TSB Bank plc
Annual Report and Accounts 2017

Registered in Scotland
Company Number: SC095237

TSB Bank plc

Annual report and consolidated financial statements
For the year ended 31 December 2017

Overview
TSB Bank plc (the 'Company'), together with its subsidiary undertakings (together the 'Bank' or 'TSB') offers a range of retail and business banking services in the UK. It is the main operating subsidiary of its immediate parent, TSB Banking Group plc, and its ultimate parent company is Banco de Sabadell SA.

Contents

Directors and Company Secretary

The Directors who served during the year or from the date of their appointment are:

Non-executive Chairman:	Will Samuel (independent on appointment)
Executive Directors:	Paul Pester (Chief Executive Officer)
	Ralph Coates (Chief Financial Officer)
Independent Non-executive Directors:	Paulina Beato (appointed 22 March 2017)
	Dame Sandra Dawson*
	Graeme Hardie
	Sandy Kinney
	Richard Meddings (appointed 20 September 2017)
	Stephen Page (appointed 20 September 2017)
	Polly Williams
Non-executive Directors:	Miquel Montes
	Tomás Varela
Company Secretary	Lorna Curry (appointed 24 January 2018)

* Senior Independent Director

Board Chairman
Towards the end of 2017, the Chairman, Will Samuel, indicated his intention to step down as a Director and Chairman of the Company. Richard Meddings will assume the role of Chairman immediately following the completion of the 2017 Annual Report and Accounts.

Registered office:
TSB Bank plc
Henry Duncan House
120 George Street
Edinburgh
EH2 4LH

Strategic report

Introduction

During 2017 TSB continued to deliver on its mission to bring more competition to UK banking. It's now four years since we launched and we continue to demonstrate that a bank focused on serving local communities really can thrive. The Bank is growing, and our high-tech transformation has gathered pace in 2017. We exceeded our target of attracting more than 6% of all new and switching bank accounts in the UK for the fourth year in a row, our lending has grown by more than 50% since launch to over £30 billion, we continue to be Britain's most recommended high street bank, and we delivered a statutory profit before tax of £159.1 million.

TSB's three strategic pillars have remained the same since relaunching onto high streets across Britain in 2013:

- to provide the kind of banking experience that people tell us they want and we believe they deserve;
- to provide great banking to more people; and
- to help more people to borrow well.

We made significant progress through the year on all three as summarised below and explained further in the context of Board approved key performance indicators on page 6.

Providing the kind of banking experience people want and deserve

In 2017 we continued to invest in becoming a more agile, digital business. Our high-tech transformation has continued at pace, and we will be the first major bank in the UK to have designed and built a state-of-the-art banking platform for the digital age. The new platform is already being used to support a number of our core services, and customers are experiencing the benefits. In April, we launched our new mobile app, and have continued to develop and enhance it every month since, responding directly to customer feedback. TSB customers were also the first in Europe to use iris scanning security with our mobile app and among the first in the world to use Apple's new facial recognition technology, accessing their accounts simply by glancing at their phones.

In November we unveiled our new banking platform to journalists, analysts and TSB Partners. TSB Partners are now using the platform for bank account services, and mortgage brokers are using it to help customers access new TSB mortgages. The final phase of the Migration Programme and the platform's roll-out to customers will follow in 2018. Alongside this, we also continue to invest in our people, and in our branch network to provide our customers with excellent levels of service however and wherever they choose to bank with us. In August, we started work on our third purpose-built, flagship branch in Manchester which will open in 2018.

TSB continues to build a different sort of bank with a diverse, inclusive and transparent culture. TSB has been tackling gender imbalance and we were proud to be one of the first companies to sign up to the Women in Finance charter and to publish our gender pay gap data. We seek to create a sustainable gender balanced workplace at TSB that reflects the communities we serve.

The results of these efforts continue to be recognised. In 2017 TSB was identified as one of the top 10 big companies to work for in the UK, the only bank on the list, and was recognised as a Great Place to Work. Customers continue to recommend TSB to friends and family and we are Britain's most recommended high street bank. While we are proud of our continued progress in 2017, there is always more to be achieved in realising our potential to provide the kind of banking experience people want and we believe they deserve.

Providing great banking to more people

When we launched we set out 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 2017 we exceeded our target with 6.2% of all customers switching banks or opening a new account choosing TSB, equivalent to around 1,000 customers a day. However, the number of people switching their bank account provider in the UK is falling. TSB believes that the industry needs to do much more to bring real competition to UK banking and we continue to campaign for a standard format monthly bill for all bank account customers, a switching service that works for everyone, including overdraft users, and for banks to make their customers aware of their ability to switch.

Helping more people to borrow well with TSB

In 2017 customer lending grew by 4.9% to over £30 billion; this has now grown by over 50% since launch. Growth in customer lending was supported by our mortgage offering with Franchise mortgage portfolio balances increasing by £3.3 billion. TSB's award winning mortgage broker service delivered a 5 star service for the third year running which contributed to TSB providing £7 billion of new mortgage lending to help more than 47,000 homeowners to get a better mortgage deal or buy a new home through the year. We have continued to grow TSB in a responsible way, with our ambitions to help more people borrow well evidenced by the average mortgage loan to value which remains low at 44.2%.

Strategic report (continued)

Helping more people to borrow well with TSB (continued)

Following on from developments in 2016, TSB's personal unsecured loans were made available through our branch network and digital channels during 2017 to customers who don't yet have a TSB bank account. This supported the growth of 16.9% in personal unsecured loans balances. In order to ensure that all consumers are able to borrow well TSB believes that the personal loans industry needs to be exposed to the full force of competition – and in April we launched our Consumers Matter: Loans campaign to create a market where consumers know what they are getting, can shop around freely and are able to switch.

In November, the Bank of England increased the base rate by 0.25% to 0.50%, unwinding the rate cut it made in August 2016. As a result, we put our customers' variable rate mortgages and savings back to the position they were at before the Bank of England reduced rates. With this being the first base rate increase in over a decade, we knew that our customers would have many questions about how the increase would affect them, and TSB Partners in our branches and on our customer service team were on hand to help guide customers through this change.

Financial summary

Customer advocacy and trust in TSB has translated into strong balance sheet growth. During 2017 customer deposit balances increased by £1.1 billion (3.9%) to £30.5 billion. This provided funding to support the third pillar of TSB's strategy, to help more customers to borrow well, with total loan balances increasing by £1.4 billion (4.9%) to £30.9 billion.

On a statutory basis, profit before taxation was £159.1 million, down £23.2 million (12.7%) compared with 2016. This was largely driven by the previously reported and expected increase of £122.0 million in outsourcing fees paid to Lloyds Banking Group (LBG) in 2017, and the recognition in 2016 of a £32.5 million non-recurring gain on the sale of our share in Visa Europe following its acquisition by Visa Inc. These anticipated reductions in profit were largely mitigated by a £96.0 million increase in net interest income from the Franchise business, reflecting the continued success of our strategy, and an increase in profits from the Mortgage Enhancement portfolio of £15.5 million, which included the recognition of a gain of £49.7 million following the early return of this £1.7 billion mortgage portfolio to LBG in June 2017.

Outlook

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. 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. While we continue to be confident in the strength of the UK economy, we are mindful of the challenges ahead.

As previously announced, we re-planned the final phase of the roll-out of our new banking platform to customers into 2018. Until this final phase of the migration is completed, and as we've seen this year, the contractual increase in outsourcing fees paid to LBG will continue into 2018. We also note that interest rates are predicted to remain at historically low levels, placing pressure on net interest margins for all banks. The effect of these factors, together with the continued roll-off of the Whistletree portfolio and the early return of the Mortgage Enhancement portfolio will, we expect, lead to a reduction in our statutory profit before tax in 2018.

Looking forward, when the roll out of the new platform is complete, TSB's costs will reduce considerably as the increase we've seen in LBG outsourcing costs is reversed. TSB's new state-of-the-art banking platform will enable us to make banking even better for UK consumers and, importantly, small businesses and entrepreneurs. Customers are already seeing the benefits of the new platform, and it will enable us to be more agile in responding to customers' needs as they evolve. This Migration Programme is, of course, of such scale and strategic importance that it does not come without delivery and operational risks. The management of these risks is overseen by the Audit Committee on behalf of the Board.

Conclusion

Our performance in 2017 demonstrates that TSB continues to deliver on its mission of bringing more competition to UK banking. At the heart of that strategy is our unrelenting focus on our customers, and the commitment and energy that our Partners bring to serving our customers every day. Without their passion and dedication TSB would not be where it is today.

Looking forward, TSB is well placed to continue to thrive despite a potentially uncertain economic environment. Our ability to bring more competition to UK banking, including small business banking, 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 on the high street.

Strategic report (continued)

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 the Bank operating in line with these predetermined parameters. This helps protect both our customers' and the shareholder's interests.

TSB's business model reflects a straightforward and simple retail business and is outlined below:

Components of our Business model	Description	Financial statements
Banking experience	We seek to deliver a banking experience that is the primary reason for customers to choose and remain with us, and increasingly sets TSB apart from other banks and providers of financial services. Central to our banking experience is the development of our brand, investments in our branch, telephony and digital capabilities and customer led service ethos. Our brand is based on transparent and straightforward values which underpinned TSB when it was established more than 200 years ago for the purpose of helping local people, and the communities they lived in, to thrive together. These values remain as relevant today as they did then.	n/a
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 23
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 28
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 39
Charges	Running a bank with 5 million customers comes with overheads. Charges we incur include the costs of paying our 8,500 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 an impairment charge. Finally, the Bank pays tax to Her Majesty's Revenue and Customs (HMRC).	Page 41
Profits and returns to the shareholder	The Board reviews the Bank's performance. It decides whether profits are put aside for future investment in the business, for protection against the uncertainties that the Bank faces, or returned to the shareholder in the form of dividends. Currently, all returns are being reinvested in the business.	Page 46

Strategic report (continued)

Strategy and key performance indicators

<table>
<tr><th>Strategic priority</th><th>2017 performance</th><th>Key performance indicator</th></tr>
<tr><th colspan="3">Provide the kind of banking experience people want and deserve</th></tr>
<tr><td>Build greater consideration of the TSB brand.

Deploy TSB's strong digital capability.

Deliver a differentiated customer experience through our Partners.</td>
<td><u>Building the TSB Brand</u>
• TSB continued to be Britain's most recommended high street bank for 2017, as measured by independent research company BDRC.
• TSB continued to partner with Trinity Mirror for Pride of Britain and Pride of Sport in 2017 reinforcing TSB's commitment to local communities.
• TSB was identified as one of the top 10 big companies to work for in the UK, and was recognised as a Great Place to Work. (Further information on how our Partners support the values that underpin the TSB Brand is set out in our Partners' report on pages 14 to 16).

<u>Strong Digital Capability</u>
• TSB continued to invest in becoming a more agile, digital business.
• A key strategic priority to further support TSB's ability to make banking better for all UK consumers is our continued investment in migrating our banking platform from the one provided by Lloyds Banking Group to a new, state-of-the-art platform designed and built with Sabadell.
• Customers are starting to see the benefits through our new TSB banking app and during 2017, TSB customers became the first in Europe to use iris scanning security with their mobile banking app, logging into their TSB accounts just by looking at their phones. They were also amongst the first to use Apple's new facial recognition technology to log in to their TSB account
• Going forward, the new platform will enable TSB to be more agile in responding to customers' needs as they evolve.

<u>Customer Experience</u>
• Customers continue to recommend TSB to friends and family with the Bank's Net Promoter Score remaining strong increasing by a further 2 points in 2017.</td>
<td>Customer advocacy (Net Promoter Score)(1)
<table><tr><th>2017</th><th>2016</th></tr><tr><td>25</td><td>23</td></tr></table></td></tr>
<tr><th colspan="3">Provide great banking to more people</th></tr>
<tr><td>Grow market share of bank accounts by consistently taking a greater than 6% share of gross flow over a five year period.</td>
<td>• TSB continued to exceed its 6% flow target, with 6.2% of all customers switching or opening a new account choosing TSB during 2017.
• In addition to the strong performance of the Classic Plus account, more customers are choosing TSB for their savings. During 2017, deposits grew by 3.9% to £30.5 billion reflecting customers' continued trust in TSB.</td>
<td>Share of personal bank account gross flow (%)(2)
<table><tr><th>2017</th><th>2016</th></tr><tr><td>6.2%</td><td>6.4%</td></tr></table>
Share of PCA stock (%)
<table><tr><th>2017</th><th>2016</th></tr><tr><td>4.6%</td><td>4.5%</td></tr></table></td></tr>
<tr><th colspan="3">Help more people borrow well</th></tr>
<tr><td>Grow Franchise customer lending by 40% to 50% over a five year period from IPO.</td>
<td>• Balance sheet growth continues to remain strong with total customer lending balances up 4.9% to £30.9 billion in the year, exceeding the target to grow customer balances by 40-50% within 5 years of the IPO.
• Mortgage gross lending continues to increase. The mortgage intermediary channel, launched in January 2015 continues to perform well and has seen £5.4 billion of mortgage loan completions advanced through this channel in 2017.</td>
<td>Mortgages gross new lending (£m)
<table><tr><th>2017</th><th>2016</th></tr><tr><td>7,001.5</td><td>6,592.5</td></tr></table>
Unsecured asset growth (£m)
<table><tr><th>2017</th><th>2016</th></tr><tr><td>232.9</td><td>36.0</td></tr></table></td></tr>
</table>

(1) NPS is based on the question "On a scale of 0 to10, 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 give a score of 9 or 10 after subtracting the percentage who give a score of 0 to 6. Calculated as a 12 month rolling average

(2) 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.

Strategic report (continued)

Review of performance

Performance is presented in a manner consistent with the Bank's business model, summarised on page 5 and is explained by reference to three customer portfolios: Franchise; Whistletree Loans, and Mortgage Enhancement. Franchise comprises the retail banking business in the UK. Whistletree Loans is a portfolio, primarily mortgages, acquired in December 2015. Mortgage Enhancement was a portfolio of mortgages which had been assigned to the Bank in 2014 and which was divested and returned early to Lloyds Banking Group in June 2017.

Summary balance sheet

	2017 £ million	2016 £ million
Customer deposits	**30,520.6**	29,383.8
Non-customer funding:		
Term Funding Scheme	**5,625.7**	5.0
Repurchase agreements	**1,446.4**	1,409.6
Debt securities in issue	**1,318.7**	2,940.1
Subordinated liabilities	**405.3**	413.3
Non-customer funding	**8,796.1**	4,768.0
	39,316.7	34,151.8
Shareholder's equity	**2,006.6**	1,879.6
Sources of funding	**41,323.3**	36,031.4
Other liabilities	**1,213.4**	1,179.2
Total equity and liabilities	**42,536.7**	37,210.6
Loans and advances to customers	**30,854.2**	29,419.1
Liquidity portfolio[1]	**9,536.2**	5,571.4
Other assets	**2,146.3**	2,220.1
Total assets	**42,536.7**	37,210.6

(1) Comprises balances at central banks of £7,419.9 million (2016: £3,473.1 million), gilts of £1,721.5 million (2016: £1,872.8 million) and supranational and development bank bonds of £394.8 million (2016: £225.5 million). Balances at central banks are combined with other cash balances and demand deposits of £143.5 million (2016: £174.6 million) when shown on the balances sheet on page 19.

Total sources of funding increased by £5.3 billion to £41.3 billion reflecting an increase in, and diversification of the sources of, non-customer funding primarily driven by £5.6 billion of borrowing from the Bank of England's Term Funding Scheme in 2017, and £0.5 billion of covered bonds issuance, offset by repayment of the £1.9 billion Cape Funding facility from LBG; and strong customer deposit net inflow, which increased by over £1.1 billion during the year.

This increased funding supported the Bank's strategic aim to help more people borrow well, funding an increase of £1.4 billion in loans and advances to customers and an increase of £4.0 billion in the liquidity portfolio, contributing to a significant increase in the surplus over regulatory requirements. The increase in loans and advances to customers to £30.9 billion (2016: £29.4 billion) was driven by strong growth in the Franchise portfolio of £3.3 billion, partially offset by the early return of the Mortgage Enhancement portfolio and the ongoing and expected repayment of the Whistletree loan portfolio.

Income statement and profitability

	2017 £ million	2016 £ million
Net interest income	**905.3**	853.8
Other income	**190.8**	146.6
Total income	**1,096.1**	1,000.4
Operating expenses	**(859.2)**	(730.8)
Impairment	**(77.8)**	(87.3)
Statutory profit before taxation	**159.1**	182.3
Taxation	**(44.0)**	(54.2)
Statutory profit for the year	**115.1**	128.1

On a statutory basis, profit before tax decreased by £23.2 million to £159.1 million. The reduction was primarily driven by:

- a £122.0 million increase in outsourcing fees in operating expenses paid to LBG in 2017; and
- a non-repeating gain in 2016 in other income of £32.5 million on the sale of the Visa Europe share.

These decreases in statutory profit before tax were partially offset by:

- a £96.0 million increase in net interest income from the Franchise and Whistletree portfolios driven by secured balance growth of 12.1%;
- a £15.5 million increase in profits earned from the Mortgage Enhancement portfolio. This increase reflected the effect of the portfolio's early return to LBG in June 2017 generating a gain at the date of its return of £49.7 million.

Strategic report (continued)

Principal risks and uncertainties

Banking is based on the effective evaluation of risks. Processes to identify, measure and control risk are fully embedded in the Bank's risk management framework. The IT Migration Programme to move the Bank's IT and operational services from LBG to a new IT platform provided by Sabadell is a key strategic imperative which should enable the Bank to become more innovative and agile in delivering its banking experience and reduce operating costs considerably. Given the size and scale of this programme, it is considered the most significant cause of risk to the delivery of the Bank's strategy.

Migration risk

The Bank is currently undertaking an extensive Migration Programme which could have impacts across a number of areas of our business, including operational stability, service resilience, vulnerability to financial crime, regulatory compliance, and data security and could therefore, impact the quality of experience that the Bank provides to its customers. Migration also presents a risk that management focus is diverted from day to day activities and other strategic initiatives to the delivery of the Migration Programme. The Bank mitigates these risks by:

- Managing the migration through a Board-led enterprise wide change programme, with an effective the Bank wide governance structure, including Audit Committee oversight and challenge of the management of the Programme's risks.
- Close management by the business of the programme risks throughout the migration lifecycle, including additional governance specifically created to support migration delivery activities, and regular review of the associated controls.
- Independent monitoring, assessment and oversight of the risks and controls by second line (Risk) and Internal Audit, covering both programme delivery and business as usual activities.
- Using the significant experience of Partners in the Bank and Sabadell who have successfully delivered large scale change and migration projects, specifically using their knowledge of the risks that arise in such projects.

Principal risks arising from TSB's business model and strategy

Providing the kind of banking experience people want and deserve

Conduct risk

TSB seeks to provide a first class banking experience that meets the needs of its customers by getting the basics of banking service right whilst delivering compelling value propositions for customers that set it apart from the competition. The Bank aims to have a strong and customer focused culture, which maintains market integrity and regulatory standards. The principal conduct risks to delivering fair customer outcomes are described below along with the steps that the Bank takes to mitigate the impact of the risks.

Principal conduct risks to delivering fair customer outcomes	• **Product design:** the risk that product design gives rise to poor customer outcomes, compromises market integrity or breaches regulation. • **Product sales and promotion:** the risk that the selling and promotion of its products gives risk to poor customer outcomes, compromises market integrity or breaches regulation. • **Product servicing**: the risk that on-going customer service gives risk to poor customer outcomes. This risk is increased where a customer's individual circumstances or potential vulnerability are not appropriately considered. • **Financial crime:** The risk that systems and controls are not adequate to manage criminal conduct within TSB's risk appetite and regulatory framework. This includes the risk of bribery and corruption. • **Firm and governance risk:** The risk that weaknesses in the Bank's overarching systems of governance, reporting and control impact on customer outcomes, market integrity or regulatory compliance.
How the Bank manages its conduct risks	The management of a suite of Board approved conduct risk appetite measures seeks to ensure that all elements of conduct risk operate within appetite. Product design, services and channels are monitored and managed to provide value over time, meet our customer requirements and deliver fair outcomes for customers. Regular outcome testing takes place to ensure that customers are receiving a fair outcome from any interaction with the Bank. A suite of policies and procedures are maintained which seek to ensure consistent standards of customer treatment. Potentially vulnerable customers are identified at an early stage and are provided with appropriate assistance to ensure their personal circumstances are considered throughout their relationship with the Bank. All Bank's Partners have regulatory responsibilities and personal obligations to deter, detect and disrupt those who would seek to use TSB to facilitate any form of financial crime including bribery, corruption and money laundering. Partners regularly undertake an education and awareness programme with the aim of ensuring roles and responsibilities are understood. The risks inherent to the Bank's business model give rise to exposures to bribery and corruption primarily through the branch network, intermediaries and third party suppliers. The anti-bribery policy and underlying standards provides controls and guidance to manage these risks. The policy applies to all Bank Partners and third parties who conduct business on behalf of the Bank. Compliance with regulation and legislation is maintained through a regular review of changes which seeks to ensure a timely response. The effectiveness of controls and governance is regularly monitored and assessed.

Strategic report (continued)

Operational risk The banking service provided by the Bank through its day to day business creates operational risk that could result in loss, damage or disruption. The Bank manages these risks through its comprehensive risk management framework. The principal operational risks are described below along with the steps that the Bank takes to mitigate the impact of the risks	
Principal operational risks arising from delivering the Bank banking service	• **Service resilience:** The risk of interruption to significant functions and services due to inadequate capacity management, recovery strategies or continuity of systems, processes and controls. • **Cyber/information security:** The risk associated with acquiring, retaining, using and destroying physical and electronic data. This includes maintaining the integrity and appropriate use of data, particularly customer data (Privacy) as well as the confidentiality, availability and protection of data from both internal and external cyber-attack (Security). Potential impacts could include IT service availability, internal/external fraud, and/or customer data loss. • **Sourcing and Contracting:** The risks arising from supplier selection, the establishment of effective service agreements, and the ongoing management of material suppliers. • **Fraud**: The risk of exposure to losses arising from criminal activity perpetrated to achieve financial gain at the expense of the firm and resulting in customer detriment or reputational damage.
How the Bank manages its operational risks	The Bank operates an effective operational risk policy and framework to identify and assess its operational risks, understand their potential impacts, and take action to mitigate and control them. To maintain its service, incident management systems and processes are in place to identify and respond quickly to customer issues arising from these risks in order to lessen their impact. The Bank has defined and implemented effective governance, reporting, and controls with LBG and SABIS (its key IT providers) to manage risk and service issues, and aims to ensure an effective, stable and compliant service. The external criminal environment is continually evolving with new threats and attacks identified almost daily. The Bank is committed to making customers' banking experience as safe as possible. Through the effective management of its Security Operations Centre (SOC) the Chief Information Security Officer (CISO) monitors the cyber threat and works with other firms, enforcement agencies, and government/industry experts to make the best use of intelligence and technology to identify and prevent suspicious activity. To successfully manage its third party deliverables the Bank operates a sourcing and contracting framework to complete due diligence, aiming to ensure contractual terms are appropriate, and operates a supplier management framework to monitor and manage the ongoing relationship. The Bank is, on occasion, targeted by criminals attempting to defraud the business and/or customers. Systems pro-actively monitor and protect against suspicious activity. The Bank operates an online Fraud Prevention Centre to educate its customers about the potential risks and ways in which it can work with customers to prevent fraudulent activity. In the event of fraud occurring, the Bank works with all parties with the aim of ensuring that a fair customer outcome is achieved.

Strategic report (continued)

Provide great banking to more people

Financial risk The Bank'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. Some of the principal financial risks from the Bank's banking model are detailed below along with the steps it takes to mitigate the impact of the risks.	
Financial risks arising from the Bank's growth strategy	• **Capital Adequacy:** The risk associated with the failure to retain sufficient reserves or quality of capital to cover the Bank's statutory requirements, losses, and support business strategy. • **Liquidity:** The risk that the Bank is unable to meet its liabilities as they fall due, or is unable to maintain regulator, investor, customer or other stakeholder confidence that this will be achieved. • **Profit Resilience:** The risk that the firm fails to realise planned profits by a significant margin, or that profits are the subject of excessive levels of volatility. • **Interest Rate:** The risk that the net value of, or net income arising from, the firm's assets and liabilities is impacted as a result of changes to interest rates.
How the Bank manages its financial risks	Regular stress testing, including the Internal capital Adequacy Assessment Process (ICAAP) assessment of the adequacy of the Bank's capital, and regulatory change impact assessments, seeks to ensure that the Bank maintains sufficient capital for continuing growth. The Bank maintains a stable and diverse funding profile. It undertakes an Internal Liquidity Adequacy Assessment Process (ILAAP) assessment of the adequacy of liquidity and funding resources, retains sufficient liquidity to meet its financial obligations as they fall due and uses wholesale funding facilities, including the Bank of England's Term Funding Scheme (TFS) where considered appropriate. Profit resilience is maintained through continued strong growth, whilst also reducing operating costs through the successful delivery of IT Migration. The Bank also benefits from protection from certain historical conduct matters under an indemnity arrangement with LBG established at the time of TSB Group's initial public offering. Despite the recent rise in base rate, rates remain historically low resulting in continued margin pressures. The Bank uses derivative financial instruments in the normal course of business to manage interest rate risk. The hedge effectiveness of these derivatives is monitored regularly.

Helping more people borrow well

Credit risk The key credit risks faced by the Bank in helping its customers to borrow well are that a genuine or fraudulent borrower fails to pay the interest or principal as it falls due. Some of the principal credit risks are detailed below along with the steps the Bank takes to mitigate the impact of the risks.	
Credit risks arising from the Bank's responsible lending strategy	• **Retail credit**: The risk that borrowers fail to repay on time interest or principal arising from personal or non-personal lending, and the risk of credit application fraud. • **Wholesale credit:** The risk of credit losses arising from counterparty lending, or the wholesale funding market. This includes credit losses from wholesale financial instruments including swaps, hedges, securitised bonds and government funding initiatives. • **Credit models:** The risk that models used to manage credit risk are inadequate, are used inappropriately, or perform ineffectively.
How the Bank manages its credit risks throughout the credit lifecycle	The Bank adopts decision making processes and systems geared to provide affordable lending. The assessment of a customer's creditworthiness is 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. Credit risk appetite is set for responsible and controlled growth and 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-value thresholds, loan-to-income ratios and credit concentration limits. Occasionally, customer circumstance can change which could impact their ability to repay borrowings. The Bank understands this and works with its customers to improve their position by offering various treatment strategies and support. The Bank manages its exposure to wholesale credit risk carefully, applying strict external counterparty credit quality thresholds including monitoring the rating of counterparties. All credit models utilised by the Bank are subject to regular independent assessment and validation. This is with the aim of ensuring that models are operating as designed and provide the correct outcomes. Any unexpected outcomes are rectified before the model becomes part of the Bank's credit risk management strategy.

Strategic report (continued)

Emerging risks

The Bank's inherent risks are managed effectively through its risk management framework. The Bank also monitors emerging and evolving risks that could increase in significance and may have an impact on the Bank's strategy or pose a threat to its business model.

Some of the key emerging risks and uncertainties in the Bank's operating environment are described below. The Bank regularly considers the likelihood of the relevant risk materialising and the potential impact on its business strategy, customers, Partners and shareholder. The Bank uses this assessment as part of the business planning process.

Global economic and political trends	The Bank is exposed to inherent risks from the macroeconomic environment. Political uncertainty leading to adverse economic changes could have an impact on its business, customers and shareholder. Developments regarding the UK's withdrawal from the European Union are monitored and potential impacts have been included in the Bank's business planning and stress test scenarios.
FinTech and digital competition	The Bank 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. The development of open banking platforms in response to the Payment Services Directive 2 (PSD2) ahead of the finalisation of the regulatory technical standards demonstrates how FinTech and other technological advances create a threat to the traditional value chain and ways in which all banks currently operate and service customers. These risks are considered as part of the business planning cycle where the Bank explores how it can continue to bring more competition to UK banking as technology and traditional value chains evolve and customer needs change. One of the major benefits of moving to the agile operating system offered by Sabadell will be the Bank's ability to react and to lead in market developments. In due course, this will allow the Bank to design, develop and deploy new products and services at a greater pace than it is currently able to.
Regulatory change	Due to the nature of the financial services industry, the Bank faces a complex legal and regulatory environment. Inadequate or incomplete adoption of regulatory initiatives could lead to increased costs, loss of competitive edge or regulatory sanction. The Bank 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 the Bank are managed through an effective governance and oversight framework. The protection of customer data and compliance with the data protection regulations are at the forefront of the Bank's strategy. The need to ensure compliance with the incoming General Data Protection Regulation (GDPR) from May 2018 has provided the opportunity to review current processes and develop solutions which includes enabling customers to have more options and control over how their data is used and protected. During 2017, the Bank completed work to understand the potential impact of IFRS 9 on our business model and continues to monitor emerging practice and developments at an industry level. The developments from Basel IV are also being monitored, but are not currently expected to be material. New requirements under the Markets in Financial Instruments Directive (MiFID II) took effect in January 2018. Whilst the majority of the regulation is not applicable to retail banks, some areas such as transaction reporting require the Bank to make changes to processes within its Treasury function which are being addressed.

Strategic report on pages 3 to 11 approved, by order of the Board

Lorna Curry
Company Secretary,
1 February 2018

Directors' report

Introduction
The Directors of TSB Bank plc (the 'Company') present their report and audited consolidated financial statements for the year ended 31 December 2017, in accordance with section 415 of the Companies Act 2006.

Principal activities and results
The principal activities and review of the Company are set out in the Strategic report on pages 3 to 11.

Dividends
The Directors do not currently propose to pay a dividend.

Directors
The Directors who served during the year are shown on page 2. Paulina Beato, was appointed to the Board on 22 March 2017, and Richard Meddings and Stephen Page were appointed to the Board on 20 September 2017 each as an Independent Non-executive Director.

Directors' indemnities
The Directors have the benefit of a deed of indemnity which constitutes a 'qualifying third party indemnity provision'. With the exception of Paulina Beato, Richard Meddings, and Stephen Page, the indemnities were in place throughout 2017. The indemnity for Paulina Beato was executed on 26 April 2017 whilst the indemnities for Richard Meddings and Stephen Page were executed on 18 October 2017. 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.

Corporate governance
Information on the Company's corporate governance arrangements can be found on pages 24 to 42 of the annual report and accounts of the Company's parent, TSB Banking Group plc, which is available at www.tsb.co.uk

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

Employee information
The Partners' report on pages 14 to 16 is an integral part of the Directors' report and provides information about the Company's Partners.

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

Financial instruments
Information on financial risk management objectives and policies in relation to the use of financial instruments can be found on pages 47 to 61 of the financial statements.

Principal risks and uncertainties
The principal risks and uncertainties faced by the Company are set out on pages 8 to 11.

Post balance sheet events
There are no significant events affecting the Company that have arisen between 31 December 2017 and the date of this report that require disclosure.

Research and development activities
The Company develops new products and services during the ordinary course of business.

Overseas branches
The Company does not have any branches outside of the United Kingdom.

Registered office
The registered office address for TSB Bank plc is Henry Duncan House, 120 George Street, Edinburgh, EH2 4LH. Website: www.tsb.co.uk.

Reappointment of external auditor
PricewaterhouseCoopers LLP, the auditors of the Company, have expressed their willingness to continue in office. A resolution proposing their reappointment as auditors of the Company will be considered at the 2018 Annual General Meeting.

Directors' report (continued)

Disclosure of information to external auditors
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 to make himself or herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

Going concern
The Directors recognise their responsibility to make an assessment of the Company's ability to continue as a going concern, for a period of at least twelve months from the date the financial statements are approved. The assessment is based on the Company having sufficient liquidity and capital, and includes consideration of its funding and capital plans and the Internal Liquidity Adequacy Assessment Process and the Internal Capital Adequacy Assessment Process approved annually by the Board. The Directors are satisfied that adequate funding and liquidity resources will be in place to allow the Company's 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 the Company's ability to continue as a going concern.

Statement of Directors' responsibilities
The Directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulation.

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared the Company's consolidated 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 the Bank and the Company and of the profit or loss of the Bank for that period. In preparing these financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- 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;
- make judgements and accounting estimates that are reasonable and prudent; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the consolidated financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Company 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 Company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

By order of the Board

Lorna Curry
Company Secretary,
1 February 2018

Partners' report

We are proud of the collaborative and engaging culture we have in the Company. This is achieved by listening to and acting on feedback from Partners. Overall Partner engagement increased in 2017 and our culture continues to grow positively, evidenced by the Partner Experience Survey, Partners' interest in internal communications articles and Partner calls regarding new IT, migration updates, customer journeys and wider community engagement. In early 2017 the Company was recognised as the only bank to appear in the *'Best Companies'* listing and is one of only four UK companies to be recognised in both the '*Great Place to Work'* and *'Best Companies'* lists. In addition, we continue to work closely with our recognised unions, Accord and Unite, to build strong relationships and with whom membership is growing steadily.

Encouraging Partner collaboration and feedback

Collaboration and two way communication is encouraged at all levels and is key to the Company's strategy. Paul Pester holds a fortnightly 'stand up' where he can communicate directly with Partners. This approach is repeated by Executives across the Company. '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 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 the Company's strategic direction.

Partner feedback is encouraged in a number of ways, including our annual Partner Experience Survey, where Partners are asked for their opinions on working at the Company. In 2017, we continued to partner with '*Great Place to Work*', an independent global research and training consultancy that helps organisations create and sustain great workplaces. We received feedback from 73% of our Partners, our highest response rate to date. Our overall '*Great Place to Work*' trust index score was 76%, an increase of 3% from the 2016 results. This score is 6% above the minimum threshold score required to be accredited as a '*Best Workplace'* and 21% above the UK national average. In respect of 15 TSB specific questions included in the survey since the Company was relaunched in 2013, our Partners provided a result of 81%, up by 3% from last year. The Company also continued to partner with '*Best Companies'* again in 2017 and the outcome of that survey will be available later in 2018.

A number of commitments were made as a result of Partner feedback from the 2016 Partner Experience Survey, including exploring ways to better support Partner wellbeing. An 'agile squad' of Partners from across the Company was established to develop and implement initiatives to support wellbeing. This included increasing visibility and engagement with existing services, as well as introducing new activities to support the wellbeing of Partners. Existing services include our Employee Assistance Programme which gives all Partners free access to confidential counselling and professional advice and an Occupational Health service which allows line managers to refer Partners for medical assessments and to ensure support is available to facilitate Partner recovery.

To demonstrate and champion commitment to Partner wellbeing at the very top of the organisation, we appointed our Chief Risk Officer Iain Laing, as executive sponsor and set up a network of Wellbeing Ambassadors across the Company who support the delivery of our wellbeing programmes. In addition we have distributed a Wellbeing Guide to provide all Partners with useful information, tips, advice and sources of support relating to all aspects of wellbeing. As a result of our focus on wellbeing over the past 12 months, we have seen a 5% improvement in how Partners feel about wellbeing at the Company from the 2016 results.

Diversity and inclusion

Diversity and Inclusion is a significant contributor to the Company's culture. The Company 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. There is executive sponsorship of each of the key audiences of disability (Rachel Lock, HR Director), gender (Helen Rose, Chief Operating Officer), ethnic diversity (Jatin Patel, Products Director) and Lesbian, Gay, Bisexual and Transgender (Peter Markey, Marketing Director).

Our Partners with disabilities are treated fairly and can compete on equal terms for career progression. The Company's Partners with Disabilities policy is designed to inform Partners of the support available to those with disabilities (including Partners who develop disabilities) and how to access this support. The Company is a level 2 Disability Confident employer, a scheme that sees the Company commit to offer an interview to disabled people who meet the minimum criteria for a job in terms of the skills needed, thereby giving them the opportunity to present their skills face to face. The Company is also a member of the Business Disability Forum.

Another key area of focus of our Diversity and Inclusion approach is Race. The Company has been included in the first annual '*Best Employers for Race'* listing and will continue to build upon this external recognition to ensure every Partner, regardless of their background, race, ethnicity or gender has the opportunity to thrive.

Partners' report (continued)

Gender balance

The culture we have built and the initiatives we have undertaken continue to improve our gender balance. We are proud of the progress we have made in this area, with 39% of women in senior manager roles and above in December 2017. Women comprise 21% of our Bank Executive Committee, against an industry average of 14% and comprise 33% of our combined population of Bank Executive Committee members and their direct reports (in line with the 33% target set by the Hampton-Alexander Review).

Helen Rose, the Company's gender sponsor, regularly speaks externally to share the Company's gender story. In particular, the Company was one of the first financial services companies to publish its gender pay gap in our '*Gender Balance Matters*' report, which highlights where we believe the industry could do more to improve gender diversity and highlights our signature actions to promote gender balance. At 31%, the Company's gender pay gap is a reflection of the structure of its workforce - just one percentage point of our overall gap relates to the difference in pay between men and women within the same grade. The rest is driven by the shape of our workforce and the number of women working flexibly in our customer facing roles. In continuing to promote our gender balance we will not artificially seek to reduce our gender pay gap in an attempt to equalise the balance of men and women. We will continue to recruit the best person for the job regardless of age, gender, ethnicity or background and place emphasis on our flexible working opportunities and our passion for diversity. Therefore, the Company has published three signature actions we believe will help to tackle gender balance head on and help us close the gap even more:

- We are taking steps to get more women into financial services and, more specifically, TSB;
- We will do more to support gender balanced progression at TSB; and
- We will talk about gender balance in a transparent way.

We have received positive feedback for publishing our gender pay gap figures earlier than the deadline and remain one of the first and few banks to have done so. We have called on businesses to take three simple steps to understand, take action and report back on progress towards creating gender balance:

- Businesses must come clean on the reasons for their gender pay gap;
- Businesses must act to address the causes of their gender pay gaps; and
- Businesses must be held to account on the progress they are making.

Training and development

To ensure that our culture and business strategies are aligned with our core values, we provide a range of training such as the TSB Experience, a transformational programme for all Partners which focuses on how they behave with customers and each other. Every Partner is also encouraged to have a personal development plan which they review regularly with their line manager. All Partners who are new to the Company are given an induction, Welcome to TSB and our values form a key part of such induction. 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. Our managers have extra responsibilities that involve managing people, so we give them special training, including sessions on Dignity and Respect at Work and Unconscious Bias.

Social responsibility

In terms of social responsibility, we are proud to be part of the community in hundreds of towns and cities across Britain. For instance, each bank branch and head office site chooses a local project or charity to support. Through the Company's local volunteering, we encourage every Partner to spend at least eight hours each year supporting a local good cause with time and/or skills. We make it as easy, accessible and flexible as possible, so each of our Partners has the opportunity to take part, no matter what their job or location. Since moving to a local model, we have seen fundraising by Partners of over £500k each year for our charity partners.

Recognition and reward

Not only do we give a voice to our Partners, but we also encourage the recognition and celebration of their contribution. This is demonstrated in the Say Thank You scheme which gives Partners the opportunity to recognise the contribution of fellow Partners who demonstrate the Company's values. In addition, the Company has a number of partnerships in place to enhance the recognition of its Partners. For example, the Company continues to develop its partnership with Pride of Britain and Pride of Sport. This partnership aligns with the Company's values, in particular the Company'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.

Partners’ report (continued)

Recognition and reward (continued)
As part of this partnership, the Company 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. The Company also created its own ‘Pride of TSB’ to recognise the Company Partners who are making a real difference through the extraordinary things they do at work or in their community. We had over a thousand nominations and 36 winners across different functions and categories, who attended the awards ceremonies.

The Company’s approach to reward aligns to our values and seeks to differentiate us from other banks. It’s driven by our core values and supports our partnership model. We believe our approach is fair, transparent and consistent for everyone. At the heart of our approach is the TSB Award. It is a flat award across the Company where everyone has the opportunity to be awarded the same percentage – regardless of grade or role, including the Chief Executive Officer and the rest of the executive team. This enables all Partners to be recognised for the important role they play in the success of our business. The Company is also committed to paying everyone at least the Living Wage. In August 2016 we became an accredited Living Wage employer which put us among a pioneering group of companies who go beyond the legal requirements and commit to paying both our direct employees and our suppliers who regularly work on our premises, at least the real Living Wage.

We also offer all Partners the opportunity to join our Sharematch scheme giving them the chance to invest between £10 and £150 each month to buy shares in our parent company, Sabadell, without paying Income Tax or National Insurance on the purchase. The Company will match their investment with matching shares, on a one for one basis, up to a maximum value of £30 per month.

Conclusion
We are proud of our continued progress in making TSB a Great Place to Work, particularly in the areas of succession and development of our leaders, our engagement scores and the recognition we are receiving externally, namely from ‘*Great Place to Work’* and ‘*Best Companies’*. We are also proud to have created a working environment where our Partners are able to be themselves regardless of gender, ethnicity, age or background. Going forward, we will continue to focus on talent, succession and capability of our Partners.

Financial statements

Basis of preparation

These consolidated financial statements of TSB Bank plc comprise the results of the TSB Bank plc (the ‘Company’) consolidated with those of its subsidiaries (together the ‘Bank’). Details of subsidiary undertakings are provided in note 28 to the financial statements. 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. The Bank 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 the Bank’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 the Company has control. The Company 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 the Bank and are deconsolidated from the date that control ceases. Inter-company transactions, balances and unrealised gains and losses on transactions between the Bank companies are eliminated.

Foreign currency translation - Foreign currency transactions are translated using the exchange rates prevailing at the date of the transaction. 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 Bank’s business model as shown in the table below.

Critical accounting estimates	**reference**
Effective interest rate methodology	Notes 1 and 7
Impairment provisioning	Note 9
Transitional impact of IFRS 9 *Financial Instruments* effective from 1 January 2018	Pages 36 to 38
Recoverability of deferred tax assets	Note 20
Customer remediation provision	Note 31

Key areas of significant judgement	**Reference**
IT Migration Programme accounting	Notes 28 and 30

Index to the consolidated financial statements

The Bank's primary consolidated financial statements are presented on pages 19 to 22. The notes to these consolidated financial statements are structured to follow the Bank's business model as set out on page 5 and are listed below.

Balance sheets

as at 31 December 2017

	Note	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016* £ million
Assets					
Cash, cash balances at central banks and other demand deposits		**7,563.4**	3,647.7	**7,563.4**	3,647.7
Financial assets held for trading:					
Derivative financial assets	26	**111.1**	143.2	**111.1**	143.2
Financial assets designated at fair value through profit or loss:					
Equity instruments	18	**1.3**	0.3	**1.3**	0.3
Available-for-sale financial assets	11	**2,123.3**	2,103.5	**2,123.3**	2,103.5
Loans and receivables:					
Loans to central banks		**56.0**	51.0	**56.0**	51.0
Loans to credit institutions	6	**329.2**	530.5	**–**	–
Loans and advances to customers	7	**30,854.2**	29,419.1	**30,854.2**	29,419.1
Other advances	10	**896.0**	799.0	**896.0**	799.0
Hedging derivative financial assets	26	**103.7**	104.3	**38.9**	48.0
Fair value adjustments for portfolio hedged risk		**(22.2)**	0.8	**(22.2)**	0.8
Property, plant and equipment	29	**172.7**	168.3	**172.7**	168.3
Intangible assets		**10.1**	2.6	**10.1**	2.6
Deferred tax assets	20	**68.6**	99.6	**68.6**	99.6
Other assets	30	**269.3**	140.7	**269.3**	140.7
Total assets		**42,536.7**	37,210.6	**42,142.7**	36,632.8
Liabilities					
Financial liabilities held for trading:					
Derivative financial liabilities	26	**37.5**	97.7	**37.5**	97.7
Financial liabilities at amortised cost:					
Borrowings from central banks		**5,625.7**	5.0	**5,625.7**	5.0
Deposits from credit institutions		**–**	2.3	**–**	2.3
Customer deposits	1	**30,520.6**	29,383.8	**30,520.6**	29,383.8
Repurchase agreements	4	**1,446.4**	1,409.6	**1,446.4**	1,409.6
Debt securities in issue	2	**1,318.7**	2,940.1	**498.0**	–
Subordinated liabilities	3	**405.3**	413.3	**405.3**	413.3
Other financial liabilities		**247.3**	228.6	**247.3**	228.6
Hedging derivative financial liabilities	26	**566.5**	529.1	**566.5**	529.1
Fair value adjustments for portfolio hedged risk		**42.2**	70.7	**42.2**	70.7
Provisions	31	**34.5**	10.8	**34.5**	10.8
Current tax liabilities		**6.9**	14.8	**6.9**	14.8
Other liabilities	31	**278.5**	225.2	**704.7**	2,578.9
Total liabilities		**40,530.1**	35,331.0	**40,135.6**	34,744.6
Equity					
Share capital	21	**79.4**	79.4	**79.4**	79.4
Share premium	21	**195.6**	195.6	**195.6**	195.6
Other reserves:					
Merger reserve	21	**412.8**	412.8	**412.8**	412.8
Retained profits brought forward	21	**1,185.5**	1,057.4	**1,185.5**	1,057.4
Profit attributable to the shareholder for the current year	21	**115.1**	128.1	**115.1**	128.1
Valuation adjustments:					
Available-for-sale reserve	21	**18.7**	5.9	**18.7**	5.9
Cash flow hedging reserve	21	**(0.5)**	0.4	**–**	–
Shareholder's equity		**2,006.6**	1,879.6	**2,007.1**	1,879.2
Total equity and liabilities		**42,536.7**	37,201.6	**42,142.7**	36,623.8

* Certain balances have been re-presented to provide consistency with the current year presentation which aligns to the presentation in the financial statements of the Company's ultimate parent undertaking, Banco de Sabadell SA (Sabadell).

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

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

The consolidated financial statements on pages 19 to 68 were approved by the Board of Directors on 1 February 2018 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 2017

	Note	Bank 2017 £ million	Bank 2016* £ million
Income statement:			
Interest and similar income	13	**1,080.6**	1,097.7
Interest and similar expense	13	**(175.3)**	(243.9)
Net interest income	13	**905.3**	853.8
Fee and commission income	14	**193.3**	197.5
Fee and commission expense	14	**(109.6)**	(97.3)
Net fee and commission income	14	**83.7**	100.2
Net gains/(losses) on financial assets and liabilities:			
Gains on derecognition of financial assets and liabilities not measured at fair value through profit or loss		**68.5**	32.5
Gains/(losses) on financial assets and liabilities held for trading		**6.6**	(5.5)
Gains on financial assets designated at fair value through profit or loss		**0.1**	–
Gains from hedge accounting	26	**24.5**	20.7
Gains/(losses) on derecognition of non-financial assets and liabilities		**5.8**	(2.6)
Other operating income	15	**1.6**	1.3
Other income		**190.8**	146.6
Total income		**1,096.1**	1,000.4
Total operating expenses	16	**(859.2)**	(730.8)
Operating profit before impairment losses and taxation		**236.9**	269.6
Impairment losses on loans and advances to customers	9	**(77.8)**	(87.3)
Profit before taxation		**159.1**	182.3
Taxation	19	**(44.0)**	(54.2)
Profit for the year	21	**115.1**	128.1
Other comprehensive income/(expense):			
Items that may be subsequently reclassified to profit or loss:			
Change in available-for-sale reserve:			
Change in fair value		**(4.5)**	114.0
Transfers to the income statement		**22.0**	(128.4)
Taxation thereon	20	**(4.7)**	4.0
	21	**12.8**	(10.4)
Change in cash flow hedging reserve:			
Change in the fair value of derivatives in cash flow hedges		**8.4**	48.6
Transfers to the income statement		**(9.3)**	(47.5)
Taxation thereon	20	**–**	0.2
	21	**(0.9)**	1.3
Other comprehensive income/(expense) for the year, net of taxation		**11.9**	(9.1)
Total comprehensive income for the year		**127.0**	119.0

* Certain amounts have been re-presented to provide consistency with the current year presentation which aligns to the presentation in the financial statements of the Company's ultimate parent undertaking, Banco de Sabadell SA (Sabadell).

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

Statements of changes in equity

for the year ended 31 December 2017

Bank	Share capital £ million	Share premium £ million	Merger reserve £ million	Available- for-sale reserve £ million	Cash flow hedging reserve £ million	Retained profit £ million	Share-holder's equity £ million
Balance at 1 January 2016	79.4	195.6	412.8	16.3	(0.9)	1,057.4	1,760.6
Comprehensive income:							
Profit for the year	–	–	–	–	–	128.1	128.1
Other comprehensive income/(expense)	–	–	–	(10.4)	1.3	–	(9.1)
Total comprehensive income	–	–	–	(10.4)	1.3	128.1	119.0
Balance at 31 December 2016	79.4	195.6	412.8	5.9	0.4	1,185.5	1,879.6
Balance at 1 January 2017	**79.4**	**195.6**	**412.8**	**5.9**	**0.4**	**1,185.5**	**1,879.6**
Comprehensive income/(expense):							
Profit for the year	**–**	**–**	**–**	**–**	**–**	**115.1**	**115.1**
Other comprehensive (expense)/income	**–**	**–**	**–**	**12.8**	**(0.9)**	**–**	**11.9**
Total comprehensive income	**–**	**–**	**–**	**12.8**	**(0.9)**	**115.1**	**127.0**
Balance at 31 December 2017	**79.4**	**195.6**	**412.8**	**18.7**	**(0.5)**	**1,300.6**	**2,006.6**

Company	Share capital £ million	Share premium £ million	Merger reserve £ million	Available- for-sale reserve £ million	Cash flow hedging reserve £ million	Retained profit £ million	Share-holder's equity £ million
Balance at 1 January 2016	79.4	195.6	412.8	16.3	0.5	1,057.4	1,762.0
Comprehensive income:							
Profit for the year	–	–	–	–	–	128.1	128.1
Other comprehensive income/(expense)	–	–	–	(10.4)	(0.5)	–	(10.9)
Total comprehensive income	–	–	–	(10.4)	(0.5)	128.1	117.2
Balance at 31 December 2016	79.4	195.6	412.8	5.9	–	1,185.5	1,879.2
Balance at 1 January 2017	**79.4**	**195.6**	**412.8**	**5.9**	**–**	**1,185.5**	**1,879.2**
Comprehensive income/(expense):							
Profit for the year	**–**	**–**	**–**	**–**	**–**	**115.1**	**115.1**
Other comprehensive (expense)/income	**–**	**–**	**–**	**12.8**	**–**	**–**	**12.8**
Total comprehensive income	**–**	**–**	**–**	**12.8**	**–**	**115.1**	**127.9**
Balance at 31 December 2017	**79.4**	**195.6**	**412.8**	**18.7**	**–**	**1,300.6**	**2,007.1**

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

Cash flow statements

for the year ended 31 December 2017

	Note	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Cash flows from operating activities					
Profit before taxation		**159.1**	182.3	**159.1**	182.3
Adjustments for:					
Change in operating assets	32	**(1,482.9)**	(3,925.2)	**(1,675.8)**	(3,648.3)
Change in operating liabilities	32	**1,173.8**	3,991.9	**1,174.4**	3,994.4
Non-cash and other items	32	**116.4**	73.9	**94.3**	(15.4)
Taxation paid		**(25.5)**	(8.7)	**(25.5)**	(8.7)
Net cash provided by/(used in) operating activities		**(59.1)**	314.2	**(273.5)**	504.3
Cash flows from investing activities					
Purchase of property, plant and equipment		**(15.8)**	(35.9)	**(15.8)**	(35.9)
Purchase of financial assets		**(62.9)**	(779.2)	**(62.9)**	(779.2)
Interest received on financial assets		**83.3**	53.7	**83.3**	53.7
Proceeds on disposal of equity assets		**–**	25.3	**–**	25.3
Maturity/(Issue) of reverse repurchase agreements		**–**	20.3	**–**	20.3
Interest received on reverse repurchase agreements		**0.4**	2.2	**0.4**	2.2
Purchase of Sabadell shares		**(0.9)**	(0.3)	**(0.9)**	(0.3)
Net cash used in investing activities		**4.1**	(713.9)	**4.1**	(713.9)
Cash flows from financing activities					
Proceeds from borrowings from central banks		**5,615.0**	–	**5,615.0**	–
Interest paid on borrowings from central banks		**(6.4)**	–	**(6.4)**	–
Proceeds from debt securities issued		**497.5**	553.7	**497.7**	–
Repayment of debt securities in issue		**(2,128.4)**	(557.4)	**–**	–
Interest paid on debt securities		**(13.4)**	(40.6)	**–**	–
Interest paid on subordinated liabilities		**(22.1)**	(22.1)	**(22.1)**	(22.1)
Net securitisation funding		**–**	–	**(1,927.6)**	(234.4)
Proceeds from/(Repayment of) repurchase agreements		**36.9**	1,408.6	**36.9**	1,408.6
Interest paid on repurchase agreements		**(8.4)**	(9.5)	**(8.4)**	(9.5)
Net cash provided by financing activities		**3,970.7**	1,332.7	**4,185.1**	1,142.6
Change in cash and cash equivalents		**3,915.7**	933.0	**3,915.7**	933.0
Cash and cash equivalents at 1 January	32	**3,647.7**	2,714.7	**3,647.7**	2,714.7
Cash and cash equivalents at 31 December	32	**7,563.4**	3,647.7	**7,563.4**	3,647.7

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 the Bank's deposits and funding. It includes customer deposits, deposits from credit institutions, borrowings from central banks, debt securities in issue, subordinated liabilities, other financial liabilities 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 the Bank 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 rate method.

1. Customer deposits

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Bank accounts	**11,047.4**	9,938.8	**11,047.4**	9,938.8
Instant access saving deposits	**15,552.3**	15,221.4	**15,552.3**	15,221.4
Deposits with agreed maturity	**3,929.8**	4,209.6	**3,929.8**	4,209.6
Deposits redeemable at notice	**–**	26.0	**–**	26.0
Valuation adjustments	**(8.9)**	(12.0)	**(8.9)**	(12.0)
Total customer deposits	**30,520.6**	29,383.8	**30,520.6**	29,383.8

At 31 December 2017 £1,082.3 million (2016: £2,766.2 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 estimate – effective interest rate methodology

The Bank uses the effective interest rate method to determine the recognition of interest expense on customer deposits. At 31 December 2017, the Bank had deferred, for accounting purposes, £11.7 million of interest expense in respect of bonus interest on certain savings products (2016: £15.0 million). This amount will be recognised as interest expense over management's estimate of 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. Management considered credible alternative customer repayment profiles and concluded that no change to the repayment assumption was required and the impact of those alternative scenarios would not be material to the deferred interest expense asset.

Notes to the consolidated financial statements

Sources of funding (continued)

2. Debt securities in issue

Bank	Balance at 1 Jan 2017 £ million	(Repayments)/ Issues £ million	Exchange rate and other adjustments £ million	Balance at 31 Dec 2017 £ million
Debt securities issued in an EU Member State requiring filing of a prospectus:				
Duncan Funding 2015-1 plc	**514.9**	**(57.1)**	**10.4**	**468.2**
Duncan Funding 2016-1 plc	**510.9**	**(158.4)**	**–**	**352.5**
Series 2017-1 Covered Bonds	**–**	**497.7**	**0.3**	**498.0**
Debt securities issued in an EU Member State not requiring filing of a prospectus	**1,914.3**	**(1,913.0)**	**(1.3)**	**–**
Total debt securities in issue	**2,940.1**	**(1,630.8)**	**9.4**	**1,318.7**

Bank	Balance at 1 Jan 2016 £ million	(Repayments)/ Issues £ million	Exchange rate and other 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

Bank	Date of issue	Amount 31 Dec 2017 £ million	Amount 31 Dec 2016 £ million	Interest rate at 31 Dec 2017	Maturity date	Issue currency	Target of offering
Issuing entity							
Cape Funding No. 1 plc	05/2014	–	1,914.3	–	–	–	–
Duncan Funding 2015-1 plc	11/2015	**202.3**	259.0	1.21281%	09/2020	GBR	Institutional
Duncan Funding 2015-1 plc	11/2015	**265.9**	255.9	0.14900%	09/2020	EUR	Institutional
Duncan Funding 2016-1 plc	05/2016	**81.8**	115.2	0.07100%	04/2021	EUR	Institutional
Duncan Funding 2016-1 plc	05/2016	**270.7**	395.7	1.15375%	04/2021	GBR	Institutional
Series 2017-1 Covered Bonds	12/2017	**498.0**	–	0.76219%	12/2022	GBR	Institutional
Total debt securities in issue		**1,318.7**	2,940.1				

Company	Balance at 1 Jan 2017 £ million	Issues/ (Repayments) £ million	Exchange rate and other adjustments £ million	Balance at 31 Dec 2017 £ million
Debt securities issued in an EU Member State requiring filing of a prospectus:				
Series 2017-1 Covered Bonds	**–**	**497.7**	**0.3**	**498.0**
Total debt securities in issue	**–**	**497.7**	**0.3**	**498.0**

Company	Date of issue	Amount 31 Dec 2017 £ million	Amount 31 Dec 2016 £ million	Interest rate at 31 Dec 2017	Maturity date	Issue currency	Target of offering
Issuing entity							
Series 2017-1 Covered Bonds	12/2017	**498.0**	–	0.76219%	12/2022	GBR	Institutional
Total debt securities in issue		**498.0**	–				

Notes to the consolidated financial statements

Sources of funding (continued)

3. Subordinated liabilities

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Fixed/floating rate reset callable subordinated Tier 2 notes due May 2026	**384.1**	383.8	**384.1**	383.8
Accrued interest	**3.4**	3.4	**3.4**	3.4
Fair value hedge accounting adjustments	**17.8**	26.1	**17.8**	26.1
Total subordinated liabilities	**405.3**	413.3	**405.3**	413.3

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 TSB Banking Group 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 PRA.

4. Repurchase agreements

At 31 December 2017, the Company had entered into repurchase agreements that transferred legal title of certain UK gilts in return for cash, together with an agreement to repurchase the assets at a later date and at a predetermined price. The gilts were not derecognised from the consolidated balance sheet as substantially all of the rewards, including interest income, and risks, including credit and interest rate risks, are retained by the Bank. In all cases, the transferee has the right to sell or repledge the gilts concerned, subject to delivering the securities at the repurchase date.

The table below presents the carrying values, including accrued interest, of the transferred gilts and the associated repurchase agreement liabilities. The associated liabilities represent the Company's obligation to repurchase the transferred assets.

Bank	Carrying amount of transferred assets 2017 £ million	Carrying amount of associated liabilities 2017 £ million	Carrying amount of transferred assets 2016 £ million	Carrying amount of associated liabilities 2016 £ million
Repurchase agreements with credit institutions	**–**	**–**	932.4	751.0
Repurchase agreements with non-credit institutions	**1,444.7**	**1,446.4**	663.8	658.6
Repurchase agreements	**1,444.7**	**1,446.4**	1,596.2	1,409.6

Company	Carrying amount of transferred assets 2017 £ million	Carrying amount of associated liabilities 2017 £ million	Carrying amount of transferred assets 2016 £ million	Carrying amount of associated liabilities 2016 £ million
Repurchase agreements with credit institutions	**–**	**–**	872.3	751.0
Repurchase agreements with non-credit institutions	**1,444.7**	**1,446.4**	663.8	658.6
Repurchase agreements	**1,444.7**	**1,446.4**	1,536.1	1,409.6

Notes to the consolidated financial statements

Sources of funding (continued)

5. Fair value of financial liabilities

The following table summarises the carrying values and fair values of financial liabilities presented on the balance sheets of the Bank and the Company. 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.

Bank	Note	2017 Carrying value £ million	2017 Fair value £ million	2016 Carrying value £ million	2016 Fair value £ million
Financial liabilities					
Customer deposits	1	**30,520.6**	**30,558.9**	29,383.8	29,451.5
Repurchase agreements	4	**1,446.4**	**1,446.4**	1,409.6	1,417.1
Debt securities in issue	2	**1,318.7**	**1,328.0**	2,940.1	2,950.2
Subordinated liabilities	3	**405.3**	**427.3**	413.3	403.4
Trading derivative liabilities	26	**37.5**	**37.5**	97.7	97.7
Hedging derivative liabilities	26	**566.5**	**566.5**	529.1	529.1

Company	Note	2017 Carrying value £ million	2017 Fair value £ million	2016 Carrying value £ million	2016 Fair value £ million
Financial liabilities					
Customer deposits	1	**30,520.6**	**30,558.9**	29,383.8	29,451.5
Repurchase agreements	4	**1,446.4**	**1,446.4**	1,409.6	1,417.1
Debt securities in issue	2	**498.0**	**500.6**	–	–
Subordinated liabilities	3	**405.3**	**427.3**	413.3	403.4
Trading derivative liabilities	26	**37.5**	**37.5**	97.7	97.7
Hedging derivative liabilities	26	**566.5**	**566.5**	529.1	529.1

The carrying amount of borrowings from central banks, deposits from credit institutions and other financial liabillities 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 the Bank's financial liabilities that are 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 the Bank. Valuation techniques used include discounted cash flow analysis and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by the Bank. Derivative financial instruments are the only financial liabilities of the Bank that are carried at fair value.

Valuation hierarchy of financial instruments

Financial instruments 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)

5. Fair value of financial liabilities (continued)

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

Bank	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2017					
Customer deposits	**–**	**30,558.9**	**–**	**30,558.9**	**30,520.6**
Repurchase agreements	**–**	**1,446.4**	**–**	**1,446.4**	**1,446.4**
Debt securities in issue	**1,328.0**	**–**	**–**	**1,328.0**	**1,318.7**
Subordinated liabilities	**–**	**427.3**	**–**	**427.3**	**405.3**
Trading derivative liabilities	**–**	**37.5**	**–**	**37.5**	**37.5**
Hedging derivative liabilities	**–**	**566.5**	**–**	**566.5**	**566.5**
At 31 December 2016					
Customer deposits	–	29,451.5	–	29,451.5	29,383.8
Repurchase agreements	–	1,417.1	–	1,417.1	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

The fair value of customer deposits repayable on demand and repurchase agreements 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. The Bank'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 the Bank.

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

Company	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2017					
Customer deposits	**–**	**30,558.9**	**–**	**30,558.9**	**30,520.6**
Repurchase agreements	**–**	**1,446.4**	**–**	**1,446.4**	**1,446.4**
Debt securities in issue	**500.6**	**–**	**–**	**500.6**	**498.0**
Subordinated liabilities	**–**	**427.3**	**–**	**427.3**	**405.3**
Trading derivative liabilities	**–**	**37.5**	**–**	**37.5**	**37.5**
Hedging derivative liabilities	**–**	**566.5**	**–**	**566.5**	**566.5**
At 31 December 2016					
Customer deposits	–	29,451.5	–	29,451.5	29,383.8
Repurchase agreements	–	1,417.1	–	1,417.1	1,409.6
Debt securities in issue	–	–	–	–	–
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

Notes to the consolidated financial statements

Loans

Funds deposited with the Bank are primarily used to support lending to customers. The Bank 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 the Bank to meet unexpected future funding requirements.

Accounting policies relevant to loans

(b) Financial assets

'Financial assets' is the term used to describe the Bank's loans to customers and other institutions. It includes loans and advances to customers, loans to credit institutions, loans to central banks, available-for-sale financial assets, cash and cash and balances with central banks and other demand deposits, derivative financial assets (see accounting policy (j) under Managing financial risk), and other advances.

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 the Bank 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 the Bank 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
- the Bank 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 the Bank 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 the Bank together with a corresponding liability for the funding where the Bank retains control of the structured entity.

(ii) Available-for-sale financial assets

The Bank 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 the Bank, 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.

Notes to the consolidated financial statements

Loans (continued)

(c) Impairment of financial assets
(i) Accounted for at amortised cost
At each balance sheet date the Bank 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 the Bank 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 the Bank'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 the Bank 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)

6. Loans to credit institutions

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Cash deposits held	**329.2**	530.5	**–**	–
Total loans to credit institutions	**329.2**	530.5	**–**	–

At 31 December 2017 £124.1 million of loans to credit institutions (2016: £196.3 million) had a contractual residual maturity of greater than one year. Loans to credit institutions comprise cash deposits held by the Bank's securitisation and covered bond entities.

7. Loans and advances to customers

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Secured loans	**28,285.0**	27,039.0	**28,285.0**	27,039.0
Other term loans	**1,491.8**	1,299.4	**1,491.8**	1,299.4
Receivable on demand	**856.8**	829.3	**856.8**	829.3
Commercial credit	**133.9**	158.8	**133.9**	158.8
Impaired assets	**128.0**	140.0	**128.0**	140.0
Other valuation adjustments	**30.3**	26.3	**30.3**	26.3
Gross loans and advances to customers	**30,925.8**	29,492.8	**30,925.8**	29,492.8
Allowance for impairment losses (note 9)	**(71.6)**	(73.7)	**(71.6)**	(73.7)
Loans and advances to customers	**30,854.2**	29,419.1	**30,854.2**	29,419.1

At 31 December 2017 £28,178.2 million of loans and advances to customers (2016: £26,851.8 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.

Significant estimate – effective interest rate methodology

The Bank uses the effective interest rate method to determine the recognition of interest income on loans and advances to customers. At 31 December 2017, the Bank had recognised, for accounting purposes, £21.1 million in respect of net fees paid in respect of mortgage originations and early redemption fee income. This amount will be reflected as a reduction in interest income over the expected remaining life of the mortgage balances. The assessment of this period requires management judgement. Management considered credible alternative mortgage repayment profiles and concluded that no change to the repayment assumption was required and that the impact of those scenarios would not be material to the carrying amount of the net asset.

Securitisation and covered bond programmes

Loans and advances to customers include loans securitised under the Bank'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 the Bank, the structured entities are consolidated fully and all of these loans are retained on the Bank's balance sheet, with the related notes in issue included within debt securities in issue.

Covered bond programmes

Certain loans and advances to customers have been assigned to a limited liability partnership to provide security for issues of covered bonds by the Bank. The Bank retains all of the risks and rewards associated with these loans and the partnership is consolidated fully with the loans on the Bank's balance sheet, and the related covered bonds in issue included within debt securities in issue.

Notes to the consolidated financial statements

Loans (continued)

7. Loans and advances to customers (continued)

The Bank's securitisation and covered bond 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.

Bank	31 December 2017 Loans and advances securitised[1] £ million	31 December 2017 Liability £ million	31 December 2016 Loans and advances securitised[1] £ million	31 December 2016 Liability £ million
Securitisation programmes:				
Cape Funding No. 1 plc	**–**	**–**	2,243.8	2,341.1
Duncan Funding 2015-1 plc	**1,598.9**	**1,679.0**	1,773.3	1,879.1
Duncan Funding 2016-1 plc	**2,717.4**	**2,878.7**	3,079.7	3,244.8
	4,316.3	**4,557.7**	7,096.8	7,465.0
Less held by the Bank		**(3,737.0)**		(4,524.9)
Total securitisation notes		**820.7**		2,940.1
Covered Bonds:				
Series 2017-1 Covered Bonds	**699.3**	**498.0**	–	–
Total (note 2)		**1,318.7**	–	2,940.1

(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.

Securitisation programmes

Cash deposits of £313.0 million (2016: £530.5 million) held by the Bank are restricted in use to repayment of the debt securities issued by the structured entities and other legal obligations. The Bank recognises the full liabilities associated with its securitisation programmes within debt securities in issue, although the obligations of the Bank are limited to the cash flows generated from the underlying assets.

Covered bond programmes

Cash deposits of £16.2 million (2016: £nil) held by the Bank are restricted in use to repayment of the term advances related to covered bonds and other legal obligations. At 31 December 2017 the Bank had over-collateralised the covered bond programmes in order to: meet the programme terms; secure the rating of the covered bonds; and to provide operational flexibility. The obligations of the Bank to provide collateral may increase due to the formal requirements of the programmes. The Bank may also voluntarily contribute collateral to support the ratings of the covered bonds.

The Company's covered bond programme, 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.

Company	31 December 2017 Loans and advances securitised £ million	31 December 2017 Liability £ million	31 December 2016 Loans and advances securitised £ million	31 December 2016 Liability £ million
Covered Bonds				
Series 2017-1 Covered Bonds	**699.3**	**498.0**	–	–
Total covered bond notes	**699.3**	**498.0**	–	–

8. Commitments arising from the banking business

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

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Undrawn formal standby facilities, credit lines and other commitments to lend:				
Mortgage offers made	**1,004.3**	1,489.8	**1,004.3**	1,489.8
Credit cards	**2,571.3**	2,695.4	**2,571.3**	2,695.4
Other	**1,107.0**	1,091.8	**1,107.0**	1,091.8
Total commitments	**4,682.6**	5,277.0	**4,682.6**	5,277.0

Of the amounts shown above, £1,282.9 million (2016: £1,778.3 million) was irrevocable. All commitments to lend to customers shown in the table above have a contractual maturity of less than one year.

Notes to the consolidated financial statements

Loans (continued)

9. Allowance for impairment losses on loans and receivables

Bank and Company	Specific coverage determined individually £ million	Specific coverage determined collectively £ million	Incurred but not reported coverage £ million	Total £ million
At 1 January 2016	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)
Recoveries	–	17.1	–	17.1
At 31 December 2016	**0.6**	**53.1**	**20.0**	**73.7**
Movements reflected in the income statement	**0.5**	**76.4**	**0.9**	**77.8**
Movements not reflected in the income statement:				
Utilisations	**(0.7)**	**(89.8)**	**–**	**(90.5)**
Recoveries	**–**	**10.9**	**–**	**10.9**
Other movements	**–**	**(13.6)**	**13.3**	**(0.3)**
At 31 December 2017	**0.4**	**37.0**	**34.2**	**71.6**

Included in total allowance for impairment losses on loans and advances to customers is £37.4 million (2016: £53.7 million) relating to lending that was determined to be impaired.

10. Other advances

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Items in the course of collection from credit institutions	**252.6**	213.8	**252.6**	213.8
Items in the course of collection from non-credit institutions	**7.8**	6.6	**7.8**	6.6
Collateral placed at central clearing houses	**635.3**	559.1	**635.3**	559.1
Other collateral placed with credit institutions	**0.3**	19.5	**0.3**	19.5
Total other advances	**896.0**	799.0	**896.0**	**799.0**

Significant 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 2017 the Bank recognised an impairment allowance against loans and advances to customers of £71.6 million (2016: £73.7 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 2017, the allowance for impairment losses would have been approximately £4.8 million higher (2016: £8.0 million higher).

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 2017, the impairment allowance included £22.8 million of post model adjustments (2016: £25.4 million).

Loans (continued)

11. Available-for-sale financial assets

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Visa Inc. convertible preferred stock	**7.0**	5.2	**7.0**	5.2
UK Gilts	**1,721.5**	1,872.8	**1,721.5**	1,872.8
Supranational and development bank bonds	**394.8**	225.5	**394.8**	225.5
Total available-for-sale financial assets	**2,123.3**	2,103.5	**2,123.3**	2,103.5

At 31 December 2017 UK gilts with a carrying value, including accrued interest, of £1,444.7 million (2016: £663.8 million) were subject to repurchase agreements (note 4). No other available-for-sale financial assets had been pledged as collateral (2016: £nil). At 31 December 2017 and 2016 all of the available-for-sale financial assets had a contractual maturity of greater than one year.

In June 2016, the Bank received Visa Inc. convertible preferred stock as partial consideration for the sale of its share in Visa Europe to Visa Inc. At 31 December 2017, the Bank's investment was recognised as an available-for-sale asset at its fair value of £7.0 million (2016: £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 the Bank's investment in Visa Inc. convertible preferred stock could be up to £21.0 million greater (2016: £15.6 million greater) if no reductions were assumed in the conversion of the preferred stock and there were no restrictions on transferability.

Notes to the consolidated financial statements

Loans (continued)

12. Fair value of financial assets

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

Bank	Note	2017 Carrying value £ million	2017 Fair value £ million	2016 Carrying value £ million	2016 Fair value £ million
Financial assets					
Loans and advances to customers	7	**30,854.2**	**30,854.0**	29,419.1	29,464.7
Available-for-sale financial assets	11	**2,123.3**	**2,123.3**	2,103.5	2,103.5
Trading derivative financial assets	26	**111.1**	**111.1**	143.2	143.2
Hedging derivative financial assets	26	**103.7**	**103.7**	104.3	104.3
Equity instruments	18	**1.3**	**1.3**	0.3	0.3

Company	Note	2017 Carrying value £ million	2017 Fair value £ million	2016 Carrying value £ million	2016 Fair value £ million
Financial assets					
Loans and advances to customers	7	**30,854.2**	**29,250.3**	29,419.1	29,464.7
Available-for-sale financial assets	11	**2,123.3**	**2,123.3**	2,103.5	2,103.5
Trading derivative assets	26	**111.1**	**111.1**	143.2	143.2
Hedging derivative assets	26	**38.9**	**38.9**	48.0	48.0
Equity instruments	18	**1.3**	**1.3**	0.3	0.3

The carrying amount of cash, cash balances at central banks and other demand deposits; loans and advances to central banks; loans and advances to credit institutions and other advances 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.

Bank and Company	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
Loans and advances to customers	**–**	**–**	**30,854.0**	**30,854.0**	**30,854.2**
At 31 December 2017	**–**	**–**	**30,854.0**	**30,854.0**	**30,854.2**
At 31 December 2016	–	–	29,464.7	29,464.7	29,419.1

The Bank 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 the Bank 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.

Notes to the consolidated financial statements

Loans (continued)

12. Fair value of financial assets (continued)

Valuation hierarchy of financial assets carried at fair value

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

Bank	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2017					
Available-for-sale financial assets	**2,116.3**	**–**	**7.0**	**2,123.3**	**2,123.3**
Trading derivative assets	**–**	**111.1**	**–**	**111.1**	**111.1**
Hedging derivative assets	**–**	**103.7**	**–**	**103.7**	**103.7**
Equity instruments	**1.3**	**–**	**–**	**1.3**	**1.3**
Total	**2,117.6**	**214.8**	**7.0**	**2,339.4**	**2,339.4**
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	0.3	–	–	0.3	0.3
Total	2,098.6	247.5	5.2	2,351.3	2,351.3

Company	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2017					
Available-for-sale financial assets	**2,116.3**	**–**	**7.0**	**2,123.3**	**2,123.3**
Trading derivative assets	**–**	**111.1**	**–**	**111.1**	**111.1**
Hedging derivative assets	**–**	**38.9**	**–**	**38.9**	**38.9**
Equity instruments	**1.3**	**–**	**–**	**1.3**	**1.3**
Total	**2,117.6**	**150.0**	**7.0**	**2,274.6**	**2,274.6**
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	–	48.0	–	48.0	48.0
Equity instruments	0.3	–	–	0.3	0.3
Total	2,098.6	191.2	5.2	2,295.0	2,295.0

A description of the fair value levels is included in Note 5 on page 26.

Level 3 financial assets	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Balance at 1 January	**5.2**	22.4	**5.2**	22.4
Disposal of share in Visa Europe	**–**	(22.4)	**–**	(22.4)
Acquisition of Visa Inc. convertible preferred stock	**–**	4.5	**–**	4.5
Gains recognised in 'changes in fair value' in other comprehensive income	**1.8**	0.7	**1.8**	0.7
Balance at 31 December	**7.0**	5.2	**7.0**	5.2

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 2017 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 33. 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 – effective from 1 January 2018*
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 the Bank 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. Comparative period amounts will not be restated as there is no requirement to do so.

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 the Bank, remain unchanged.

  The majority of the Bank's financial assets are loans and advances to customers currently classified, under IAS 39 as loans and receivables and held at amortised cost. The adoption of IFRS 9 from 1 January 2018 has not resulted in any material changes to the measurement basis of the Bank's financial assets.

- *Impairment* **-** The impairment requirements of IFRS 9 apply to financial assets measured at amortised cost and debt instruments measured at 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 the impairment allowance.

  In respect of financial assets which were considered to be credit impaired at the date they were purchased or originated, the cumulative change in lifetime expected credit losses since initial recognition is required to be recognised as an impairment provision.

  The assessment of whether credit risk has increased significantly since initial recognition is performed for each reporting period. This is primarily achieved by considering the change in the probability of default occurring over the remaining life of the financial instrument as described in section 3 on the following page.

  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 and which is available without undue cost or effort. 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 expected to result in an increase in the total level of impairment allowances as outlined on page 36. This increase primarily arises in TSB's unsecured portfolios and reflects the effect on unimpaired exposures of the replacement of a 3 month loss emergence period under IAS 39 with a 12 month expected loss provision (or shorter in the case of unsecured loans with residual maturity less than 12 months)

- *Hedge accounting* - IFRS 9 does not explicitly address the macro hedge accounting that is undertaken by the Bank and includes an accounting policy choice to continue applying the hedge accounting requirements of IAS 39, which the Bank 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 the Bank's implementation of IFRS 9

Within the Bank, 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 Bank's 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 the Bank accounting policies and is designing data systems and process requirements. The Programme's focus in 2017 has been to complete the build of the models and IT infrastructure and testing operational readiness which has included a period of parallel run to support the refinement of key model parameters and policy decisions.

The adoption of IFRS 9 at 1 January 2018, by applying the accounting policies and ECL measurement methodologies outlined below, is expected to result in an increase in the allowance for loans losses of £96 million with a corresponding increase in deferred tax assets of £24 million leading to a decrease in shareholder's equity of £72 million. The application of the classification and measurement requirements is not expected to result in any material changes to the measurement of the Bank's financial assets.

3. Comparison of the Bank'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 28 and 31. 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*

  The Bank has substantially aligned the IFRS 9 and regulatory definitions of default, the definition of credit impaired and the definition of non-performing exposure. This has resulted 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. The Bank policy is not 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 the Bank's mortgage loan portfolios) or longer than (in respect of the Bank's unsecured and business banking portfolios) the period estimated under IAS 39. This will result in IFRS 9 allowances being larger than 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 has resulted 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 is considered by the Bank is an increase in the residual lifetime Probability of Default (PD) since initial recognition. A loan will be considered to have experienced a significant increase in credit risk, and be transferred from stage 1 to stage 2 if the residual lifetime PD has increased by a factor of 2 times the origination PD and the increase is at least 10 bps (for mortgages) and between 30 and 100 bps for unsecured products. As a secondary assessment criterion, financial assets that are in forbearance but not in default are considered to have experienced significant increase in credit risk and will be in stage 2. As a backstop, the Bank does not 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.

  In respect of loans, the Bank does not 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 the Bank's investment grade debt securities, the Bank does take advantage of the low credit risk exemption and categorises these financial assets as stage 1.

Notes to the consolidated financial statements

Loans (continued)

IFRS 9 *Financial Instruments* (continued)

- *Stage 3*
  Financial assets will be included in stage 3 when there is objective evidence of credit impairment. Under IFRS 9, the Bank assesses a loan as stage 3 when 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. This 90 days past due time horizon will be shorter than the 180 day period applied under IAS 39 in respect of the Bank's mortgage loan portfolios and will be longer than the 60 days period applied under IAS 39 in respect of the Bank's unsecured and business banking portfolios).

- *Purchased or originated credit impaired (POCI)*
  Financial assets that are credit impaired at the date of their purchase or origination will be reported in a separate POCI category and will recognise the cumulative change in lifetime expected credit loss since origination as a loss allowance. Subsequent to origination, POCI financial assets that no longer meet the stage 3 criteria will no longer be considered to be credit impaired but will continue to be reported as POCI.

- *Write-off of financial assets*
  The Bank's policy on the write-off of loans and advances, included on page 29, is expected to remain unchanged.

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. The Bank bases 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 the 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 also requires the use of multiple economic scenarios to calculate a probability weighted forward looking estimate. The Bank has considered five scenarios as part of an overarching governance framework for the use of forecast economic scenarios for planning, stress testing and IFRS 9 and has selected three of these for use in measuring ECL for IFRS 9. The base scenario reflects a supportive global economic environment and gradual normalisation of monetary policy. An upside scenario, reflecting improving productivity, and a down side scenario, reflecting increasing inflation and more hawkish central bank policy, are also used for IFRS 9. The weighting of these scenarios reflects a mild skew to the downside. Transfers between stages 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 the Bank 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

Bank	2017 £ million	2016 £ million
Interest and similar income		
Cash, cash balances at central banks and other demand deposits	**13.5**	11.0
Available-for-sale financial assets	**44.7**	28.9
Loans to credit institutions	**0.9**	3.4
Derivative financial instruments	**(33.3)**	(8.9)
Loans and advances to customers	**1,054.8**	1,063.3
Total interest and similar income	**1,080.6**	1,097.7
Interest and similar expense		
Deposits from credit institutions	**(12.5)**	(0.2)
Repurchase agreements	**(8.0)**	(10.3)
Customer deposits	**(120.5)**	(174.0)
Debt securities in issue	**(11.9)**	(37.0)
Subordinated liabilities	**(22.4)**	(22.4)
Total interest and similar expense	**(175.3)**	(243.9)
Net interest income	**905.3**	853.8

Included within interest and similar income is £9.1 million (2016: £9.5 million) in respect of impaired financial assets.

Notes to the consolidated financial statements

Income (continued)

14. Net fee and commission income

Bank	2017 £ million	2016 £ million
Fee and commission income		
Bank accounts	**84.5**	89.6
Credit and debit card fee income	**66.5**	62.5
Insurance commission income	**19.1**	21.0
Other	**23.2**	24.4
Total fee and commission income	**193.3**	197.5
Fee and commission expense		
Bank accounts	**(84.7)**	(74.4)
Credit and debit card fee expense	**(13.3)**	(8.8)
Other	**(11.6)**	(14.1)
Total fee and commission expense	**(109.6)**	(97.3)
Net fee and commission income	**83.7**	100.2

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

15. Other operating income

Bank	2017 £ million	2016 £ million
Rent receivable	**1.2**	1.3
Dividend income	**0.2**	–
Other income	**0.2**	–
Total other operating income	**1.6**	1.3

IFRS 15 *Revenue from Contracts with Customers – effective from 1 January 2018*

IFRS 15 '*Revenue from Contracts with Customers*' replaces IAS 18 '*Revenue*' and other existing revenue recognition interpretations. It describes the principles an entity must follow to measure and recognise revenue using a five step approach. The standard requires revenue to be recognised when goods or services are transferred to customers and the entity has satisfied its performance obligations under the contract, 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.

IFRS 15 will be applied by the Bank from 1 January 2018 and will require a change to the Bank's accounting policy with respect to the recognition of commission income from the sale of insurance contracts. Specifically, under IAS 18, the Bank recognised commission income from the renewal by customers of insurance contracts when the commission income was earned and received from the underwriter. Under IFRS 15, such renewal commission income is recognised when the Bank satisfies its performance obligations under the relevant contract and management concludes that there is a high probability that there will be no significant reversal of the estimated income. There are no other changes to the Bank's accounting policies as a result of adopting IFRS 15.

As a consequence, the adoption of IFRS 15 will result in the accelerated recognition of insurance commission income that was previously expected to be recognised during 2018 and 2019. At 1 January 2018, the Bank will recognise an expected contract receivable of £5.9 million and an associated deferred tax liability of £1.6 million, leading to an expected £4.3 million increase in shareholder's reserves. In estimating the contract receivable, judgement has been applied in assessing the level of future policy renewals and policy early terminations.

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, the Bank pays tax to HMRC on the profits we earn.

Accounting policies relevant to recognising charges

(f) Pensions and other post-retirement benefits
The Bank operates defined contribution pension plans under which fixed contributions are paid. The costs of the Bank'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
The Bank 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 the 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

Bank	2017 £ million	2016 £ million
Partner (staff) costs		
Wages and salaries	**262.6**	254.0
Social security costs	**29.7**	28.0
Other pension costs	**32.7**	31.9
Share-based payments	**6.4**	3.4
Other staff costs	**38.9**	62.0
Total staff costs	**370.3**	379.3
Premises and equipment expenses		
Rent	**30.8**	33.6
Rates	**14.7**	16.0
Other	**31.3**	33.1
Total premises and equipment expenses	**76.8**	82.7
Other expenses		
Transitional Services Agreement (TSA) costs	**213.8**	91.8
Professional fees	**27.2**	21.3
Advertising and promotion	**59.0**	59.1
Financial Services Compensation Scheme (FSCS) levy	**0.3**	6.2
Other	**84.0**	67.1
Total other expenses	**384.3**	245.5
Depreciation of property plant and equipment	**27.5**	23.1
Depreciation of intangible assets	**0.3**	0.5
Total operating expenses	**859.2**	731.1

The monthly average number of Partners on a headcount basis during the year was 8,583 (2016: 8,296), all of whom were employed in the UK. Included in Partner costs is remuneration paid to key management personnel as set out in note 28(i) on page 63.

Included in other expenses are fees paid to the Bank's auditors in respect of work carried out for the Bank of £2.5 million (2016: £2.1 million). Of this amount, £2.2 million (2016: £1.7 million) was in respect of the audit of the Bank's and Company's financial statements and £0.3 million (2016: £0.4 million) was in respect of non-audit services. The 2017 fee for the audit of the Bank's and Company's financial statements includes audit related services performed during the year to support the Sabadell interim audit and audit procedures relating to the Bank's IFRS 9 programme.

17. Directors' emoluments

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

	2017 £ 000	2016 £ 000
Aggregate remuneration paid to Directors in respect of qualifying services	**3,008**	2,884
Aggregate cash received under long-term incentive arrangements	**83**	1,803
Total	**3,091**	4,687

The aggregate remuneration, including cash received under long-term incentive arrangements, of the highest paid director was £1,753,477 (2016: £3,717,701).

The table below presents the number of Directors, including the highest paid Director, who:

	2017 Number	2016 Number
Exercised share options	**1**	2
Received shares under long term incentive schemes	**1**	1
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 the Bank's share-based compensation schemes, all of which are accounted for as cash-settled share based compensation schemes:

Bank	2017 £ million	2016 £ million
Share options – TSB Sharesave	**2.2**	0.3
Share grants – TSB Sustainable Performance Award	**2.8**	2.9
Other share based compensation schemes	**1.4**	0.2
	6.4	3.4

During 2017, the Bank operated a Sharesave scheme and a Share Incentive Plan (SIP), both of which provide all Bank Partners with the opportunity to own shares in Sabadell and the Sustainable Performance Award (SPA) scheme for more senior Partners. As all share-based compensation schemes 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. This liability is remeasured annually, with changes recognised in operating expenses, to reflect the latest Sabadell share price and the estimated numbers of shares expected to vest. At 31 December 2017 £10.1 million (2016: £6.6 million) was recognised in respect of share-based payments liability (see note 31).

Sustainable Performance Award (SPA)
The SPA is a discretionary long term incentive arrangement under which share grants vest between one and five years post grant (and between three and seven years post grant for certain senior executives) subject to the achievement of certain personal and corporate performance conditions. During 2017, 2,938,753 Sabadell shares (2016: 2,700,434 Sabadell shares), with a fair value calculated using the market price at 31 December 2017, of £4.3 million (2016: £3.0 million), were awarded to certain senior Partners under the SPA. The carrying amount of the liability in respect of the SPA at 31 December 2017 was £6.3 million (2016: £5.5 million).

Sharesave scheme
Eligible Partners may choose 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. Movements in the number of Sharesave options outstanding are set out below:

Bank	2017		2016	
	Number of options (Sabadell) (000's)	Weighted average exercise price (pence)	Number of options (Sabadell) (000's)	Weighted average exercise price (pence)
Outstanding at 1 January	**13,974**	**77.68**	–	–
Granted	**–**	**–**	14,213	77.68
Exercised	**(65)**	**77.68**	–	–
Forfeited	**(554)**	**77.68**	(116)	77.68
Cancelled	**(354)**	**77.68**	(123)	77.68
Outstanding at 31 December	**13,001**	**77.68**	13,974	77.68
Exercisable at 31 December	**–**	**–**	–	–

The remaining contractual life of the options outstanding at 31 December 2017 was one year and nine months. At 31 December 2017, the fair value of the options, determined using a Black Scholes option pricing model, was 32.0 pence (2016: 29.7 pence) and a liability of £2.3 million (2016: £0.3 million) was recognised on the consolidated balance sheet.

Equity instruments designated at fair value through profit or loss
At 31 December 2017, £1.3 million (2016: £0.3 million) of Sabadell shares were held for the purpose of hedging the Bank's obligations under the above share-based payment schemes. These equity instruments reduce the accounting mismatch arising from the volatility of marking to market the share-based payment liability and are designated at fair value through profit or loss on the consolidated balance sheet.

Notes to the consolidated financial statements

Charges (continued)

19. Taxation

	2017 £ million	2016 £ million
UK corporation tax		
Current tax on profit for the year	**(20.4)**	(28.6)
Adjustments in respect of prior year	**2.7**	0.1
Current tax charge	**(17.7)**	(28.5)
Deferred tax (note 20)		
Origination and reversal of temporary differences:		
Deferred tax on business transfers	**(23.8)**	(24.5)
Changes in UK corporation tax rates	**–**	(1.3)
Deferred tax on pension	**–**	0.2
Accelerated capital allowances	**1.7**	0.2
Adjustments in respect of prior years	**(4.2)**	–
Other	**–**	(0.3)
Deferred tax charge	**(26.3)**	(25.7)
Taxation charge	**(44.0)**	(54.2)

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:

	2017 £ million	2016 £ million
Profit before taxation	**159.1**	182.3
Taxation charge at applied UK corporation tax rate of 27.25% (2016: 28.0%)	**(43.4)**	(51.0)
Factors affecting charge:		
Disallowed costs	**(1.2)**	(4.0)
Non-taxable items	**0.1**	–
Changes to UK corporation tax rates	**–**	(1.3)
Taxable profits not subject to 8% bank surcharge	**2.0**	2.0
Adjustments in respect of prior years	**(1.5)**	0.1
Taxation charge	**(44.0)**	(54.2)

The applied UK corporation tax rate of 27.25% for 2017 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 19.25%.

Disallowed costs primarily reflect certain recurring property and restructuring costs. 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:

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
At 1 January	**99.6**	121.1	**99.6**	121.1
Income statement charge (note 19)	**(26.3)**	(25.7)	**(26.3)**	(25.7)
Amounts credited/(charged) to equity:				
Movements in cash flow hedging reserve	**–**	0.2	**–**	0.2
Movements in available-for-sale reserve	**(4.7)**	4.0	**(4.7)**	4.0
At 31 December	**68.6**	99.6	**68.6**	99.6

Deferred tax assets are comprised as follows:

	Bank 2017 £ million	Bank 2016 £ million	Bank 2017 £ million	Company 2016 £ million
Deferred tax impact of business transfers	**78.2**	102.0	**78.2**	102.0
Revaluations of available-for-sale financial assets	**(7.0)**	(2.3)	**(7.0)**	(2.3)
Other temporary differences	**(2.6)**	(0.1)	**(2.6)**	(0.1)
Total deferred tax assets	**68.6**	99.6	**68.6**	99.6

Significant estimates - recoverability of deferred tax assets

At 31 December 2017, the Bank recognised deferred tax assets of £68.6 million (2016: £99.6 million), primarily comprising £78.2 million in respect of temporary differences arising from the transfer of customer accounts during 2013 (2016: £99.5 million) which will unwind over the period to December 2021, being offset primarily by £7.0 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 an estimate of the amount and timing of future taxable profits. The Bank'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 the Bank's performance. It decides whether profits are put aside for future investment in the business, for protection against the uncertainties that the Bank 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. Shareholder's equity

Bank	Share capital £ million	Share premium £ million	Merger reserve £ million	Available- for-sale reserve £ million	Cash flow hedging reserve £ million	Retained profits £ million
Balance at 1 January 2016	79.4	195.6	412.8	16.3	(0.9)	1,057.4
Net movement in available-for-sale reserve	–	–	–	(10.4)	–	–
Net movement in cash flow hedging reserve	–	–	–	–	1.3	–
Profit for the year	–	–	–		–	128.1
At 31 December 2016	79.4	195.6	412.8	5.9	0.4	1,185.5
Balance at 1 January 2017	**79.4**	**195.6**	**412.8**	**5.9**	**0.4**	**1,185.5**
Net movement in available-for-sale reserve	**–**	**–**	**–**	**12.8**	**–**	**–**
Net movement in cash flow hedging reserve	**–**	**–**	**–**	**–**	**(0.9)**	**–**
Profit for the year	**–**	**–**	**–**	**–**	**–**	**115.1**
At 31 December 2017	**79.4**	**195.6**	**412.8**	**18.7**	**(0.5)**	**1,300.6**

Company	Share capital £ million	Share premium £ million	Merger reserve £ million	Available- for-sale reserve £ million	Cash flow hedging reserve £ million	Retained profits £ million
Balance at 1 January 2016	79.4	195.6	412.8	16.3	(0.5)	1,057.4
Net movement in available-for-sale reserve	–	–	–	(10.4)	–	–
Net movement in cash flow hedging reserve	–	–	–	–	0.5	–
Profit for the year	–	–	–		–	128.1
At 31 December 2016	79.4	195.6	412.8	5.9	–	1,185.5
Balance at 1 January 2017	**79.4**	**195.6**	**412.8**	**5.9**	**–**	**1,185.5**
Net movement in available-for-sale reserve	**–**	**–**	**–**	**12.8**	**–**	**–**
Profit for the year	**–**	**–**	**–**	**–**	**–**	**115.1**
At 31 December 2017	**79.4**	**195.6**	**412.8**	**18.7**	**–**	**1,300.6**

Description of reserves

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 the Bank'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 the Bank through its use of financial instruments are: credit risk; liquidity risk; and market risk. A summary of the Bank'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, the Bank 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, specifically relating to hedging core deposits. 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. The Bank 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.

Notes to the consolidated financial statements

Managing financial risk (continued)

22. Measurement basis of financial instruments

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

Bank At 31 December 2017	Fair value through profit or loss £ 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	**37.5**	**–**	**–**	**566.5**	**–**	**604.0**
Financial liabilities at amortised cost:						
Deposits from central banks	**–**	**–**	**5,625.7**	**–**	**–**	**5,625.7**
Customer deposits	**–**	**–**	**30,520.6**	**–**	**–**	**30,520.6**
Repurchase agreements	**–**	**–**	**1,446.4**	**–**	**–**	**1,446.4**
Debt securities in issue	**–**	**–**	**1,318.7**	**–**	**–**	**1,318.7**
Subordinated liabilities	**–**	**–**	**405.3**	**–**	**–**	**405.3**
Other financial liabilities	**–**	**–**	**247.3**	**–**	**–**	**247.3**
Total financial liabilities	**37.5**	**–**	**39,564.0**	**566.5**	**–**	**40,168.0**
Financial assets						
Cash, cash balances at central banks and other demands deposits	**–**	**–**	**7,563.4**	**–**	**–**	**7,563.4**
Trading derivative financial assets	**111.1**	**–**	**–**	**103.7**	**–**	**214.8**
Equity instruments designated at FVTPL	**1.3**	**–**	**–**	**–**	**–**	**1.3**
Available-for-sale financial assets	**–**	**2,123.3**	**–**	**–**	**–**	**2,123.3**
Loans and receivables:						
Loans to central banks	**–**	**–**	**–**	**–**	**56.0**	**56.0**
Loans to credit institutions	**–**	**–**	**–**	**–**	**329.2**	**329.2**
Loans and advances to customers	**–**	**–**	**–**	**–**	**30,854.2**	**30,854.2**
Other advances	**–**	**–**	**–**	**–**	**896.0**	**896.0**
Total financial assets	**112.4**	**2,123.3**	**7,563.4**	**103.7**	**32,135.4**	**42,038.2**

At 31 December 2016						
Financial liabilities						
Derivative financial liabilities	97.7	–	–	529.1	–	626.8
Financial liabilities at amortised cost:						
Deposits from central banks	–	–	5.0	–	–	5.0
Deposits from credit institutions	–	–	2.3	–	–	2.3
Repurchase agreements	–	–	1,409.6	–	–	1,409.6
Customer deposits	–	–	29,383.8	–	–	29,383.8
Debt securities in issue	–	–	2,940.1	–	–	2,940.1
Subordinated liabilities	–	–	413.3	–	–	413.3
Other financial liabilities	–	–	228.6	–	–	228.6
Total financial liabilities	97.7	–	34,382.7	529.1	–	35,009.5
Financial assets						
Cash, cash balances at central banks and other demands deposits	–	–	3,647.7	–	–	3,647.7
Derivative financial assets	143.2	–	–	104.3	–	247.5
Equity instruments designated at FVPL	0.3	–	–	–	–	0.3
Available-for-sale financial assets:	–	2,103.5	–	–	–	2,103.5
Loans and receivables:						
Loans and advances to central banks	–	–	–	–	51.0	51.0
Loans and advances to credit institutions	–	–	–	–	530.5	530.5
Loans and advances to customers	–	–	–	–	29,419.1	29,419.1
Other advances	–	–	–	–	799.0	799.0
Total financial assets	143.5	2,103.5	3,647.7	104.3	30,799.6	36,798.6

Notes to the consolidated financial statements

Managing financial risk (continued)

22. Measurement basis of financial instruments

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

Company At 31 December 2017	Fair value through profit or loss £ 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	**37.5**	**–**	**–**	**566.5**	**–**	**604.0**
Financial liabilities at amortised cost:						
Deposits from central banks	**–**	**–**	**5,625.7**	**–**	**–**	**5,625.7**
Customer deposits	**–**	**–**	**30,520.6**	**–**	**–**	**30,520.6**
Repurchase agreements	**–**	**–**	**1,446.4**	**–**	**–**	**1,446.4**
Debt securities in issue	**–**	**–**	**498.0**	**–**	**–**	**498.0**
Subordinated liabilities	**–**	**–**	**405.3**	**–**	**–**	**405.3**
Other financial liabilities	**–**	**–**	**247.3**	**–**	**–**	**247.3**
Total financial liabilities	**37.5**	**–**	**38,743.3**	**566.5**	**–**	**39,347.3**
Financial assets						
Cash, cash balances at central banks and other demands deposits	**–**	**–**	**7,563.4**	**–**	**–**	**7,563.4**
Trading derivative financial assets	**111.1**	**–**	**–**	**38.9**	**–**	**150.0**
Equity instruments designated at FVTPL	**1.3**	**–**	**–**	**–**	**–**	**1.3**
Available-for-sale financial assets	**–**	**2,123.3**	**–**	**–**	**–**	**2,123.3**
Loans and receivables:						
Loans to central banks	**–**	**–**	**–**	**–**	**56.0**	**56.0**
Loans to credit institutions	**–**	**–**	**–**	**–**	**–**	**–**
Loans and advances to customers	**–**	**–**	**–**	**–**	**30,854.2**	**30,854.2**
Other advances	**–**	**–**	**–**	**–**	**896.0**	**896.0**
Total financial assets	**112.4**	**2,123.3**	**7,563.4**	**38.9**	**31,806.2**	**41,644.2**
At 31 December 2016						
Financial liabilities						
Derivative financial liabilities	97.7	–	–	529.1	–	626.8
Financial liabilities at amortised cost:						
Deposits from central banks	–	–	5.0	–	–	5.0
Deposits from credit institutions	–	–	2.3	–	–	2.3
Repurchase agreements	–	–	1,409.6	–	–	1,409.6
Customer deposits	–	–	29,383.8	–	–	29,383.8
Debt securities in issue	–	–	–	–	–	–
Subordinated liabilities	–	–	413.3	–	–	413.3
Other financial liabilities	–	–	228.6	–	–	228.6
Total financial liabilities	97.7	–	31,442.6	529.1	–	32,069.4
Financial assets						
Cash, cash balances at central banks and other demands deposits	–	–	3,647.7	–	–	3,647.7
Derivative financial assets	143.2	–	–	48.0	–	191.2
Equity instruments designated at FVTPL	0.3	–	–	–	–	0.3
Available-for-sale financial assets:	–	2,103.5	–	–	–	2,103.5
Loans and receivables:						
Loans and advances to central banks	–	–	–	–	51.0	51.0
Loans and advances to credit institutions	–	–	–	–	–	–
Loans and advances to customers	–	–	–	–	29,419.1	29,419.1
Other advances	–	–	–	–	799.0	799.0
Total financial assets	143.5	2,103.5	3,647.7	48.0	30,269.1	36,211.8

Notes to the consolidated financial statements

Managing financial risk (continued)

23. 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. The Bank 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. The Bank'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.

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Loans to central banks	**56.0**	51.0	**56.0**	51.0
Loans to credit institutions	**329.2**	530.5	**–**	–
Loans and advances to customers [1]	**30,854.2**	29,419.1	**30,854.2**	29,419.1
Available-for-sale financial assets	**2,116.3**	2,098.3	**2,116.3**	2,098.3
Other advances (excluding collateral)	**260.4**	220.4	**260.4**	220.4
Derivative financial assets	**214.8**	247.5	**150.0**	191.2
	33,830.9	32,566.8	**33,436.9**	31,980.0
Lending commitments – revocable	**3,399.7**	3,498.7	**3,399.7**	3,498.7
Lending commitments – irrevocable	**1,282.9**	1,778.3	**1,282.9**	1,778.3
Maximum credit risk exposure	**38,513.5**	37,843.8	**38,119.5**	37,257.0

(1) Amounts shown are net of related impairment allowances.

(ii) Credit quality of assets

Loans and receivables

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

Bank and Company	Loans and advances to customers		
At 31 December 2017	Mortgages £ million	Unsecured lending and business banking £ million	Total £ million
Neither past due nor impaired	**27,988.5**	**2,425.2**	**30,413.7**
Past due but not impaired	**323.8**	**34.2**	**358.0**
Impaired – no provision required	**46.3**	**27.1**	**73.4**
Impaired - provision held	**35.1**	**45.6**	**80.7**
Gross loans and receivables	**28,393.7**	**2,532.1**	**30,925.8**
Allowance for impairment losses (note 9)	**(25.7)**	**(45.9)**	**(71.6)**
Net loans and receivables	**28,368.0**	**2,486.2**	**30,854.2**
At 31 December 2016			
Neither past due nor impaired	26,645.3	2,254.6	28,899.9
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
Allowance for impairment losses (note 9)	(28.0)	(45.7)	(73.7)
Net loans and receivables	27,124.1	2,295.0	29,419.1

Loans to central banks and loans to credit institutions as shown on the balance sheets on page 19 comprise balances that are neither past due nor impaired.

Notes to the consolidated financial statements

Managing financial risk (continued)

23. Credit risk (continued)

Loans and receivables which are neither past due nor impaired

Bank and Company	Loans and advances to customers		
31 December 2017	**Mortgages £ million**	**Unsecured lending and business banking £ million**	**Total £ million**
Good quality	**27,939.2**	**2,108.6**	**30,047.8**
Satisfactory quality	**41.3**	**252.8**	**294.1**
Lower quality	**5.1**	**30.4**	**35.5**
Below standard, but not impaired	**2.9**	**33.4**	**36.3**
Total loans and receivables which are neither past due nor impaired	**27,988.5**	**2,425.2**	**30,413.7**
31 December 2016			
Good quality	26,605.2	1,964.6	28,569.8
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

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 and receivables with low expected losses in the event of a default, with other categories reflecting progressively higher risks and lower expected recoveries.

Loans to central banks and loans to credit institutions as shown on the balance sheets on page 19 comprise balances that are considered good quality.

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

Bank and Company	Loans and advances to customers		
31 December 2017	**Mortgages £ million**	**Unsecured lending and business banking £ million**	**Total £ million**
0-30 days	**158.8**	**19.5**	**178.3**
30-60 days	**53.8**	**8.5**	**62.3**
60-90 days	**40.7**	**0.1**	**40.8**
90-180 days	**50.0**	**0.2**	**50.2**
Over 180 days	**20.5**	**5.9**	**26.4**
Total loans and receivables which are past due but not impaired	**323.8**	**34.2**	**358.0**
31 December 2016			
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

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

An analysis of derivative financial assets is presented in note 26. Derivative financial instruments are collateralised, in the majority of cases, via a central clearing house which mitigates credit risk arising from these financial instruments.

Notes to the consolidated financial statements

Managing financial risk (continued)

23. Credit risk (continued)

(iii) Collateral held as security for financial assets

The Bank 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 the Bank'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.

Bank and Company 31 December 2017	Neither past due nor impaired £ million	Past due but not impaired £ million	Impaired £ million	Gross £ million
Less than 70%	**20,158.1**	**223.2**	**48.8**	**20,430.1**
70% to 80%	**4,851.8**	**48.9**	**14.5**	**4,915.2**
80% to 90%	**2,367.0**	**32.3**	**9.4**	**2,408.7**
90% to 100%	**553.9**	**10.8**	**5.9**	**570.6**
Greater than 100%	**57.7**	**8.6**	**2.8**	**69.1**
Total mortgages	**27,988.5**	**323.8**	**81.4**	**28,393.7**
31 December 2016				
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

Unsecured lending and business banking

At 31 December 2017, unimpaired unsecured and business banking lending amounted to £2,485.5 million (2016: £2,290.4 million). At 31 December 2017, impaired unsecured and business banking lending amounted to £0.7 million (2016: £4.6 million), net of an impairment allowance of £45.9 million (2016: £45.7 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 2017, credit risk is mitigated by collateral held totalling £159.1 million (2016: £137.7 million).

(iv) Collateral repossessed

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Residential property	**6.1**	3.7	**6.1**	3.7
Total collateral repossessed	**6.1**	3.7	**6.1**	3.7

The Bank 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

The Bank 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 2017, total forborne loans were £363.1 million (2016: £371.1 million), of which £59.2 million (2016: £67.0 million) were impaired. At 31 December 2017, the allowance for loan losses held in respect of forborne loans was £13.2 million (2016: £15.3 million).

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Liquidity risk

Definition and exposure

Liquidity risk is the risk that the Bank is unable to meet its liabilities as they fall due, or is unable to maintain regulator, investor, customer or stakeholder confidence that this will be achieved. 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

The Bank'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. The Bank has also diversified its funding base further during 2017 through issuance of covered bonds, and accessing funding under the Bank of England's Term Funding Scheme. At 31 December 2017, the Bank's primary liquidity portfolio totalled £9,536.2 million (2016: £5,571.4 million). This comprised £7,419.9 million (2016: £3,473.1 million) held on deposit with the Bank of England, a £1,721.5 million (2016: £1,872.8 million) portfolio of UK gilts (of which £1,444.7 million (2016: £662.8 million) had been sold under repurchase agreements – see note 4) and £394.8 million (2016: £225.5 million) of supranational and development bank bonds.

Risk appetite

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

Measurement and monitoring

A series of measures are used across the Bank 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)

24. Liquidity risk (continued)

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

Bank At 31 December 2017	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Liabilities						
Financial liabilities measured at amortised cost:						
Deposits from central banks	**5,625.7**	**–**	**–**	**–**	**–**	**5,625.7**
Deposits from credit institutions	**–**	**–**	**–**	**–**	**–**	**–**
Repurchase agreements	**1,446.4**	**–**	**–**	**–**	**–**	**1,446.4**
Customer deposits	**26,680.8**	**669.7**	**2,087.8**	**1,082.3**	**–**	**30,520.6**
Debt securities in issue	**–**	**62.6**	**144.1**	**1,112.0**	**–**	**1,318.7**
Subordinated liabilities	**17.8**	**–**	**3.4**	**384.1**	**–**	**405.3**
Other financial liabilities	**247.3**	**–**	**–**	**–**	**–**	**247.3**
Trading derivative liabilities	**0.3**	**0.9**	**4.7**	**24.4**	**7.2**	**37.5**
Hedging derivative liabilities	**–**	**–**	**3.2**	**19.4**	**543.9**	**566.5**
Other liabilities [(1)]	**320.7**	**0.1**	**(2.7)**	**9.5**	**34.5**	**362.1**
Total liabilities	**34,339.0**	**733.3**	**2,240.5**	**2,631.7**	**585.6**	**40,530.1**

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

Assets						
Loans and receivables:						
Loans to central banks	**56.0**	**–**	**–**	**–**	**–**	**56.0**
Loans to credit institutions	**–**	**205.1**	**–**	**124.1**	**–**	**329.2**
Loans and advances to customers	**1,094.8**	**260.8**	**1,320.4**	**5,987.4**	**22,190.8**	**30,854.2**
Other advances	**896.0**	**–**	**–**	**–**	**–**	**896.0**
Available-for-sale financial assets	**–**	**–**	**–**	**–**	**2,123.3**	**2,123.3**
Trading derivative assets	**0.2**	**0.6**	**10.9**	**66.1**	**33.3**	**111.1**
Hedging derivative assets	**–**	**–**	**1.3**	**96.1**	**6.3**	**103.7**
Other assets [(2)]	**7,833.0**	**–**	**10.9**	**57.7**	**161.6**	**8,063.2**
Total assets	**9,880.0**	**466.5**	**1,343.5**	**6,331.4**	**24,515.3**	**42,536.7**

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

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Liquidity risk (continued)

Bank 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						
Financial liabilities measured at amortised cost:						
Deposits from central banks	5.0	–	–	–	–	5.0
Deposits from credit institutions	2.3	–	–	–	–	2.3
Customer deposits	25,296.7	266.2	1,054.7	2,766.2	–	29,383.8
Repurchase agreements	659.6	–	750.0	–	–	1,409.6
Debt securities in issue	–	159.9	507.9	2,272.3	–	2,940.1
Subordinated liabilities	26.1	3.4	–	–	383.8	413.3
Other financial liabilities	228.6	–	–	–	–	228.6
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	217.2	0.4	(1.5)	16.3	89.1	321.5
Total liabilities	26,435.6	430.3	2,325.6	5,141.8	997.7	35,331.0
Assets						
Loans and receivables:						
Loans to central banks	51.0	–	–	–	–	51.0
Loans to credit institutions	–	334.2	–	196.3	–	530.5
Loans and advances to customers	1,194.5	272.0	1,229.7	5,609.7	21,113.2	29,419.1
Other advances	799.0	–	–	–	–	799.0
Available-for-sale financial assets	–	–	–	–	2,103.5	2,103.5
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	3,736.3	–	19.7	79.8	224.2	4,060.0
Total assets	5,781.2	606.5	1,257.6	6,081.1	23,484.2	37,210.6

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Liquidity risk (continued)

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

Bank At 31 December 2017	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						
Financial liabilities measured at amortised cost:						
Deposits from central banks	**5,625.7**	**–**	**–**	**–**	**–**	**5,625.7**
Deposits from credit institutions	**–**	**–**	**–**	**–**	**–**	**–**
Customer deposits	**26,679.4**	**680.0**	**2,120.0**	**1,099.0**	**–**	**30,578.4**
Repurchase agreements	**1,296.2**	**–**	**150.2**	**–**	**–**	**1,446.4**
Debt securities in issue	**–**	**52.6**	**148.9**	**1,080.0**	**–**	**1,281.5**
Subordinated liabilities	**–**	**–**	**22.1**	**440.3**	**–**	**462.4**
Other financial liabilities	**247.3**	**–**	**–**	**–**	**–**	**247.3**
Total non-derivative financial liabilities	**33,848.6**	**732.6**	**2,441.2**	**2,619.3**	**–**	**39,641.7**
Gross settled derivative - outflows	**16.7**	**16.8**	**161.3**	**753.4**	**605.9**	**1,554.1**
Gross settled derivative - inflows	**(15.6)**	**(12.6)**	**(87.8)**	**(591.3)**	**(271.1)**	**(978.4)**
Total financial liabilities	**33,849.7**	**736.8**	**2,514.7**	**2,781.4**	**334.8**	**40,217.4**

Bank 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						
Financial liabilities measured at amortised cost:						
Deposits from central banks	5.0	–	–	–	–	5.0
Deposits from credit institutions	2.3	–	–	–	–	2.3
Customer deposits	25,292.9	218.0	1,126.7	2,887.7	–	29,525.3
Repurchase agreements	658.6	2.9	756.8	–	–	1,418.3
Debt securities in issue	–	163.6	526.8	2,297.1	–	2,987.5
Subordinated liabilities	–	–	22.1	462.5	–	484.6
Other financial liabilities	228.6	–	–	–	–	228.6
Total non-derivative financial liabilities	26,187.4	384.5	2,432.4	5,647.3	–	34,651.6
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	26,200.2	398.5	2,543.2	5,860.5	258.5	35,260.9

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Liquidity risk (continued)

The tables below analyses 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.

Company At 31 December 2017	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						
Financial liabilities measured at amortised cost:						
Deposits from central banks	**5,625.7**	**–**	**–**	**–**	**–**	**5,625.7**
Deposits from credit institutions	**–**	**–**	**–**	**–**	**–**	**–**
Customer deposits	**26,679.4**	**680.0**	**2,120.0**	**1,099.0**	**–**	**30,578.4**
Repurchase agreements	**1,296.2**	**–**	**150.2**	**–**	**–**	**1,446.4**
Debt securities in issue	**–**	**0.9**	**2.9**	**515.3**	**–**	**519.1**
Subordinated liabilities	**–**	**–**	**22.1**	**440.3**	**–**	**462.4**
Other financial liabilities	**247.3**	**–**	**–**	**–**	**–**	**247.3**
Total non-derivative financial liabilities	**33,848.6**	**680.9**	**2,295.2**	**2,054.6**	**–**	**38,879.3**
Gross settled derivative - outflows	**8.7**	**16.0**	**136.1**	**497.1**	**605.9**	**1,263.8**
Gross settled derivative - inflows	**(6.7)**	**(12.5)**	**(61.8)**	**(271.0)**	**(271.1)**	**(623.1)**
Total financial liabilities	**33,850.6**	**684.4**	**2,369.5**	**2,280.7**	**334.8**	**39,520.0**

Company 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						
Financial liabilities measured at amortised cost:						
Deposits from central banks	5.0	–	–	–	–	5.0
Deposits from credit institutions	2.3	–	–	–	–	2.3
Customer deposits	25,292.9	218.0	1,126.7	2,887.7	–	29,525.3
Repurchase agreements	658.6	2.9	756.8	–	–	1,418.3
Subordinated liabilities	–	–	22.1	462.5	–	484.6
Other financial liabilities	228.6	–	–	–	–	228.6
Total non-derivative financial liabilities	26,187.4	220.9	1,905.6	3,350.2	–	31,664.1
Gross settled derivative - outflows	22.6	24.0	163.5	420.7	472.1	1,102.9
Gross settled derivative - inflows	(9.2)	(10.5)	(52.7)	(163.6)	(213.6)	(449.6)
Total financial liabilities	26,200.8	234.4	2,016.4	3,607.3	258.5	32,317.4

25. Capital resources

The Bank maintains a strong capital base which has met regulatory requirements under the Capital Requirements Regulation and which seeks to support the growth of the business, even under stressed conditions. The table below presents the Bank's regulatory capital resources.

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Shareholder's equity	**2,006.6**	1,879.6	**2,007.1**	1,879.2
Regulatory deductions	**(97.5)**	(79.2)	**(97.5)**	(79.2)
Common Equity Tier 1/Total Tier 1 capital	**1,909.1**	1,800.4	**1,909.6**	1,800.0
Tier 2 capital	**384.1**	383.9	**384.1**	383.9
Total capital resources	**2,293.2**	2,184.3	**2,293.7**	2,183.9

Notes to the consolidated financial statements

Managing financial risk (continued)

26. 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. The Bank's market risk consists primarily of exposure to changes in interest rates. Interest rate risk is the risk that the net value of, or net income arising from, the firm's assets and liabilities is impacted as a result of changes to interest rates. Interest rate risk can arise as a result of changes in customer behaviour, which may affect the maturity profiles of The Bank's assets and liabilities. The Bank's exposure to changes in interest rates includes 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 the Bank 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 the Bank's risk appetite.

A 12 month view of the sensitivity of net interest income is calculated on the basis of the Bank's current consolidated balance sheet with re-pricing dates adjusted according to behavioural assumptions. At 31 December 2017, 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 £10.2 million (2016: £9.4 million) from a 25bps increase in rates, and a decrease of £18.3 million (2016: £19.7 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

The Bank 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 the consolidated balance sheet. The fair values and notional amounts of derivative instruments of the Bank are presented in the following table:

	2017			2016		
Bank	**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	**21,069.7**	**104.2**	**(37.5)**	19,722.5	139.9	(97.7)
Equity options	**8.7**	**6.9**	**–**	8.7	3.3	–
Trading derivative instruments	**21,078.4**	**111.1**	**(37.5)**	19,731.2	143.2	(97.7)
Designated as micro fair value hedges	**4,631.9**	**21.5**	**(2.1)**	845.0	26.3	(1.1)
Designated as macro fair value hedges	**9,036.9**	**17.4**	**(564.4)**	4,673.7	21.7	(528.0)
Designated as cash flow hedges	**348.4**	**64.8**	**–**	372.1	56.3	–
Hedging derivative instruments	**14,017.2**	**103.7**	**(566.5)**	5,890.8	104.3	(529.1)
Total derivative instruments	**35,095.6**	**214.8**	**(604.0)**	25,622.0	247.5	(626.8)

Derivative assets of the Bank of £201.8 million (2016: £238.6 million) are expected to be recovered after more than one year. Derivative liabilities of £594.9 million (2016: £611.8 million) are expected to be settled after more than one year.

Notes to the consolidated financial statements

Managing financial risk (continued)

26. Market risk (continued)

The fair values and notional amounts of derivative instruments of the Company are presented in the following table:

Company	2017 Contract/ notional amount £ million	2017 Assets fair value £ million	2017 Liabilities fair value £ million	2016 Contract/ notional amount £ million	2016 Assets fair value £ million	2016 Liabilities fair value £ million
Interest rate swaps	**21,069.7**	**104.2**	**(37.5)**	19,722.5	139.9	(97.7)
Equity options	**8.7**	**6.9**	**–**	8.7	3.3	–
Trading derivative instruments	**21,078.4**	**111.1**	**(37.5)**	19,731.2	143.2	(97.7)
Designated as micro fair value hedges	**4,631.9**	**21.5**	**(2.1)**	845.0	26.3	(1.1)
Designated as macro fair value hedges	**9,036.9**	**17.4**	**(564.4)**	4,673.7	21.7	(528.0)
Designated as cash flow hedges	**–**	**–**	**–**	–	–	–
Hedging derivative instruments	**13,668.8**	**38.9**	**(566.5)**	5,518.7	48.0	(529.1)
Total derivative instruments	**34,747.2**	**150.0**	**(604.0)**	25,249.9	191.2	(626.8)

Derivative assets of the Company of £136.9 million (2016: £181.9 million) are expected to be recovered after more than one year. Derivative liabilities of £594.9 million (2016: £611.8 million) are expected to be settled after more than one year.

Gains/(losses) from hedge accounting

The Bank recognised gains from hedge accounting as follows:

Bank	2017 £ million	2016 £ million
Fair value hedges	**24.5**	17.1
Cash flows hedges	**–**	3.6
Gains from hedge accounting	**24.5**	20.7

Fair value hedges

The Bank designates certain of its fixed rate customer loans, debt securities, customer deposits and subordinated debt in fair value hedge accounting relationships. During the year gains of £55.4 million (2016: losses of £40.8 million) were recognised on derivatives in hedge accounting relationships and losses of £63.5 million (2016: gains of £37.2 million) were recognised on the hedged items attributable to the hedged interest rate risk resulting in fair value hedge ineffectiveness losses of £8.1 million (2016: losses of £3.6 million). Gains from hedge accounting also includes other hedge accounting adjustments of £32.6 million (2016: £20.7 million) reflect the amortisation of hedge adjustments in respect of previous fair value hedges relationships that have been de-designated.

Cash flow hedges

The Bank 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. During the year, gains of £9.3 million (2016: £47.0 million) were transferred from the cash flow hedging reserve to other operating income, no gains were transferred to net interest income in 2017 (2016: £0.5 million). In 2017, no gains were recognised in other operating income in respect of ineffectiveness arising from cash flow hedges (2016: £3.6 million).

The following tables present the periods when the Bank's hedged cash flows are expected to occur and when they will affect income for designated cash flow hedges.

Notes to the consolidated financial statements

Managing financial risk (continued)

26. **Market risk (continued)**

Bank At 31 December 2017	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	**(34.9)**	**(32.0)**	**(284.6)**	**–**	**–**	**–**	**(351.5)**
Hedged forecast cash flows affect profit or loss:							
Forecast receivable cash flows	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Forecast payable cash flows	**(0.5)**	**(1.1)**	**(1.4)**	**–**	**–**	**–**	**(3.0)**

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)

During 2017 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 the Bank has enforceable master netting agreements in place with counterparties.

Bank				Related amounts where set off in the balance sheet is not permitted		
At 31 December 2017	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[1] £ million	Potential net amount £ million
Derivative financial assets	**214.8**	**–**	**214.8**	**(143.1)**	**(6.9)**	**64.8**
Total assets	**214.8**	**–**	**214.8**	**(143.1)**	**(6.9)**	**64.8**
Derivative financial liabilities	**(604.0)**	**–**	**(604.0)**	**143.1**	**460.4**	**(0.5)**
Repurchase agreements	**(1,446.4)**	**–**	**(1,446.4)**	**1,444.7**	**1.7**	**–**
Total liabilities	**(2,050.4)**	**–**	**(2,050.4)**	**1,587.8**	**462.1**	**(0.5)**
At 31 December 2016						
Derivative financial assets	247.5	–	247.5	(187.9)	(3.3)	56.3
Total assets	247.5	–	247.5	(187.9)	(3.3)	56.3
Derivative financial liabilities	(626.8)	–	(626.8)	187.9	438.9	–
Repurchase agreements	(1,409.6)	–	(1,409.6)	1,409.6	–	–
Total liabilities	(2,036.4)	–	(2,036.4)	1,597.5	438.9	–

(1) Collateral amounts (cash and non-cash financial collateral) are reflected at their fair value and this amount is limited to the net balance sheet exposure in order to exclude any over collateralisation.
(2) Amounts have been re-presented to be consistent with current year presentation.

Notes to the consolidated financial statements

Managing financial risk (continued)

26. Market risk (continued)

Offsetting financial assets and financial liabilities (continued)

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

Company				Related amounts where set off in the balance sheet is not permitted		
At 31 December 2017	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[1] £ million	Potential net amount £ million
Derivative financial assets	**150.0**	**–**	**150.0**	**(143.1)**	**(6.9)**	**–**
Total assets	**150.0**	**–**	**150.0**	**(143.1)**	**(6.9)**	**–**
Derivative financial liabilities	**(604.0)**	**–**	**(604.0)**	**143.1**	**460.4**	**(0.5)**
Repurchase agreements	**(1,446.4)**	**–**	**(1,446.4)**	**1,444.7**	**1.7**	**–**
Total liabilities	**(2,050.4)**	**–**	**(2,050.4)**	**1,587.8**	**462.1**	**(0.5)**

At 31 December 2016[2]						
Derivative financial assets	191.2	–	191.2	(187.9)	(3.3)	–
Total assets	191.2	–	191.2	(187.9)	(3.3)	–
Derivative financial liabilities	(626.8)	–	(626.8)	187.9	438.9	–
Repurchase agreements	(1,409.6)	–	(1,409.6)	1,409.6	–	–
Total liabilities	(2,036.4)	–	(2,036.4)	1,597.5	438.9	–

(1) Collateral amounts (cash and non-cash financial collateral) are reflected at their fair value and this amount is limited to the net balance sheet exposure in order to exclude any over collateralisation.
(2) Amounts have been re-presented to be consistent with current year presentation.

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 the Bank'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 the Bank as lessee are 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)

27. 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 2017, the Bank has paid, as required, its share of the 2016/17 interest and accrued for its share of the 2017/18 interest element, payable in September 2018.

The amount of future compensation costs levies payable by the Bank 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, the Bank may be subject to other actual or potential 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 the Bank 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, the Bank 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.

28. Related party transactions

The Bank'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 the Bank which is the Board and Executive Committee. The compensation paid or payable to key management personnel is shown in the table below.

	Bank 2017 £ 000	Bank 2016 £ 000	Company 2017 £ 000	Company 2016 £ 000
Short term Partner benefits	**7,500**	7,144	**7,500**	7,144
Post-employment benefits	**892**	880	**892**	880
Other long term benefits	**4,645**	1,340	**4,645**	1,340
Share-based payments	**1,333**	2,430	**1,333**	2,430
Payments for loss of office	**30**	14	**30**	14
Total	**14,400**	11,808	**14,400**	11,808

Notes to the consolidated financial statements

Other important disclosures (continued)

28. 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.

	Bank 2017 £ 000	Bank 2016 £ 000	Company 2017 £ 000	Company 2016 £ 000
Loans				
At 1 January	**211**	262	**211**	262
Advances (includes key management personnel appointed during the year)	**242**	254	**242**	254
Interest charged during the year	**5**	8	**5**	8
Repayments (includes key management personnel who resigned during the year)	**(220)**	(313)	**(220)**	(313)
At 31 December	**238**	211	**238**	211

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 (2017: £nil).

	Bank 2017 £ 000	Bank 2016 £ 000	Company 2017 £ 000	Company 2016 £ 000
Deposits				
At 1 January	**819**	1,161	**819**	1,161
Deposits (includes key management personnel appointed during the year)	**4,892**	3,567	**4,892**	3,567
Interest expense on deposits	**–**	1	**–**	1
Repayments (includes key management personnel who resigned during the year)	**(4,371)**	(3,910)	**(4,371)**	(3,910)
At 31 December	**1,340**	819	**1,340**	819

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 TSB Group companies

Amounts due from TSB Banking Group plc totalled £12.9 million (2016: £12.8 million) and arise from the payment and recharge, in the normal course of business, of certain costs of TSB Banking Group plc, the Company's immediate parent company. Amounts due from TSB Banking Group Employee Share Trust (EST) totalled £14.8 million (2016: £10.5 million) reflecting an interest free loan to enable the EST to acquire shares in respect of the Bank's share based compensation schemes. Amounts due by the Company to other TSB Group companies of £426.6 million (2016: £2,354.2 million) arise from the Bank's securitisation programmes.

(iii) Transactions and balances with Sabadell Group companies

During 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, at 31 December 2017 the Bank deferred £124.5 million (2016: £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 Bank holds options purchased in 2016 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. At 31 December 2017, the options had a fair value of £6.9 million (2016: £3.3 million) and Sabadell had placed cash collateral with the Bank of £7.3 million (2016: £3.8 million).

Sabadell was appointed as a Joint Lead Manager in relation to the Bank's first covered bond issue, which completed in December 2017, and received a fee of £0.3 million for the services provided to the Bank.

(iv) Subsidiary undertakings

The following entities are accounted for as subsidiary companies of TSB Bank plc as it exercises control of each entity under IFRS 10 *Consolidated Financial Statements.* The registered office of each of these entities is 35 Great St Helen's, London, EC3A 6AP*:*

- Duncan Holdings 2015-1 Limited (and its subsidiary Duncan Funding 2015-1 plc);
- Duncan Holdings 2016-1 Limited (and its subsidiary Duncan Funding 2016-1 plc);
- TSB Covered Bonds LLP, TSB Covered Bonds (LM) Limited; and TSB Covered Bonds (Holdings) Limited.

Notes to the consolidated financial statements

Other important disclosures (continued)

29. Property, plant and equipment

Bank and Company	Premises £ million	Equipment £ million	Total £ million
Cost			
At 1 January 2016	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**
Additions	**26.3**	**11.1**	**37.4**
Disposals	**(4.3)**	**–**	**(4.3)**
Write-offs	**(3.6)**	**(3.4)**	**(7.0)**
At 31 December 2017	**228.8**	**102.2**	**331.0**
Accumulated depreciation			
At 1 January 2016	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**
Depreciation charge for the year (note 16)	**16.8**	**10.7**	**27.5**
Disposals	**(2.2)**	**–**	**(2.2)**
Write-offs	**(1.3)**	**(2.3)**	**(3.6)**
At 31 December 2017	**92.3**	**66.0**	**158.3**
Carrying amount			
At 31 December 2017	**136.5**	**36.2**	**172.7**
At 31 December 2016	131.4	36.9	168.3

At 31 December 2017, there was no capital expenditure authorised and contracted for but not provided or incurred (2016: £0.1 million).

Operating lease commitments

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

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Not later than 1 year	**32.4**	32.0	**32.4**	32.0
Later than 1 year and no later than 5 years	**100.1**	105.2	**100.1**	105.2
Later than 5 years	**85.3**	77.7	**85.3**	77.7
Total operating lease commitments	**217.8**	214.9	**217.8**	214.9

Operating lease payments represent rental payable by the Bank 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.

30. Other assets

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Prepaid migration costs	**124.5**	37.0	**124.5**	37.0
Other assets and prepayments	**82.9**	68.6	**82.9**	68.6
Amounts recoverable under customer remediation indemnity (note 31)	**34.2**	11.8	**34.2**	11.8
Amounts due from other TSB Group companies (note 28)	**27.7**	23.3	**27.7**	23.3
Total other assets	**269.3**	140.7	**269.3**	140.7

As discussed in Note 28(ii) on page 64, the Bank deferred £124.5 million (2016: £37.0 million) of IT Migration Programme costs incurred to date as a prepayment of charges for services from Sabadell Group that will crystallise on the completion of the final phase of the Migration Programme.

Notes to the consolidated financial statements

Other important disclosures (continued)

31. Other liabilities and provisions

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Amounts due to other TSB Group companies (note 28)	**0.1**	0.1	**426.6**	2,354.2
Accruals and deferred income	**216.8**	152.8	**216.8**	153.0
Share-based payments liability	**10.1**	6.6	**10.1**	6.6
Other creditors	**51.5**	65.7	**51.2**	65.1
Total other liabilities	**278.5**	**225.2**	**704.7**	2,578.9

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Customer remediation provision	**34.5**	10.8	**34.5**	10.8
Total provision	**34.5**	10.8	**34.5**	10.8

Significant estimates – customer remediation provision

The Bank is protected from losses arising from historic misconduct under an indemnity provided by Lloyds Bank plc. However, the Bank retains the primary liability for the alleged misconduct to its customers and a provision for customer remediation of £34.5 million has been recognised at 31 December 2017 (2016: £10.8 million). A recoverable of £34.2 million (2016: £11.8 million) has been recognised under the indemnity provided by Lloyds Bank plc (note 30). 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.

32. Notes to the consolidated cash flow statement

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

	Bank 2017 £ million	Bank 2016 £ million	Company 2017 £ million	Company 2016 £ million
Change in loans to credit institutions	**99.5**	(299.6)	**(101.9)**	(71.6)
Change in loans and advances to customers	**(1,478.0)**	(3,097.8)	**(1,478.0)**	(3,097.8)
Change in derivative assets	**32.7**	(157.0)	**41.2**	(108.1)
Change in other operating assets	**(137.1)**	(370.8)	**(137.1)**	(370.8)
Change in operating assets	**(1,482.9)**	(3,925.2)	**(1,675.8)**	(3,648.3)
Change in deposits from credit institutions	**16.4**	72.6	**16.4**	72.6
Change in customer deposits	**1,104.9**	3,545.9	**1,104.9**	3,545.9
Change in derivative liabilities	**(22.7)**	343.4	**(22.7)**	343.4
Change in other operating liabilities	**75.2**	30.0	**75.8**	32.5
Change in operating liabilities	**1,173.8**	3,991.9	**1,174.4**	3,994.4
Depreciation and amortisation	**27.8**	23.1	**27.8**	23.1
Allowance for loan losses	**77.8**	87.3	**77.8**	87.3
Other non-cash items	**10.8**	(36.5)	**(11.1)**	(125.8)
Non-cash and other items	**116.4**	73.9	**94.5**	(15.4)
Analysis of cash and cash equivalents as shown in the balance sheet				
Cash	**143.0**	174.2	**143.0**	174.2
Balances with central banks	**7,419.9**	3,473.1	**7,419.9**	3,473.1
On demand deposits	**0.5**	0.4	**0.5**	0.4
Total cash and cash equivalents	**7,563.4**	3,647.7	**7,563.4**	3,647.7

Notes to the consolidated financial statements

Other important disclosures (continued)

32. Notes to the consolidated cash flow statement (continued)

Change in liabilities arising from financing activities

Bank	Borrowings from central banks £ million	Repurchase agreements £ million	Debt securities in issue £ million	Subordinated liabilities £ million	Amounts due from other TSB Group companies £ million	Total non customer funding £ million
At 1 January 2017	5.0	1,409.6	2,940.1	413.3	–	4,768.0
Borrowings under the BoE Term Funding Scheme	5,615.0	–	–	–	–	5,615.0
Issuance of covered bonds	–	–	497.7	–	–	497.7
Repayments securitisation funding	–	–	(2,128.5)	–	–	(2,128.5)
Proceeds from repurchase agreements (net)	–	36.8	–	–	–	36.8
Non-cash movements	5.7	–	9.4	(8.0)	–	7.1
At 31 December 2017	**5,625.7**	**1,446.4**	**1,318.7**	**405.3**	**–**	**8,796.1**

Company	Borrowings from central banks £ million	Repurchase agreements £ million	Debt securities in issue £ million	Subordinated liabilities £ million	Amounts due from other TSB Group companies £ million	Total non customer funding £ million
At 1 January 2017	5.0	1,409.6	–	413.3	2,354.2	4,182.1
Borrowings under the BoE Term Funding Scheme	5,620.7	–	–	–	–	5,620.7
Issuance of covered bonds	–	–	497.7	–	–	497.7
Repayments securitisation funding	–	–	–	–	(1,927.6)	(1,927.6)
Proceeds from repurchase agreements (net)	–	36.8	–	–	–	36.8
Non-cash movements	–	–	0.3	(8.0)	–	(7.7)
At 31 December 2017	**5,625.7**	**1,446.4**	**498.0**	**405.3**	**426.6**	**8,402.0**

Notes to the consolidated financial statements

Other important disclosures (continued)

33. Future accounting developments

The following pronouncements will impact the Bank's consolidated financial statements but are not applicable for the year ended 31 December 2017 and have not been applied in preparing these consolidated financial statements.

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 impact of adoption of IFRS 9 on TSB's accounting policies and financial statements is set out on pages 36 to 38.	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 the Bank is set out on page 40.	Annual periods beginning on or after 1 January 2018
IFRS 16 *Leases*	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 the Bank is not expected to be material.	Annual periods beginning on or after 1 January 2019

34. Approval of the consolidated financial statements

These consolidated financial statements were approved by the Directors of TSB Bank plc on 1 February 2018.

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 Company is a member. TSB Banking Group plc is the Company's immediate parent undertaking and 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 de Sabadell, S.A. are expected to be available in due course from www.grupbancsabadell.com/en/.

Independent auditors' report to the members of TSB Bank plc

Report on the audit of the financial statements

Opinion

In our opinion, TSB Bank plc's (the "Bank") consolidated financial statements and the Company financial statements (the "financial statements"):

- give a true and fair view of the state of the Bank's and of the Company's affairs as at 31 December 2017 and of the Bank's profit and the Bank's and the Company's cash flows for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union and, as regards the Company's financial statements, 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 and, as regards the Bank financial statements, Article 4 of the IAS Regulation.

We have audited the financial statements, included within the Annual Report and Accounts 2017 (the 'Annual Report'), which comprise: the Bank and Company balance sheets as at 31 December 2017; the consolidated statement of comprehensive income for the year then ended; the Bank and Company statements of changes in equity for the year then ended; the Bank and Company cash flow statements for the year then ended; and the notes to the financial statements, which include a description of the significant accounting policies.

Our opinion is consistent with our reporting to the Audit Committee.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We remained independent of the Bank in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

To the best of our knowledge and belief, we declare that non-audit services prohibited by the FRC's Ethical Standard were not provided to the Bank or the Company.

Other than those disclosed in note 16 to the financial statements, we have provided no non-audit services to the Bank or the Company in the period from 1 January 2017 to 31 December 2017.

Our audit approach

Overview	
Materiality	Overall Bank and Company materiality: £13.2 million (2016: £9.1 million), based on 5% of adjusted Bank profit before tax.
Audit scope	The scope of our audit and the nature, timing and extent of audit procedures performed were determined by our risk assessment, the financial significance of reporting units and other qualitative factors (including history of misstatement through fraud or error).
Areas of focus	The areas of focus for our audit which involved the greatest allocation of our resources and effort were: • Impairment of retail loans and advances to customers; and • Multiple economic scenarios, expert credit judgements and selection of 'staging' thresholds as they relate to the transitional disclosure of IFRS 9.

Independent auditors' report to the members of TSB Bank plc

The scope of our audit

As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the financial statements. In particular, we looked at where the directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain.

We gained an understanding of the legal and regulatory framework applicable to the Bank and the industry in which it operates, and considered the risk of acts by the Bank which were contrary to applicable laws and regulations, including fraud. We designed audit procedures to respond to the risk, recognising that the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion. We designed audit procedures that focused on the risk of non-compliance of banking law and regulation relevant to the Bank's financial statements, for example compliance with the Consumer Credit Act and financial conduct issues. Our tests included inspecting correspondence with regulators, discussions with legal counsel, and testing particular classes of transactions. We did not identify any key audit matters relating to irregularities, including fraud. As in all of our audits, we also addressed the risk of management override of internal controls, including testing journals and evaluating whether there was evidence of bias by the directors that represented a risk of material misstatement due to fraud.

Key audit matters

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

Key audit matter	**How our audit addressed the key audit matter**
Impairment of retail loans and advances to customers	
Impairment of loans and advances to customers is a key audit matter as it is an area where a high level of judgement is applied in determining the necessity for, and then estimating the size of, any impairment. Retail impairment is calculated on a modelled basis for each portfolio of loans. Inputs to the models are primarily based on historical data. Management have adjusted the modelled provisions to take account of risks associated with the high level of affordability of loans in the current interest rate environment and uncertainties around future house prices. We therefore focused our work on testing these model adjustments.	• We identified and tested the design and operating effectiveness of key controls over the impairment models. We determined that these controls were effective and could be relied upon for the purpose of our audit. • We tested the key assumptions, using modelling specialists where appropriate, in the impairment calculation and also agreed them to historical data where appropriate. • We tested the accuracy and completeness of underlying data used in the impairment models. We found no material differences in these tests. • We tested all significant model adjustments, including considering the basis for the adjustment, the logic applied, the source data used and the key assumptions adopted. We found these adjustments to be reasonable and supportable. • We also considered the completeness of model adjustments identified for latent risks given our own assessment of the industry and economic environment. We did not identify any additional material latent risks not considered by management. Based on the evidence we obtained, we determined that the impairment model assumptions, data used within the models and model adjustments were reasonable and the resulting estimate is in accordance with accounting standards.

Independent auditors' report to the members of TSB Bank plc

Key audit matter	How our audit addressed the key audit matter
Multiple economic scenarios, expert credit judgements and selection of 'staging' thresholds as they relate to the transitional disclosure of IFRS 9	
IFRS 9 will be implemented by the Bank on 1 January 2018. This is a key audit matter for the 31 December 2017 accounts as the impact of this transition is disclosed in the notes to the financial statements, therefore is subject to audit. The IFRS 9 standard includes a new impairment model, where losses are recognised on an expected loss basis. This contrasts to the treatment under IAS 39, where losses are recognised when incurred and there is evidence to support the fact the loan may not be recoverable. Furthermore, expected credit losses are required to be measured on a forward-looking basis, reflecting the Group's view of potential future economic events. We focused our audit work on the areas of the methodology that we identified as most judgemental. There are three areas we focused on: 1. Expert credit judgements made by management by adjusting the core IFRS 9 models; 2. The thresholds selected to determine a significant increase in credit risk ('staging') and hence whether a 12 month or lifetime loss provision is recorded; and 3. Determining appropriate assumptions in applying forward looking multiple economic scenarios in the models.	• We performed testing to confirm that the methodology in the newly developed models complied with the requirements of IFRS 9. • We understood and critically assessed the models used, including performing independent empirical tests on key model components. No exceptions were noted. • To validate management's 'staging' thresholds, we re-performed key aspects of management's testing and also performed independent back testing to confirm that the criteria selected by management were reasonable. No exceptions were noted. • When testing the application of forward looking information, we validated the accuracy and soundness of the model, and compared the forward looking assumptions to publically available benchmarks and PwC consensus views. • We performed substantive testing on significant expert credit judgments made by management and considered the completeness of adjustments to core models to take account of latent risks. We concluded that the assumptions in expert credit judgements were reasonable and did not identify any additional material latent risks not considered by management. • We performed substantive testing on the extraction of key data from underlying systems and data warehouses that is used in the models without exception. As management continue to implement IFRS 9, we will continue to assess the transitional impact. • We reconciled the IFRS 9 transitional impact disclosed on pages 36 to 38 of the accounts to source calculations and models without exception. Based on the evidence obtained we found that the impairment model assumptions, data used within the models and expert credit judgements made by management to be reasonable and therefore concluded that the transitional impact disclosed is reasonable.

Independent auditors' report to the members of TSB Bank plc

How we tailored the audit scope
We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the structure of the group, the accounting processes and controls, and the industry in which it operates. We scoped the Bank and Company as one component.

For each financial statement line item we considered the financial significance and qualitative factors, including the presence of any significant audit risks, to determine our audit scope. Additionally the risk of material misstatement was mitigated through audit procedures including testing of entity level controls and analytical review procedures.

We do not rely on any component auditors or other PwC offices. As TSB still use the Lloyds Banking Group plc IT platforms, we place reliance on the 'ISAE 3402 report on controls placed in operation and tests of operational effectiveness', that is performed by Lloyds' external auditors.

Materiality
The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating the effect of misstatements, both individually and in aggregate on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Bank financial statements	*Company financial statements*
Overall materiality	£13.2 million. This is the first year that the Bank has prepared consolidated accounts.	£13.2 million.
How we determined it	For the Bank we used 5% of profit before tax, adjusted for one-off transition costs, as these are not considered to be recurring.	1% of total assets, capped to Group overall materiality of £13.2 million
Rationale for benchmark applied	Statutory profits have been adjusted to remove costs in relation to the transition from Lloyds Banking Group. These costs are material for 2017, but do not reflect the underlying business performance management is focusing on and are not expected to recur. Management have separately disclosed these costs on page 15 of the TSB Banking Group plc Annual Report. Therefore adjusted profits is considered an appropriate benchmark upon which to base our materiality.	As the Company is not profit oriented on a solo-entity basis, we have used 1% of total assets but cap this to the lower materiality of the Bank.

There is no component materiality, however certain balances were audited to a local statutory audit materiality that was less than our overall Bank materiality.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £0.7 million as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

Conclusions relating to going concern
We have nothing to report in respect of the following matters in relation to which ISAs (UK) require us to report to you when:

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

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Bank's and Company's ability to continue as a going concern.

Independent auditors' report to the members of TSB Bank plc

Reporting on other information
The other information comprises all of the information in the Annual Report other than the financial statements and our auditors' report thereon. The directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except to the extent otherwise explicitly stated in this report, any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify an apparent material inconsistency or material misstatement, we are required to perform procedures to conclude whether there is a material misstatement of the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

With respect to the Strategic Report and Directors' Report, we also considered whether the disclosures required by the UK Companies Act 2006 have been included.

Based on the responsibilities described above and our work undertaken in the course of the audit, ISAs (UK) require us also to report certain opinions and matters as described below.

Strategic report and Directors' report
In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic Report and Directors' Report for the year ended 31 December 2017 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

In light of the knowledge and understanding of the Bank and Company and their environment obtained in the course of the audit, we did not identify any material misstatements in the Strategic Report and Directors' Report.

Responsibilities for the financial statements and the audit
Responsibilities of the directors for the financial statements
As explained more fully in the Statement of Directors' responsibilities set out on page 13, the directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The directors are also responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

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

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

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditors' report.

Use of this report
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.

Independent auditors' report to the members of TSB Bank plc

Other required reporting

Companies Act 2006 exception reporting
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
- certain disclosures of directors' remuneration specified by law are not made; or
- the Company financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Appointment
Following the recommendation of the Audit Committee, we were appointed by the members on 1 January 1997 to audit the financial statements for the year ended 31 December 1997 and subsequent financial periods. The period of total uninterrupted engagement is 21 years, covering the years ended 31 December 1997 to 31 December 2017.

Laura Needham (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
1 February 2018

Contacts

For further information please contact:

Media

Charlotte Sjoberg
Head of Media Relations
Phone: +44 (0)207 003 9281 / 9369
Mobile: +44 (0)7901 104067
Email: charlotte.sjoberg@tsb.co.uk

Abigail Whittaker
Senior Media Relations Manager
Phone: +44 (0)207 003 9462
Mobile: +44 (0)7795 300734
Email: abigail.whitaker@tsb.co.uk

Investors and analysts

investorrelations@bancsabadell.com