	**136.6**
Carrying amount			
At 31 December 2016	**131.4**	**36.9**	**168.3**
At 31 December 2015	**122.4**	**38.7**	**161.1**

At 31 December 2016, capital expenditure of £0.1 million was authorised and contracted for but not provided or incurred (2015: £0.5 million).

Operating lease commitments

Where TSB Group is the lessee, the future minimum lease payments under non-cancellable premises operating leases are as follows:

	2016 £ million	2015 £ million
Not later than 1 year	**32.0**	29.4
Later than 1 year and no later than 5 years	**105.2**	100.0
Later than 5 years	**77.7**	66.3
Total operating lease commitments	**214.9**	195.7

Operating lease payments represent rental payable by TSB Group for certain of its properties. Some of these operating lease arrangements have renewal options and rent escalation clauses, although the effect of these is not material. No arrangements have been entered into for contingent rental payments.

31. Other assets

	2016 £ million	2015 £ million
Other assets and prepayments	**116.9**	77.4
Collateral placed with central clearing houses	**557.0**	227.8
Amounts recoverable under customer remediation indemnity (note 32)	**11.8**	14.5
Total other assets	**685.7**	319.7

Notes to the consolidated financial statements

Other important disclosures (continued)

32. Other liabilities

	2016 £ million	2015 £ million
Accruals and deferred income	**152.8**	130.9
Customer remediation provision	**10.8**	14.5
Share-based payments liability	**6.6**	5.1
Other creditors	**75.8**	67.4
Total other liabilities	**246.0**	217.9

Significant judgements and estimates – customer remediation provision

TSB Group is protected from losses arising from historic misconduct under an indemnity provided by Lloyds Bank plc. However, TSB Group retains the primary liability for the alleged misconduct to its customers and a provision for customer remediation of £10.8 million has been recognised at 31 December 2016 (2015: £14.5 million). A recoverable of £11.8 million (2015: £14.5 million) has been recognised under the indemnity provided by Lloyds Bank plc (note 31). The size of the liability follows an assessment of emerging themes in customer complaints, an assessment of broader industry commentary and discussions with regulators. The ultimate cost and timing of payments are uncertain as a result of the inherent difficulties in estimating factors such as future levels of customer complaints and remediation settlements. The provision represents management's current best estimate.

33. Notes to the consolidated cash flow statement

The following table presents further analysis of balances in the consolidated cash flow statement:

	2016 £ million	2015 £ million
Change in loans and advances to credit institutions	**(299.6)**	(332.6)
Change in loans and advances to customers	**(3,097.8)**	(1,794.3)
Change in derivative assets	**(157.0)**	32.6
Change in other operating assets	**(366.2)**	(176.2)
Change in operating assets	**(3,920.6)**	(2,270.5)
Change in deposits from credit institutions	**72.6**	8.5
Change in customer deposits	**3,545.9**	1,282.2
Change in derivative liabilities	**343.4**	166.6
Change in other operating liabilities	**28.3**	20.8
Change in operating liabilities	**3,990.2**	1,478.1
Depreciation and amortisation	**23.1**	20.6
Allowance for loan losses	**87.3**	82.3
Other non-cash items	**(34.2)**	39.2
Non-cash and other items	**76.2**	142.1
Analysis of cash and cash equivalents as shown in the balance sheet		
Cash and balances with central banks	**3,698.3**	2,755.6
Less: mandatory reserve deposits [1]	**(51.0)**	(49.7)
	3,647.3	2,705.9
Loans and advances to credit institutions with maturity less than three months	**0.4**	8.8
Total cash and cash equivalents	**3,647.7**	2,714.7

(1) Mandatory reserve deposits are held with local central banks in accordance with statutory requirements; these deposits are not available to finance TSB Group's day-to-day operations.

Notes to the consolidated financial statements

Other important disclosures (continued)

34. Future accounting developments

The following pronouncements may impact TSB Group's consolidated financial statements but are not applicable for the year ended 31 December 2016 and have not been applied in preparing these consolidated financial statements. The full impact of these accounting changes is being assessed by TSB Group.

Pronouncement	Nature of Change	IASB effective date
IFRS 9: *Financial Instruments*	Replaces IAS 39 *Financial Instruments: Recognition and Measurement*. A description of the changes required by IFRS 9 and the potential impact on TSB's accounting policies and financial statements is set out on pages 73 to 75.	Annual periods beginning on or after 1 January 2018
IFRS 15 *Revenue from Contracts with Customers*	Replaces IAS 18 *Revenue* and other existing revenue recognition interpretations and requires revenue to be recognised when goods or services are transferred to customers and at an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. The standard does not apply to financial instruments or lease contracts. The impact of IFRS 15 on TSB Group is still being assessed.	Annual periods beginning on or after 1 January 2018
IFRS 16 *Leases*(1)	Replaces IAS 17 *Leases* and brings most leases on-balance sheet for lessees under a single model, eliminating the distinction between operating and finance leases. IFRS 16 requires a lessee to recognise a 'right-of-use' asset and a lease liability. Lessor accounting remains largely unchanged. The impact of IFRS 16 on TSB Group is still being assessed.	Annual periods beginning on or after 1 January 2019

(1) As at 25 January 2017, this pronouncement is awaiting EU endorsement.

35. Post balance sheet event

On 17 January 2017, TSB Group completed the acquisition of the beneficial interest in a £51 million portfolio of loans from Airdrie Savings Bank. The loan portfolio is primarily comprises of mainstream, buy-to-let and commercial mortgages and the acquisition is not expected to have a material effect on TSB Group's consolidated income statement.

36. Approval of the consolidated financial statements

These consolidated financial statements were approved by the Directors of TSB Banking Group plc on 25 January 2017.

The Company's ultimate parent company and ultimate controlling party is Banco de Sabadell S.A. (incorporated in Spain), which is also the parent undertaking of the largest group of undertakings for which consolidated financial statements are drawn up and of which the Company is a member. Banco de Sabadell S.A. is the parent undertaking of the smallest such group of undertakings for which consolidated financial statements are drawn up and of which the Company is a member. Copies of the consolidated annual report and accounts of Banco Sabadell S.A. are expected to be available in due course from www.grupbancsabadell.com/en/.

Independent auditors' report to the members of TSB Banking Group plc

Report on the group financial statements

Our opinion

In our opinion, TSB Banking Group plc's group financial statements (the "financial statements"):

- give a true and fair view of the state of the group's affairs as at 31 December 2016 and of its profit and cash flows for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards ("IFRSs") as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006 and Article 4 of the IAS Regulation.

What we have audited

The financial statements, included within the Annual Report and Accounts (the "Annual Report"), comprise:

- the consolidated balance sheet as at 31 December 2016;
- the consolidated statement of comprehensive income for the year then ended;
- the consolidated cash flow statement for the year then ended;
- the consolidated statement of changes in equity for the year then ended; and
- the notes to the financial statements, which include a summary of significant accounting policies and other explanatory information.

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

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

In applying the financial reporting framework, the directors have made a number of subjective judgements, for example in respect of significant accounting estimates. In making such estimates, they have made assumptions and considered future events.

Opinions on other matters prescribed by the Companies Act 2006

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

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

In addition, in light of the knowledge and understanding of the group and its environment obtained in the course of the audit, we are required to report if we have identified any material misstatements in the Strategic Report and the Directors' Report. We have nothing to report in this respect.

Other matters on which we are required to report by exception

Adequacy of information and explanations received

Under the Companies Act 2006 we are required to report to you if, in our opinion, we have not received all the information and explanations we require for our audit. We have no exceptions to report arising from this responsibility.

Directors' remuneration

Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law are not made. We have no exceptions to report arising from this responsibility.

Responsibilities for the financial statements and the audit

Our responsibilities and those of the directors

As explained more fully in the Statement of Directors' responsibilities set out on page 54, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view.

Independent auditors' report to the members of TSB Banking Group plc (continued)

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

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

What an audit of financial statements involves

We conducted our audit in accordance with ISAs (UK & Ireland). An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

- whether the accounting policies are appropriate to the group's circumstances and have been consistently applied and adequately disclosed;
- the reasonableness of significant accounting estimates made by the directors; and
- the overall presentation of the financial statements.

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

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

In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report. With respect to the Strategic Report and Directors' Report, we consider whether those reports include the disclosures required by applicable legal requirements.

Other matter

We have reported separately on the company financial statements of TSB Banking Group plc for the year ended 31 December 2016.

Allan McGrath (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Edinburgh
25 January 2017

Company balance sheet

As at 31 December 2016

Company Number: 08871766

	Note	2016 £ million	2015 £ million
Assets			
Non-current assets:			
Investments in subsidiaries	4	**1,589.4**	1,589.4
Loans to subsidiaries	4	**387.2**	386.9
		1,976.6	1,976.3
Current assets:			
Amounts due from subsidiaries		**0.1**	0.2
Current tax asset		**0.1**	–
Total assets		**1,976.8**	1,976.5
Liabilities			
Non-current liabilities:			
Subordinated liabilities	2	**387.2**	386.9
Current liabilities:			
Amounts due to subsidiaries		**12.8**	12.7
Total liabilities		**400.0**	399.6
Equity			
Share capital	3	**5.0**	5.0
Share premium	3	**965.1**	965.1
Merger reserve	3	**616.5**	616.5
Loss for the year		**(0.1)**	(10.1)
(Accumulated losses)/Retained profits		**(9.7)**	0.4
Shareholder's equity		**1,576.8**	1,576.9
Total equity and liabilities		**1,976.8**	1,976.5

The accompanying notes are an integral part of the financial statements.

The Company financial statements on pages 104 to 109 were approved by the Board of Directors on 25 January 2017 and signed on its behalf by:

Paul Pester
Chief Executive Officer

Ralph Coates
Chief Financial Officer

Company statement of changes in equity

for the year ended 31 December 2016

	Share capital £ million	Share premium £ million	Merger reserve £ million	(Accumulated losses)/ retained profits £ million	Total equity £ million
Balance at 1 January 2015	5.0	965.1	616.5	0.2	1,586.8
Comprehensive loss					
Total comprehensive loss for the year	–	–	–	(10.1)	(10.1)
Transactions with owners					
Movement in shares held by trusts	–	–	–	1.2	1.2
Movement in share-based compensation reserve	–	–	–	(1.0)	(1.0)
Total transactions with owners	–	–	–	0.2	0.2
Balance at 31 December 2015	5.0	965.1	616.5	(9.7)	1,576.9
Balance at 1 January 2016	**5.0**	**965.1**	**616.5**	**(9.7)**	**1,576.9**
Comprehensive loss					
Total comprehensive loss for the year	**–**	**–**	**–**	**(0.1)**	**(0.1)**
Balance at 31 December 2016	**5.0**	**965.1**	**616.5**	**(9.8)**	**1,576.8**

Total comprehensive loss for the year comprises only the loss for the year. No statement of comprehensive income has been shown for the Company, as permitted by section 408 of the Companies Act 2006.

Company cash flow statement

for the year ended 31 December 2016

	2016 £ million	2015 £ million
Cash flows from operating activities		
Loss before taxation	**(0.1)**	(10.1)
Adjustments for:		
Change in current liabilities	**0.1**	11.0
Change in current assets	**–**	(0.1)
Other non-cash and other items	**–**	(0.8)
Net cash provided by operating activities	**–**	–
Cash flows from investing activities		
Interest received on financial assets	**22.1**	22.1
Net cash provided by investing activities	**22.1**	22.1
Cash flows from financing activities		
Interest paid on subordinated liabilities	**(22.1)**	(22.1)
Net cash used in financing activities	**(22.1)**	(22.1)
Change in cash and cash equivalents	**–**	–
Cash and cash equivalents at beginning of year	**–**	–
Cash and cash equivalents at end of year	**–**	–

The accompanying notes are an integral part of the financial statements.

Notes to the Company financial statements

1. Basis of preparation

The financial statements of TSB Banking Group plc (the Company), a public limited company, are prepared on a going concern basis and in accordance with IFRS as adopted by the EU. IFRS comprises accounting standards prefixed IFRS issued by the IASB and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the IFRS Interpretations Committee. The Company's financial statements are presented in accordance with the Companies Act 2006. The Company is domiciled and incorporated in the UK and registered in England and Wales. The financial statements are prepared on the historical cost basis.

The accounting policies that are applicable to the Company are included in TSB Group accounting policies and the following policy is also applicable.

Investments in subsidiaries
Investments in subsidiaries are initially recognised at cost and subsequently held at cost less any impairment charge. An impairment charge is recognised when the carrying amount of the investment exceeds its recoverable amount.

2. Subordinated liabilities

	2016 £ million	2015 £ million
Fixed/floating rate reset callable subordinated Tier 2 notes due May 2026	**383.8**	383.5
Accrued interest	**3.4**	3.4
Total subordinated liabilities	**387.2**	386.9

The Company issued, in 2014, £385.0 million of fixed/floating rate reset callable subordinated Tier 2 notes at an issue price of 99.493% of the principal amount to Lloyds Bank plc. The notes pay interest at a rate of 5.75% per annum, payable semi-annually in arrears until 6 May 2021 at which time the interest rate becomes 3 month LIBOR plus 3.43% per annum payable quarterly in arrears. The Company has the option to redeem these notes on 6 May 2021 and quarterly thereafter, subject to approval of the Prudential Regulatory Authority.

3. Share capital, share premium and merger reserve

Details of the Company's share capital, share premium and merger reserve are set out in note 22 to the consolidated financial statements

4. Related party transactions

The Company enters into transactions with related parties in the normal course of its business. The tables below detail, on an aggregated basis, related party transactions, balances outstanding at the year end and related income.

(i) Key management personnel
The key management personnel of TSB Group and the Company are the same. The relevant disclosures are set out in note 29 to the consolidated financial statements. The Company has no employees.

(ii) Investment in subsidiaries

	2016 £ million	2015 £ million
At 1 January	**1,589.4**	1,588.4
Value of partner services	**–**	4.1
Reclassification of equity settled share schemes to cash settled share schemes	**–**	(3.1)
At 31 December	**1,589.4**	1,589.4

Notes to the Company financial statements

4. Related party transactions (continued)

The Company's legal subsidiary undertakings, all of which prepare financial statements to 31 December, are as follows:

At 31 December 2016	Share class	Country of registration/ incorporation	Percentage of equity share capital and voting rights held	Nature of business
TSB Bank plc[1]	Ordinary	Scotland	100%	Banking
TSB Scotland Nominees Limited[1][2]	Ordinary	Scotland	100%	Dormant
TSB Scotland (Investment) Nominees Limited[1][2]	Ordinary	Scotland	100%	Dormant

In addition, TSB Banking Group plc Employee Share Trust is accounted for as a subsidiary of the Company.

The following are accounted for as subsidiary companies of TSB Bank plc as it has control over these special purpose entities under IFRS 10 *Consolidated Financial Statements:*

- Cape Holdings No. 1 Limited (and its subsidiary Cape Funding No.1 plc)[3];
- Duncan Holdings 2015-1 Limited (and its subsidiary Duncan Funding 2015-1 plc)[3];
- Duncan Holdings 2016-1 Limited (and its subsidiary Duncan Funding 2016-1 plc)[3];
- TSB Covered Bonds LLP[3];
- TSB Covered Bonds (LM) Limited[3]; and
- TSB Covered Bonds (Holdings) Limited[3].

(1) Registered office: Henry Duncan House, 120 George Street, Edinburgh, EH2 4LH.
(2) Subsidiary companies of TSB Bank plc.
(3) Registered office: 35 Great St Helen's, London, EC3A 6AP.

(iii) Loans to subsidiaries

	2016 £ million	2015 £ million
Loans to subsidiaries	**387.2**	386.9
Total loans to subsidiaries	**387.2**	386.9

On 1 May 2014, the Company subscribed for fixed/floating rate reset callable subordinated Tier 2 notes due May 2026 issued by its principal subsidiary, TSB Bank plc.

(iv) Other related party transactions

Details of other related party transactions is given in note 29 to the consolidated financial statements.

5. Financial instruments

(i) Measurement basis of financial instruments

The following table analyses the carrying amounts of the Company's financial instruments:

At 31 December 2016	Fair value £ million	Loans and receivables £ million	Held at amortised cost £ million	Total £ million
Financial assets				
Loans to subsidiaries	**–**	**387.2**	**–**	**387.2**
Total financial assets	**–**	**387.2**	**–**	**387.2**
Financial liabilities				
Subordinated liabilities	**–**	**–**	**387.2**	**387.2**
Total financial liabilities	**–**	**–**	**387.2**	**387.2**
At 31 December 2015				
Financial assets				
Loans to subsidiaries	–	386.9	–	386.9
Total financial assets	–	386.9	–	386.9
Financial liabilities				
Subordinated liabilities	–	–	386.9	386.9
Total financial liabilities	–	–	386.9	386.9

Notes to the Company financial statements

5. Financial instruments (continued)

(ii) Fair value of financial assets and liabilities

At 31 December	2016 Carrying value £ million	2016 Fair value £ million	2015 Carrying value £ million	2015 Fair value £ million
Financial assets				
Loans to subsidiaries	**387.2**	**403.4**	386.9	412.4
Financial liabilities				
Subordinated liabilities	**387.2**	**403.4**	386.9	412.4

The valuation techniques for the Company's financial assets and liabilities are set out in notes 6 and 12 to the consolidated financial statements.

(iii) Valuation hierarchy of financial assets and liabilities carried at amortised cost

The table below analyses the fair values of the financial assets and liabilities of the Company which are carried at amortised cost.

At 31 December 2016	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
Financial assets					
Loans to subsidiaries	**–**	**403.4**	**–**	**403.4**	**387.2**
Financial liabilities					
Subordinated liabilities	**–**	**403.4**	**–**	**403.4**	**387.2**
At 31 December 2015					
Financial assets					
Loans to subsidiaries	–	412.4	–	412.4	386.9
Financial liabilities					
Subordinated liabilities	–	412.4	–	412.4	386.9

(iv) Credit risk

The Company's credit risk arises solely from amounts due from its wholly owned subsidiary, TSB Bank plc.

(v) Liquidity risk

The table below analyses the financial liabilities of the Company by relevant contractual maturity grouping on an undiscounted future cash flow basis based on the remaining period at the balance sheet date.

At 31 December 2016	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Subordinated liabilities	**–**	**–**	**22.1**	**462.5**	**–**	**484.6**
Total	**–**	**–**	**22.1**	**462.5**	**–**	**484.6**
At 31 December 2015						
Subordinated liabilities	–	–	22.1	88.6	396.1	506.8
Total	–	–	22.1	88.6	396.1	506.8

Independent auditors' report to the members of TSB Banking Group plc

Report on the company financial statements

Our opinion

In our opinion, TSB Banking Group plc's company financial statements (the "financial statements"):

- give a true and fair view of the state of the company's affairs as at 31 December 2016 and of its cash flows for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards ("IFRSs") as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

What we have audited

The financial statements, included within the Annual Report and Accounts (the "Annual Report"), comprise:

- the company balance sheet as at 31 December 2016;
- the company cash flow statement for the year then ended;
- the company statement of changes in equity for the year then ended; and
- the notes to the financial statements, which include a summary of significant accounting policies and other explanatory information.

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

The financial reporting framework that has been applied in the preparation of the financial statements is IFRSs as adopted by the European Union, and applicable law, and as applied in accordance with the provisions of the Companies Act 2006.

In applying the financial reporting framework, the directors have made a number of subjective judgements, for example in respect of significant accounting estimates. In making such estimates, they have made assumptions and considered future events.

Opinion on other matter prescribed by the Companies Act 2006

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

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

In addition, in light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we are required to report if we have identified any material misstatements in the Strategic Report and the Directors' Report. We have nothing to report in this respect.

Other matters on which we are required to report by exception

Adequacy of accounting records and information and explanations received

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the company, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Directors' remuneration

Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law are not made. We have no exceptions to report arising from this responsibility.

Independent auditors' report to the members of TSB Banking Group plc

Responsibilities for the financial statements and the audit

Our responsibilities and those of the directors
As explained more fully in the Statement of Directors' responsibilities set out on page 54, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view.

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

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

What an audit of financial statements involves
We conducted our audit in accordance with ISAs (UK & Ireland). An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

- whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed;
- the reasonableness of significant accounting estimates made by the directors; and
- the overall presentation of the financial statements.

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

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

In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report. With respect to the Strategic Report and Directors' Report, we consider whether those reports include the disclosures required by applicable legal requirements.

Other matter

We have reported separately on the group financial statements of TSB Banking Group plc for the year ended 31 December 2016.

Allan McGrath (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Edinburgh
25 January 2017

EDTF Recommendations

The Enhanced Disclosure Task Force (EDTF), formed by the Financial Stability Board to develop principles for enhanced risk disclosures, issued a report in October 2012 setting out 32 recommendations across seven risk areas. These are primarily aimed at large international banks. However, aligned to TSB Group's commitment to transparency, the table below provides an overview of how TSB Group has responded to the recommendations, where relevant to its business model and risk profile.

Type of risk	EDTF Ref	Description	TSB Group's approach
General	1	Risks to which TSB Group is exposed	A summary of TSB Group's principal risks and uncertainties is disclosed on pages 9 to 12.
	2	Definition of risk terminology, principles and appetite	
	3	Top and emerging risks and changes during the reporting period	
	4	Analysis of future regulatory developments affecting the business model and profitability	
Risk governance and management	5	TSB Group's risk management organisation, process and key functions	Described in the Risk management in TSB section on page 9 and in the Corporate governance statement on pages 25 to 31.
	6	Risk culture and risk governance and ownership	
	7	Description of the key risks that arise from the business model, risk appetite, and how TSB Group manages such risks.	TSB Group's principal risks and uncertainties that arise from the business model are explained on pages 9 to 12. Further explanation of financial risks is provided in the notes to the consolidated financial statements on pages 86 to 95.
	8	Stress testing and the underlying assumptions	
Capital adequacy	9	Minimum Pillar 3 disclosures requirements	Disclosed in the Sabadell Pillar 3 report*.
	10	Reconciliation of accounting balance sheet to regulatory balance sheet	Disclosed on page 16.
	11	Flow statement of movements in regulatory capital	Disclosed on page 16.
	12	Discussion of targeted level of capital and how this will be established	A description of TSB Group's capital composition and changes is provided on pages 15 to 17.
	13	Analysis of risk-weighted assets and how they relate to business activities	An analysis of risk-weighted assets is disclosed on page 16.
	14	Analysis of capital requirements for each Basel asset class	
	15	Analysis of credit risk for each Basel asset class	Disclosed in the Sabadell Pillar 3 report*.
	16	Flow statements reconciling movements in Risk Weighted Assets for each Risk Weighted Asset type	
	17	Discussion of Basel credit risk model performance	
Liquidity & funding	18	Analysis of TSB Group's liquid asset buffer	Details of the liquidity portfolio and encumbered assets are disclosed in the 'Review of our performance in 2016' section on page 19.
	19	Encumbered and unencumbered assets analysed by balance sheet category	
	20	TSB Group assets, liabilities and off balance sheet commitments analysed by remaining contractual maturity	An analysis of the contractual maturity of TSB Group's assets and liabilities is disclosed in note 25 to the consolidated financial statements.
	21	Analysis of TSB Group's sources of funding	TSB Group's sources of funding are set out in notes 1 to 5 of the consolidated financial statements.
Market risk	22	Relationship between market risk measures for trading and non trading portfolios and the balance sheet	A summary of the sources, measurement and monitoring of market risk, including sources and sensitivity of net interest income to non-trading market risk is disclosed in note 27 to the consolidated financial statements. TSB Group has no trading market risk.
	23	Discussion of significant trading and non trading market risk factors	
	24	VaR assumptions, limitations and validation	
	25	Description of the primary risk management techniques employed by TSB Group	
Credit risk	26	Analysis of the aggregate credit risk exposures	A table showing the maximum exposure to credit risk is disclosed in note 24 to the consolidated financial statements.
	27	Description of the policies for identifying impaired or non-performing loans including forbearance	TSB Group policy for identifying impaired loans is disclosed on page 67. A summary of forborne loans is set out on page 90.
	28	Reconciliation of the opening and closing balances of non-performing or impaired loans and the allowance for loan losses.	Disclosure of the movement in the allowance for loan losses is disclosed in note 10 to the consolidated financial statements.
	29	Analysis of counterparty credit risk that arises from derivative transactions	TSB Group's derivatives are set out in note 27 to the consolidated financial statements.
	30	Discussion of credit risk mitigation, including collateral held for all sources of risk	Credit risk mitigation and analysis of collateral held is disclosed in note 24 to the consolidated financial statements.
Other risks	31	Description of other risks	A description of principal and emerging risks is disclosed in the 'Risk Management in TSB' section on pages 9 to 12.
	32	Discussion of publicly known risks	

* As at the date of this report, the 2016 Sabadell Pillar 3 report has not been approved and is expected to be available in due course from www.grupbancsabadell.com/en/.

Glossary

Arrears	A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan is unpaid or overdue. Such a customer is also said to be in a state of delinquency and the entire outstanding balance is delinquent.
Asset Quality Ratio (AQR)	The impairment charge for the year in respect of loans and advances to customers expressed as a percentage of average loans and advances to customers, gross of impairment allowance.
Basel III	The capital reforms and introduction of a global liquidity standard proposed by the Basel Committee on Banking Supervision in 2010 and due to be phased in, through CRD IV, from 1 January 2015 onward.
Basis point	One hundredth of a per cent (0.01 per cent). 100 basis points is 1 per cent. Used in quoting movements in interest rates.
Buy-to-let mortgages	Buy-to-let mortgages are those mortgages offered to customers purchasing residential property as a rental investment.
Capital Requirements Directive (CRD) IV	On 27 June 2013, the European Commission published, through the official journal of the European Union, its legislation for a CRD and Capital Requirements Regulation (CRR), which form the CRD IV package. Amendments were subsequently made to the Regulation published on 30 November 2013. The package implements the Basel III proposals in addition to the inclusion of new proposals on sanctions for non-compliance with prudential rules, corporate governance and remuneration. The rules were implemented from 1 January 2015 onwards, with certain sections yet to be phased in.
Collectively assessed loan impairment provision	A provision established following an impairment assessment on a collective basis for homogeneous groups of loans, such as credit card receivables and personal loans, that are not considered individually significant and for loan losses that have been incurred but not separately identified at the balance sheet date.
Common Equity Tier 1 (CET1) capital	The highest quality form of regulatory capital under CRD IV that comprises common shares issued and related share premium, retained earnings and other reserves less specified regulatory adjustments.
Common Equity Tier 1 capital ratio	Common Equity Tier 1 capital as a percentage of risk-weighted assets.
Contractual maturities	Contractual maturity refers to the final payment date of a loan or other financial instrument, at which point all the remaining outstanding principal will be repaid and interest is due to be paid.
Coverage ratio	Impairment provisions as a percentage of impaired loans.
Customer deposits	Money deposited by account holders. Such funds are recorded as liabilities of TSB Group.
Delinquency	See Arrears.
Encumbrance	The use of assets to secure liabilities, such as by way of a lien or charge.
Expected loss	Expected loss (EL) represents the anticipated loss, in the event of default, on a credit risk exposure modelled under the internal ratings based approach. EL is determined by multiplying the associated PD%, LGD% and EAD together and assumes a 12 month time horizon.
Exposure at default	Exposure at default (EAD) represents the estimated exposure to a customer in the event of default. In determining EAD amounts, consideration is made of the extent to which undrawn commitments may be drawn down at the point of default and the application of credit risk mitigation (i.e. eligible financial collateral).
Financial Services Compensation Scheme (FSCS)	The Financial Services Compensation Scheme (FSCS) is the UK's independent statutory compensation fund for customers of authorised financial services firms and pays compensation if a firm is unable to pay claims against it. The FSCS is funded by management expenses levies and, where necessary, compensation levies on authorised firms.

Glossary (continued)

Forbearance	Forbearance takes place when a concession is made on the contractual terms of a loan in response to an obligor's financial difficulties.
Impaired loans	Impaired loans are loans where TSB Group does not expect to collect all the contractual cash flows or to collect them when they are contractually due.
Impairment allowances	Impairment allowances are a provision held on the balance sheet as a result of the raising of a charge against profit for the incurred loss inherent in the lending book. An impairment allowance may either be individual or collective.
Impairment Individually/collectively assessed	Impairment is measured individually for assets that are individually significant, and collectively where a portfolio comprises homogenous assets and where appropriate statistical techniques are available.
Impairment losses	An impairment loss is the reduction in value that arises following an impairment review of an asset that determines that the asset's value is lower than its carrying value. For impaired financial assets measured at amortised cost, impairment losses are the difference between the carrying value and the present value of estimated future cash flows, discounted at the asset's original effective interest rate.
Internal Capital Adequacy Assessment Process (ICAAP)	TSB Group's own assessment of the amount and type of capital it considers adequate to cover the level and nature of the risks to which it is or might be exposed.
Internal Liquidity Adequacy Assessment Process (ILAAP)	TSB Group's own assessment of the adequacy of its liquidity and funding resources to cover the level and nature of risks to which it is or might be exposed
Internal Ratings-Based approach (IRB)	A methodology of estimating the credit risk within a portfolio by utilising internal risk parameters to calculate credit risk regulatory capital requirements. There are two approaches to IRB: Foundation IRB and Advanced IRB.
IT Migration Programme	A programme designed to migrate our IT infrastructure from the one provided by LBG under a transitional outsourcing arrangement to one provided by our parent Sabadell.
Leverage ratio	Tier 1 capital divided by the exposure measure. Basel III reforms introduced a leverage ratio framework designed to reinforce risk based capital requirements with a simple, transparent, non-risk based 'backstop' measure.
Liquidity Coverage Ratio (LCR)	Measures the percentage of high quality liquid assets relative to expected net cash outflows over a 30 day period. High quality liquid assets should be unencumbered, liquid in markets during a time of stress and ideally, be central bank eligible.
Loan to deposit ratio	The ratio of loans and advances to customers net of allowance for impairment losses divided by customer deposits.
Loans past due	Loans are past due when a counterparty has failed to make a payment when contractually due.
Loan-to-value ratio (LTV)	The LTV ratio is a mathematical calculation which expresses the amount of a mortgage balance outstanding as a percentage of the total appraised value of the property. A high LTV indicates that there is less value to protect the lender against house price falls or increases in the loan if repayments are not made and interest is added to the outstanding balance of the loan.
Loss given default	Loss given default (LGD) represents the estimated proportion of an EAD amount that will be lost in the event of default. It is calculated after taking account of credit risk mitigation and includes the cost of recovery.
Master netting agreement	An agreement between two counterparties that have multiple derivative contracts with each other that provides for the net settlement of all contracts through a single payment, in a single currency, in the event of default on, or termination of, any one contract.

Glossary (continued)

Net interest income	The difference between revenues generated by interest-earning assets and the cost of interest-bearing liabilities.
Net interest margin	Net interest margin is net interest income as a percentage of average interest-earning assets.
Net Promoter Score (NPS)	NPS is based on the question "On a scale of 0-10, where 0 is not at all likely and 10 is extremely likely, how likely is it that you would recommend TSB to a friend or colleague?" NPS is the percentage of TSB customers who score 9-10 after subtracting the percentage who score 0-6.
Pillar 3	The third pillar of the Basel III framework aims to encourage market discipline by setting out disclosure requirements for Banks on their capital, risk exposures and risk assessment processes. These disclosures are aimed at improving the information made available to the market.
Probability of default	Probability of default (PD) represents an estimate of the likelihood that a customer will default on their obligation within a 12 month time horizon.
Repurchase agreements	Short-term funding agreements which allow a borrower to sell a financial asset as collateral for cash. As part of the agreement the borrower agrees to repurchase the security at some later date, usually less than 30 days, repaying the proceeds of the loan.
Risk-weighted assets	A measure of a bank's assets adjusted for their associated risks. Risk weightings are established in accordance with the Basel Capital Accord as implemented by the PRA.
Securities financing transactions	Securities financing transactions are repurchase and reverse repurchase agreements, buy/sell backs and securities lending. For the lender (seller) of the securities it is usually a way to raise funds to finance the securities positions. For the borrower (buyer) of the securities it is a way to invest short–term funds or to cover short (bond) positions.
Securitisation	Securitisation is a process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities.
Standardised approach	The Standardised approach to calculating credit risk capital requirements requires the use of a standard set of risk weights prescribed by the regulator. Use may be made of external credit ratings supplied by external credit assessment institutions to assign risk weights to exposures. Standardised approaches, following prescribed methodologies, also exist for calculating market risk and operational risk capital requirements.
Subordinated liabilities	Liabilities which, in the event of insolvency or liquidation of the issuer, are subordinated to the claims of depositors and other creditors of the issuer.
Tier 1 capital	A measure of a bank's financial strength defined by the CRD IV. It captures Common Equity Tier 1 capital plus other Tier 1 securities in issue, subject to deductions.
Tier 1 capital ratio	Tier 1 capital as a percentage of risk-weighted assets.
Tier 2 capital	A component of regulatory capital defined by the CRD IV, mainly comprising qualifying subordinated loan capital and eligible collective impairment allowances.

Abbreviations

AQR	Asset quality ratio
BPS	Basis points
CET1	Common Equity Tier 1
CRD IV	Capital Requirements Directive IV
EIR	Effective interest rate
FCA	Financial Conduct Authority
HMRC	Her Majesty's Revenue and Customs
IAS	International Accounting Standards
ICAAP	Internal Capital Adequacy Assessment Process
IFRS IC	International Financial Reporting Standards Interpretations Committee
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IPO	Initial public offering
ISAE	International Standard on Assurance Engagements
LBG	Lloyds Banking Group
LCR	Liquidity Coverage Ratio
LTIP	Long Term Incentive Plan
LTV	Loan to value
NPS	Net Promoter Score
PCA	Personal current account
PP	Percentage points
PRA	Prudential Regulatory Authority
SPA	Sustainable Performance Award
TSA	Transitional Services Agreement

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