TSB Banking Group plc

Annual Report and Accounts 2018

“2018 was TSB’s most challenging year, but we enter 2019 with renewed ambition to regain our position as the leading challenger bank in the UK.”

Richard Meddings,
Executive Chairman, TSB

“2018 was TSB’s most challenging year and we are sorry for letting our customers down.

Looking forward, we’re now a stronger bank for our experience, with a trusted brand, able to serve more customers in more communities than ever before.”

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Strategic report

Summary results

Summary consolidated balance sheet

	2018 £ million	2017 £ million	Change %
Loans and advances to customers	**30,008.5**	30,854.2	(2.7)
Other assets	**11,115.8**	11,671.3	(4.8)
Total assets	**41,124.3**	42,525.5	(3.3)
Customer deposits	**29,084.3**	30,520.6	(4.7)
Other liabilities	**10,176.0**	10,009.3	1.7
Shareholder's equity	**1,864.0**	1,995.6	(6.6)
Total equity and liabilities	**41,124.3**	42,525.5	(3.3)

Summary consolidated statutory income statement

	2018 £ million	2017 (1) £ million	Change %
Net interest income	**884.8**	925.9	(4.4)
Other income	**406.1**	173.9	133.5
Total income	**1,290.9**	1,099.8	17.4
Operating expenses	**(1,323.0)**	(859.3)	54.0
Impairment	**(73.3)**	(77.8)	(5.8)
Statutory (loss)/profit before taxation	**(105.4)**	162.7	(164.8)
Taxation	**42.4**	(44.0)	(196.4)
Statutory (loss)/profit for the year	**(63.0)**	118.7	(153.1)

Management basis profit before taxation

	2018 £ million	2017 £ million	Change %
Franchise (excluding additional post migration charges)	**173.3**	119.7	44.8
Post migration charges (2)	**(330.2)**	–	
Recovery of post migration charges	**153.0**	–	
Mortgage Enhancement portfolio	**–**	61.7	
Management (loss)/profit before taxation	**(3.9)**	181.4	(102.1)
Migration related income from LBG	**318.3**	–	
Costs of preparing for TSB's migration (3)	**(417.3)**	–	
Banking volatility (4)	**(8.7)**	10.1	(186.1)
One-off items (5)	**6.2**	(28.8)	(121.5)
Statutory (loss)/profit before taxation	**(105.4)**	162.7	(164.8)

Key performance indicators

Operational (explained in the context of our business model on page 9)			
Customer advocacy – Net Promoter Score (NPS) (6)	**(9)**	27	(36)
Share of new personal bank account gross flow (7)	**3.6%**	6.2%	(2.6)pp
Mortgage gross new lending (£ million)	**4,803.5**	7,001.5	(31.4)%
Financial			
Loan to deposit ratio	**103.2%**	101.1%	2.1pp
Common Equity Tier 1 Capital ratio (fully loaded)	**19.5%**	20.0%	(0.5)pp
Leverage ratio (fully loaded)	**4.4%**	4.5%	(0.1)pp
Group banking net interest margin (8)	**2.87%**	3.02%	(15)bps
Asset quality ratio (9)	**0.24%**	0.25%	(1)bp

(1) Interest on trading derivatives entered into as economic hedges has been reclassified to interest income from gains or losses on financial assets and liabilities held for trading to align with current year presentation.
(2) Increased operating expenses of £296.7 million (comprising customer redress and associated costs of £107.3 million, customer rectification and associated costs of £17.9 million, fraud and operational losses of £49.1 million, additional resource and advisory costs of £122.4 million) and lower income in the form of waived interest and fee income of £33.5 million.
(3) Comprising £249.0 million payable to Sabadell under the Migration Services Agreement, £44.3 million of associated VAT, £187.7 million of project related costs, offset by reimbursement by LBG of £63.7 million of VAT related costs.
(4) Banking volatility reflects gains and losses on derivatives not in hedge accounting relationships, hedge accounting ineffectiveness, and volatility associated with share schemes.
(5) One off items reflect changes to the branch network and movement in Partner reward schemes.
(6) NPS is based on the question "On a scale of 0-10, where 0 is not at all likely and 10 is extremely likely, how likely is it that you would recommend TSB to a friend or colleague?" NPS is the percentage of TSB customers who give a score of 9 or 10 after subtracting the percentage who give a score 0 to 6. Calculated as a 3 month rolling average.
(7) 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. Calculated on a 12 month rolling average basis. Data presented on a 2 month lag.
(8) Management basis net interest income divided by average loans and advances to customers, gross of impairment allowance (see page 16).
(9) Impairment charge on loans and advances to customers divided by average loans and advances to customers, gross of impairment allowance.

Executive Chairman’s statement

It is five years since TSB was launched back onto high streets across Britain. In this time, we have established our credentials as a values-led, full service challenger bank, with over 200 years of heritage, a trusted brand and a mission to make banking better for all UK consumers.

However, 2018 was an incredibly challenging year for TSB as we moved to our new IT platform.

On behalf of everyone at TSB, I want to say sorry again for the service disruption which followed the IT migration, and for letting our customers down. I also want to thank every TSB Partner for their dedication and service over the past 12 months. Despite our difficulties and the resulting short-term financial impact this has caused, with a statutory loss before tax of £105.4 million in 2018, we continue to make good progress as a challenger bank, and we are looking forward with real optimism and renewed ambition in 2019.

This year I have no doubt we will start to re-emerge as the UK’s leading challenger bank – firmly on the side of the customer. We have a truly customer-focused team, strong banking systems, and are back on a growth strategy. We will also have new leadership with Debbie Crosbie who joins us, subject to regulatory approval, as Chief Executive in the Spring.

TSB’s IT migration

On 22 April 2018 TSB moved to a new IT system developed and implemented by TSB’s IT provider, Sabis (also a wholly owned subsidiary of Sabadell), with support from a range of telecommunications and technology firms. Whilst the migration of all customer records took place as planned, customers experienced problems in the initial period after migration in accessing their accounts online, with long wait times on the phone and slower transaction times in our branches. The large amount of publicity this created also precipitated an intense fraud attack on TSB’s customers. I know how frustrated many customers have been by what happened. It was not the level of service our customers deserve and we have been working hard to put things right for them. Our Migration Report on pages 6 and 7 provides a more comprehensive analysis of the strategic case for the IT migration, the steps we took to prepare and how we have responded.

Our immediate focus in the period following the migration was on resolving the service issues impacting our customers, and then moving swiftly to identify and fix the causes of these issues. Our internal analysis indicated that the design of the platform itself was sound, but that the deployment onto the technical infrastructure led to many of the problems. The underlying issues related primarily to elements in three key areas, the initial configuration and the capacity of the infrastructure, and some aspects of coding. A programme of remediation work, overseen by the Board Audit Committee, was implemented to resolve these issues.

The TSB Board also commissioned an independent review, from Slaughter and May, to understand why these problems occurred, and the FCA and PRA are conducting their own joint investigation. The TSB Board asked Slaughter and May to work as expeditiously as the process, which is independent of the Bank, allows, whilst also respecting the corresponding work of the FCA and PRA, so that TSB can learn from, and act on, its findings. This review is underway, and Slaughter and May is working through the significant volume of evidence to deliver a report as soon as is practically possible.

At the beginning of September, the TSB Board announced that Paul Pester was stepping down from his position as Chief Executive and leaving the Company. Notwithstanding the much-improved levels of service delivered since migration, Paul and the Board agreed that it was the right time for a change of CEO. Paul made an enormous contribution to TSB and on behalf of the TSB Board, I want to reiterate my thanks to Paul for everything he achieved.

TSB’s immediate priorities following the IT migration

At the time Paul Pester stepped down, the TSB Board asked me to take on the role of Executive Chairman on an interim basis. Together with the Executive Committee, we set three immediate priorities: (1) to complete the work of putting things right for customers; (2) to enable the bank to achieve full functionality for customers – including the availability of all product services and the launch of a leading business banking offer; and (3) to appoint a CEO for the next chapter of TSB.

At the time of writing, I can report that we have made very significant progress against each of these and achieved this at good pace.

Executive Chairman’s statement (continued)

Putting things right for customers

Since migration, our absolute focus has been on resolving the IT issues and ensuring that every customer who was affected is compensated properly. To respond to the issues, significant resource has been added, with over 2,100 people recruited and 700 Partners redeployed, in addition to around 500 people recruited ahead of migration.

Following the service disruption, we created a dedicated team to resolve every customer complaint. We grew this team from 54 people prior to April to over 700 people at its peak. As part of our remediation framework, we made a firm commitment that no customer would be left out of pocket where they had experienced financial loss, and that we would also take any distress or inconvenience that our customers had experienced into consideration. Throughout the process we have continued to combine the desire to accelerate the rate of complaint resolution, for example by increasing the number of Partners devoted to resolving customer complaints and simplifying the approach to determine distress and inconvenience payments for customers, with the need to ensure that each complaint is considered and resolved properly in line with regulatory obligations.

As of 30 January 2019, we have resolved circa 181,000 complaints from customers since migration, around 90% of the 204,000 complaints received, of which an estimated 25% would have occurred in the ordinary course of business. New complaints now being received are significantly lower in volume, closer to pre-migration levels, with the majority no longer connected to migration issues.

Enabling the bank to achieve full functionality for customers

All critical and urgent IT fixes have been applied and the most significant customer-facing issues have been resolved. Although we still see occasional IT issues and interruptions, the number of these incidents has reduced significantly since the immediate post migration period and IT services are now stable and within the range of industry performance, including, for example, processing the greater volume of transactions seen during intense periods like ‘Black Friday’ in November.

Customers are now starting to see the benefits of the new IT system come through, with one single platform and faster processing times for some of our services for Partners and customers. For example, our mortgage brokers can submit mortgage applications in half the time compared to pre-migration and can upload documents in real time. As a result, in December we saw the highest level of mortgage applications of any week in TSB’s history. Towards the end of 2018, customers also started to see more products become available through our online channels for the first time since migration. Online current account sales have now returned to levels consistent with the most recent comparable pre-migration period and similarly, we now receive 90% fewer calls from customers needing help with their online applications due to our significantly improved application process. Customers can also open a current account in our branches in almost half the time compared with before migration.

In 2019, we are also going to make a significant move into business banking supported initially in 2018 by £11.7 million of investment covering areas including improvements to customer onboarding processes and growth in the number of relationship managers. We have over 100,000 business customers currently, but we want to grow this with new customers in every town and city whom we serve with great products – our business current account, savings, lending, and innovative partnerships that help small businesses grow and serve their own customers brilliantly. We have already been named as a participant in the Incentivised Switching Scheme and we have submitted our bid for a grant from the Capability and Innovation Fund.

Appointing a new CEO for TSB

In November, the Board of TSB, with the support of our parent Sabadell, was pleased to announce that Debbie Crosbie will join the TSB Board as CEO, subject to regulatory approval. Debbie joins from CYBG PLC where she has worked for over twenty years. In an impressive field of candidates, Debbie stood out. With over two decades of experience, superb retail and SME banking expertise, and an open and engaging style of leadership, we have found an outstanding new CEO. Debbie brings a clear challenger mindset to TSB and shares our vision of making banking better for all UK customers. She will join TSB in the Spring.

Financial summary

TSB’s 2018 financial performance was significantly impacted by the IT migration and subsequent service disruption. As a result, TSB incurred a statutory loss before tax of £105.4 million, a reduction of £268.1 million compared to the profit of £162.7 million in 2017. This was predominantly driven by additional charges associated with the post migration service disruption of £330.2 million. This includes customer compensation, fraud and operational losses, additional resource and advisory costs and foregone income predominantly as a result of waived overdraft fees and interest charges.

Executive Chairman’s statement (continued)

TSB’s common equity tier 1 capital ratio remained relatively stable at 19.5%. During 2018, customer deposit balances decreased by £1.4 billion (4.7%) to £29.1 billion reflecting a planned reduction in savings balances through the year. Notably, current account deposits have continued to increase year-on-year, having grown from £11.0 billion to £11.3 billion throughout 2018. Around 140,000 customers opened a new bank account or switched their account to TSB in 2018, and TSB now has 3.8 million current account customers and over 5 million customers in total. Around 80,000 customers switched their bank account away from TSB in 2018 with volumes peaking when we experienced our IT issues in the second quarter of the year. This compares with around 50,000 customers switching their account away from TSB in 2017.

Helping local communities to thrive

Helping local communities and local businesses to thrive is just one element in being an essential part of the fabric of communities and their high streets – along with creating jobs, tackling fraud, and helping those in need through our charity partnerships. At a time when some banks are retreating from communities, we’re proud of maintaining a branch network across the whole country, supported by digital and telephone banking options. This means we can serve customers the way they genuinely want to be served, rather than forcing them to bank in a specific way.

Our Partners in branches and offices continue to work with good causes or charities in their local communities and, since the launch of our new communities’ strategy in February 2015, £3 million has been donated to over 1,300 local causes. In addition to these fundraising activities, TSB Partners have spent more than 13,000 hours, when they would normally be working, supporting a local good cause in their community. Also, in 2018 TSB has continued to demonstrate its commitment to help local communities by partnering with Trinity Mirror for Pride of Britain and Pride of Sport. These awards celebrate ordinary people who do extraordinary things for the benefit of their local communities.

Outlook – delivering through uncertainty

While the loss incurred in 2018 has contributed to the reduction in TSB’s capital ratio from 20.0% to 19.5%, TSB remains one of the most strongly capitalised banks in the UK and, with a healthy liquidity reserve, is well positioned both to weather economic uncertainty or shocks but also to deploy its financial reserves in further growth. While we continue to be confident in the relative strength of the UK economy, we are mindful of the challenges ahead, as economic and market conditions remain uncertain for a range of reasons, including the UK’s exit from the EU.

Whilst the migration to our new platform caused considerable frustration and difficulties, looking forward we remain confident that the platform is now delivering real benefits to customers and, importantly, also enables TSB to support more local businesses right across the UK.

Conclusion

2018 has been TSB’s most challenging year. Despite our difficulties, and the associated short-term financial impact, I have no doubt that in 2019 we will re-emerge as the UK’s leading challenger bank – firmly on the side of the customer with a truly customer-focused team, strong banking systems, and back on a growth strategy under new leadership with Debbie Crosbie, subject to regulatory approval.

I want to acknowledge our TSB Partners for all their hard work and thank them again for putting things right for our customers – without their dedication and service TSB would not be where it is today. To acknowledge this exceptional team effort across the business to put things right for customers, the Board recognised all TSB Partners (excluding members of the Bank Executive Committee) with a cash award of £1,500 in December. However, no other bonuses will be paid this year and the TSB Award, an annual performance-related award based on achievement of key customer service metrics and paying Partners a flat percentage of salary, will also not be paid.

I also want to thank the TSB Board for their intense commitment throughout 2018 and the wholehearted support that they have shown to the TSB Executive team. I also take this opportunity to thank Sandy Kinney, who stepped down from the Board in December, for her considerable contribution to TSB and for chairing our Risk Committee and to welcome Andy Simmonds who joined the Board in July.

Although there will be moments when we will have to look back to the events of 2018, we’re now a stronger bank for our experience, with a trusted brand, able to service more customers in more communities than ever before. I am very proud of how the Bank and its Partners have dealt with the challenges of the year and am confident in the prospects of TSB and in its improving ability to deliver the service our customers expect. We have come through a very difficult systems migration, but now operate on a more coherent, responsive and modern platform as the foundation for our future success, differentiating us from many of our competitors.

Richard Meddings
Executive Chairman

Migration report

Background

In April 2018, TSB completed its phased migration onto a new IT platform built by Sabis, a subsidiary of TSB's parent company, Sabadell. The new IT platform covers all customer systems and channels as well as all back office and Partner-based systems and is critical to TSB's long-term ability to deliver for customers.

When TSB was initially established, it rented its IT platform from Lloyds Banking Group (LBG), one of its competitors operating on legacy banking systems. This meant that making changes to TSB's products and services was slow, and the cost, timing, design and pace of executing changes was set by a competitor. In June 2015, the acquisition of TSB by Sabadell provided the opportunity to leverage their significant experience in migrating the Bank to a new system, which would enable TSB to provide better products and services more suited to its customers' needs.

Preparation

The design and build of TSB's new system took place over a period of almost three years. Subsequently, before TSB made the decision to migrate to the new platform, a significant testing programme was undertaken. This included functional testing of business processes, non-functional testing on the IT architecture and performance, systems integration testing, and a series of dress rehearsals to practise moving the data across to the new system ahead of migration.

A comprehensive assurance process was established for each area of TSB to confirm that it was ready to enter the migration process. This process was used to:

- confirm the adequacy and completeness of the system design, build and testing;
- confirm organisational readiness to use the new platform;
- confirm the availability of resources and processes to respond to post migration incidents;
- establish a process to manage the introduction of functionality that was scheduled to "go live" after the migration event; and
- assess plans to validate that the systems operated as expected post migration.

This was subject to a broad programme of Risk function oversight and Internal Audit assurance, supported by a number of external advisors and was the subject of continuous engagement with the FCA and PRA, the Bank's primary regulators. In advance of the final migration weekend, TSB also recruited and trained additional Partners so that its customers could be supported through the changes in the immediate post migration period.

The Board Audit Committee was requested by the Board to oversee the management of the risks arising from the migration programme. The Board Audit Committee report on page 43 includes a comprehensive summary of the scrutiny and challenge it brought to the programme.

The IT migration event

On 22 April 2018 TSB moved to its new IT system. This involved moving around eight million customer records onto a new consolidated platform. The migration of core banking data completed successfully, with all customers' records transferring accurately.

However, at migration a number of infrastructure components did not perform to TSB's expectations. Thus, the migration event led to unexpected problems for customers in accessing their accounts through internet banking and the mobile app, in the initial period after migration. TSB's two other customer facing channels, telephony and branch, also experienced challenges with platform instability which was exacerbated by the significantly higher levels of customer demand resulting from the problems with the digital channels and the additional publicity. As a consequence, some customers experienced long wait times on the phone and slower transaction times in branches.

We acknowledge, in summarising the impacts on our customers post migration, we can't do justice to the individual experience of every customer, some of whom had more complicated issues. For example, some customers were affected by the use of old telephone numbers for SMS texts, or faced issues in processing certain types of payments, or had problems with receiving cards and chequebooks.

These events, coupled with the large amount of publicity, also precipitated fraudsters to switch their activity from other banks towards TSB's customers. While our fraud-prevention defences remained up and running, the systems issues created circumstances in which fraudsters were more easily able to confuse and entrap customers. We took the decision to refund all customers who were the victims of fraud at the time of the attack and for several months afterward, without seeking to attribute any potential responsibility for the loss to customers' actions. We also immediately informed and worked closely with law enforcement and a number of arrests have been made. In December 2018, we announced that TSB will fund a number of initiatives and take a leading role in gathering industry support to help law enforcement in fighting fraud.

Migration report (continued)

The IT migration event (continued)

Whilst customers experienced problems in accessing their accounts, the core record keeping and account management functions within the platform continued to operate predominantly as designed which allowed the fundamental components of the Bank such as debit cards, credit cards, regular payments and ATMs to work as normal. As part of the migration programme, TSB successfully joined the Faster Payments and BACS payments schemes and switched agency providers for CHAPS. TSB has consistently met the payment scheme service levels since migration. Whilst there were minor issues, TSB's overnight batch runs completed ensuring customer balances were correctly updated and direct debit and standing order runs completed.

As outlined in the Executive Chairman's statement, internal analysis indicated that the design of the platform itself was sound, but that the deployment onto the technical infrastructure led to many of the problems. Primarily, the underlying issues related to aspects of three key inter-connected areas – the initial configuration, the capacity of the infrastructure, and also some aspects of coding. Configuration is important to enable technology systems to accurately reflect the designed functionality; capacity is required to support a volume of concurrent users; and coding influences the way customers and TSB interact with each other, for example, determining how an unexpected error message is presented.

As a consequence of the migration issues, TSB and Sabadell representatives gave evidence twice, and very soon after the migration, to the Treasury Select Committee outlining the issues that TSB customers had experienced. TSB continues to maintain an ongoing dialogue with the Treasury Select Committee, providing updates on the Bank's progress and performance in putting things right for customers.

Putting things right for customers

As soon as our post migration monitoring processes identified that problems were emerging, the business continuity processes that had been designed for such eventualities were invoked. Incident management protocols were activated through a framework of 'war-rooms' where issues were prioritised, triaged by the appropriate business areas within TSB, and fixes identified and effected by Sabis. As the scale of the issues became apparent, steps, including the appointment of IBM to help identify and resolve performance issues in the platform, were taken to enhance the IT change management processes. Further to the 500 additional staff taken on in advance of, and to assist with, migration the Bank hired another 2,100 individuals and redeployed 700 Partners to manage the emerging issues and help put things right for customers.

A formal remediation programme was implemented to oversee the programme of work to stabilise TSB's IT service and was overseen by the Board Audit Committee. The steps TSB has taken to put things right for customers are outlined in the Executive Chairman's statement on page 4. TSB has also commissioned an independent review, from Slaughter and May, so that the Bank can learn from, and act on, its findings. The review will, among other aspects of the migration programme, consider the governance arrangements around the preparations for the migration, making the decision to migrate, as well as why the issues arose.

TSB now operates on a more coherent, responsive and modern platform, positively differentiating it from many of its competitors and providing a foundation for future growth. The Bank is sorry that it caused considerable frustration and difficulties for many of its customers in the period after migration. The second half of 2018 focused on putting things right for the customers impacted by this and applying all critical and urgent fixes. The platform is now, however, delivering real benefits to customers. Importantly the new platform enables TSB to support more customers and more local businesses right across Britain, allowing the Bank to have an even bigger economic and social impact in the communities we serve.

How we seek to create value – our business model

What's our purpose?
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'.

What's our strategy?
TSB strategy is one of measured growth. The strategy is aimed at efficiently growing our key market shares by utilising the substantial scale of our distribution capability and infrastructure. The key components of TSB's strategy are to grow our share of the current account market, to lend more to people right across Britain, and to continue to enhance our proposition including deploying our considerable digital banking capability and strengthen our position in the small business banking market.

What are TSB's principal activities?
TSB is a fully functioning UK bank with a multi-channel, national distribution model, including 551 branches with coverage across the UK and a full digital (internet and mobile) and telephony capability. TSB offers a range of banking services and products to individuals and predominantly 'micro' business banking customers throughout the UK.

Deposits
- Personal current accounts (PCA) - for many retail customers, a PCA is at the core of their overall relationship with a bank. PCAs typically provide retail banks with loyal customers and a source of resilient, low-cost funding. Whilst TSB offers attractive rates of interest on qualifying balances held on some of our PCA products, in common with other banks, the majority of our PCA balances are non-interest bearing.
- Savings accounts - savings accounts can offer a fixed interest rate for a fixed term, or a variable interest rate (which may change at the discretion of the Bank but often moves in response to changes in the Bank of England Base Rate). Variable rate savings accounts may also include a bonus rate on top of the standard variable deposit rate for a specified term. Savings accounts can either be instant access (where customers can withdraw the deposits at any time) or term deposits (where customers can only withdraw deposits without penalty at the end of the term).

Residential mortgages
TSB's mortgage portfolio consists solely of loans to individuals secured on residential properties located in the UK. TSB offers mainstream mortgages (where the borrower is the owner and occupier of the mortgaged property) and buy-to-let lending (where the borrower intends to let the mortgaged property). TSB does not offer mortgages to borrowers who self-certify their income or who have adverse credit histories (sub-prime).

Unsecured lending
- Personal loans – TSB's personal loans portfolio consists of fixed rate lending to customers on an unsecured basis. Our customers use the funds from their loans for a variety of purposes, including for purchasing a car, debt consolidation (that allow our customers to refinance and combine their existing debt), home improvement (for customers looking to extend, convert, refurbish or renovate their home) and graduate loans (for customers who require assistance with their finance following graduation).
- Credit cards - Credit cards meet a range of customers' buying and borrowing needs. While TSB's focus is providing compelling credit card propositions and pricing to meet the needs of its existing current account customers and to deepen the banking relationship with them, we also offer credit card products to customers who do not have an existing relationship with TSB.
- PCA overdrafts - TSB offers overdrafts to its PCA customers. Planned overdrafts are overdrafts that have been formally agreed by TSB. From time to time, customers will exceed their overdraft limit resulting in unplanned overdrafts which have not been formally agreed to by TSB. This occurs where a PCA customer pays or withdraws money from their PCA in excess of their credit balance or the amount of their planned overdraft limit.

Business banking
As TSB initially focused on retail customers, its business banking services are geared towards the needs of 'micro' business customers, which TSB defines as business banking customers with a revenue of less than £1 million and borrowing requirements of no more than £1 million. As outlined in the Executive Chairman's statement, TSB plans to broaden its offering to small businesses in 2019.

Insurance products
TSB offers general insurance products to retail customers, underwritten by Aviva Insurance Limited, through its branch, digital and telephony channels.

How we seek to create value – our business model

Our business model is simple

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

Component	Description	2018 performance	Financial statements	Key performance indicator
Banking experience	We seek to deliver a banking experience that is the primary reason for customers to choose and remain with TSB, and which will increasingly set TSB apart from other banks and providers of financial services. Central to this is the development of our brand, investment 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.	n/a	n/a	**Customer advocacy (Net Promoter Score)** 2018: (9) 2017: 27
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 funding in the form of equity capital in the business.	Page 12	Page 69	**Share of personal bank account gross flow (%)** 2018: 3.6% 2017: 6.2% **Share of PCA stock (%)** 2018: 4.5% 2017: 4.6%
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 14	Page 73	**Mortgages gross lending (£m)** 2018: 4,803.5 2017: 7,001.5
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 16	Page 84	**Net interest margin (%)** 2018: 2.87% 2017: 3.02%
Charges	Charges we incur include the costs of paying our TSB Partners, running our branches, investing in our business and paying for advertising and marketing. Occasionally, our customers are unable to repay the money they borrow from us; this is also a cost to the bank in the form of an impairment charge. Finally, TSB complies with its tax obligations to Her Majesty's Revenue and Customs (HMRC).	Page 17	Page 87	**Cost:income ratio (management basis) (%)** 2018: 92.9% 2017: 76.0% **Asset quality ratio (£m)** 2018: 0.24% 2017: 0.25%
Profits and returns to the shareholder	The Board reviews all aspects of TSB's performance. It decides whether profits are put aside for future investment in the business, for protection against the uncertainties that TSB faces, or returned to the shareholder in the form of dividends.	Page 10	Page 92	**Return on equity (%)** 2018: (3.3)% 2017: 6.1%
Risk management	Banking is based on the effective evaluation of risks and ensuring an appropriate return is earned for taking them. The overall level of risk we are willing to take, our 'risk appetite', is determined by our Board, and robust systems and practices are in place to support TSB operating in line with these predetermined parameters. This helps protect both our customers' and the shareholder's interests.	Page 19	Page 93	Not applicable

Non-financial disclosures

Being responsible is a core value at TSB. TSB is mindful of the impact that its actions can have on customers and local communities across Britain as well as on its Partners. We outline the importance of the role that our Partners play and our commitment to our wider social responsibilities in the Executive Chairman's statement on pages 3 to 5 and in the Partners' report on pages 47 to 49. TSB's Modern Slavery Statement (which is available on our website) sets out the policies we apply and actions we take to ensure that our Partners and customers are treated with dignity and respect, in particular raising awareness of issues that could put our customers at risk such as vulnerability and exploitation. The statement also explains how we ensure that TSB's values are applied within our supply chain including the due diligence we carry out on our suppliers.

While TSB does not have a formal environmental policy, we are also committed to reducing our environmental impact and using resources in a more responsible way as outlined in the Directors' report on page 46. Financial crime (including bribery and corruption) is one of the principal risks that we face as a bank and the Risk management section, on page 25, describes the steps we take to mitigate this risk.

Financial performance in 2018

TSB's performance is presented on a statutory basis and structured in a manner consistent with the key elements of TSB's business model as explained on page 9.

Profitability (statutory basis)

	Analysis	2018 £ million	2017[1] £ million
Net interest income	Page 16	**884.8**	925.9
Other income	Page 16	**406.1**	173.9
Total income		**1,290.9**	1,099.8
Operating expenses	Page 17	**(1,323.0)**	(859.3)
Impairment	Page 18	**(73.3)**	(77.8)
Statutory (loss)/profit before tax		**(105.4)**	162.7

(1) Interest on trading derivatives entered into as economic hedges has been reclassified to interest income from gains/(losses) on financial assets and liabilities held for trading to align with current year presentation.

TSB incurred a statutory loss before tax for 2018 of £105.4 million with our financial performance significantly affected by the IT migration resulting in a significant proportion of income, costs and resultant loss before taxation being derived from activities not forming part of TSB's core business model. The two key factors driving the loss before taxation were:

- *Delivery of the migration programme up to April 2018* – Preparations for the delivery of the migration programme were a key contributor to TSB's loss before taxation in 2018. Operating expenses of £417.3 million were incurred in respect of delivering the programme. In partial mitigation of these costs, having notified LBG of the intention to exit the framework of IT and operational banking services in April 2018, TSB became entitled to receipt of a cash payment of £318.3 million, recognised as other income.

- *Charges arising from post migration service disruption* – Charges and waivers of income arising from the post migration service disruption totalled £330.2 million of which £296.7 million was recognised as operating expenses (comprising customer redress and associated costs of £107.3 million, customer rectification and associated costs of £17.9 million, fraud and operational losses of £49.1 million, additional resource and advisory costs of £122.4 million) and £33.5 million was recognised as lower income in the form of waived interest and fee income. This was partially offset by the estimated recovery of £153.0 million of post migration charges under the respective Migration Services Agreement (MSA) and Outsourced Services Agreement (OSA) contracts, as further explained on page, as further explained on page 17.

Profitability (management basis)

The management basis excludes certain volatile and one-off items to enable a more meaningful assessment of TSB's underlying financial performance.

The costs of preparing for and delivering the migration programme up to April 2018 are excluded from the management basis as these are considered one-off investment related and not representative of financial performance in 2018. The charges arising from post migration service disruption are included in the management basis as they are reflective of TSB's financial performance in 2018.

Profit before tax	2018 £ million	2017 £ million
Franchise (excluding additional post migration charges)	**173.3**	119.7
Post migration charges	**(330.2)**	–
Recovery of post migration charges	**153.0**	–
Mortgage Enhancement portfolio	**–**	61.7
Management (loss)/profit before tax	**(3.9)**	181.4
Migration related income from LBG	**318.3**	–
Costs of preparing for TSB's migration	**(417.3)**	–
Banking volatility and other one-off items	**(2.5)**	(18.7)
Statutory (loss)/profit before tax	**(105.4)**	162.7

For 2018, TSB incurred a management loss before tax of £3.9 million compared to a profit before tax of £181.4 million in 2017. The significant decrease reflected the net charges arising from the post migration service disruption.

Excluding this impact, profit before tax arising from the Franchise business increased by £53.6 million to £173.3 million due, primarily, to lower operating expenses. This reduction reflected lower outsourcing costs following the migration in April 2018 and the termination of the previous service agreements with LBG and lower Partner costs as variable awards did not vest.

Further information on the drivers of TSB's income and charges is set out on pages 16 to 18.

Financial performance in 2018 (continued)

Balance sheet, funding and capital

	Analysis	2018 £ million	2017 £ million
Customer deposits		**29,084.3**	30,520.6
Non-customer funding		**9,087.8**	8,796.1
Shareholder’s equity		**1,864.0**	1,995.6
Sources of funding	**Page 12**	**40,036.1**	41,312.3
Other liabilities		**1,088.2**	1,213.2
Total equity and liabilities		**41,124.3**	42,525.5
Loans and advances to customers	**Page 14**	**30,008.5**	30,854.2
Liquid asset portfolio	**Page 14**	**9,438.9**	9,536.2
Loans and liquid assets		**39,447.4**	40,390.4
Other assets		**1,676.9**	2,135.1
Total assets		**41,124.3**	42,525.5

Sources of funding decreased by £1.3 billion reflecting a managed reduction in customer deposits of £1.4 billion, a £0.3 billion increase in non-customer funding sources and a £0.1 billion decrease in shareholder’s equity.

Loans and liquid assets decreased by £1.0 billion primarily reflecting a decrease in mortgage balances following the curtailment of origination activity to manage customer service levels throughout the year and from the ongoing repayment of the closed Whistletree book. Personal loan balances decreased reflecting operational constraints in the post migration period.

Further information on the drivers of TSB’s sources of funding and loans and liquid assets is set out on pages 12 to 15.

Financial performance in 2018 (continued)

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.

	Further information	2018 £ million	2017 £ million	Change %
Customer deposits	Note 1 on page 69	**29,084.3**	30,520.6	(4.7)
Non-customer funding:				
Borrowings from the Bank of England		**6,482.2**	5,625.7	15.2
Debt securities in issue	Note 2 on page 69	**1,122.6**	1,318.7	(14.9)
Subordinated liabilities	Note 3 on page 71	**398.2**	405.3	(1.8)
Repurchase agreements	Note 4 on page 71	**1,084.8**	1,446.4	(25.0)
Total non-customer funding		**9,087.8**	8,796.1	3.3
Funding resources		**38,172.1**	39,316.7	(2.9)
Shareholder's equity	Note 21 on page 92	**1,864.0**	1,995.6	(6.6)
Total sources of funding		**40,036.1**	41,312.3	(3.1)

Sources of funding

Total sources of funding decreased by 3.1% to £40.0 billion, reflecting a decrease in customer deposits offset by a small increase in non-customer funding.

Customer Deposits

Customer deposits decreased by £1.4 billion to £29.1 billion primarily due to a reduction in retail savings balances from £19.3 billion to £17.5 billion. This largely reflected the result of pricing decisions to manage ISA deposit volumes ahead of the 2018 'ISA season' given TSB's strong liquidity position.

Retail current account deposits grew by £0.4 billion from £10.0 billion to £10.4 billion, offsetting the above decrease, as TSB continued to attract new customers but at a slower rate than previously, opening 3.6% (2017: 6.2%) of all new and switching personal banks accounts in the UK during 2018.

Non-customer funding

Non-customer funding increased by £0.3 billion to £9.1 billion due to a further £0.9 billion drawn on the Bank of England's Term Funding Scheme, which provides four year term funding to UK banks at rates at or close to the Bank Base Rate. This was partially offset by lower borrowings from short term repurchase agreements at 31 December 2018.

Capital resources

TSB's capital position has remained above risk appetite threshold with a Common Equity Tier 1 (CET1) capital ratio of 19.5% and a leverage ratio of 4.4% on a fully loaded basis. The CET 1 capital ratio decreased by 50bps primarily due to losses incurred in 2018.

	At 31 Dec 2018 £ million	At 31 Dec 2017 £ million
Shareholder's equity per balance sheet	**1,864.0**	1,995.6
Excess of regulatory expected losses over impairment provisions	**–**	(84.9)
Deferred tax assets arising from carry forward losses	**(37.8)**	–
Cash flow reserve regulatory adjustment	**0.7**	0.5
Prudent valuation prudential filter adjustment	**(3.0)**	(3.0)
Intangible assets	**(18.4)**	(10.1)
Common Equity Tier 1/Total Tier 1 capital (fully loaded)	**1,805.5**	1,898.1
Tier 2 capital (fully loaded)	**390.6**	384.1
Total capital resources (fully loaded)	**2,196.1**	2,282.2
Risk-weighted assets (RWA)	**9,271.0**	9,490.7
Common Equity Tier 1/Total Tier 1 capital ratio (fully loaded)	**19.5%**	20.0%
Total Capital ratio (fully loaded)	**23.7%**	24.0%

Financial performance in 2018 (continued)

Sources of funding (continued)

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

	CET 1/ Total Tier 1 £ million	Tier 2 £ million	Total resources £ million
At 31 December 2017	**1,898.1**	**384.1**	**2,282.2**
Application of IFRS 9 and IFRS 15	**(67.6)**	**–**	**(67.6)**
Loss attributable to ordinary shareholder	**(63.0)**	**–**	**(63.0)**
Change in excess of regulatory expected losses over impairment provisions	**84.8**	**–**	**84.8**
Change in excess of provision over expected loss	**–**	**6.2**	**6.2**
Movement in other comprehensive income	**(1.0)**	**–**	**(1.0)**
Change in intangible assets	**(8.3)**	**–**	**(8.3)**
Movement in Tier 2 subordinated liabilities	**–**	**0.3**	**0.3**
Deferred tax assets on carried forward tax losses	**(37.8)**	**–**	**(37.8)**
Cash flow hedging reserve regulatory adjustment	**0.2**	**–**	**0.2**
Prudent valuation prudential filter adjustment	**0.1**	**–**	**0.1**
At 31 December 2018	**1,805.5**	**390.6**	**2,196.1**

Risk-weighted assets (CRD IV)

RWAs at 31 December 2018 decreased by £219.7 million (2.3%) compared to December 2017 reflecting lower unsecured and business banking exposures as explained on page 14.

	At 31 Dec 2018 £ million	At 31 Dec 2017 £ million
Risk type analysis of risk-weighted assets:		
Standardised approach	**1,574.0**	1,812.3
Internal Ratings Based (IRB) approach	**6,099.5**	6,095.1
Total credit risk	**7,673.5**	7,907.4
Operational risk	**1,487.6**	1,463.7
Counterparty risk	**109.9**	119.6
Total risk-weighted assets	**9,271.0**	9,490.7

Leverage ratio

The leverage ratio measure is defined as the ratio of Tier 1 capital to total exposure. This is intended to complement the risk based capital requirements with a simple, non-risk based 'backstop' measure. TSB calculates its leverage ratio based on the exposure measure in the revised Basel III leverage ratio framework published in January 2014 and adopted in the Capital Requirements Regulation (CRR) and the CRR definition of Tier 1.

	At 31 Dec 2018 £ million	At 31 Dec 2017 £ million
Total Tier 1 Capital for leverage ratio (fully loaded)	**1,805.5**	1,898.1
Exposures for leverage ratio		
Total statutory balance sheet assets	**41,124.3**	42,525.5
Removal of accounting value for derivatives	**(195.0)**	(214.8)
Exposure value for derivatives and securities financing transactions	**(93.9)**	(233.2)
Off-balance sheet	**688.9**	690.1
Other regulatory adjustments	**(78.4)**	(99.0)
Total exposures	**41,445.9**	42,668.6
Leverage ratio	**4.4%**	4.5%

The leverage ratio of 4.4% exceeds the Basel Committee's proposed minimum of 3% applicable from 2018.

Following application of IFRS9, TSB and other UK banks are supervised by the PRA under IFRS9 transitional rules following EBA guidelines. Based on these guidelines TSB's CET1 ratio is 19.7%, total capital ratio is 23.8% and leverage ratio is 4.4% . The effect of the transitional adjustment to own funds, capital requirement and leverage will be disclosed within Key Metrics and IFRS9 Comparison tables in the Significant Subsidiary Disclosures.

Financial performance in 2018 (continued)

Loans and liquid assets

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

Loans and advances to customers	2018 £ million	2017 £ million	Change %
Secured (retail)	**27,923.8**	28,321.5	(1.4)
Unsecured and business banking (1)	**2,084.7**	2,532.7	(17.7)
Total loans and advances to customers	**30,008.5**	30,854.2	(2.7)
Liquidity portfolio			
Balances at central banks (2)	**6,954.9**	7,419.9	(6.3)
UK gilts (3) (4)	**2,058.7**	1,721.5	19.6
Supranational and development bank bonds	**425.3**	394.8	7.7
Total liquid asset portfolio	**9,438.9**	9,536.2	(1.0)

(1) Comprises unsecured lending of £1,972.4 million (2017: £2,398.7 million) and business banking lending of £112.3 million (2017: £134.0 million).
(2) Balances at central banks are combined with other cash balances and demand deposits of £181.1 million (2017: £143.9 million) when shown on TSB's consolidated balance sheet on page 65.
(3) UK gilts in 2018 comprise £1,962.5 million recognised on the consolidated balance sheet at fair value through profit and loss and £96.2 million at amortised cost (see note 6 to the consolidated financial statements).
(4) UK gilts totalling £1,084.5 million (2017: £1,444.7 million) were sold under repurchase agreements but not derecognised from TSB's consolidated balance sheet (see note 4 to the consolidated financial statements).

Loans and advances to customers

Loans to customers decreased by £0.9 billion to £30.0 billion. The decline in mortgage balances was due to customer repayments and the expected reduction in the closed Whistletree portfolio, in addition to lower origination activity than prior year. New mortgage lending decreased to £4.8 billion (2017: £7.0 billion) reflecting curtailed lending activity both pre and post migration as customer service levels were prioritised. The 17.7% decrease in unsecured balances was driven by lower unsecured personal loan balances as post migration operational constraints limited new lending.

Further information about the credit risk of TSB's loans is set out in note 22 to the consolidated financial statements.

Liquid asset portfolio

TSB's liquidity portfolio comprises highly liquid assets, primarily cash deposits at the Bank of England, UK gilts and supranational and development bank bonds which are available and immediately accessible to meet potential cash outflows.

TSB's liquidity position is managed centrally by TSB's Treasury function. The liquid asset portfolio is available for deployment at immediate notice, subject to complying with regulatory requirements. A key regulatory measure of liquidity adequacy is the Liquidity Coverage Ratio (LCR). This is designed to promote the short-term resilience of TSB's liquidity risk profile and is regularly monitored and forecast alongside other cash flow and liquidity ratios. At 31 December 2018, the LCR was 298.1% (2017: 295.3%). This compares to the minimum regulatory requirement of 100% set by the PRA.

Financial performance in 2018 (continued)

Loans and liquid assets (continued)

Encumbered assets

The table below summarises the extent to which assets have been encumbered. At 31 December 2018, £3,156.8 million of assets were encumbered with counterparties other than central banks primarily as collateral for funding under repurchase agreements and to support the issuance of debt securities (as outlined in note 2 to the consolidated financial statements). A further £21,277.8 million of assets were positioned at central banks as collateral in support of drawings under the Bank of England's Term Funding Scheme and for normal liquidity management purposes including held as cash.

			Assets not positioned at central banks			
	Assets encumbered with counterparties other than central banks £ million	Assets positioned at central banks (pre-positioned plus encumbered) £ million	Readily available for encumbrance £ million	Capable of being encumbered £ million	Unencumbered-cannot be used £ million	Total assets £million
Cash, cash balances at central banks and other demand deposits	**–**	**6,954.9**	**–**	**–**	**181.1**	**7,136.0**
Financial assets at fair value through other comprehensive income	**1,121.5** (1)	**–**	**1,266.3**	**–**	**–**	**2,387.8**
Financial assets at amortised cost:						
Debt securities	**–**	**–**	**96.2**	**–**	**–**	**96.2**
Loans to central banks	**–**	**87.8**	**–**	**–**	**–**	**87.8**
Loans to credit institutions	**370.6** (2)	**–**	**–**	**–**	**–**	**370.6**
Loans and advances to customers	**1,325.0** (3)	**14,235.1**	**2,673.2**	**11,775.2**	**–**	**30,008.5**
Other advances	**339.7** (4)	**–**	**–**	**–**	**42.4**	**382.1**
Remainder of assets	**–**	**–**	**–**	**–**	**655.3**	**655.3**
Total – December 2018	**3,156.8**	**21,277.8**	**4,035.7**	**11,775.2**	**878.8**	**41,124.3**
Total – December 2017	3,956.6	15,247.8	4,676.7	17,530.1	1,114.3	42,525.5

(1) Gilts sold under repurchase agreements and pledged as collateral – see note 6 to the consolidated financial statements.
(2) Cash held on deposit by the securitisation and covered bond entities.
(3) Mortgage loans encumbered in support of external securitisation notes and covered bond issuance.
(4) Cash collateral placed with counterparties in respect of TSB's derivative financial liabilities.

Financial performance in 2018 (continued)

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 banking services and commissions from the sale of certain products such as general insurance. In 2018, TSB recognised non-recurring income from LBG following the exit from outsourcing arrangements.

Net interest income

	2018 £ million	2017 [1] £ million	Change %
Franchise (excluding additional post migration charges)	**910.4**	910.3	**–**
Waiver of interest following post migration service disruption	**(25.6)**	–	
Mortgage Enhancement	**–**	15.6	
Net interest income (management and statutory basis)	**884.8**	925.9	(4.4)
Group banking net interest margin	**2.87%**	3.02%	(15)bps

(1) Interest on trading derivatives entered into as economic hedges has been reclassified to interest income from gains/(losses) on financial assets and liabilities held for trading to align with current year presentation.

Net interest income decreased by 4.4% to £884.8 million. This was primarily due to the impact of waiving £25.6 million of overdraft interest following the post migration service disruption and the absence of earnings in 2018 from the Mortgage Enhancement portfolio that was returned to LBG in June 2017.

Interest rates earned on loans

In 2018, the average rate earned on TSB's loans reduced to 3.12% (2017: 3.22%) reflecting increased competition, lower wholesale market rates, and the effect of waived interest income referred to above.

The average rate earned on mortgages reduced to 2.60% (2017: 2.62%). Lower rates were earned on the fixed rate portion of the portfolio, reflecting increased competition in the market. Yields on unsecured lending decreased to 9.4% (2017: 10.24%) primarily due to the effect of waived interest.

Cost of funding resources

The cost of customer deposits remained stable at 0.40% in 2018 (2017: 0.40%).

Savings deposit interest costs of 0.47% remained broadly stable year-on-year (2017: 0.48%). Bank account interest costs increased to 0.32% (2017: 0.24%) reflecting the increase in interest rates in April 2018 on balances of up to £1,500 in the Classic Plus bank account from 3% to 5%.

Other income

	2018 £ million	2017 £ million	Change %
Franchise (excluding additional post migration costs)	**106.9**	108.5	(1.5)
Waiver of fees following post migration service disruption	**(7.9)**	–	
Mortgage Enhancement	**–**	46.1	
Management basis other income	**99.0**	154.6	(36.0)
Migration related income from LBG	**318.3**	–	
Banking volatility	**(8.7)**	13.5	(164.4)
One off items	**(2.5)**	5.8	(143.1)
Statutory other income	**406.1**	173.9	133.5

Other income increased by 133.5% to £406.1 million driven by the recognition of £318.3 million of income from LBG as a result of exiting the Transitional Services Agreement on migration to the new IT platform. Partially offsetting this, banking volatility and other one-off items decreased, in aggregate, by £30.5 million primarily reflecting market volatility in the derivatives transacted to hedge interest rate risk and exposures under share schemes.

Excluding these factors, other income decreased by 36.0% to £99.0 million. This was primarily due to the recognition in 2017 income of £46.1 million on the return of the Mortgage Enhancement portfolio to LBG in June 2017.

Financial performance in 2018 (continued)

Charges

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

Operating expenses

	2018 £ million	2017 £ million	Change %
Franchise (excluding additional post migration charges)	**770.6**	821.3	(6.2)
Post migration charges	**296.7**	–	
Recovery of post migration charges	**(153.0)**	–	
Management basis operating expenses	**914.3**	821.3	11.3
Costs of preparing for TSB's migration	**417.3**	–	
Banking volatility	–	2.2	
One-off items	**(8.6)**	35.8	(124.0)
Statutory operating expenses	**1,323.0**	859.3	54.0

Operating expenses increased by £463.7 million or 54.0% to £1,323.0 million. This primarily reflected the costs of preparing for the migration of £417.3 million and charges associated with the post migration service disruption of £296.7 million, partially offset by the recognition of an accrued estimated recovery of £153.0 million from Sabadell under the MSA and OSA contracts.

The costs of preparing for TSB's migration included £249.0 million payable under the MSA and £44.3 million of associated VAT charges and project management costs of £187.7 million, offset by reimbursement by LBG of £63.7 million of VAT related costs.

The charges arising from post migration service disruption included customer redress and associated operational costs of £107.3 million, customer rectification and associated costs of £17.9 million, incremental resource and advisory costs of £122.4 million to support TSB's remediation programme, fraud and operational costs of £49.1 million, and include costs incurred in 2018 in respect of the independent investigation by Slaughter and May commissioned by the Board.

The MSA and OSA contracts provide TSB with the right to seek recovery of losses from Sabis, the Sabadell Group IT provider, for breach of contract up to the level of liability caps in each agreement. TSB and Sabis have reached provisional agreement, subject to mutual reservations of rights while negotiations are concluded, to recognise an aggregate estimated recovery under the agreements of £153.0 million. Claims under certain insurance policies are ongoing and are not yet sufficiently advanced for any amounts to be recognised in the financial statements.

Excluding these factors, costs decreased by £50.7 million (6.2%) from £821.3 million to £770.6 million. This reduction was due to lower outsourcing costs following the termination of the Transitional Services Agreement with LBG and the establishment of the OSA following the migration in April 2018. The reduction in costs also reflected lower Partner related costs (following review of the expected outcomes of the TSB Award and previously awarded but unvested SPA awards) and reduced investment expenditure as TSB scaled back projects to prioritise migration activity. These decreases were partially offset by £9.6 million of operating expenses (and total expenditure of £11.7 million in 2018) included in 'Other' supporting the build out of TSB's business banking offering as highlighted in the Executive Chairman's statement.

Franchise (excluding additional post migration charges)	2018 £ million	2017 £ million	Change %
TSB Partner related costs	**332.5**	352.7	(5.7)
Regulatory and professional costs	**29.5**	24.5	20.4
Operational and IT costs	**51.3**	42.8	19.9
Marketing costs	**48.9**	58.1	(15.8)
Property costs	**94.6**	93.5	1.2
Investment costs	**9.8**	26.0	(62.3)
Outsourcing costs	**180.1**	213.8	(15.8)
Other	**23.9**	9.9	141.4
Franchise (excluding additional post migration charges)	**770.6**	821.3	(6.2)

Financial performance in 2018 (continued)

Charges (continued)

Impairment charge [(1)]

	2018 £ million	2017 £ million	Change %
Secured (retail)	**3.1**	–	
Unsecured and business banking [(2)]	**70.2**	77.8	(9.8)
Total impairment charge	**73.3**	77.8	(5.8)
Asset quality ratio	**0.24%**	0.25%	(1)bps

(1) As described on pages 61 to 62, TSB adopted IFRS 9 with effect from 1 January 2018. 2018 is presented on an IFRS 9 basis and 2017 is presented on an IAS 39 basis.
(2) Comprises unsecured lending of £70.3 million (2017: £77.3 million) and business banking lending of £(0.1) million (2017: £0.5 million).

The impairment charge decreased by 5.8% to £73.3 million reflecting an improvement in UK unemployment, a revised outlook for house prices relative to 2017 and a downward revision in 2017 to unsecured recovery valuations. Further information on the credit risk of TSB's financial assets is set out in note 22 to the consolidated financial statements.

Taxation

The tax credit of £42.4 million (2017: tax charge of £44.0 million) reflects an effective tax credit rate of 40.2% which is higher than the applied UK corporation tax rate in 2018 of 27%. This is primarily due to the net tax effect of the migration related income from LBG, as offset by the costs incurred under the MSA, resulting in non-taxable income. The applied UK corporation tax rate comprises the standard corporation tax rate of 19% and the bank surcharge of 8% applicable to taxable profits in excess of £25 million per annum.

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

Risk management in TSB

Approach to risk

TSB identifies, assesses and manages the risks inherent in its business model and strategy, seeking to ensure that it remains liquid, solvent, operationally stable, trusted, and compliant. Risks faced by TSB in delivering its business strategy are managed to protect the interests of customers, Partners, and our shareholder. TSB's approach to managing these risks is described by an overarching Risk Management Framework described on page 20. TSB's principal risks and uncertainties are described on page 26.

Management of key risk outcomes arising from the post migration service disruption

As outlined in the Executive Chairman's statement, the migration of TSB's IT and operational services from LBG to a new IT platform resulted in a period of service disruption. The instability of the IT platform, related stretch placed on TSB Partners, and significant increase in customer complaints, resulted in financial, conduct and operational risk outcomes that were outside of TSB's risk appetite. The heightened risk profile continues to be managed robustly by applying TSB's risk management framework. The key outcomes in 2018 were:

- *Operational resilience has recovered after a period of instability* – The instability of TSB's IT systems following migration caused harm to some of TSB's customers. The impact of this instability is managed through an IT remediation programme, to enable the Bank to achieve full functionality, and a customer remediation programme to resolve customers' complaints. Progress has been made to improve operational IT stability and data integrity. The frequency of IT incidents has reduced steadily since the immediate post migration period and is now close to a return within risk appetite.

- *TSB remained highly liquid* – The heightened risk of deposit outflows did not crystallise and was managed through more frequent reporting and monitoring of liquidity reserves. Liquidity has remained strong as outlined on page 14 and has remained within risk appetite throughout the year.

- *TSB remained highly solvent* – As described on page 10, financial performance in 2018 was impacted by migration related charges and slower than recent growth rates. This resulted in a statutory loss before tax of £105.4m. While capital resources reduced marginally during 2018, TSB remains well capitalised as outlined on page 12. Timely completion of the customer remediation programme and the relaunch of products and services are required to improve TSB's financial performance in 2019.

- *Trust has been weakened and is rebuilding* – Migration and the subsequent targeted fraud attacks affected a number of TSB's customers, impacting TSB's reputation and straining customer loyalty. To address this, TSB set three immediate priorities following the migration; (1) to complete the work of putting things right for customers; (2) to enable the bank to achieve full functionality for customers – including the availability of all product services and the launch of a leading business banking offer; and (3) to appoint a CEO for the next chapter of TSB. As described in the Executive Chairman's report on page 4, good progress has been made on each of these.

Organisational preparedness for the planned UK withdrawal from the EU

TSB has prepared the business for a range of potential Brexit outcomes to ensure operational continuity, liquidity, solvency and trust are maintained:

- *Operational continuity* – As a UK retail bank with an on-shore IT infrastructure serviced by a UK company (Sabis UK), TSB does not anticipate significant disruption as a result of Brexit. However, appropriate steps have been taken to ensure operational continuity. These include building appropriate flexibility into the service contract with Sabis UK to accommodate any changes required as a result of Brexit and supplementing third party supplier controls with additional activities to gain assurance around cross-border data transfer and resilience under a range of Brexit scenarios. Access to the European Payment Systems has been safeguarded indirectly through TSB's parent, Sabadell and Brexit scenarios were considered as part of TSB's annual refresh of its operational risk assessment.

- *Liquid and solvent* – TSB's internal liquidity and capital adequacy assessments are designed to ensure sufficient financial resources are available to cover outflows and losses under a range of scenarios, including a 'Disorderly Brexit'. As stated on page 12, TSB maintains a robust level of financial resources with a healthy surplus above the level required by these assessments. TSB also has no exposure to non-UK based, or non-UK regulated, central counterparty clearing houses or central securities depositories. Together, this provides confidence that financial resources are sufficient and available to enable TSB to continue lending responsibly during a stress event, supporting the UK economy.

- *Trustworthy* – TSB has taken appropriate steps to ensure its customers and Partners continue to be supported and communicated with throughout this period of uncertainty. Frequent and open dialogue has been maintained with regulators, helping to build an overall view of the UK financial system's resilience to any Brexit related impacts and to ensure it remains compliant with current and future regulations.

Risk management in TSB (continued)

Risk management framework

The risk management framework provides the foundation for all of the risk management activities and processes in TSB. The framework is designed around a simple model for categorising risk, so that all the components of our risk management such as risk appetite, governance, policies, reporting and assurance and organisational design are aligned to the same hierarchy of risks. At the top of this hierarchy are four principal risks faced by TSB.

Principal risk categories

Financial risk	The risk of the firm having inadequate earnings, cash flow or capital to meet current or future requirements and expectations as they fall due.
Credit risk	The risk that a genuine or fraudulent borrower or counterparty fails to pay the interest or to repay the principal on a loan or other financial instrument as they fall due.
Operational risk	The risk of loss, damage or disruption arising from inadequate or failed processes, people and systems.
Conduct risk	The risk to the delivery of fair customer outcomes and market integrity.

Accountability

Risk management is embedded at all levels of TSB through clear accountabilities across three independent lines of defence. This enables clear understanding and ensures separation between functions that own and manage risks faced by the business (first line), provides oversight and challenge (second line), and provides for independent audit and assurance (third line).

The three lines of defence

First line of defence	• All business units and line management have ownership and primary accountability for directly assessing, controlling and mitigating risks within their area of responsibility. • The first line of defence establishes controls to ensure compliance with TSB's policies, risk appetite and regulatory requirements. • Specialist Risk Functions in the first line provide subject matter expertise for one or more risk category (e.g. Credit). Business Unit Control functions support the business to manage their risk profile and provide evidence through risk reporting and control testing.
Second line of defence	• Sits within TSB's Risk Division, sets enterprise wide standards for risk management activity and provides oversight and challenge to the first line in managing risks to these standards. • Monitors and oversees risk management activity in the first line and aggregates risk reporting to maintain an enterprise wide view of TSB's risk profile and risk appetite.
Third line of defence	• Provides independent and objective assessment of the risk management activities of the first and second lines. • Reports on the effectiveness of risk management activities to the Board and senior management.

Partners in TSB are individually accountable for identifying, assessing and managing risks within their area of responsibility. Risk management responsibilities are embedded through a risk focused culture, supported by efficient governance and achieved through a prudent risk appetite to support TSB's growth strategy.

Risk culture

Partners' accountability for risk management is reflected in TSB's risk culture which stems from its core values to be pioneering, responsible, straightforward, collaborative and transparent. TSB aims to have a strong conduct and customer focused culture that maintains regulatory standards. TSB is a responsible lender and aims not to lend more than its customers can afford. Partners in TSB are guided through training on how to meet customers' needs and treat them fairly. A suite of policies and risk appetite measures support Partners in keeping with TSB's risk appetite. The importance of individual accountability for managing risk is reinforced by both TSB Board and the approach to performance management and remuneration for all Partners.

Risk governance

The culture of risk awareness and behaviours that support the achievement of sustainable business goals and the right customer outcomes are underpinned by TSB's governance model. A committee structure enables fast, efficient decision making with an appropriate minimum of bureaucracy, providing clear escalation and reporting of risk to senior management and the Board.

Each committee within the governance structure is responsible for ensuring that a risk and control environment is established within its area of authority. Clear reporting lines are established through the Bank Executive Committee and the Risk Committee, and ultimately to the Board which is responsible for providing oversight of the effectiveness of the risk management framework. Further information on TSB's committee governance is set out in the corporate governance statement on pages 28 to 36.

Risk management in TSB (continued)

Risk governance (continued)

TSB's risk committees are aligned to the four principal types of risk. Collectively, the Executive risk committees monitor and challenge risk exposures and take appropriate action to monitor TSB's risk profile across each principal risk type in line with the risk appetite set by the Board.

Risk appetite

TSB defines risk appetite as the amount and type of risk that it is willing to take in the pursuit of its objectives. The Board approves the risk appetite within each planning cycle and, through collaboration with Sabadell, ensures alignment to Sabadell risk appetite. Through a hierarchy of regular meetings and reporting, it monitors performance against appetite, seeking to ensure that senior management operates within appetite and, if necessary, has appropriate plans to address any appetite breaches. TSB aligns its risk appetite to a statement of its attitude to each of its four principal types of risk. These, along with appetite measures and thresholds, are articulated in the Risk Appetite Statement.

Risk category	Attitude to risk statements
Financial risk	• We will use our capital effectively and efficiently to fuel TSB's growth, whilst ensuring that we remain solvent in all plausible scenarios. • We will ensure that we maintain an underlying risk-adjusted margin which is sufficient to cover our operating costs, and to deliver an appropriate return to our shareholder. • We maintain a prudent liquidity profile to ensure that we can continue to operate under stressed conditions, and will limit the proportion of our balance sheet which is reliant on wholesale funding. • TSB manages the market risk from changes in prices of financial instruments in terms of potential changes to both short term earnings and long term economic value. • TSB has no appetite for foreign exchange rate risk. • We ensure that our financial risk models perform effectively, appropriately assessing our risk. We ensure model risk is minimised through robust model governance; we review and approve material risk models annually, ensuring model actions are closed in appropriate timeframes and monitor model performance.
Credit risk	• We are a responsible lender and will not lend more than we or our customers can afford. • We design our lending to be sustainable and profitable under stress. • We will maintain a well-balanced, capital efficient portfolio, focused on UK customers and assets, and prime lending criteria. • We have an appetite to grow in the retail and SME lending markets, to make efficient use of our platforms and distribution. We will not allow any high risk concentration to develop that might threaten our financial stability or allow TSB to become an outlier compared to peers. • We ensure that our credit risk models perform effectively, appropriately assessing our risk. We ensure model risk is minimised through robust model governance; we review and approve material risk models annually, ensuring model actions are closed in appropriate timeframes and monitor model performance.
Operational risk	• In order to deliver our objectives, we need to take risks, and may suffer events and losses whilst doing this. • However, we are only prepared to accept a low number of events and losses caused by TSB or its suppliers which materially detriment our customers, Partners, reputation or financial performance and we have no appetite to damage our relationship with our regulators. • Our customers expect that they can bank with us '24x7', and as a result we have a limited appetite for interruptions to service to prevent them from doing so. • Our customers expect that their personal data is safe with us. We aim never to put their details at risk.
Conduct risk	• Our objective at all times is to have a strong conduct and customer focused culture. Our systems of governance, reporting and controls support fair customer outcomes and Partner reward are designed to maintain market integrity and regulatory standards. • We understand people make mistakes. But we will not tolerate systemic conduct failings in any area. • Our product design, sales practices and post sales servicing ensure that products and services are straightforward, transparent and meet customer needs, expectations and deliver a fair exchange of value.

Risk management in TSB (continued)

Principal risks arising from TSB's business model

Banking is based on the effective evaluation of risks. Processes to identify, measure and control risk are fully embedded in TSB's risk management framework. TSB's business model requires the acceptance of a certain level of risk – our risk appetite.

The principal risks arising from TSB's business model are categorised under TSB's risk management framework as described on page 20.

<table>
<tr><th colspan="3">Financial risk</th></tr>
<tr><td>Principal financial risks</td><td colspan="2">• Capital adequacy: The risk associated with the failure to retain sufficient reserves or quality of capital to cover TSB's statutory requirements, losses and support business strategy.

• Liquidity: The risk that the TSB is unable to meet its liabilities that are expected to fall due, or is unable to maintain regulator, investor or stakeholder confidence that this will be achieved.

• Profit resilience: The risk that TSB 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.</td></tr>
<tr><td>How TSB manages its financial risks</td><td colspan="2">• Capital adequacy: Regular stress testing, including the Internal Capital Adequacy Assessment Process (ICAAP) assessment of the adequacy of TSB's capital, and regulatory change impact assessments, seeks to ensure that TSB maintains sufficient capital for continuing growth.

• Liquidity: TSB 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.

• Profit Resilience: Risk adjusted returns are monitored and used both as an input to TSB's pricing decisions and to inform our strategy and medium term plan. Our planned growth of the SME book will also create further opportunities for income diversification.

• Interest Rate: Rates remain historically low resulting in continued margin pressures. TSB uses derivative financial instruments in the normal course of business to manage interest rate risk. The hedge effectiveness of these derivatives is monitored regularly.</td></tr>
<tr><td>Further information</td><td>• Capital adequacy:
• Liquidity risk:
• Profit resilience:
• Interest rate risk:</td><td>Page 12 of Financial performance in 2018.
Page 14 of Financial performance in 2018.
Page 10 of Financial performance in 2018.
Note 26 on page 102 of the consolidated financial statements.</td></tr>
</table>

Risk management in TSB (continued)

Credit risk	
Principal credit risks	• **Retail credit risk:** The risk that borrowers fail to repay on time interest or principal arising from retail personal or non-personal lending, and the risk of credit application fraud. • **Wholesale credit:** The risk of credit losses arising from counterparty lending. This includes credit losses from wholesale financial instruments including swaps, hedges, securitised bonds and governments funding initiatives. • **Credit models:** The risk that models used to manage credit risk are inadequate, are used inappropriately, or perform ineffectively.
How TSB manages its credit risks	• TSB 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. TSB understands this and works with its customers to improve their position by offering various treatment strategies and support. • TSB monitors economic developments and assesses the impact on credit impairment losses from various forecast economic scenarios. Further information on the scenarios considered in measuring the credit impairment loss allowance at 31 December 2018, and sensitivities to alternative assumptions, is set out in note 11 to the consolidated financial statements. • TSB manages its exposure to wholesale credit risk carefully, applying strict external counterparty credit quality thresholds including monitoring the rating of counterparties. • All material credit models utilised by TSB are subject to regular independent assessment and validation which seeks to ensure that models operate as designed and provide the correct outcomes. Any unexpected outcomes are rectified or mitigated before the model becomes part of TSB's credit risk management strategy. As a result of Sabadell's acquisition of TSB, there is an inspection by the Single Supervisory Mechanism (SSM), driven by a material change in the Sabadell Group IRB framework from the consolidation of TSB into Sabadell Group reporting. This inspection is focusing on TSB's IRB framework.
Further information	• Further information on TSB's credit risk exposures and how these are managed can be found in note 22 to the consolidated financial statements.

Risk management in TSB (continued)

Operational risk	
Principal operational risks	• **IT 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. • **Sourcing and contracting:** The risks arising from supplier selection, the establishment of effective service agreements, and the ongoing management of material suppliers, such as IT service provision by Sabis UK. • **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. • **Fraud**: The risk of exposure to losses arising from criminal activity perpetrated to achieve financial gain at the expense of the firm and our customers and resulting in customer detriment or reputational damage.
How TSB manages its operational risks	• TSB operates an 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. Sabis UK is the primary supplier of IT services to TSB and the combined risk and control environment has continued to be assessed and strengthened since migration with the aim of delivering a stable and compliant service. • To successfully manage its third party deliverables TSB 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 external criminal environment is continually evolving with new threats and attacks identified almost daily. TSB is committed to making customers' banking experience as safe as possible. Certain functions, including the Security Operations Centre, are led and operated by Sabadell at a Group level. Within TSB, the Chief Information Security Officer establishes TSB's requirements for this capability. • TSB is, on occasion, targeted by criminals attempting to defraud the business and/or customers. Systems pro-actively monitor and protect against suspicious activity and have continued to be strengthened since migration. TSB 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, TSB works with all parties with the aim of ensuring that a fair customer outcome is achieved.

Risk management in TSB (continued)

Conduct risk	
Principal conduct risks	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. TSB 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 as follows: • **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 rise 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. Includes the risk of bribery and corruption. • **Firm and governance risk:** The risk that weaknesses in TSB's overarching systems of governance, reporting and control impact on customer outcomes, market integrity or regulatory compliance.
How TSB 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 TSB. • 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 so that their personal circumstances are considered throughout their relationship with TSB. • All TSB'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 TSB'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 TSB Partners and third parties who conduct business on behalf of TSB. • Compliance with regulation and legislation is maintained by ongoing monitoring of regulatory developments and establishing plans to comply on a timely basis. The effectiveness of controls and governance is regularly monitored and assessed.

Risk management in TSB (continued)

Emerging risks

TSB also monitors emerging and evolving risks that could increase in significance and may pose a threat to its business model. Some of the key emerging risks and uncertainties in TSB's operating environment are described below. TSB regularly considers the likelihood of the relevant risk materialising and the potential impact on its business strategy, customers, Partners and shareholder. TSB uses this assessment as part of the business planning process. The top risks emerging in 2018 are:

Principal risk	Overview of risk	Mitigating actions
Global economic and political trends	TSB is exposed to inherent risks from the macroeconomic environment and political uncertainty leading to adverse economic changes. These could have an impact on its business, customers and shareholder. TSB's credit impairment losses are sensitive to a deterioration in the UK economic environment and in particular to house prices, unemployment and interest rates.	TSB's business model and lending strategy have been designed to be resilient to a credit crisis. Political and economic developments are monitored and potential impacts have been included in TSB's business planning and stress test scenarios. The key economic variables that influence the level of TSB's credit losses are house prices, unemployment and interest rates. The sensitivity of TSB's profits and capital to alternative economic scenarios is explained in note 11 to the consolidated financial statements.
Fin Tech and digital competition	Partnerships with FinTech and other technological advances create a threat to the traditional value chain and ways in which all banks currently operate and service customers. Incumbent banks with traditional banking relationships are obligated to deliver IT development safely and securely without exposing customers to potential disruption and harm.	These risks are considered as part of the business planning cycle. Capabilities have been established within TSB, supported by specialist groups at Sabadell Group level, to understand and respond to the rapid evolution of these developments in banking. Connections have been established with a range of FinTech innovators, to stimulate new thinking. TSB's new system will be an enabler, allowing us to design, develop and deploy new processes and products efficiently.
Regulatory change	Due to the nature of the financial services industry, TSB 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.	TSB monitors forthcoming legal and regulatory changes and continues to invest in its people and IT systems with the aim that standards are met and maintained. All legal and regulatory changes faced by TSB are managed through its governance and oversight framework.
	The Second Payment Services Directive (PSD2) and the implementation of Open Banking means that banks will have to disclose to third party providers any data relating to our customers that they have authorised us to provide.	TSB welcomes the opportunities that PSD2 and Open Banking provides and has mobilised a programme to ensure that its customers can benefit from these developments.
	In June 2018, the Bank of England published a policy statement on its approach to setting Minimum Requirement for own funds and Eligible Liabilities (MREL).	TSB is working towards meeting the MREL requirements that will transition from 2020 to reach the full requirement in 2022.
	The FCA has a focus on bringing more competition and better consumer outcomes to the overdraft market. The regulator's ongoing review of this market is likely to result in a number of remedies to help boost competition and address customer vulnerability.	Customers have always been at the heart of TSB's business and it has already acted to implement recent FCA remedies on creditworthiness assessments, persistent debt and unsolicited credit card limit increases so that TSB continues to meet the latest regulatory developments in this area.
	In December 2017, the Basel Committee on Banking Supervision finalised the 'Basel III' international regulatory capital framework for banks.	TSB has completed an assessment of its additional capital requirements under Basel III and is implementing the changes to its capital planning.
	In April 2017, the Bank of England recommended that the Sterling Overnight Index Average (SONIA) replaces LIBOR as their preferred risk-free rate for Sterling.	In line with financial markets, TSB is working towards a transition to SONIA from the end of 2021.

Going concern and viability

Going concern

The Directors recognise their responsibility to make an assessment of TSB's ability to continue as a going concern for a period of at least twelve months from the date the financial statements are approved. As noted on page 46, the Directors consider that it is appropriate to adopt the going concern basis in preparing the consolidated financial statements.

Viability statement

As more fully explained in the corporate governance statement on page 29, TSB is not required to comply with the UK Corporate Governance Code 2016 (the Code) issued by the Financial Reporting Council. However, TSB has committed to voluntarily adopt those principles of the Code that are considered appropriate for TSB as a wholly owned subsidiary of Sabadell which includes provisions that require the Directors to confirm that TSB will be able to continue in operation and to meet its financial liabilities as they fall due over a specified period determined by the Directors taking account of the current position and principal risks of the TSB.

Assessment of prospects of TSB

In making this assessment, the Directors have considered a wide range of information. Central to this assessment is the 2018 medium term plan which assesses TSB's future strategic and financial prospects over the five years to December 2023. This includes assessment of future projections of profitability, capital requirements, capability, resources and funding.

TSB uses stress testing and scenario analysis to assess and support the delivery of the business plan. This allows senior management and the Board to assess the impact of adverse macroeconomic scenarios and take appropriate management actions if required to ensure that business plans will not breach TSB's risk appetite. Such testing includes stress tests for capital and liquidity regulatory submissions, the ICAAP and the ILAAP. TSB's stress testing also covers adverse situations in the wider operating environment to assess market risk sensitivities, financial market disruption, and operational risks. Reverse stress testing is undertaken to understand the kinds of stress that would cause TSB to fail, understand the path to failure and help to prepare mitigants and early warning indicators. All outputs are subject to a robust governance process prior to Board approval.

In addition, the Directors have assessed the top and emerging risks that could threaten TSB's future prospects and business model more broadly and the monitoring and mitigation activities around them.

Viability assessment

The Directors have assessed TSB's viability to December 2021, being a period of three years and representing a one year reduction in the assessment period as compared to 2017. The assessment has been made over this period as it is within the period over which TSB's medium term strategic and financial plan is prepared, key capital and leverage ratios are forecast and regulatory and internal stress testing of the profit, capital and funding forecasts are carried out. In doing so, the increasing uncertainty of forecasts in the outer years of the planning period from developments in the economic environment, and competition and regulatory developments were taken into account. The period also considered the residual term of TSB's non-customer funding sources under securitisation and covered bond programmes and the BoE's Term Funding Scheme.

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

- they have carried out a robust assessment of the principal risks facing TSB, including those that would threaten its business model, future performance, solvency or liquidity; and
- in light of TSB's capital and funding resources (pages 12 and 13) they have a reasonable expectation that TSB will be able to continue in operation and meet its liabilities as they fall due in the period to December 2021.

Strategic report on pages 2 to 27 approved, by order of the Board:

K. H

Keith Hawkins
Company Secretary,
31 January 2019

Corporate governance statement

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How the business is managed

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

- Board authorities being delegated from the Boards of the Company and the Bank to Board committees and to the Chief Executive Officer/Executive Chairman; and
- Delegated executive authorities through which the Chief Executive Officer/Executive Chairman delegates aspects of his own authority to other senior executives and sets out the support provided to him by the executive committees.

The corporate governance structure is supported by the Internal Control and Governance Framework as outlined on pages 35 and 36. An important principle, applied throughout the Company's governance framework, is that the delegation of executive authority is to the individual office holders (who may in turn delegate aspects of their authority to others). Executive committees may be established to support the individuals in exercising their delegated authorities but the committees do not separately hold any delegated authority in their own right. This approach to individual accountability is aligned to the principles of the Senior Managers Regime.

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

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

Although the Company does not have shares with a premium listing on the London Stock Exchange, and does not need to comply with the Code, the Board has committed to voluntarily adopt those principles of the Code that are considered appropriate for TSB as a wholly owned subsidiary of Sabadell. A copy of the Code is available at www.frc.org.uk.

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

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

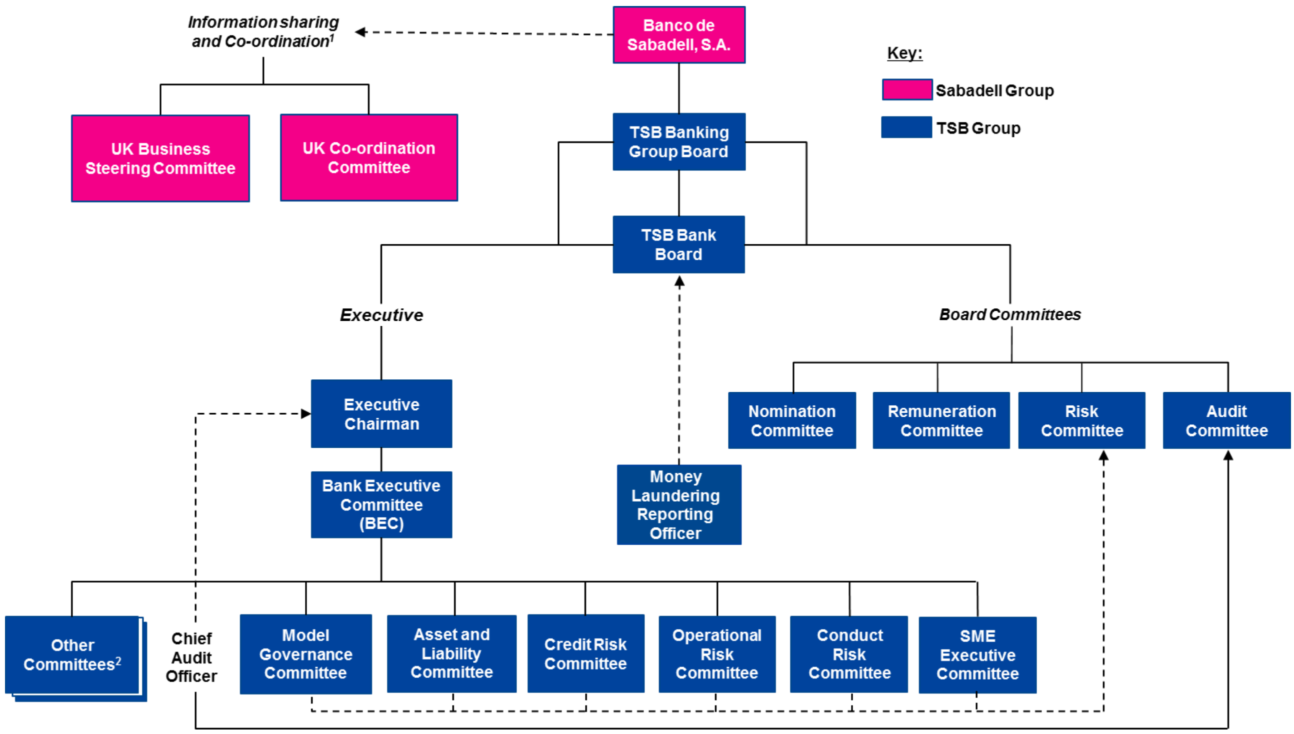
In addition, Directors appointed at the nomination of Sabadell have not been appointed for a specified term as recommended by the Code (B.2.3).

Following the departure, by mutual agreement, of Paul Pester as TSB's Chief Executive Officer on 3 September 2018, Richard Meddings has served as TSB's Executive Chairman. This was always intended to be a temporary arrangement whilst the search for a new Chief Executive Officer was undertaken. On 19 November 2018, TSB announced the appointment of Debbie Crosbie as TSB's new Chief Executive Officer, with Debbie's start date in 2019 to be agreed in due course, subject to regulatory approval. During the period whilst Richard Meddings is acting as the Executive Chairman, the Company will not be in compliance with provision A.2.1 of the Code, which requires that the roles of chairman and chief executive not be performed by the same individual. Whilst TSB understands the requirements for a separation of the roles of chairman and chief executive, it was considered to be in the best interests of TSB and of all its stakeholders for Richard to assume the role of Executive Chairman whilst a successor to Paul was sought.

How the business is managed (continued)

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

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



[1] The information sharing and co-ordination committees are Sabadell Group committees. Membership of these committees includes TSB Executives. The UK Business Steering Committees discusses TSB products, distribution, financial performance updates and other matters at Sabadell's request. The UK Co-ordination Committee's purpose is to co-ordinate the alignment of TSB's policies and processes with those of Sabadell, where appropriate.

[2] Includes Product Pricing Committee, Executive Product and Sales Process Governance Committee, and Disclosure Committee.

The role and responsibilities of the Board

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

(i) Strategy

- Approving TSB's strategy, values and long-term objectives and ensuring that rigorous and robust processes are in place to monitor organisational compliance with the agreed strategy and risk appetite and with all applicable laws and regulations;
- Determining Board structure, size and composition for the Company and Bank, determining the roles and responsibilities of Chairman, Senior Independent Director, Non-executive Directors, Chief Executive Officer, and Executive Directors;
- Approving the high-level framework of Board delegations;
- Approving material TSB contracts and material acquisition or disposal of assets or equity investments by the Company or any subsidiary of the Company; and
- Approving material changes to TSB corporate and organisational structure, including changes to the Company's listing status or its status as a plc.

How the business is managed (continued)

(ii) Risk

- Reviewing the effectiveness of the Company's and Bank's risk management and internal control systems; and
- Approval of the Bank's Risk Appetite, ICAAP, ILAAP, Reverse Stress Test and Recovery Plan.

(iii) Shareholder communications

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

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

Role of Directors

There is a clear division of responsibility between the Chairman and Chief Executive Officer, approved by the Board. As noted on page 29, these roles have been combined on a temporary basis into the role of Executive Chairman until Debbie Crosbie joins as TSB's new Chief Executive Officer.

(i) Chairman

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

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

During the period whilst Richard Meddings is acting as the Executive Chairman, additional governance arrangements have been established to support the Executive Chairman in his role and to ensure effective governance with checks and challenges. These revised arrangements include informal meetings of the Non-executive Directors ahead of each Board meeting without the Executive Chairman present and regular meetings between the Executive Chairman and the Senior Independent Director.

(ii) Chief Executive Officer

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

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

Other than matters expressly reserved to the Chief Executive Officer, authority can be delegated to the respective Bank Executive Committee members, jointly or severally. The headline authorities delegated to Paul Pester were passed to Richard Meddings for the period whilst he is acting as the Executive Chairman. The risk of concentration of authority in the Executive Chairman was reviewed by the Senior Independent Director and the chair of the Audit Committee and is being mitigated by reducing the materiality of certain matters that are required to be escalated to the Board.

How the business is managed (continued)

(iii) Non-executive Directors

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

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

(iv) Senior Independent Director

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

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

Board membership and composition

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

Executive Chairman:	Richard Meddings (independent on appointment)
Executive Director:	
Chief Financial Officer	Ralph Coates
Independent Non-executive Directors:	Paulina Beato
	Dame Sandra Dawson (Senior Independent Director)
	Graeme Hardie
	Stephen Page
	Andy Simmonds
	Polly Williams
Non-executive Directors:	Miquel Montes
	Tomás Varela

Full biographical details including their skills and experience are shown on pages 54 to 57. A record of the Directors who have served during the year is shown in the Directors' Report on page 45. The letters of appointment for Non-executive Directors are available at the Company's registered office and at the Annual General Meeting.

Board Committees

Certain responsibilities of the TSB Boards are delegated to committees of the Board to assist the TSB Boards in carrying out their functions.

- The Risk Committee (chaired by Andy Simmonds) oversees the management of the risks TSB faces;
- The Audit Committee (chaired by Polly Williams) oversees financial reporting and internal control;
- The Nomination Committee (temporarily chaired by Dame Sandra Dawson) leads the process for appointments to the TSB Boards and succession planning for the TSB Boards and Bank Executive Committee; and
- The Remuneration Committee (chaired by Dame Sandra Dawson) formulates TSB Remuneration Policy and supports the ongoing delivery of sustainable performance.

The Audit and Nomination Committees have each prepared reports which include a description of their role, structure and composition. Each of the Board Committee's terms of reference is available at www.tsb.co.uk/investors/people/.

Andy Simmonds replaced Sandy Kinney as the Chair of the Risk Committee on 11 July 2018. In accordance with SYSC 4.3A.8(1), Richard Meddings has stepped down from the position of member and Chair of the Nomination Committee during the time that he is acting as Executive Chairman, with Dame Sandra Dawson assuming, subject to regulatory approval, the Chair of this committee on a temporary basis. The Nomination Committee chair will revert to Richard Meddings when Debbie Crosbie takes up her appointment as Chief Executive Officer.

How the business is managed (continued)

Meeting attendance

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

Name of Director (vi)	Board meetings attended	Audit Committee meetings attended(vii)	Risk Committee meetings attended(viii)	Nomination Committee meetings attended	Remuneration Committee meetings attended
Will Samuel (i)	1 out of 1	–	–	–	–
Paul Pester (ii)	12 out of 13	–	–	–	–
Ralph Coates	18 out of 18	–	–	–	–
Paulina Beato	17 out of 18	–	9 out of 10	–	9 out of 9
Dame Sandra Dawson	18 out of 18	–	–	2 out of 2	9 out of 9
Graeme Hardie	16 out of 18	11 out of 12	10 out of 10	–	–
Sandy Kinney (iii)	16 out of 17	10 out of 12	9 out of 10	–	–
Richard Meddings (iv)	18 out of 18	–	–	1 out of 1	–
Stephen Page	17 out of 18	–	10 out of 10	–	–
Andy Simmonds (v)	7 out of 7	4 out of 5	3 out of 3	–	–
Polly Williams	17 out of 18	12 out of 12	10 out of 10	–	9 out of 9
Miquel Montes	17 out of 18	–	–	2 out of 2	8 out of 9
Tomás Varela	17 out of 18	11 out of 12	10 out of 10	–	–

(i) Resigned from the Board on 2 February 2018.
(ii) Left the Board by mutual agreement on 3 September 2018.
(iii) Resigned from the Board on 10 December 2018.
(iv) Stepped down from the Nomination Committee on 14 November 2018 (whilst in the role of Executive Chairman)
(v) Appointed to the Board on 11 July 2018.
(vi) Directors not able to attend meetings due to longstanding prior commitments, illness or unavoidable circumstances, provided comments to the relevant Chair on matters to be discussed at the relevant meeting.
(vii) The Audit Committee met 12 times during 2018 (2017 – 11), enabling the Committee to discharge its responsibilities to oversee the management of the risks associated with the IT Migration Programme as outlined on page 43.
(viii) A joint meeting of the Risk and Audit Committees was held on 21 May 2018. Attendance for this meeting is included within the Risk Committee figures and has not been repeated within the Audit Committee figures.

Board development

During the year, Andy Simmonds completed a comprehensive induction programme following his appointment to the Board as an Independent Non-executive Director. Additionally, Directors are given the opportunity to undertake further training in order that they are fully comfortable with their role within the Board and to enable them to contribute to the operation of the Board and the long-term success of the Company in the fullest manner possible.

In addition, 'deep-dive' sessions are regularly held to allow Non-executive Directors to explore key strategic and risk issues outside of the time constraints of a formal Board meeting. A number of such sessions, run by relevant members of the Bank Executive Committee, were held during 2018 and covered topics including the IT Migration project, Cyber Security, material and emerging risks to TSB, and Competition Law.

How the business is managed (continued)

Board effectiveness

The review of Board effectiveness for 2018 was facilitated externally by Independent Audit Limited during October and November, with the results presented to and discussed at the December meeting of the Board. The exercise was conducted using a self-assessment questionnaire developed by Independent Audit Limited with input from the Senior Independent Director and Company Secretarial team, which was provided to each member of the Board and members of the executive team/senior management who regularly attend Board meetings. The feedback provided by the completed questionnaires was collated and analysed by Independent Audit Limited and summarised in a report presented to the Board. This report reflected the key feedback themes and included suggested actions for consideration by the Board. The Board agreed to take these actions forward as the basis of a plan of work for delivery in 2019 to enhance the effectiveness of the Board. During the year, Independent Audit Limited also conducted a review of the effectiveness of TSB's Internal Audit function. Independent Audit Limited have no other connection with TSB Group.

The Board's Audit, Risk and Remuneration Committees have also conducted reviews of their own effectiveness during 2018. Each committee agreed a questionnaire which was circulated to committee members and other members of the executive team who regularly attend committee meetings. The results were analysed by the Company Secretarial team, discussed with the chair of the relevant Board committee and actions agreed for the coming year. These results were also fed into the externally facilitated Board effectiveness review and included as necessary in the output considered by the Board at its meeting in December.

Independence

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

Management of conflicts of interest

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

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

As Executive officers of Sabadell, Miquel Montes and Tomás Varela will have a conflict of interest in circumstances where the interests of TSB and the wider Sabadell Group are not, or may not be, aligned. This conflict was authorised by the Board on 22 July 2015. In relation to consideration of matters pertaining to the IT migration, this potential conflict was managed on a case by case basis throughout 2018 by the Board determining in each case whether Miquel and Tomás would be permitted to participate in the discussion and/or decision, as applicable.

Whistleblowing arrangements

TSB has a robust whistleblowing process in place which is available to all Partners, with the Board delegating responsibility to the Audit Committee to provide challenge and oversight of these arrangements. Further details on this oversight are contained in the Audit Committee report on page 43.

How the business is managed (continued)

Reappointment of Directors

The Board considers that all Directors continue to be effective, committed to their roles and have sufficient time available to perform their duties. All Non-executive Directors, with the exception of Miquel Montes and Tomás Varela (being the Directors appointed at the nomination of Sabadell), have been appointed for an initial three year term and their continued appointment thereafter is considered by the Board at the end of the initial period of office. During 2018, Sandy Kinney's tenure as an Independent Non-executive Director was extended in order that she could provide additional support to the business during the period following the IT migration. As the Company is a wholly owned subsidiary of Sabadell it is not considered necessary for Directors to seek annual re-election or for the Directors appointed at the nomination of Sabadell to be appointed for a specified term.

Company Secretary and independent professional advice

The Company Secretary, Susan Crichton, retired on 24 January 2018 and was replaced by Lorna Curry. Lorna Curry resigned as Company Secretary on 31 December 2018 and was replaced by Keith Hawkins on an interim basis. The Company Secretary is responsible to the Board for ensuring compliance with corporate governance requirements. The Board has access to the Company Secretary individually and collectively. As well as the support of the Company Secretary, any Director may take independent professional advice at the Company's expense in the furtherance of their duties, where considered necessary.

Evaluation of internal controls procedures

The Board has carried out an assessment of the effectiveness of the Company's risk management and internal control systems. The Audit Committee report explains the process in more detail on page 42.

External auditors

PricewaterhouseCoopers LLP (PwC) have expressed their willingness to continue as the Company's auditors. As outlined in the Audit Committee report on page 44, resolutions proposing their reappointment for 2019, and to authorise the Directors to determine their remuneration, will be proposed at the 2019 Annual General Meeting, as recommended by the Audit Committee. The Audit Committee report on page 44 includes details of a process to rotate TSB's external auditors commencing with the audit of the 2020 financial statements.

Principal accountant fees and services

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

Internal Control and Governance Framework

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

(i) Bank Executive Committee

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

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

(ii) Bank Executive Committee Sub-Committees

The following sub-committees of the Bank Executive Committee are structured to align with the Risk Management Framework described on page 20 and indirectly report to the Risk Committee:

- **Asset and Liability Committee**

Chaired by the Chief Financial Officer, the Asset and Liability Committee is responsible for the strategic management of TSB's balance sheet, the profit and loss implications of balance sheet management actions and the risk management framework for market risk, liquidity risk, capital risk, earnings volatility and economic value.

How the business is managed (continued)

- **Credit Risk Committee**

Chaired by the Chief Risk Officer, the Credit Risk Committee is responsible for the coordination and aggregation of all credit risk management activity, management of TSB's credit risk profile, including credit risk appetite metrics and credit strategies, and TSB's compliance with all relevant credit regulation and legislation.

- **Operational Risk Committee**

Chaired by the Chief Operating Officer, the Operational Risk Committee is responsible for identifying, assessing, managing and reporting of operational risks and the aggregation and coordination of operational risk management across the Bank, monitoring and challenging the operational risk profile, including key operational risks and controls, and for ensuring appropriate escalation and visibility of relevant breaches, losses and events.

- **Conduct Risk Committee**

Chaired by the Distribution Director, the Conduct Risk Committee is responsible for identifying, assessing, managing and reporting conduct risk and for ensuring the delivery of substantially fair customer outcomes, that the Bank is compliant with all relevant conduct regulation and legislation, that there are no systemic conduct failings in any area, monitoring and challenging the conduct risk profile, including key conduct risks and controls, and for ensuring appropriate escalation and visibility of relevant breaches, losses and events.

- **Model Governance Committee**

Chaired by the Chief Risk Officer, the Model Governance Committee is responsible for ensuring the development, implementation and effectiveness of the model governance framework (embracing policies, methodologies, systems, processes, procedures and people), the clear articulation of the extent and type of model risk to which TSB is exposed, acting as the Designated Committee as required by the Capital Requirements Regulation and approving, monitoring and reviewing TSB's material risk models as defined by policy. This is the Board's designated model governance committee and the Chief Financial Officer is the designated Board member attending.

- **SME Executive Committee**

Chaired by the Commercial Banking Director, the SME Executive Committee is responsible for developing and implementing the strategy, business objectives and operations of the SME Business, including the activities of the Business Banking Centre, and for monitoring the performance of the SME business.

- **Other Bank Executive Committee Sub-Committees**

A number of further sub-committees of the Bank Executive Committee enable oversight over, among other matters, product pricing and design and the external disclosure of inside information.

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

The Executive Product and Sales Process Governance Committee is responsible for approving changes to products and sales processes, through six key stages of the product lifecycle. The Committee provides strategic and senior oversight to identify, measure, mitigate and monitor risks associated with product design and sales processes.

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

By order of the Board

Keith Hawkins
Company Secretary,
31 January 2019

Nomination Committee report

Chairman's introduction

All the Nomination Committee members are Non-executive Directors. The Committee is authorised by the Board to keep the structure, size and composition of the TSB Boards under review and for making recommendations to the Board with regard to any changes required. It leads the process for appointments to the TSB Boards, Board committees and the chairmanship of those committees and also considers succession planning for the TSB Boards and Executive, taking into account the skills and expertise that will be needed in the future. As at the date of this report, the members of the Nomination Committee are Dame Sandra Dawson (Chair, subject to regulatory approval), Polly Williams and Miquel Montes. Until 14 November 2018, Richard Meddings chaired the Nomination Committee, but has stepped down from the position of member and chair of the Committee during the time that he is acting as Executive Chairman. To maintain a membership at three, Polly Williams was added as an interim member of the Committee on 14 November 2018. It is intended that composition of the Nomination Committee will revert to its previous state (Richard Meddings as Chair, Dame Sandra Dawson and Miquel Montes) when Debbie Crosbie joins as Chief Executive Officer.

Recruitment of Directors and Succession Planning

The Committee met twice during the course of 2018 to discuss the composition of the Board. The focus of the meeting held on 23 May 2018 was to appoint a successor to Sandy Kinney as Chair of the Risk Committee, given Sandy's stated intention to resign as an Independent Non-executive Director during the course of 2018. Following an extensive search supported by Korn Ferry (who have no other connection with TSB), the Committee considered and recommended to the Board the appointment of Andy Simmonds as an Independent Non-executive Director and Chair of the Risk Committee. Andy was appointed as a Director of TSB and as the Chair of the Risk Committee on 11 July 2018.

The focus of the meeting held on 14 November 2018 was twofold: (i) to progress the appointment of a successor to Paul Pester as TSB's Chief Executive Officer, and (ii) to discuss the wider topic of succession planning for the TSB Boards and Bank Executive Committee. Following an extensive search by Odgers Berndston (who have no other connection with TSB), which covered a broad range of candidates, the Committee considered and recommended to the Board the appointment of Debbie Crosbie as TSB's new Chief Executive Officer. The Board subsequently approved the appointment of Debbie Crosbie as a Director and Chief Executive Officer of TSB, subject to regulatory approval. Regarding wider succession planning, the Committee held an initial discussion on succession for the roles of Chair of both the Audit and Remuneration Committees. The Committee also gave preliminary consideration to particular areas where the Board would look to enhance its skills and experience in the future, given the changing world of financial services provision. Both these topics will be explored further by the Committee in 2019.

Diversity

TSB is committed to fair and consistent treatment of all Partners regardless of their personal characteristics, which include gender, ethnicity, religion, sexual orientation, transgender status, disability, nationality or age, as further detailed in the Partners' report starting on page 47. The Board has adopted this approach to diversity and had regard to it during the recruitment process for the Directors discussed above. The Board diversity policy promotes and affirms TSB's aspiration to meet and exceed the target of 33% of Board positions being held by women, as set out in the Hampton-Alexander Review. Currently 30% of members of the Board are women. This figure was 36% up to the point of Sandy Kinney's departure from the Board on 10 December. Additionally, three of the four Board Committees are currently chaired by women (including Dame Sandra Dawson's chairing of the Nomination Committee, which is subject to regulatory approval). In identifying candidates for future appointments, the Committee will consider the balance of skills, knowledge, experience and diversity required on the Board for a particular appointment. The percentage of women in senior management positions is set out on page 48.

The Executive Chairman's other significant commitments

Richard Meddings' primary commitments in addition to the role of TSB Executive Chairman are: i) Non-executive Director of Jardine Lloyd Thompson Group plc, and ii) Non-executive Director of Deutsche Bank AG. His other external appointments are recorded in the biographical details shown on page 54.

Dame Sandra Dawson

Chair, Nomination Committee

31 January 2019

Audit Committee report

Chair's introduction

Running the bank in a transparent and straightforward manner is central to TSB's local banking business model. These values apply equally to the operation of the Audit Committee and, as a reflection of this transparency and the importance placed on the role of the Committee, we continue with our established practice of including a report on its activities in this Annual Report on a voluntary basis. I will ensure that I and the Committee are held to account and that its activities continue to be reported in a transparent and straightforward manner.

I am a chartered accountant and spent a number of years as an Audit Partner at KPMG. As well as my TSB Board role, I am a Non-executive Director of Jupiter Fund Management plc, RBC Europe Limited and XP Power Ltd.

I have been chair of the Committee throughout 2018 and have been ably supported by my fellow Non-executive Directors, Graeme Hardie and Tomás Varela, who have served as members of the Committee throughout the year. I extend a heart-felt thank you to Sandy Kinney who stepped down from the Committee on 10 December 2018 when she resigned from the Board. Sandy has been a deeply valued member of the Audit Committee since she joined the Board in May 2014. I extend a warm welcome to Andy Simmonds who became a member of the Committee when he joined the Board as a Non-executive director on 11 July 2018. The Committee will benefit significantly from Andy's experience of the financial services sector. Biographies of the members of the Committee can be found on pages 54 to 57. All Non-executive Directors, including the Executive Chairman, of TSB have a standing invitation to attend meetings of the Committee.

The report that follows describes the Committee's responsibilities and its activities during 2018. Consistent with 2017, the Committee devoted a considerable amount of its time to oversight and challenge of the management of the risks associated with the IT migration programme. In particular, in the period leading up to the migration event, the Committee scrutinised management's plans to execute and control the data migration process and management's assessment of TSB's organisational readiness to use the new platform. The Committee devoted time to assessing the robustness of the design and the governance arrangements for taking the decision to proceed with the migration event, including the evidence collated by management. Subsequently, and in light of the immediate disruption to customer service, the Committee prioritised its activities to challenge the remediation plans to improve the robustness of the IT change management approach; determine the underlying cause of the platform instability; and monitor platform stability and service levels.

The report also explains the Committee's work in assessing the effectiveness of TSB's risk management and internal control systems and describes the matters reviewed by the Committee in assessing the transparency and integrity of TSB's financial reporting, management's preparations for the Single Supervisory Mechanism's validation of TSB's Internal Ratings Based capital models, and the activities undertaken to monitor the work and priorities of the Internal Audit function.

In discharging its responsibilities during 2018, the Committee has sought to maintain a transparent and open framework of review and challenge of management's key financial reporting estimates and judgements. External audit provides a key role in this challenge process and the Committee has satisfied itself as to the effectiveness and independence of the external auditors during 2018. Mindful of the impending mandatory requirement to rotate the external auditor, the Committee led a tender process for the provision of external audit services for TSB and provided input to a Sabadell group wide audit tender. Following the conclusion of the tender, TSB Board has accepted the Committee's recommendation to propose a resolution to appoint KPMG for the audit of the financial statements for the year ending 31 December 2020 at a future general meeting.

During 2019, I expect the frequency of the Committee's meetings to reduce from the 12 meetings in 2018, reflecting the significant improvement in the stability of the IT platform. In 2019, the Committee's attention will be targeted at oversighting management's plans to maintain the effectiveness of TSB's risk management and internal control systems while improving their efficiency as TSB seeks to grow. The Committee will also maintain a deep interest in the industry wide implementation of IFRS 9 and will continue to challenge management's key accounting judgements, particularly the use of multiple economic scenarios in evaluating expected credit losses, during an extended period of economic uncertainty.

Polly Williams
Chair, Audit Committee
31 January 2019

Audit Committee report (continued)

Membership and operation of the Committee

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

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

I report to the Board after each Committee meeting on the main matters discussed so that all Directors are informed on the activity of the Committee. I am available to all Directors for discussion of any matters in more detail and maintain regular dialogue outside Committee meetings with the Bank Executive Committee members, particularly the Chief Executive Officer/Executive Chairman, Chief Financial Officer, Chief Operating Officer and Chief Audit Officer, and also with the lead partner of the external auditor.

The Committee met 12 times during 2018. This was consistent with 2017, enabling the Committee to provide regular oversight, on behalf of the Board, of the management of the risks associated with the IT Migration Programme.

Audit Committee responsibilities and activity in 2018

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

- Financial statements and related financial reporting;
- Risk management and internal control systems;
- Risks associated with TSB's IT Migration Programme;
- Adequacy of whistleblowing arrangements;
- Performance and effectiveness of the Internal Audit function; and
- Effectiveness of the relationship with the external auditor.

Financial statements and related financial reporting

The Committee is responsible for review and challenge of TSB's interim results announcements and annual financial statements, including the significant financial reporting estimates and judgements which they contain. During 2018, the Committee has considered the following matters:

(i) The consistency and appropriateness of, and any changes to, significant accounting policies

The Committee has considered and accepted management's review of TSB's accounting policies. These have been updated in 2018 to reflect the adoption of IFRS 9 'Financial Instruments' (page 61) and IFRS 15 'Revenue from contracts with customers' (page 62) both of which came in to force with effect from 1 January 2018. The Committee considered a report from management which noted that the accounting policies applied in the 2018 financial statements were consistent with those disclosed in the 2017 annual report and with analysis presented by management in preparation for the adoption of IFRS 9.

The Committee also received reports from management on TSB's readiness for IFRS 16 *'Leasing'* which came into force with effect from 1 January 2019. The Committee requested a report from management addressing the key areas of judgement and proposals for related accounting policies, particularly in respect of the accounting treatment of the new Outsourced Services Agreement that came into effect during 2018 following the IT migration.

(ii) The methods used to account for significant transactions

The Committee has reviewed and supported proposals from management on the income statement presentation for migration related costs (page 88) and the establishment of a new 'hold-to-collect' liquidity portfolio accounted for at amortised cost (note 6 on page 78).

(iii) Viability and going concern assessments

The Committee has considered management's approach to, and the conclusions of, the assessment of TSB's ability to remain a going concern. The Committee considered and, after taking external market developments into account, supported management's conclusion that it remained appropriate to adopt the going concern basis in preparing the consolidated financial statements. The Committee also considered management's approach to, and the conclusions of, the assessment of TSB's viability. The Committee challenged management's viability assessment period, noting it was over the three years to December 2021, a one year reduction in the assessment period compared to 2017. After consideration, the Committee supported the approach adopted by management as described on page 27.

Audit Committee report (continued)

(iv) Review of annual report – fair, balanced and understandable

The Committee considered management's approach to, and governance arrangements over, the preparation of this annual report and recommended to the Board that, taken as a whole, it was considered to be fair, balanced and understandable. The approach and results of the assessment are set out in the Directors' report (page 46).

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

The judgements and estimates required in the preparation of the 2018 financial statements and related disclosure notes were significantly impacted by the preparation for, and the impact of the service disruption that occurred immediately following, the IT migration. In addition, the 2018 financial statements and disclosure notes reflect the adoption of IFRS 9 '*Financial Instruments*' which was effective from 1 January 2018. The Committee has assessed the nature, basis for, and appropriateness of the estimates and judgements proposed by management in the financial statements as presented below. After challenge, the Committee supported management's proposals.

Accounting estimates	Audit Committee considerations	Financial statement reference
Allowance for credit impairment losses	As explained on page 62, the adoption of IFRS 9 at 1 January 2018 resulted in a £93.7 million increase in the allowance for credit impairment losses and a £2.5 million increase in provisions for loan commitments. At 31 December 2018, TSB's credit loss allowance was £198.7 million. During 2017, in preparation for the transition to IFRS 9, the Committee requested that management hold a series of 'deep dive' reviews on TSB's approach, including a focus on the key areas of management judgement. These included management's application of multiple economic scenarios and selection of associated probability weightings, and the application of expert credit judgements to modelled outputs. During 2018, the Committee reviewed regular reports from management assessing the adequacy of the allowance for credit impairment losses. These reports assessed the adequacy of historic provisions against subsequent recoveries, reviewed management's governance arrangements over provisioning adequacy and in particular the governance over impairment models and benchmarked TSB's metrics against other banks. *Economic scenarios and associated weightings* The Committee received a report from management that assessed the appropriateness of the scenarios and probability weightings in light of the current environment. The Committee challenged management over their scenarios and probability weightings, including in respect of uncertainty around the impact and probability, of the UK's exit from the EU. The Committee noted that the downside scenario presented by management was reflective of economic metrics that might occur in a no deal exit scenario. Management assessed the key metrics by way of benchmarking against the 'Disruptive' and 'Disorderly' EU withdrawal scenarios published in November 2018 by the Bank of England and reports from TSB's economic consultants. The paper noted that, while highly judgemental, a 20% probability had been assigned to this scenario in light of market commentaries on their relative probabilities and reducing political appetite for a no-deal exit from the EU. Management presented analysis of the sensitivity of the allowance for credit impairment losses to alternative scenario weightings and concluded that the impact was limited. Management also presented proposals for the disclosures of those sensitivities, set out on page 82, to provide context to their impact. After substantial debate and challenge, the Committee supported management's proposals.	Note 11 *'Allowance for credit impairment losses'* page 82

Audit Committee report (continued)

(v) Whether TSB has made appropriate accounting estimates and judgements (continued)

Accounting estimates	Audit Committee considerations	Financial statement reference
Allowance for credit impairment losses (continued)	*Expert credit judgements* At 31 December 2018, the impairment provisions included £51.4 million of management's adjustments to modelled outcomes. A key focus of the Committee during the year was an assessment of the level and rationale for such adjustments. The Committee challenged reports prepared by management to support these adjustments, and management's plans to amend, where appropriate, the relevant models to minimise future adjustments. The Committee concluded that a robust governance framework existed to monitor provisioning adequacy and that the assumptions and judgements applied by management were appropriate. The Committee was satisfied that the provision and related disclosures in the financial statements were appropriate.	
Provision for migration related customer remediation	As explained in the Executive Chairman's statement the customer service disruption caused by the instability of TSB's IT systems following migration caused harm to some of TSB's customers. Customer redress and rectification is expected to cost £125.1 million. Following the resolution of complaints during 2018, a provision of £41.1 million was carried at 31 December 2018. In assessing the total cost of the customer redress and the adequacy of the provision at December 2018, judgement was required in estimating the number of complaints, the complexity and expected redress cost of each complaint, including the proportion that might be referred to the Financial Ombudsman Service, and the incremental operational and personnel costs required to undertake the redress programme. The Committee reviewed reports from management setting out the approach undertaken to assess the extent of the estimated costs. These included an assessment of the costs incurred in processing complaints received to date and the forecast productivity of claims handlers in processing complaints. The Committee considered and challenged the sensitivity of estimated redress costs and the residual provision to alternative assumptions and was satisfied that the remaining provision and related disclosures in the financial statements were appropriate.	Note 32 *'Provisions'* page 111
Customer remediation provisions	Conduct issues remain a key focus of the banking industry. Notwithstanding the indemnity given by LBG, TSB retains the primary liability for alleged misconduct to its customers. At 31 December 2018, TSB carried provisions of £15.0 million which was materially covered by a corresponding asset in respect of an indemnity provided by Lloyds Bank plc. The provisions carried are primarily in respect of alleged mis-selling of added value current accounts and alleged breaches of the Consumer Credit Act. The Committee reviewed reports from management setting out the approach undertaken to assess any liability for alleged conduct issues. This included assessing themes and volumes of customer complaints received by TSB. The Committee was satisfied that the provisions, recovery under the indemnity and related disclosures in the financial statements were appropriate.	Note 32 *'Provisions'* page 112

Audit Committee report (continued)

(v) Whether TSB has made appropriate accounting estimates and judgements (continued)

Accounting judgements	Audit Committee considerations	Financial statement reference
Assessment of exposure to regulatory investigations	During 2018, the FCA and PRA commenced a formal joint investigation in connection with the handling of the migration of data and IT systems. This investigation is ongoing and it is not possible to make a reliable assessment of any findings. The Committee was satisfied with management's assessment, which included the consideration of industry wide practice in similar circumstances, and the disclosure as a contingent liability included in the financial statements.	Note 27(i) *'Contingent liabilities'* page 108
Recovery of post migration charges	As set out on page 10, subsequent to the migration in April 2018, TSB incurred charges of £330.2 million relating to matters arising from the associated disruption to service. Recovery of these charges is being considered from a number of potential sources including relevant insurance policies and under the MSA and OSA contracts. Discussions with insurance providers are at an early stage and no amounts have been recognised. The MSA and OSA contracts provide TSB with the right to seek recovery of losses from Sabis for breach of contract up to the level of liability caps in each agreement. The parties have reached provisional agreement, subject to mutual reservation of rights while negotiations are concluded, where TSB will recover an aggregate of £153.0 million under the respective contracts. Management note that this represents the current best estimate and may change as these negotiations conclude. The Committee agreed with management's conclusion that, in light of the current agreement between the parties, it is appropriate to recognise the aggregate recovery under the respective agreements. The Committee also agreed with management that as the amount reflects recovery of post migration costs, it was appropriate to present the charges net of associated recovery in the income statement.	Note 16 *'Operating expenses'* page 88 Note 33 *'Other liabilities'* page 112

Risk management and internal control systems

The Committee is responsible for reviewing the adequacy and effectiveness of TSB's risk management and internal control systems and reporting on that review. For 2018, the Committee's review was required to consider the change in internal control systems arising at the migration event in April. The Committee's review considered:

- the pre-migration period to 22 April, when TSB was dependent on LBG for the provision of banking services and the effective operation of related controls under the Long Term Services Agreement; and
- the post migration period when the IT platform was provided under an Outsourced Services Agreement with Sabis, the Sabadell in house IT services provider.

Reflecting this transition, the Committee has deployed a 'close and continuous' approach to its review throughout 2018. Throughout the year, the Committee took the following inputs into its review:

- Ongoing monitoring reports on the effectiveness of TSB's risk management and internal control systems;
- Quarterly reports from management which concluded that TSB's internal financial control framework has adequate coverage and is operating effectively;
- The results from an 'agreed upon procedures' engagement with PwC, LBG's external auditor, in respect of controls over TSB financial reporting and IT systems operated by LBG for the pre-migration period;
- Reports from management on the accuracy of the data migration to the new IT platform; and
- Regular management information on the activities of Internal Audit and its annual report on internal controls, including the findings from audit reports over the IT control framework operated by Sabis.

Audit Committee report (continued)

Risk management and internal control systems (continued)

On the basis of this work, the Committee was satisfied that TSB's risk management and internal control systems operated effectively during the pre-migration period to 22 April 2018. As outlined in the Risk Management report (page 19) the instability of the IT platform immediately post migration resulted in a period of service disruption when certain financial, conduct and operational risk outcomes were outside of TSB's risk appetite. This reflected a period of control weaknesses in a number of areas, including fraud prevention, IT service stability, product servicing, complaints handling and fraud. During the year, substantial progress has been made such that by the end of 2018, the TSB risk management and internal control systems were considered adequate but requiring ongoing improvement. In forming this view, in respect of the post migration period, the Committee noted that aspects of the internal control systems could operate more efficiently and that, as the IT control framework had not had time to be properly embedded and reach the expected levels of maturity, reliance was placed on mitigating controls.

The key elements of the management of risk within the business and the effective system for internal controls are set out within the corporate governance statement (see page 35).

Risks associated with TSB's IT Migration Programme

The Committee was requested by the Board to oversee the management of the risks arising from the programme to migrate from the IT and operational services provided by LBG to an IT platform provided by companies within the Sabadell Group and other third party suppliers.

The Committee requested reports from management on both the progress of the Programme against a defined and pre-approved delivery plan and the management of the associated Programme risks. In preparation for the migration event, the Committee challenged the adequacy of systems testing, the approach to defect management and the assessment of management's readiness to operate the new platform. The Committee requested reports from management to assess the adequacy of the planned data migration process and sought assurance over its adequacy by reviewing reports from the four dress rehearsals of that process, including 'back out plans' should these be required. The Committee reviewed and, having taken account of advice from external advisors, recommended enhancements to the design and content of the portfolio of evidence collated by management to support its recommendation to the Board to commence the migration event. The body of evidence covered all aspects of the adequacy and completeness of the system design, build and testing; organisational readiness to use the new platform; the availability of resources and processes to respond to post migration incidents and manage deferred functionality; and plans to validate that the systems operated as expected post migration. The Committee routinely sought assurance from oversight reports provided by the 2nd line Risk team and targeted Internal Audit reviews.

During the period of service disruption that immediately followed the migration event, the Committee considered reports from management that summarised the effectiveness of the incident management approach and, in particular, provided challenge over actions taken by management to improve the robustness of the IT change management approach.

Subsequently, the Committee requested reports on the causes of the post migration service disruption from management and Sabis and, for the remainder of the year, requested and challenged reports from management that summarised the stability of the IT platform.

Adequacy of whistleblowing arrangements

The Committee oversees the adequacy of TSB's whistleblowing arrangements, ensuring that they are proportionate and enable Partners and contractors to raise concerns, in confidence, about possible wrongdoing in financial reporting or other matters. During 2018, in my role as TSB's Whistleblowing Champion, I sought, and received, regular reports from management which provided details of whistleblowing matters. The Committee received an annual report from management providing details of whistleblowing matters including details of specific cases as appropriate and challenged management on TSB's plans to ensure whistleblowing policies and processes were aligned with external best practice. The Committee reviewed TSB's whistleblowing arrangements through the Bank's participation in a FCA benchmarking survey and in comparison to industry best practice. The Committee noted that the Bank's performance was satisfactory. The Committee was satisfied that there were no material concerns raised nor breaches of policy or failure in controls relating to TSB's Whistleblowing processes.

Performance and effectiveness of the Internal Audit function

The Committee is responsible for monitoring the performance and effectiveness of Internal Audit. During 2018, the Committee carried out this responsibility by:

- Reviewing and approving the remit of Internal Audit, in line with the Chartered Institute of Internal Auditors' Guidance on Effective Internal Audit in the Financial Services Sector;
- Reviewing and approving the 2018 Internal Audit plans in line with TSB's strategy, so that these had appropriate coverage of the business and were flexible to enable a focus on significant risks in 2018;

Audit Committee report (continued)

Performance and effectiveness of the Internal Audit function (continued)

- Receiving regular reports from the Chief Audit Officer on the range of Internal Audit activities undertaken in 2018 and monitoring activities resulting from Internal Audit reports;
- Approving the Internal Audit budget, including for using subject matter expertise where appropriate, to deliver the audit plan;
- Engaging a third party, Independent Audit Limited, to complete an independent and objective external assessment of the effectiveness of Internal Audit function; the report concluded favourably on Internal Audit's effectiveness and did not identify any material shortcomings nor any instances of non-conformance with industry standards or code;
- Reviewing the interaction between Internal Audit and the Risk function;
- Reviewing the interaction between Internal Audit and the external auditor; and
- Confirming that Internal Audit makes independent assessments of TSB's control framework but is fully informed by management's and the Risk function's reporting and views on risks and controls.

Effectiveness of the relationship with the external auditors

The Committee is responsible for the effectiveness of TSB's relationship with its external auditor and for assessing their independence and objectivity. During 2018 the Committee discharged this responsibility by:

- Agreeing the terms of the audit engagement letter and reviewing and approving the audit fee proposal. Fees paid to the external auditor are set out in note 16 to the consolidated financial statements on page 89;
- Reviewing and challenging the external auditor's audit strategy and consideration of significant and elevated audit risks to ensure TSB's circumstances are appropriately reflected;
- Receiving reports from the external auditor covering management's estimates and judgements;
- Reviewing the outcomes of the Financial Reporting Council's (FRC) Audit Quality Review inspection reports as they relate to PwC and potential considerations for TSB's audit;
- Considering the approach to obtaining independent assurance over outsourced controls;
- Performing ongoing review of the audit service through discussions between the Chair of the Audit Committee, Chief Financial Officer and Chief Risk Officer and PwC colleagues; and
- Ensuring compliance with policy governing the use of the external auditor for non-audit services to safeguard their objectivity and independence (see note 16 to the consolidated financial statements on page 89 for fees paid to the external auditor).

In addition, during 2018, the FRC's Audit Quality Review team reviewed PwC's audit of TSB's 2017 financial statements, as part of their annual inspection of audit firms. As Chair of the Audit Committee, I held an initial preparatory discussion with the FRC review team, received a copy of the concluding letter issued in January 2019 by the FRC, and discussed the results of the review with our audit partner at PwC. These were also considered by the Audit Committee. I am pleased to note that there were no significant findings arising.

PwC has held the position of external auditor of TSB Bank plc since 1997 and of the Company since its incorporation, both as part of the wider historical LBG audit relationship. The Committee has taken into account the knowledge and experience that PwC has of TSB's business and the need to align with the broader Sabadell Group wide audit arrangements. Consequently, the Committee has recommended to the Board that the re-appointment of PwC for the audit of the 2019 financial statements is put to the shareholder along with a resolution for the Committee to set the remuneration and terms of engagement of the Company's auditor. Laura Needham was the senior statutory auditor for the audit of the 2018 financial statements.

Mindful of the impending mandatory requirement to rotate external auditor, the Committee led a tender process for the provision of external audit services for TSB and provided input to a Sabadell group wide audit tender. This audit tender complied with the Statutory Auditors and Third Country Auditors Regulations 2016 (SATCAR), which introduced requirements for the Audit Committees of Public Interest Entities (PIEs) in respect of tender processes. The tender was conducted having regard to the FRC's best practice guidelines in respect of an audit tender as they applied in the circumstances of a wholly owned subsidiary.

Following the conclusion of the tender, TSB Board accepted the Committee's recommendation to propose a resolution to appoint KPMG for the audit of the financial statements for the year ending 31 December 2020 at a future general meeting.

Directors' report

Introduction
The Directors of TSB Banking Group plc (the Company) present their report and audited consolidated financial statements for the year ended 31 December 2018, in accordance with section 415 of the Companies Act 2006.

The information set out on pages 2 to 27 and, in particular, the following cross-referenced material, is incorporated into this Directors' report:

- The corporate governance statement (pages 28 to 58);
- Outlook – delivering through uncertainty (page 5);
- Statement of Directors' responsibilities (page 58); and
- Partners' report (pages 47 to 49).

Results and dividends
The consolidated balance sheet can be found on page 65 and the consolidated statement of comprehensive income is on page 66. The Directors do not currently propose to pay a dividend.

Directors
The Directors of the Company who were in office during the year, or from the date of their appointment, and up to the date of signing the financial statements were:

Will Samuel	(resigned 2 February 2018)
Richard Meddings	
Paul Pester	(left the bank by mutual agreement on 3 September 2018)
Ralph Coates	
Paulina Beato	
Dame Sandra Dawson	
Graeme Hardie	
Sandy Kinney	(resigned 10 December 2018)
Miquel Montes	
Stephen Page	
Andy Simmonds	(appointed 11 July 2018)
Tomás Varela	
Polly Williams	

The biographies of TSB's Directors appear on pages 54 to 57. The Company's articles of association (the Articles) give the Directors power to appoint and replace Directors. Under the terms of reference of the Nomination Committee, any appointment must be recommended by it for approval by the Board of Directors. Directors can also be appointed or removed from office by written notice provided to the Company by Sabadell as the sole shareholder.

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

Directors' indemnities
Each of the Directors has the benefit of a deed of indemnity which constitutes a 'qualifying third party indemnity provision'. This indemnification for Directors provided by the Company has been arranged in accordance with the Articles and the Companies Act 2006. With the exception of Andy Simmonds, the indemnities were in place throughout 2018. The indemnity for Andy Simmonds was executed on 7 August 2018. Each of the indemnities remain in force at the date of signing these financial statements and are available for inspection at the Company's registered office.

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

Share capital
At 31 January 2019, the total issued share capital with voting rights consisted of 500,000,000 ordinary shares of £0.01 each. The total issued share capital is held by Banco de Sabadell, S.A.

Future developments
The development of TSB is set out in the Executive Chairman's statement on pages 3 to 5.

Directors' report (continued)

Employee information

The Partners' report (pages 47 to 49) is an integral part of the Directors' report providing information about TSB's Partners.

Environmental information

TSB Group is committed to being a responsible user of resources. We continue to consider ways in which we can improve our environmental impact; for instance we reduced the use of vehicles in our business by streamlining waste collections and postal deliveries. One of the anticipated benefits of the IT Migration Programme will be an ongoing reduction in our energy usage as a result of a more efficient use of technology. In addition, where we invest in new branches all equipment meets high standards of energy efficiency rating.

Political donations and expenditure

No amounts were given for political purposes during the year.

Financial risk management and hedging policies

Details of the use of financial instruments, together with risk management disclosures can be found in the Managing financial risk section of the financial statements on pages 93 to 106 and the Risk management section in the Strategic report on pages 19 to 26.

Post balance sheet events

There are no significant events affecting TSB that have arisen between 31 December 2018 and the date of this report that require disclosure.

Research and development activities

TSB develops new products and services during the ordinary course of business.

Overseas branches

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

Corporate headquarters and registered office

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

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

Going concern

The Directors recognise their responsibility to make an assessment of TSB's ability to continue as a going concern, for a period of at least twelve months from the date the financial statements are approved. As set out on page 27, the Directors' assessment of going concern is integrated with that of the assessment of the viability of TSB. The Directors are satisfied that adequate funding and liquidity resources will be in place to allow the financial statements to continue being prepared on a going concern basis and are not aware of any material uncertainties that may cast significant doubt upon TSB's ability to continue as a going concern.

Fair, balanced and understandable

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

- The annual report is drafted and comprehensively reviewed by appropriate senior management with overall co-ordination by the Financial Controller;
- A verification process is undertaken to ensure factual accuracy, with third party review by legal advisers; and
- The annual report is reviewed by TSB Partners from a range of functions, TSB's Bank Executive Committee and the Audit Committee prior to approval by the Board.

By order of the Board

Keith Hawkins

Company Secretary, 31 January 2019

Registered in England and Wales, Company Number 08871766

Partners' report

We are proud of the commitment of our Partners and the collaborative culture we have in TSB. During a challenging year the overwhelming feedback has been that TSB Partners have acted with determination, resilience and pride to put things right for our customers and support each other as referred to in the Executive Chairman's report. I would like to add my thanks to all of our Partners for helping our customers through the challenging period.

Partners collaborate to shape our Partner experience by providing open and honest feedback. We know engagement levels have been impacted in 2018 by the circumstances we have found ourselves in. But by putting listening at the heart of what we do, we know that we can take action on the things that matter most and restore the Partner experience we're so proud of at TSB.

Encouraging Partner collaboration and feedback

Collaboration and two-way communication is encouraged at all levels and is key to TSB's strategy. '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 TSB's decision making and the direction of our bank. In 2019, they will also present directly to the Board.

Following the migration in April 2018 our listening activities were expanded to include 'Partner Voice' sessions. These were designed to give more Partners the opportunity to engage directly with senior leaders in TSB. In August, an additional 500 Partners provided feedback about the issues facing them and our customers. We will continue to run these listening programmes as we restore engagement levels, including Partner Voice sessions run personally by the Executive Chairman. These are supported by our regular TSB wide 'town hall' meetings and site-specific meetings run by members of the Bank Executive Committee. We also continue to work closely with our recognised unions, Accord and Unite, to build strong relationships and with whom membership is growing steadily.

Our annual Partner Experience Survey provides all Partners the opportunity to feedback on working at TSB. In 2018, we partnered with 'Great Place to Work' for the third year, an independent global research and training consultancy that helps organisations create and sustain great workplaces. During a challenging year our objective was to hear from as many Partners as possible. Feedback was received from 78% of our Partners, our highest response rate to date. While TSB's overall Trust Index score for 2018 at 64% reflected a decrease of 12% from 2017, encouragingly it remains 11% above the UK average score. Partner feedback evidenced the strength of diversity, team work and line management capability, as well as identifying aspects of working at TSB where improvements could be made. We are already using the feedback to target improvements to our Partner experience during 2019.

We've launched our new digital workplace. For the first time ever, everyone in TSB is working on the same platform to access the information they need, to share stories and collaborate across the country. Easy access takes priority, and two-way communication is crucial. Content has been centralised and our news is released through channels which provide daily reporting. We're seeing over 1.65 million hits to our intranet per month, so Partners are using our intranet to find the information they need, when they need it. Partners can use the platform to connect directly with leaders, posting questions or joining discussions.

Partner Wellbeing

Wellbeing was identified as an area for improvement by Partners in 2016 and throughout 2017 we had taken action to raise awareness of how Partners could find support from resources and tools available to them. This provided a solid foundation to ensure Partners were supported effectively during a challenging work environment experienced after the IT migration in 2018. 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. In December 2018, TSB signed up to the TUC's *Dying to Work Charter* demonstrating our commitment to improving support at work for Partners who are living with terminal illnesses.

This year we deployed our Employee Assistance Programme onsite to provide easy access to listening services, as well as holding resilience training sessions for managers. Senior leaders benefited from focused post migration sessions, and all Partners were encouraged to discuss wellbeing during formal performance conversations as well as during regular "1 to 1s". Our network of wellbeing ambassadors continues to support day to day wellbeing activity across our sites to support a healthy working environment, and we've launched Mental Health Awareness training for all Partners (in conjunction with Mind) to open up the conversation around mental health.

Partners' report (continued)

Diversity and inclusion

Diversity and Inclusion is a significant contributor to TSB's culture. TSB achieves this through its industry-leading diversity network, '*Inclusion*'. This aims to help every Partner achieve their potential, focusing on three key themes: personal progression, work-life balance and an inclusive culture. Each of the key 'audiences' has executive sponsorship; disability (Rachel Lock, HR Director); ethnic diversity (Jatin Patel, Products Director); LGBT (Peter Markey, Marketing Director); and gender (Helen Rose, Chief Operating Officer).

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

We're committed to ensuring every Partner, regardless of their background, race, ethnicity or gender has the opportunity to thrive. TSB participates in Business in the Community's Cross Organisational Mentoring Circles, which brings mentees from different organisations together to learn, coach, challenge and support each other under the mentorship of a senior leader. Jatin Patel participates as a mentor along with 10 TSB mentees.

TSB also participates in the annual Stonewall workplace equality index. We were commended for the commitment shown by senior management in engaging with our work on LGBT equality and our great work on monitoring LGBT responses around their experience at work through our annual Partner Experience Survey.

Gender balance

In 2018 TSB was recognised as one of the top 5 *'UK's Best Workplaces for Women'*. This is an indicator of the inclusive culture we have built, and we're committed to being the catalyst for change for gender balance in our industry. That is why in July 2017, TSB was one of the first financial services companies to publish its gender pay gap in our '*Gender Balance Matters*' report, openly highlighting what needed to change at TSB, and encouraging others across the industry to follow suit and challenge the status quo.

Since then we have put in place key initiatives to start to tackle the causes of gender imbalance at TSB. Our strategy for gender balance is focused on four key areas, as outlined in our '*Gender Balance Matters'* report:

1. Attract more women to financial services and TSB;
2. Break down barriers for women;
3. Implement policies that deliver a sustainable long-lasting gender balanced and transparent culture; and
4. Measure Partners' experience and key metrics.

Our approach is improving gender balance:

- Women comprise 20% of our Bank Executive Committee, against an industry average of 14% and comprise 36% of our combined population of Bank Executive Committee members and their direct reports (above the 33% target set by the Hampton-Alexander Review).
- We have created a diverse leadership team in SME banking by appointing eight female executives out of an eleven strong team, and promoted some of our female talent to key Executive and senior leadership roles (including our Treasurer and Chief Information Security Officer).
- As at the date of this report, 30% of members of the Board are women. This figure was 36% up to the point of Sandy Kinney's departure from the Board on 10 December. TSB's aspiration remains to meet and exceed the Government backed target for 33% of boards to be made up of women. This target was met as at 31 December 2017 and for the majority of 2018.

And, as part of our commitment to the HM Treasury's Women in Finance Charter, we've made a commitment to have between 45% and 55% of our senior roles held by women, making us one of the most ambitious organisations on gender balance in financial services.

Partners' report (continued)

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 TSB are given an induction, Welcome to TSB, and our values form a key part of such induction. The Source (our new Learning Management System) 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 Mental Health awareness.

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 TSB 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 role or location. Since moving to a local model, we have seen fundraising by Partners of over £500,000 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 TSB's values. In addition, TSB has a number of partnerships in place to enhance the recognition of its Partners. For example, TSB continues to develop its partnership with Pride of Britain and Pride of Sport. This partnership aligns with TSB values, in particular TSB's support for local people helping local people.

As part of this partnership, TSB created the Pride of Britain TSB Community Partner Award – aimed at celebrating the very special people, whether an individual or group, who have worked together in partnership as a force for good in their local community to improve the lives of people around them. TSB also created its own Pride of TSB to recognise the TSB Partners who are making a real difference through the extraordinary things they do at work or in their community. We had over 1,500 nominations in 2018 and 45 winners across different functions and categories, who attended the awards ceremonies. That's nine more winners than in previous years reflecting the high number of exceptional nominations in a challenging year. Additionally, some of our winners have been profiled in their local community press as part of our partnership with Trinity Mirror.

As reflected in our Remuneration review starting on page 50, TSB's approach to reward aligns to our values and seeks to differentiate us from other banks. It is 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 TSB 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. TSB 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 TSB 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 income used to fund the purchase. TSB 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 the strength of our culture and the extraordinary efforts of our Partners to put things right for our customers in 2018. 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 building an organisation where our Partners are proud to work, whilst focusing on talent, succession and capability of our Partners.

Rachel Lock
Human Resources Director
31 January 2019

Remuneration review 2018

In the five years since TSB was launched onto High streets across Britain, our remuneration approach has remained consistent: it is designed to be simple, fair and in line with our core values. This underlying set of principles remains integral to our reward philosophy.

Business performance in 2018

As outlined in the Executive Chairman's statement, 2018 was an incredibly challenging year for TSB as we moved to our new IT platform. Whilst the migration of all customer records took place as planned, customers experienced problems in accessing their accounts online, long wait times on the telephone and slower transaction times in our branches. The associated disruption, and the large amount of publicity this created, also precipitated an intense and focused fraud attack on TSB's customers. The TSB Board commissioned an independent review, from Slaughter and May, to understand why these problems occurred, and the FCA and the PRA are also conducting their own joint investigation. Findings from these investigations remain outstanding.

TSB's 2018 financial performance was significantly impacted by the IT migration and subsequent service disruption. As a result, TSB incurred a statutory loss before tax of £105.4 million. The Committee has made its reward decisions for 2018 in the context of this disappointing financial performance, balancing the need for reward outcomes appropriate in the business context with the necessity of retaining talent able to rebuild TSB to its previous standing and success.

Reward Outcomes in 2018

As a result of the business performance in 2018, the Remuneration Committee has determined that no TSB Award or SPA will be made in March 2019 in respect of 2018 performance.

In recognition of the efforts made by all of our Partners we announced an individual cash award of £1,500 reflecting the team effort across the business to put things right for our customers in recent months. This was paid to all Partners except members of the Bank Executive Committee (BEC) in December 2018.

In terms of unvested prior year SPA awards due to vest in March 2019, these awards will not vest due to performance against the pre-determined financial target (cumulative Return on Equity) not having been achieved. In addition, the Committee has decided to delay the payment of the vested but as yet unpaid tranches of the Sabadell Integration Awards (SIA) and other awards due to vest in March 2019, subject to the outcome of both internal and external regulatory investigations in to the post migration issues and subsequent consideration by the Committee in light of any findings.

Consideration for all TSB Partners

The Remuneration Committee's focus goes beyond executive pay. We are mindful of the relationship between pay for executives and more junior Partners, and to that end have sought to ensure consistency in the pay outcomes against the salary increase budget of 2% across the whole Bank.

TSB is 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 what the law requires and commit to paying both our direct employees and our suppliers who regularly work on our premises, at least, the real Living Wage.

Gender Pay Gap

TSB was one of the first financial services companies to publish its gender pay gap in our 'Gender Balance Matters' report, openly highlighting improvements TSB could make, and encouraging others across the industry to follow suit and challenge the status quo. Further information is provided in our Partners' report on page 48.

Outlining our Obligations

TSB's remuneration policy continues to comply with the PRA and the FCA Remuneration Codes which came into effect from June 2015 and the PRA's required approach to buyouts for Material Risk Takers (MRTs), which came into effect from 1 January 2017.

For any SPA award in respect of the 2016 performance year and beyond, grants for PRA Senior Managers (in effect, BEC members) were deferred over seven years with pro rata release between the third and seventh year based on an annual release underpin. Any shares issued are subject to a 12 month retention period after the point of release. For MRTs, other than Senior Managers, the deferral period is three or five years, depending on the regulatory status of the Partner, with a retention period on the shares up to 12 months after the point of release. TSB's approach to deferral of total variable remuneration for senior Partners ensures that awards are subject to deferral as required by regulations.

Remuneration review 2018 (continued)

Consideration of Conduct and Risk

The Remuneration Committee takes risk and conduct issues very seriously. Risk profile and behaviours are a key gateway that must be satisfied for any of the incentive awards to pay out to individuals. Incentive pools and awards may be adjusted, including to zero, in the event of any material breaches. All elements of variable remuneration for MRTs are subject to malus and clawback provisions in line with regulatory requirements.

Overview of TSB Remuneration Approach for 2018

The aim of our remuneration policy is to provide competitive remuneration aligned to the delivery of our strategic goals (providing the kind of banking experience people want and deserve, providing great banking to more people, and helping more people to borrow well). It is designed to attract and retain talented individuals, to promote TSB's values, to generate sustainable business performance, while taking into account effective risk management and acceptable conduct.

The key elements of our reward framework are as follows:

- **Basic salary** - provides core remuneration taking into account relevant market benchmarks, complexity of the role and the individual's experience and performance.
- **Market appropriate benefits** - principally pension contributions to a defined contribution scheme or, where appropriate, an equivalent cash payment; 4% of basic salary available to use in our flexible benefits offering; and an employer provided car or alternative cash allowance.
- **Role based allowance** - this was received only by Paul Pester as CEO to reflect the change in his role and specific duties following the acquisition of TSB by Banco Sabadell in 2015.
- The **TSB Award** - which provides an 'on-target' annual short term incentive award opportunity of 10% of basic salary and applies to every Partner, from the Chief Executive Officer to those on the front line. The 10% on-target award may increase, in an exceptional year, to a maximum award of 15% of basic salaries. In any given year the very best performers, whom we call Pioneers, may receive up to twice the on-target award. The TSB Award reflects the collective effort made by all Partners to deliver business success. Awards are made only if certain 'gateways', including risk, profitability and individual conduct are satisfied and corporate performance targets are met.
- The **Sustainable Performance Award (SPA)** - was designed to support achievement of targets based on sustained business and individual performance. This award was granted annually to a limited number of senior Partners and was funded after the TSB Award was funded, if sufficient profit was made and risk management gateways had been satisfied. There were no SPA awards granted for the 2018 performance year.
- We will not exceed an **annual cap** on total variable remuneration of **one times fixed pay** (basic salary plus pension and other benefits) calculated in accordance with the PRA's remuneration regulations, other than in rare circumstances as approved by the Sabadell Remuneration Committee following Sabadell's acquisition of TSB.

Remuneration review 2018 (continued)

Highest paid Director – 2018 remuneration disclosure (*)

On 4 September 2018, the TSB Board announced that Paul Pester was stepping down, by mutual agreement, from his position as Chief Executive and leaving the company. Richard Meddings (the then Non-executive Chairman) agreed to take on the role of Executive Chairman with immediate effect. Mr Meddings did not receive any additional payment to his fees for taking on this role. The table below sets out the total remuneration paid to Mr Pester, TSB's highest paid director, for qualifying services as a TSB director in the period to 3 September 2018 and separately shows the notice paid to 31 December and payable to him from 1 January to 2 September 2019.

The decrease in Mr Pester's total remuneration package in 2018 reflects his service period ending on 3 September 2018 and that, in light of the impacts of post migration service disruption, the Remuneration Committee decided that no TSB Award would be made in respect of 2018 performance and that there would be no vesting of prior year SPA awards due to be released in March 2019. The Remuneration Committee also decided that all Sabadell Integration Awards would be frozen, including those that had not yet been released into nominee accounts and all unvested tranches, pending the outcome of both further internal analysis and external regulatory investigations into the post migration issues.

CEO Remuneration	2018 (2) £	2017 (1) £
Basic salary	627,300	913,500
Role based allowance (3)	135,000	200,000
Benefits (4)	31,351	45,574
Pension (5)	110,246	160,545
Fixed Pay	**903,897**	**1,319,619**
TSB Award (6)	-	114,750
2014 SPA – Release of Tranche 3 (2017) (7) (8)	-	143,805
2015 SPA – Release of Tranche 2 (2017) (7) (8)	-	177,296
2015 SIA (Part 1) (9)	-	-
2015 SIA (Part 2) (10)	-	-
2016 SIA (9)	-	-
2017 SIA (10)	-	-
Variable Remuneration	**-**	**435,851**
Total Remuneration (audited) (11)	**903,897**	**1,755,470**
Notice payments		
Notice paid in 2018 (12)	437,720	-
Notice payable in 2019 (13)	801,030	-

Notes

(1) 2017 figures represent relevant remuneration for the full year as stated in TSB's 2017 Remuneration Report updated to take account of the actual release value of the 2017 TSB Award, Tranche 3 of the 2014 SPA and Tranche 2 of the 2015 SPA.

(2) Basic salary from 1 January to 3 September 2018. This was last changed on 1 April 2018.

(3) Role based allowance for the period from 1 January to 3 September 2018. This was set from 1 July 2015.

(4) Benefits include the taxable value of all benefits received, which included a car allowance and a flexible benefits allowance set annually at 4% of basic salary.

(5) Represents the value of the pension allowance provided which has been paid as cash.

(6) 50% of the 2017 TSB Award was granted in Sabadell shares in March 2018 with a holding period of 12 months. These shares are frozen pending the outcome of both further internal analysis and external regulatory investigations into the post migration issues.

(7) The values shown in respect of the 2014 and 2015 SPA grants represent, in turn:
   a. The release of Tranche 3 of the 2014 SPA grant for the performance period 1 January to 31 December 2017 (2017 column). 100% of this tranche of the award was approved for release after the testing of the performance conditions.
   b. The release of Tranche 2 of the 2015 SPA grant for the performance period 1 January to 31 December 2017 (2017 column). 100% of this tranche of the award was approved for release after the testing of the performance conditions.

   The award values shown in the table are the actual values of the awards at release on 9 March 2018. The release values differ from those shown in the 2017 Remuneration Report because its publication pre-dated the release date and the value of the share element therefore had to be estimated. Relevant variable and total remuneration figures for 2017 have been adjusted accordingly.

(8) The release of Tranche 4 of the 2014 SPA in March 2019 and Tranche 3 of the 2015 SPA, both in respect of the performance period 1 January to 31 December 2018, will not be made due to the required performance conditions for 2018 not being met.

(9) A decision was taken by the Remuneration Committee in September 2018 that all Sabadell Integration Awards (SIA) would be frozen, including those that had not yet been released into nominee accounts and all unvested tranches, pending the outcome of both further internal analysis and external regulatory investigations in to the post migration issues.

(10) Mr Pester agreed to voluntarily surrender his 2015 SIA (Part 2) and 2017 (SIA) awards – with a total grant value of £2,000,000.

(11) This sum represents remuneration for Mr Pester from 1 January to 3 September 2018.

(12) Mr Pester received notice payments between 4 September 2018 and 31 December 2018. The value shown includes basic salary, role based allowance, benefits and pension.

(13) From 1 January until 2 September 2019, Mr Pester will receive monthly notice payments subject to the following. From 5 March 2019, Mr Pester will be obliged to seek alternative income and to disclose the gross amount of any such income (save for any income received as a non-executive director) to TSB as evidenced by payslips and/or invoices. TSB's gross monthly instalment payments shall then be reduced by the gross amount of such alternative income. From 5 March 2019, the value of the payments to Mr Pester will include basic salary and role based allowance only.

(14) Mr Pester did not exercise share options in 2018.

(*) The aggregate remuneration for all Directors is set out in note 17 to the financial statements on page 89.

Remuneration review 2018 (continued)

Consideration by the Directors of matters relating to Directors' remuneration

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

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

The Board Remuneration Committee is chaired by Dame Sandra Dawson and the other committee members are Polly Williams, who also chairs the Board Audit Committee, Miquel Montes and Paulina Beato. Andy Simmonds, Chair of the Risk Committee, attends meetings of the Remuneration Committee from time to time to ensure alignment between the work of the Remuneration Committee and the Risk Committee. Remuneration Committee meetings are also attended by the Executive Chairman, the Chief Financial Officer, the HR Director, the Chief Risk Officer, and the Director of Performance and Reward to provide input on their specialist areas. The Company Secretary, or an appropriate delegate, acts as the secretary to the Remuneration Committee. None of these additional attendees participates in the discussion of issues directly affecting their own remuneration.

The Remuneration Committee appointed Deloitte LLP (Deloitte) to provide independent advice on remuneration matters following a presentation to the Remuneration Committee members in 2014. The Remuneration Committee reviewed Deloitte's work during 2018 and decided to continue with Deloitte's appointment. Deloitte is a member of the Remuneration Consultants Group and, as such, voluntarily operates under the code of conduct in relation to executive remuneration consulting in the UK. Deloitte has provided independent advice on matters under consideration by the Remuneration Committee including compliance with regulations, advice on market trends and data, remuneration policy and implementation of remuneration arrangements, including support in remuneration arrangements for departing Executives. The Remuneration Committee is satisfied the advice it has received has been objective and independent.

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

Herbert Smith Freehills attended several Remuneration Committee meetings during the year and have provided advice in relation to any legal questions that have arisen.

Directors' biographies

Richard Meddings
Executive Chairman

Skills and background
Richard was appointed to the Board on 20 September 2017 and became Chairman on 2 February 2018. On 4 September 2018, he became Executive Chairman on an interim basis, acting as both Chief Executive and Chairman. He has more than 30 years of executive experience in the financial sector in both retail, business and investment banking. A chartered accountant, he has worked in various positions in Finance, Risk, Governance and Corporate Finance at Hill Samuel, Barclays and Credit Suisse. He was an Executive main Board Director of Standard Chartered from 2002 to 2014 and served as Group Finance Director between 2006 and 2014.

Richard's non-executive positions currently include Deutsche Bank AG and Jardine Lloyd Thompson Group plc. He also sits on the Boards of Teach First and is a member of the Governing Council of ICC UK. Richard has voluntarily stepped down from the Board of HM Treasury for the period in which he has executive responsibilities at TSB. He has in the past also served as a Non-executive Director of 3i Group plc and Legal & General Group plc.

Richard studied modern history at the University of Oxford.

Current external appointments
- Non-executive Director, Jardine Lloyd Thompson Group plc
- Non-executive Director, Deutsche Bank AG
- Trustee, Teach First
- Member of the Governing Council, ICC UK

Dame Sandra Dawson
Senior Independent Non-executive Director

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

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

She is currently Chairman of the Executive Committee and Trustee at the Social Science Research Council USA, and Trustee of American University of Sharjah.

Current external appointments
- Chairman of the Executive Committee and Trustee, Social Science Research Council USA
- Trustee, American University of Sharjah

Committee membership
- Remuneration Committee (Chair)
- Nomination Committee (Chair), subject to regulatory approval

Directors' biographies (continued)

Graeme Hardie

Independent Non-executive Director

Skills and background

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

Committee membership

- Audit Committee
- Risk Committee

Polly Williams

Independent Non-executive Director

Skills and background

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

She is currently Non-executive Director at Jupiter Fund Management plc, Non-executive Director at XP Power Ltd, Non-executive Director at RBC Europe Limited, and Trustee of the Guide Dogs for the Blind Association.

Current external appointments

- Non-executive Director, Jupiter Fund Management plc
- Non-executive Director, XP Power Ltd
- Non-executive Director, RBC Europe Limited
- Trustee of the Guide Dogs for the Blind Association

Committee membership

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

Paulina Beato

Independent Non-executive Director

Skills and background

Paulina was appointed to the Board on 22 March 2017. She is an experienced board member and advisor with significant international expertise across a range of different industries and government agencies. She has been very active with financial regulation and was involved in the restructuring of the utilities sector in Spain and several Latin-American countries. Paulina brings a diverse range of experience, including a strong knowledge of audit, risk analytics, and a passion for bringing competition to markets.

Paulina holds a Ph.D. in economics from the University of Minnesota and Chairs the Board of Trustees of the Barcelona Graduate School of Economics.

Current external appointments

- Chair, Board of Trustees of the Barcelona Graduate School of Economics

Committee membership

- Risk Committee
- Remuneration Committee

Directors' biographies (continued)

Andy Simmonds
Independent Non-executive Director

Skills and background
Andy was appointed to the Board on 11 July 2018. He brings a wealth of experience in the financial services sector having spent much of his executive career at Barclays Bank and Standard Chartered Bank. He currently holds Non-executive Director positions at EFG Private Bank Ltd and ICBC Standard Bank plc, and recently stood down after four years on the Board at Sainsbury's Bank.

Current external appointments
- Non-executive Director, EFG Private Bank Ltd
- Non-executive Director, ICBC Standard Bank plc

Committee membership
- Risk Committee (Chair)
- Audit Committee

Stephen Page
Independent Non-executive Director

Skills and background
Stephen was appointed to the Board on 20 September 2017. He has more than 30 years' experience across strategy, change management and technology. He is especially focused on the challenges that companies face doing business in the digital age. He was formerly the Global Managing Director for Strategic IT Effectiveness at Accenture. Here he helped large and complex businesses to deliver business value from digital investments, to transform business processes, and to strengthen operational performance. He also held the global role of Commercial Director for Accenture Technology Consulting.

He is a Non-executive Director of BSI Group (British Standards Institution) and Nominet UK. He was previously Non-executive Director of the National Crime Agency. Stephen studied computer science and music at the University of Queensland and he holds a D.Phil. from New College, Oxford where he was a Commonwealth Scholar and a member of the Programming Research Group. He is also a professional photographer specialising in portraiture.

Current external appointments
- Non-executive Director, British Standards Institution
- Non-executive Director, The British Library
- Non-executive Director, Nominet UK

Committee membership
- Risk Committee

Miquel Montes
Non-executive Director

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

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

Current external appointments
- President of Solvia

Committee membership
- Remuneration Committee
- Nomination Committee

Directors' biographies (continued)

Tomás Varela
Non-executive Director

Skills and background
Tomás was appointed to the Board on 30 June 2015. He is General Manager and Group Chief Financial Officer of Sabadell, which he joined in 1992. Over 26 years he has developed his career at Sabadell, having previously held different managerial positions in the insurance sector at Allianz (Spain) and as an auditor at Price Waterhouse (a legacy firm of PwC) over a 10 year period.

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

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

Committee membership
- Audit Committee
- Risk Committee

Ralph Coates
Chief Financial Officer

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

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

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

Statement of Directors' responsibilities

The Directors are responsible for preparing the annual report and the financial statements in accordance with applicable law and regulation.

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

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain TSB's and the Company's transactions and disclose with reasonable accuracy at any time the financial position of TSB and the Company and enable them to ensure that the financial statements comply with the Companies Act 2006 and, as regards TSB financial statements, Article 4 of the IAS Regulation. The Directors are also responsible for safeguarding the assets of the Company and TSB 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 TSB's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

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Financial statements

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Alignment with TSB's business model

The presentation of TSB's consolidated financial statements aligns with the execution of its strategy, its business model and the management of the financial risk to which it is exposed. As such, the consolidated financial statements are structured around the key elements of TSB's business model as explained on page 9.

Basis of preparation

These consolidated financial statements of TSB Banking Group plc (TSB) comprise the results of TSB Banking Group plc consolidated with those of its subsidiaries, including TSB Bank plc. Details of subsidiary undertakings are provided in note 4 to the Company financial statements on page 118. These consolidated financial statements have been prepared in accordance with the Companies Act 2006 as applicable to companies using International Financial Reporting Standards (IFRS) and with IFRS, as adopted by the European Union (EU). IFRS comprise accounting standards prefixed IFRS, issued by the International Accounting Standards Board (IASB) and those prefixed IAS, issued by the IASB's predecessor body, as well as interpretations issued by the IFRS Interpretations Committee (IFRS IC) and its predecessor body. TSB applies the relaxations in hedge accounting requirements in the EU endorsed version of IAS 39 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 the recognition of certain financial assets and financial liabilities, including derivative contracts, at fair value through profit or loss and financial assets at fair value through comprehensive income. The Directors consider that it is appropriate to continue to adopt the going concern basis in preparing the consolidated financial statements.

Accounting policies

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

Consolidation

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

Changes to accounting policies

The accounting policies are consistent with those applied in the 2017 Annual Report and Accounts with the exception of new accounting policies in respect of IFRS 9 '*Financial* Instruments' and IFRS 15 *'Revenue from Contracts with Customers'*, both of which were adopted on 1 January 2018. In addition, interest on trading derivatives entered is presented in interest income and the 2017 comparative restated to reclassify these amounts from gains/(losses) on financial assets and liabilities held for trading.

IFRS 9 Financial Instruments

IFRS 9 replaces IAS 39 '*Financial Instruments: Recognition and Measurement'*. This new accounting standard includes requirements in three areas: classification and measurement of financial instruments; impairment of financial instruments; and hedge accounting. The most significant impact on TSB's financial statements arises from the changes to the calculation of impairment on financial instruments. As permitted by IFRS 9, TSB has elected to continue to apply the approach for hedge accounting available in the EU adopted version of IAS 39.

Details of the new accounting policies applied in respect of classification and measurement and impairment are set out on page 62. As permitted by the transitional provisions of IFRS 9, TSB has elected not to restate comparative figures for 2017. Adjustments to the carrying value of financial assets arising from TSB's adoption of IFRS 9 were recognised in retained earnings as at 1 January 2018, the date of initial application. Consequently, for note disclosures, the consequential amendments to IFRS 7 '*Financial Instruments: Disclosures'* have only been applied to the current year. Details of the impact of the adoption of IFRS 9 are set out below.

Changes to accounting policies (continued)

IFRS 9 Financial Instruments (continued)
The classification and measurement of financial assets 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 majority of TSB's financial assets are loans and advances to customers previously classified, under IAS 39, as loans and receivables and held at amortised cost.

The measurement category and the carrying amount of financial assets in accordance with IAS 39 and IFRS 9 at 1 January 2018 are compared as follows:

	IAS 39		IFRS 9	
	Measurement category	Carrying amount £ million	Measurement category	Carrying amount £ million
Financial assets:				
Cash, cash balances at central banks and other demand deposits	Loans and receivables (Amortised cost)	**7,563.8**	Amortised cost	**7,563.8**
Derivative financial assets	FVPL	**111.1**	FVPL	**111.1**
Equity instruments	FVPL	**17.2**	FVPL	**17.2**
Financial assets at fair value through profit or loss		**–**	FVPL	**7.0**
Available-for-sale financial assets	Available-for-sale	**2,123.3**	FVOCI	**2,116.3**
Loans to central banks	Loans and receivables	**56.0**	Amortised cost	**56.0**
Loans to credit institutions	Loans and receivables	**329.2**	Amortised cost	**329.2**
Loans and advances to customers	Loans and receivables	**30,854.2**	Amortised cost	**30,760.5**
Other advances	Loans and receivables	**896.0**	Amortised cost	**896.0**
Hedging derivative financial assets	FVPL	**103.7**	FVPL	**103.7**

The impact of the IFRS 9 transitional adjustment on TSB's credit impairment loss allowance and provisions at 1 January 2018 is set out below.

	Allowance for credit impairment losses (note 11) £ million	Provisions (note 32) £ million	Total £ million
IAS 39 at 31 December 2017	71.6	–	71.6
Changes on adoption of IFRS 9	93.7	2.5	96.2
IFRS 9 at 1 January 2018 (note 11 and note 32)	**165.3**	**2.5**	**167.8**

IFRS 15 Revenue from Contracts with Customers
IFRS 15 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 was applied by TSB from 1 January 2018 and required a change to TSB's accounting policy with respect to the recognition of commission income from the sale of insurance contracts. Specifically, under IAS 18, TSB 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 TSB 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 TSB's accounting policies as a result of adopting IFRS 15.

As a consequence, the adoption of IFRS 15 resulted in the accelerated recognition of insurance commission income that was previously expected to be recognised during 2018 and 2019. At 1 January 2018, TSB recognised a contract asset in respect of the accelerated future commission income of £5.9 million and an associated deferred tax liability of £1.6 million, leading to a £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.

Changes to accounting policies (continued)

Impact of the adoption of IFRS 9 and IFRS 15 at 1 January 2018

The table below summarises the adjustments to TSB's balance sheet arising on adoption of IFRS 9 and IFRS 15.

	As at 31 Dec 2017 £ million	IFRS 9 Classification & measurement £ million	IFRS 9 Impairment £ million	IFRS 15 £ million	As at 1 Jan 2018 £ million
Assets					
Cash, cash balances at central banks and other demand deposits	7,563.8	–	–	–	**7,563.8**
Financial assets held for trading:					
Derivative financial assets	111.1	–	–	–	**111.1**
Financial assets at fair value through profit or loss	17.2	7.0	–	–	**24.2**
Financial assets at fair value through other comprehensive income	–	2,116.3	–	–	**2,116.3**
Available-for-sale financial assets	2,123.3	(2,123.3)	–	–	–
Financial assets at amortised cost:					
Loans to central banks	56.0	–	–	–	**56.0**
Loans to credit institutions	329.2	–	–	–	**329.2**
Loans and advances to customers	30,854.2	–	(93.7)	–	**30,760.5**
Other advances	896.0	–	–	–	**896.0**
Hedging derivative financial assets	103.7	–	–	–	**103.7**
Fair value adjustment for portfolio hedged risk	(22.2)	–	–	–	**(22.2)**
Property, plant and equipment	172.7	–	–	–	**172.7**
Intangible assets	10.1	–	–	–	**10.1**
Deferred tax assets	68.6	0.7	24.3	(1.6)	**92.0**
Other assets	241.8	–	–	5.9	**247.7**
Total assets	42,525.5	0.7	(69.4)	4.3	**42,461.1**
Provisions	34.5	–	2.5	–	**37.0**
Current tax liabilities	6.8	0.7			**7.5**
Other liabilities	40,488.6	–	–	–	**40,488.6**
Total liabilities	40,529.9	0.7	2.5	–	**40,533.1**
Share capital	5.0	–	–	–	**5.0**
Share premium	965.1	–	–	–	**965.1**
Other reserves	(285.1)	–	–	–	**(285.1)**
Retained profits	1,292.4	1.8	(71.9)	4.3	**1,226.6**
Valuation adjustments:					
Fair value reserve	–	16.9	–	–	**16.9**
Available-for-sale reserve	18.7	(18.7)	–	–	**–**
Cash flow hedging reserve	(0.5)	–	–	–	**(0.5)**
Shareholder's equity	1,995.6	–	(71.9)	4.3	**1,928.0**
Total equity and liabilities	42,525.5	0.7	(69.4)	4.3	**42,461.1**

Significant 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's business model as shown in the table below. These areas are discussed in detail by the Audit Committee as set out in the corporate governance statement on pages 40 to 42.

Significant accounting estimates	**Financial statement note**
Allowance for credit impairment losses on financial assets at amortised cost	Note 11
Provision for migration related customer remediation and rectification	Note 32
Customer remediation provisions	Note 32
Significant judgements	
Recovery of post migration charges	Note 16
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TSB's primary consolidated financial statements are presented on pages 65 to 113. The notes to these consolidated financial statements are structured to follow TSB's business model as set out on page 8 and are listed below.

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Consolidated balance sheet

as at 31 December 2018

	Note	2018 £ million	2017 £ million
Assets			
Cash, cash balances at central banks and other demand deposits		**7,136.0**	7,563.8
Financial assets held for trading:			
Derivative financial assets	26	**88.4**	111.1
Financial assets at fair value through profit or loss	18	**2.2**	17.2
Financial assets at fair value through other comprehensive income	6	**2,387.8**	–
Available-for-sale financial assets	7	**–**	2,123.3
Financial assets at amortised cost:			
Debt securities	6	**96.2**	–
Loans to central banks		**87.8**	56.0
Loans to credit institutions	8	**370.6**	329.2
Loans and advances to customers	9	**30,008.5**	30,854.2
Other advances	10	**382.1**	896.0
Hedging derivative financial assets	26	**106.6**	103.7
Fair value adjustment for portfolio hedged risk		**(37.3)**	(22.2)
Property, plant and equipment	29	**163.1**	172.7
Intangible assets	30	**18.4**	10.1
Current tax assets		**20.4**	–
Deferred tax assets	20	**113.0**	68.6
Other assets	31	**180.5**	241.8
Total assets		**41,124.3**	42,525.5
Liabilities			
Financial liabilities held for trading:			
Derivative financial liabilities	26	**94.0**	37.5
Financial liabilities at amortised cost:			
Borrowings from central banks		**6,482.2**	5,625.7
Deposits from credit institutions		**3.4**	–
Customer deposits	1	**29,084.3**	30,520.6
Repurchase agreements	4	**1,084.8**	1,446.4
Debt securities in issue	2	**1,122.6**	1,318.7
Subordinated liabilities	3	**398.2**	405.3
Other financial liabilities		**66.4**	247.3
Hedging derivative financial liabilities	26	**346.0**	566.5
Fair value adjustments for portfolio hedged risk		**19.4**	42.2
Current tax liabilities		**–**	6.8
Provisions	32	**63.6**	34.5
Other liabilities	33	**495.4**	278.4
Total liabilities		**39,260.3**	40,529.9
Equity			
Share capital	21	**5.0**	5.0
Share premium	21	**965.1**	965.1
Other reserves:			
Merger reserve	21	**616.5**	616.5
Capital reorganisation reserve	21	**(1,311.6)**	(1,311.6)
Capital reserve	21	**410.0**	410.0
Retained profits brought forward	21	**1,226.6**	1,173.7
(Loss)/profit attributable to the shareholder for the current year	21	**(63.0)**	118.7
Valuation adjustments:			
Fair value reserve	21	**18.6**	–
Available-for-sale reserve	21	**–**	18.7
Cash flow hedging reserve	21	**(3.2)**	(0.5)
Shareholder's equity		**1,864.0**	1,995.6
Total equity and liabilities		**41,124.3**	42,525.5

The accompanying notes are an integral part of the consolidated financial statements. The consolidated financial statements on pages 64 to 113 were approved by the Board of Directors on 31 January 2019 and signed on its behalf by:

Richard Meddings

Richard Meddings
Executive Chairman

Ralph Coates
Chief Financial Officer

Consolidated statement of comprehensive income

for the year ended 31 December 2018

Income statement:	Note	2018 £ million	2017* £ million
Interest and similar income:			
Interest income calculated using the effective interest method	13	**1,072.2**	1,113.9
Other interest income*	13	**(2.0)**	(26.4)
Total interest and similar income*		**1,070.2**	1,087.5
Interest and similar expense*	13	**(185.4)**	(161.6)
Net interest income	13	**884.8**	925.9
Fee and commission income	14	**122.1**	193.3
Fee and commission expense	14	**(46.7)**	(109.6)
Net fee and commission income	14	**75.4**	83.7
Net gains/(losses) on financial assets and liabilities:			
Gains on derecognition of financial assets measured at amortised cost		**–**	49.8
Gains on derecognition of financial assets measured at fair value through other comprehensive income		**21.4**	–
Gains on derecognition of available-for-sale financial assets		**–**	18.7
(Losses)/Gains on financial assets at fair value through profit or loss		**(1.4)**	3.8
Losses on financial assets and liabilities held for trading*		**(34.0)**	(14.0)
Gains from hedge accounting	26	**23.3**	24.5
Gains on derecognition of non-financial assets and liabilities		**1.1**	5.8
Other operating income:			
Migration related income from LBG	15	**318.3**	–
Other operating income	15	**2.0**	1.6
Other income		**406.1**	173.9
Total income		**1,290.9**	1,099.8
Operating expenses excluding costs of preparing for migration	16	**(905.7)**	(859.3)
Costs of preparing for migration	16	**(417.3)**	–
Total operating expenses	16	**(1,323.0)**	(859.3)
Operating profit before impairment losses and taxation		**(32.1)**	240.5
Impairment losses on loans and advances to customers	11	**(72.8)**	(77.8)
Impairment losses on loan commitments	32	**(0.5)**	-
Total Impairment losses		**(73.3)**	**(77.8)**
(Loss)/Profit before taxation		**(105.4)**	162.7
Taxation	19	**42.4**	(44.0)
(Loss)/Profit for the year	21	**(63.0)**	118.7
Other comprehensive (loss)/income:			
Items that may be subsequently reclassified to profit or loss:			
Change in available-for-sale reserve:			
Change in fair value		**–**	(4.5)
Gains transferred to profit or loss on disposal		**–**	22.0
Taxation thereon	20	**–**	(4.7)
	21	**–**	12.8
Change in fair value reserve:			
Change in fair value		**9.6**	–
Gains transferred to profit or loss on disposal		**(7.3)**	–
Taxation thereon	20	**(0.6)**	–
	21	**1.7**	–
Change in cash flow hedging reserve:			
Change in the fair value of derivatives in cash flow hedges		**(3.8)**	8.4
Transfers to the income statement		**1.1**	(9.3)
	21	**(2.7)**	(0.9)
Other comprehensive (loss)/income for the year, net of taxation		**(1.0)**	11.9
Total comprehensive (loss)/income for the year		**(64.0)**	130.6

* Interest on derivatives held for trading (and entered into as economic hedges) of £20.6 million in 2017 has been reclassified to interest income from losses on financial instruments held for trading. Further, £13.7 million of interest income on derivatives in hedging accounting relationships where the hedged item was a liability has been reclassified from interest income to interest expense. This align with the accounting policy on page 84.

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

Consolidated statement of changes in equity

for the year ended 31 December 2018

	Share capital £ million	Share premium £ million	Merger reserve £ million	Capital reorg-anisation reserve £ million	Capital reserve £ million	Fair value reserve £ million	Available-for-sale reserve £ million	Cash flow hedging reserve £ million	Retained profit £ million	Share-holder's equity £ million
Balance at 1 January 2017	5.0	965.1	616.5	(1,311.6)	410.0	–	5.9	0.4	1,173.7	1,865.0
Comprehensive income:										
Profit for the year	–	–	–	–	–	–	–	–	118.7	118.7
Other comprehensive income/(loss)	–	–	–	–	–	–	12.8	(0.9)	–	11.9
Total comprehensive income	–	–	–	–	–	–	12.8	(0.9)	118.7	130.6
Balance at 31 December 2017	5.0	965.1	616.5	(1,311.6)	410.0	–	18.7	(0.5)	1,292.4	1,995.6
Change on initial application of IFRS 9	–	–	–	–	–	16.9	(18.7)	–	(70.1)	(71.9)
Change on initial application of IFRS 15	–	–	–	–	–	–	–	–	4.3	4.3
Balance at 1 January 2018	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**16.9**	–	**(0.5)**	**1,226.6**	**1,928.0**
Comprehensive loss:										
Loss for the year	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**(63.0)**	**(63.0)**
Other comprehensive income/(loss)	**–**	**–**	**–**	**–**	**–**	**1.7**	**–**	**(2.7)**	**–**	**(1.0)**
Total comprehensive loss	**–**	**–**	**–**	**–**	**–**	**1.7**	**–**	**(2.7)**	**(63.0)**	**(64.0)**
Balance at 31 December 2018	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**18.6**	**–**	**(3.2)**	**1,163.6**	**1,864.0**

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

Consolidated cash flow statement

for the year ended 31 December 2018

	Note	2018 £ million	2017 £ million
Cash flows from operating activities			
(Loss)/Profit before taxation		**(105.4)**	162.7
Adjustments for:			
Change in operating assets	34	**1,190.0**	(1,477.8)
Change in operating liabilities	34	**(1,556.7)**	1,175.4
Non-cash and other items	34	**151.5**	114.0
Taxation paid		**(7.0)**	(25.5)
Net cash provided by/(used in) operating activities		**(327.6)**	(51.2)
Cash flows from investing activities			
Purchase of property, plant and equipment		**(15.8)**	(15.8)
Purchase of financial assets		**(398.1)**	(62.9)
Interest received on financial assets		**76.6**	83.3
Proceeds on disposal of equity assets		**9.2**	–
Interest received on reverse repurchase agreements		**0.4**	0.4
Sale/(Purchase) of Sabadell shares		**9.2**	(8.4)
Net cash used in investing activities		**(318.5)**	(3.4)
Cash flows from financing activities			
Proceeds from borrowing from central banks		**850.0**	5,615.0
Interest paid on borrowings from central banks		**(32.0)**	(6.4)
Proceeds from debt securities issued		**–**	497.5
Repayment of debt securities in issue		**(197.9)**	(2,128.4)
Interest paid on debt securities		**(14.0)**	(13.4)
Interest paid on subordinated liabilities		**(22.4)**	(22.1)
(Repayment of)/Proceeds from repurchase agreements		**(361.9)**	36.9
Interest paid on repurchase agreements		**(3.5)**	(8.4)
Net cash provided by financing activities		**218.3**	3,970.7
Change in cash and cash equivalents		**(427.8)**	3,916.1
Cash and cash equivalents at 1 January	34	**7,563.8**	3,647.7
Cash and cash equivalents at 31 December		**7,136.0**	7,563.8

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 capital in the business.

Accounting policies relevant to sources of funding

(a) Financial liabilities

Financial liabilities is the term used to describe TSB'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 (k) under Managing financial risk).

Financial liabilities which are not derivatives are measured at amortised cost. Issues of financial liabilities measured at amortised cost are recognised on settlement date. A financial liability is derecognised from the balance sheet when TSB 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

	2018 £ million	2017 £ million
Bank accounts	**10,366.3**	10,044.2
Instant access saving deposits	**15,237.7**	15,358.6
Deposits with agreed maturity	**2,290.0**	3,929.8
Business banking deposits	**1,190.3**	1,188.0
Total customer deposits	**29,084.3**	30,520.6

2. Debt securities in issue

2018	Balance at 1 Jan 2018 £ million	(Repayments)/ Issues £ million	Exchange rate and other adjustments £ million	Balance at 31 Dec 2018 £ million
Debt securities issues in an EU Member State requiring filing of a prospectus:				
Securitisation programmes:				
Duncan Funding 2015-1 plc	**468.2**	**(53.1)**	**3.5**	**418.6**
Duncan Funding 2016-1 plc	**352.5**	**(143.3)**	**(3.6)**	**205.6**
	820.7	**(196.4)**	**(0.1)**	**624.2**
Covered bond programme:				
Series 2017-1 Covered Bonds	**498.0**	**–**	**0.4**	**498.4**
Total debt securities in issue	**1,318.7**	**(196.4)**	**0.3**	**1,122.6**

2017	Balance at 1 Jan 2017 £ million	(Repayments)/ Issues £ million	Exchange rate and other adjustments £ million	Balance at 31 Dec 2017 £ million
Debt securities issues in an EU Member State requiring filing of a prospectus:				
Securitisation programmes:				
Duncan Funding 2015-1 plc	514.9	(57.1)	10.4	468.2
Duncan Funding 2016-1 plc	510.9	(158.4)	–	352.5
	1,025.8	(215.5)	10.4	820.7
Covered bond programme:				
Series 2017-1 Covered Bonds	–	497.7	0.3	498.0
Debt securities issues 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

Notes to the consolidated financial statements

Sources of funding (continued)

2. Debt securities in issue (continued)

		Amount					
	Date of issue	31 Dec 2018 £ million	31 Dec 2017 £ million	Interest rate at 31 Dec 2018	Maturity date	Issue currency	Target of offering
Issuing entity							
Duncan Funding 2015-1 plc	11/2015	**149.5**	202.3	1.60638%	09/2020	GBR	Institutional
Duncan Funding 2015-1 plc	11/2015	**269.1**	265.9	0.16900%	09/2020	EUR	Institutional
Duncan Funding 2016-1 plc	05/2016	**48.1**	81.8	0.08200%	04/2021	EUR	Institutional
Duncan Funding 2016-1 plc	05/2016	**157.5**	270.7	1.57344%	04/2021	GBR	Institutional
TSB Bank plc	12/2017	**498.4**	498.0	1.14650%	12/2022	GBR	Institutional
Total debt securities in issue		**1,122.6**	1,318.7				

Securitisation programmes

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

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

	31 December 2018		31 December 2017	
	Loans and advances securitised (1) £ million	Liability £ million	Loans and advances securitised (1) £ million	Liability £ million
Securitisation programmes:				
Duncan Funding 2015-1 plc	**1,370.9**	**1,486.4**	1,598.9	1,679.0
Duncan Funding 2016-1 plc	**2,386.1**	**2,546.1**	2,717.4	2,878.7
	3,757.0	**4,032.5**	4,316.3	4,557.7
Less held by TSB		**(3,408.3)**		(3,737.0)
Total securitisation notes		**624.2**		820.7

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

Cash deposits of £342.3 million (2017: £313.0 million) held by TSB are restricted in use to repayment of the debt securities issued by the structured entities and other legal obligations. TSB recognises the full liabilities associated with its securitisation programmes within debt securities in issue, although the obligations of TSB are limited to the cash flows generated from the underlying assets.

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 TSB. TSB retains all of the risks and rewards associated with these loans and the partnership is consolidated fully with the loans on TSB's balance sheet, and the related covered bonds in issue included within debt securities in issue.

TSB's 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.

	31 December 2018		31 December 2017	
	Loans and advances securitised £ million	Liability £ million	Loans and advances securitised £ million	Liability £ million
Covered bonds:				
Series 2017-1 Covered Bonds	**1,311.5**	**498.4**	699.3	498.0
Total covered bond notes		**498.4**		498.0

Notes to the consolidated financial statements

Sources of funding (continued)

2. Debt securities in issue (continued)

Cash deposits of £28.3 million (2017: £16.2 million) held by TSB are restricted in use to repayment of the term advances related to covered bonds and other legal obligations. At 31 December 2018 TSB 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 TSB to provide collateral may increase due to the formal requirements of the programmes. TSB may also voluntarily contribute collateral to support the ratings of the covered bonds.

3. Subordinated liabilities

	2018 £ million	2017 £ million
Fixed/floating rate reset callable subordinated Tier 2 notes due May 2026	**384.4**	384.1
Accrued interest	**3.4**	3.4
Fair value hedge accounting adjustments	**10.4**	17.8
Total subordinated liabilities	**398.2**	405.3

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

4. Repurchase agreements

At 31 December 2018, TSB 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 TSB's consolidated balance sheet as substantially all of the rewards, including interest income, and risks, including credit and interest rate risks, are retained by TSB. 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 TSB's obligation to repurchase the transferred assets.

	Carrying amount of transferred assets 2018 £ million	Carrying amount of associated liabilities 2018 £ million	Carrying amount of transferred assets 2017 £ million	Carrying amount of associated liabilities 2017 £ million
Repurchase agreements with non-credit institutions	**1,084.5**	**1,084.8**	1,444.7	1,446.4
Repurchase agreements	**1,084.5**	**1,084.8**	1,444.7	1,446.4

5. Fair value of financial liabilities

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

		2018		2017	
	Note	Carrying value £ million	Fair value £ million	Carrying value £ million	Fair value £ million
Financial liabilities					
Customer deposits	1	**29,084.3**	**29,096.4**	30,520.6	30,558.9
Debt securities in issue	2	**1,122.6**	**1,121.4**	1,318.7	1,328.0
Subordinated liabilities	3	**398.2**	**381.1**	405.3	427.3
Trading derivative liabilities	26	**94.0**	**94.0**	37.5	37.5
Hedging derivative liabilities	26	**346.0**	**346.0**	566.5	566.5

The carrying amount of borrowings from central banks, deposits from credit institutions, repurchase agreements and other financial liabilities is a reasonable approximation of fair value as these balances are either on demand or variable rate. 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.

Sources of funding (continued)

5. Fair value of financial liabilities (continued)

The fair values of TSB'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 TSB. Valuation techniques used include discounted cash flow analysis and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by TSB.

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. TSB's subordinated liabilities and derivative financial liabilities are primarily valued using discounted cash flows where the most significant input is interest yield curves developed from publicly quoted rates and by reference to instruments with similar risk characteristics as the instruments held by TSB. Derivative financial instruments are the only financial liabilities of TSB 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.

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

	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2018					
Customer deposits	**–**	**29,096.4**	**–**	**29,096.4**	**29,084.3**
Debt securities in issue	**1,121.4**	**–**	**–**	**1,121.4**	**1,122.6**
Subordinated liabilities	**–**	**381.1**	**–**	**381.1**	**398.2**
Trading derivative liabilities	**–**	**94.0**	**–**	**94.0**	**94.0**
Hedging derivative liabilities	**–**	**346.0**	**–**	**346.0**	**346.0**
At 31 December 2017					
Customer deposits	–	30,558.9	–	30,558.9	30,520.6
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

Notes to the consolidated financial statements

Loans

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

Accounting policies effective for the year ended December 2018 – IFRS 9

(b) Classification and measurement of financial assets

Financial assets is the term used to describe TSB's loans to customers and other institutions. It includes loans and advances to customers, credit institutions, and central banks, financial assets at fair value through other comprehensive income, cash and balances with central banks and other demand deposits, derivative financial assets (see accounting policy (k) under Managing financial risk), and other advances.

On initial recognition, financial assets are classified into one of three measurement categories, amortised cost, fair value through other comprehensive income, or fair value through profit or loss depending on TSB's business model for managing the financial assets and whether the cash flows represent solely payments of principal and interest.

TSB assesses its business models at a portfolio level based on its objectives for the relevant portfolio, how performance of the portfolio is measured and reported, how management are compensated, and the frequency and the reasons for asset sales from the portfolio. TSB reclassifies financial assets only when its business model for managing the portfolio of assets changes.

Financial assets measured at amortised cost

Financial assets in portfolios where the business model is to hold the assets to collect the contractual cash flows and where those cash flows represent solely payments of principal and interest are measured at amortised cost. Cash flows are considered to represent solely payments of principal and interest where they are consistent with a basic lending arrangement. Where the contractual cash flows introduce exposures to risk or volatility unrelated to a basic lending arrangement, such as from changes in equity prices, the cash flows are not considered to be solely payments of principal and interest.

Financial assets measured at amortised cost are initially recognised when the cash is advanced to the borrower at fair value including transaction costs. Subsequent measurement is at amortised cost, using the effective interest rate method. The carrying amount of these assets is adjusted by an expected credit loss allowance. TSB's cash, cash balances at central banks and other demand deposits, loans to customers, loans to credit institutions, loans to central banks, and other advances are measured at amortised cost.

Financial assets measured at fair value through other comprehensive income (FVOCI)

Financial assets in portfolios where the business model is to hold the assets to collect the contractual cash flows and to generate cash flows from selling assets are measured at fair value including transaction costs. Where the cash flows represent solely payments of principal and interest, gains and losses arising from changes in fair value are recognised directly in other comprehensive income. When the financial asset is either sold or matures, the cumulative gain or loss previously recognised in other comprehensive income is recognised in the income statement. Interest income is calculated using the effective interest method and is recognised in the income statement in net interest income. Foreign exchange gains and losses on financial assets denominated in foreign currencies are recognised in the income statement in exchange gains or losses. Impairment losses are recognised in the income statement.

Financial assets measured at fair value through profit or loss (FVPL)

Financial assets that do not meet the criteria for amortised cost or FVOCI are measured at fair value on initial recognition and subsequently. Fair value gains and losses are recognised in the income statement within net trading income. Derivative financial assets are measured at FVPL (see accounting policy (k) under Managing financial risk). All equity instruments are measured at fair value through profit or loss. Dividends continue to be recognised in the income statement.

Notes to the consolidated financial statements

Loans (continued)

Accounting policies effective for the year ended December 2018 – IFRS 9 (continued)

(c) Impairment of financial assets

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 the following three 'stages':

- 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 or 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.

Financial assets that are credit impaired at the date of their purchase or origination will be reported in a separate 'purchased or originated as credit impaired' (POCI) category until the loan is derecognised. The cumulative change in lifetime expected credit loss since the purchase or origination of the financial asset is recognised as a loss allowance.

Definition of default

Loans and advances that are more than 90 days past due, or considered by management as unlikely to pay their obligations in full without realisation of collateral, are considered to be in default for IFRS 9. TSB policy is not to rebut the presumption in IFRS 9 that loans which are more than 90 days past due are in default.

Grouping of financial assets for credit impairment losses measured on a collective basis

Expected credit losses are assessed and measured on a collective basis for homogenous groups where the financial assets within that group share similar credit risk characteristics and are not individually assessed. Given the predominant retail nature of TSB's loans, groupings are determined using product type, such as residential mortgages, personal loans, overdrafts, and credit card balances. The appropriateness of the groupings is monitored and reviewed on a periodic basis. TSB does not currently assess any material exposures on an individual basis.

Significant increase in credit risk

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 TSB 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, TSB 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, TSB 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 TSB's investment grade debt securities, TSB does take advantage of the low credit risk exemption and categorises these financial assets as stage 1.

Credit Impaired (stage 3)

Financial assets are considered to be credit impaired and included in stage 3 when there is objective evidence of credit impairment. TSB 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.

Notes to the consolidated financial statements

Loans (continued)

Accounting policies effective for the year ended December 2018 – IFRS 9

(c) Impairment of financial assets (continued)

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 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.

Modified financial assets and derecognition
Where the contractual cash flows of a financial asset have been renegotiated or modified and the financial asset was not derecognised, its gross carrying amount is recalculated as the present value of the modified contractual cash flows, discounted at the original effective interest rate with a gain or loss recognised in the income statement. The contractual terms of a TSB loan may be modified for a number of reasons, primarily due to customers being granted a concession due to their financial difficulty and the loan being considered in forbearance. Customer treatments identified as entry to forbearance will result in loans being considered as modified under IFRS 9.

Methodology for measuring 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 expected 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 and is discounted using the effective interest rate. 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 expected remaining behavioural life of the financial asset. The measurement of ECL also requires the incorporation of multiple economic scenarios to calculate a probability weighted forward looking estimate. Further details on the approach and scenarios, together with sensitivity analysis is set out on page 81.

(d) Derecognition of financial assets
Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when TSB has transferred its contractual right to receive the cash flows from the assets and either (i) substantially all of the risks and rewards of ownership have been transferred; or (ii) TSB has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

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

Repurchase agreements
Financial instruments sold under a repurchase agreement, under which substantially all the risks and rewards of ownership are retained by TSB, 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)

Accounting policies effective for the year ended December 2017 – IAS 39

Financial assets
'Financial assets' is the term used to describe TSB'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 (k) 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 TSB is committed to purchase or sell an asset.

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

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

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

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

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

(iii) Repurchase agreements
Financial instruments sold under a repurchase agreement, under which substantially all the risks and rewards of ownership are retained by TSB, 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.

Impairment of financial assets
(i) Accounted for at amortised cost
At each balance sheet date TSB 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.

Notes to the consolidated financial statements

Loans (continued)

Accounting policies effective for the year ended December 2017 – IAS 39

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

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

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

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

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

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

Fair value through other comprehensive income (FVOCI)	2018 £ million	2017 £ million
UK Gilts	**1,962.5**	–
Supranational and development bank bonds	**425.3**	–
Total debt securities at FVOCI	**2,387.8**	–

Amortised cost	2018 £ million	2017 £ million
UK Gilts	**96.2**	–
Total debt securities at amortised cost	**96.2**	–

At 31 December 2018, TSB held £2,387.8 million of debt securities as part of its liquid asset portfolio where the business model is to hold the assets to collect the contractual cash flows and to generate cash flows from selling the assets. These assets are carried at FVOCI. During 2018, TSB established a second portfolio of liquid assets, which at 31 December 2018 held £96.2 million of debt securities, where the business model is solely to hold the assets to collect the contractual cash flows and which are carried at amortised cost.

At 31 December 2018 UK gilts at FVOCI with a carrying value, including accrued interest, of £1,084.5 million (2017: £1,444.7 million) were subject to repurchase agreements (note 4). A further £37.0 million had been pledged as collateral (2017: £nil).

7. Available-for-sale financial assets – IAS 39

	2017 £ million
UK Gilts	1,721.5
Supranational and development bank bonds	394.8
Visa Inc. convertible preferred stock	7.0
Total available-for-sale financial assets	2,123.3

In June 2016, TSB 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, TSB's investment was recognised as a financial asset at fair value through other comprehensive income at its fair value of £7.0 million. On 10 December 2018, this investment was sold to the parent company at its then fair value of £9.2 million.

The key inputs to the valuation were 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 required management judgement as the preferred stock was not transferrable outside the wider Sabadell Group and conversion to Visa Inc. common stock was subject to reduction to reflect potential litigation losses incurred by Visa. The most significant unobservable input to the valuation was an estimate of potential litigation losses which could reduce the conversion rate of the preferred stock.

8. Loans to credit institutions

	2018 £ million	2017 £ million
Cash deposits held	**370.6**	329.2
Total loans to credit institutions	**370.6**	329.2

Loans to credit institutions comprise cash deposits held by TSB's securitisation and covered bond entities.

Notes to the consolidated financial statements

Loans (continued)

9. Loans and advances to customers

	2018 £ million	2017 £ million
Secured (retail)	**27,960.3**	28,346.9
Unsecured and business banking [(1)]	**2,246.9**	2,578.9
Gross loans and advances to customers	**30,207.2**	30,925.8
Allowance for impairment losses [(2)] (note 11)	**(198.7)**	(71.6)
Loans and advances to customers	**30,008.5**	30,854.2

(1) Comprises unsecured lending of £2,132.6 million (2017: £2,444.4 million) and business banking lending of £114.3 million (2017: £134.5 million).
(2) Comprises secured lending of £36.5 million (2017: £25.4 million), unsecured lending of £160.2 million (2017: £45.7 million) and business banking lending of £2.0 million (2017: £0.5 million).

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

	2018 £ million	2017 £ million
Credit cards	**2,661.8**	2,571.3
Mortgage offers made	**1,030.0**	1,004.3
Current accounts and other lending	**1,086.3**	1,107.0
Total commitments	**4,778.1**	4,682.6

The credit impairment provision in respect of total loan commitments was £3.0 million as set out in note 32 and primarily relates to credit impairment provisions in respect of current account overdrafts. Expected credit losses on credit card commitments are recognised as part of the allowance for credit impairment losses as set out in note 11.

Of the amounts shown above, £1,312.9 million (2017: £1,282.9 million) was irrevocable. All commitments to lend to customers shown in the table above have a contractual maturity of less than one year.

10. Other advances

	2018 £ million	2017 £ million
Items in the course of collection from credit institutions	**27.6**	252.6
Items in the course of collection from non-credit institutions	**14.8**	7.8
Collateral placed at central clearing houses	**326.9**	635.3
Collateral placed with credit institutions	**12.8**	0.3
Total other advances	**382.1**	896.0

Notes to the consolidated financial statements

Loans (continued)

11. Allowance for credit impairment losses on financial assets at amortised cost

(i) Allowance for credit impairment losses – IFRS 9

The following tables detail changes in the loss allowance and gross carrying value of loans to customers during the year.

	Stage 1		Stage 2		Stage 3		POCI [(1)]		Total	
TSB	**Gross Loans £ million**	**Allow. for credit impair-ment losses £ million**	**Gross Loans £ million**	**Allow. for credit impair-ment losses £ million**	**Gross Loans £ million**	**Allow. for credit impair-ment losses £ million**	**Gross Loans £ million**	**Allow. for credit impair-ment losses £ million**	**Gross Loans £ million**	**Allow. for credit impair-ment losses £ million**
At 31 December 2017									**30,925.8**	**(71.6)**
Change on adoption of IFRS 9									**–**	**(93.7)**
At 1 January 2018	**28,548.8**	**(54.0)**	**1,812.6**	**(52.2)**	**338.0**	**(50.6)**	**226.4**	**(8.5)**	**30,925.8**	**(165.3)**
Changes reflected in imp. loss:										
Increases due to originations	**5,181.4**	**(9.4)**	**27.4**	**–**	**9.3**	**–**	**–**	**–**	**5,218.1**	**(9.4)**
Decreases due to repayments	**(5,389.6)**	**3.5**	**(393.7)**	**5.5**	**(65.3)**	**0.9**	**(36.2)**	**0.7**	**(5,884.8)**	**10.6**
Changes in credit risk [(2)]	**–**	**9.1**	**–**	**(23.1)**	**–**	**(59.2)**	**–**	**0.6**	**–**	**(72.6)**
Other movements:										
Transfers between stages	**(1,607.4)**	**–**	**1,438.4**	**–**	**169.0**	**–**	**–**	**–**	**–**	**–**
Amounts written off	**(0.7)**	**–**	**(0.5)**	**0.1**	**(50.7)**	**37.9**	**–**	**–**	**(51.9)**	**38.0**
At 31 December 2018	**26,732.5**	**(50.8)**	**2,884.2**	**(69.7)**	**400.3**	**(71.0)**	**190.2**	**(7.2)**	**30,207.2**	**(198.7)**

(1) Purchased or originated as credit impaired.
(2) Includes changes to the allowance for credit impairment losses arising from stage transfers and other changes to risk parameters.

Impairment losses on loans and advances to customers of £72.8 million recognised in the income statement comprise movements in the allowance for credit impairment losses of £71.4 million as set out in the table above and £1.4 million in respect of amounts charged directly the income statement.

During 2018, stage 2 balances increased by £1,071.6 million primarily reflecting transfers from stage 1 driven by refinements made to the probability of default models to reflect more recent experience, partially offset by customer repayments. Stage 3 balances increased by £62.3 million due to a temporary cessation in unsecured charge-off activity in the post migration period and a modest deterioration from early arrears in mortgage balances due to limited post migration collection activities. Charge off and collection activities have subsequently returned to levels closer to normalised pre migration levels.

The tables below set out movements during 2018 analysed between TSB's mortgage portfolios and other lending classes.

	Stage 1		Stage 2		Stage 3		POCI		Total	
Secured (retail)	**Gross Loans £ million**	**Allow. for credit impair-ment losses £ million**	**Gross Loans £ million**	**Allow. for credit impair-ment losses £ million**	**Gross Loans £ million**	**Allow. for credit impair-ment losses £ million**	**Gross Loans £ million**	**Allow. for credit impair-ment losses £ million**	**Gross Loans £ million**	**Allow. for credit impair-ment losses £ million**
At 1 January 2018	**26,542.3**	**(15.9)**	**1,332.4**	**(2.2)**	**249.2**	**(7.6)**	**223.0**	**(8.2)**	**28,346.9**	**(33.9)**
Changes reflected in imp. loss:										
Increases due to originations	**4,834.3**	**(4.8)**	**–**	**–**	**–**	**–**	**–**	**–**	**4,834.3**	**(4.8)**
Decreases due to repayments	**(4,936.4)**	**1.8**	**(201.1)**	**0.6**	**(46.7)**	**0.4**	**(33.0)**	**0.6**	**(5,217.2)**	**3.4**
Changes in credit risk	**–**	**1.3**	**–**	**(2.8)**	**–**	**(1.3)**	**–**	**0.6**	**–**	**(2.2)**
Other movements:										
Transfers between stages	**(1,207.8)**	**–**	**1,120.4**	**–**	**87.4**	**–**	**–**	**–**	**–**	**–**
Amounts written off	**(0.7)**	**–**	**(0.5)**	**–**	**(2.5)**	**1.0**	**–**	**–**	**(3.7)**	**1.0**
At 31 December 2018	**25,231.7**	**(17.6)**	**2,251.2**	**(4.4)**	**287.4**	**(7.5)**	**190.0**	**(7.0)**	**27,960.3**	**(36.5)**
Unsecured and business banking	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**	**£ million**
At 1 January 2018	**2,006.5**	**(38.1)**	**480.2**	**(50.0)**	**88.8**	**(43.0)**	**3.4**	**(0.3)**	**2,578.9**	**(131.4)**
Changes reflected in imp. loss:										
Increases due to originations	**347.1**	**(4.6)**	**27.4**	**–**	**9.3**	**–**	**–**	**–**	**383.8**	**(4.6)**
Decreases due to repayments	**(453.2)**	**1.7**	**(192.6)**	**4.9**	**(18.6)**	**0.5**	**(3.2)**	**0.1**	**(667.6)**	**7.2**
Changes in credit risk	**–**	**7.8**	**–**	**(20.3)**	**–**	**(57.9)**	**–**	**–**	**–**	**(70.4)**
Other movements:										
Transfers between stages	**(399.6)**	**–**	**318.0**	**–**	**81.6**	**–**	**–**	**–**	**–**	**–**
Amounts written off	**–**	**–**	**–**	**0.1**	**(48.2)**	**36.9**	**–**	**–**	**(48.2)**	**37.0**
At 31 December 2018	**1,500.8**	**(33.2)**	**633.0**	**(65.3)**	**112.9**	**(63.5)**	**0.2**	**(0.2)**	**2,246.9**	**(162.2)**

Gross loans written off during 2018 of £51.9 million remains subject to enforcement action.

Notes to the consolidated financial statements

Loans (continued)

11. Allowance for credit impairment losses on financial assets at amortised cost (continued)

Significant estimates - measurement uncertainty and sensitivity analysis of expected credit losses

The adequacy of the allowance is estimated using models which use a variety of inputs, including recent historical experience to estimate the level of expected credit losses (ECL) 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 2018, the allowance included £51.4 million (2017 - IAS 39: £22.8 million) of post model adjustments. The most significant adjustments to modelled outputs reflect management's judgement as to the level of expected losses not captured by the impairment models arising from risks associated with interest only mortgage redemptions and customers that may not be able to service their borrowings in a higher interest rate environment. The recognition and measurement of ECL is highly complex and involves the use of significant judgement and estimation. This includes the formulation and incorporation of multiple forward-looking economic conditions into ECL to meet the measurement objective of IFRS 9.

Methodology

TSB currently uses three economic scenarios, representative of our view of forecast economic conditions, which are selected in order to capture material non-linearities and calculate an unbiased ECL. They represent a most likely outcome ('base' scenario) and two, less likely, outer scenarios, referred to as the 'upside' and 'downside' scenarios. The base scenario is assigned a weighting of 65%, the upside scenario 15% and the downside scenario 20%. This weighting is deemed appropriate for the computation of unbiased ECL. Key scenario assumptions are set using forecasts from external economists, helping to ensure the IFRS 9 scenarios are unbiased and maximise the use of independent information.

For the base scenario, key assumptions are set for house price inflation, unemployment and Bank Base Rate, and are benchmarked against Bank of England forecasts. In assessing the severity of the upside and downside scenarios the key variables are considered using the Bank of England's forecast distribution and relative to upside and downside scenarios provided by an external economic consultancy. While key economic variables are set with reference to external forecasts, the overall 'shape' of the scenarios is assessed with reference to the macroeconomic risks in TSB's top and emerging risks. This seeks to ensure that scenarios remain consistent with the more qualitative assessment of risks captured in top and emerging risks. Scenarios used for IFRS 9 are formally reassessed twice a year and updated, as necessary. Economic developments and the number of scenarios are reviewed throughout the year to enable significant developments to be taken into account in measuring credit impairment provisions.

Forecast Economic Scenarios

In determining scenarios for inclusion in measuring credit impairment provisions, the following scenarios were considered:

- Base - This scenario features a relatively hard, but smooth, Brexit. Supply and demand remain balanced supporting GDP growth which remains consistent with recent experience at sub 2%, a lower rate than historically experienced. This scenario features a steady circa 4% unemployment rate with house prices trending gently higher in real terms and base rate remaining at historical lows, peaking at 2%.
- Downside – assumes a rapid tightening of UK and global financial conditions triggered by higher inflation and concerns about asset price valuations. These lead to reduced liquidity, higher risk premia and interest rates and weaker economic activity. This scenario features a peak to trough house price fall of 25.6%, unemployment and interest rate peaking at 6.4% and 3.3%, respectively. This scenario is considered to be reflective of a 'No Deal' Brexit but where the transition to WTO rules and future trading arrangements is more orderly than a 'cliff-edge' exit in March 2019.
- Upside – assumes an increase in productivity growth and continued loose financial conditions. These lead to faster growth relative to the base case without the development of serious inflation and provide a more favourable interest rate environment for banks' earnings. Unemployment shows a steady decline to a low of 3%, marking an historical UK low. Wage growth supports faster house price growth.

The table below summarises the forecast economic scenarios applied in measuring ECL at 31 December 2018.

		At 31 December 2018			At 1 January 2018		
		Base case %	**Upside %**	**Downside %**	Base case %	Upside %	Downside %
Scenario weighting		**65**	**15**	**20**	65	15	20
Unemployment	Peak rate	**4.2**	**4.2**	**6.4**	5.0	4.5	7.0
House prices	Peak-to-trough fall	**(3.1)**	**(3.1)**	**(25.6)**	(2.3)	n/a	(23.0)
Interest rates	Most extreme rate	**2.0**	**2.5**	**3.3**	1.0	2.5	3.3

Notes to the consolidated financial statements

Loans (continued)

11. Allowance for credit impairment losses on financial assets at amortised cost (continued)

Significant estimates - measurement uncertainty and sensitivity analysis of expected credit losses (continued)

Effect of multiple economic scenarios on ECL and sensitivity to alternative assumptions
The ECL recognised in the financial statements reflects the effect on expected credit losses of a range of possible outcomes, calculated on a probability-weighted basis, based on the economic scenarios described above. The probability-weighted amount is typically a higher number than would result from using only the base economic scenario. Credit losses and defaults typically have a non-linear relationship to the many factors which influence credit losses, such that more favourable macroeconomic factors do not reduce expected losses as much as less favourable macroeconomic factors increase expected losses. The probability-weighted ECL are 9% higher than the ECL prepared using only base scenario assumptions.

The credit impairment provision is sensitive to reasonably possible alternative economic scenarios and weightings. A 10% increase in the scenario weighting of the downside scenario (from 20% to 30%), coupled with a 10% decrease in the weighting of the base scenario (from 65% to 55%) would result in an increase of £11 million in the impairment provision. Applying a weighting of 100% to the downside scenario would result in an increase of £81 million in the impairment provision.

(ii) Allowance for credit impairment losses – 2017 comparatives measured in accordance with IAS 39

	Specific coverage determined individually £ million	Specific coverage determined collectively £ million	Incurred but not reported coverage £ million	Total £ million
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

As explained on page 61 to 63, with effect from 1 January 2018, TSB adopted IFRS 9 which had the effect of increasing the allowance for credit impairment losses by £93.7 million from £71.6 million at 31 December 2017 to £165.3 million at 1 January 2018.

12. Fair value of financial assets

The following table summarises the carrying values of financial assets presented on TSB'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.

		2018		2017	
	Note	Carrying value £ million	Fair value £ million	Carrying value £ million	Fair value £ million
Financial assets					
Debt securities		**96.2**	**95.1**	–	–
Loans and advances to customers	9	**30,008.5**	**29,962.0**	30,854.2	30,854.0
Financial assets at fair value through other comprehensive income	6	**2,387.8**	**2,387.8**	–	–
Available-for-sale financial assets	7	–	–	2,123.3	2,123.3
Trading derivative financial assets	26	**88.4**	**88.4**	111.1	111.1
Hedging derivative financial assets	26	**106.6**	**106.6**	103.7	103.7
Financial assets at fair value through profit or loss	18	**2.2**	**2.2**	17.2	17.2

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 are generally short term in nature and to counterparties with a high credit quality and the carrying amount is a reasonable approximation of fair value.

Notes to the consolidated financial statements

Loans (continued)

12. Fair value of financial assets (continued)

Valuation hierarchy of financial assets carried at amortised cost

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

	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
Debt securities	**95.1**	**–**	**–**	**95.1**	**96.2**
Loans and advances to customers	**–**	**–**	**29,962.0**	**29,962.0**	**30,008.5**
At 31 December 2018	**95.1**	**–**	**29,962.0**	**30,057.1**	**30,104.7**
At 31 December 2017	–	–	30,854.0	30,854.0	30,854.2

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

Valuation hierarchy of financial assets carried at fair value

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

	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2018					
Financial assets at fair value through other comprehensive income	**2,387.8**	**–**	**–**	**2,387.8**	**2,387.8**
Trading derivative assets	**–**	**88.4**	**–**	**88.4**	**88.4**
Hedging derivative assets	**–**	**106.6**	**–**	**106.6**	**106.6**
Financial assets at fair value through profit or loss	**2.2**	**–**	**–**	**2.2**	**2.2**
Total	**2,390.0**	**195.0**	**–**	**2,585.0**	**2,585.0**
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
Financial assets at fair value through profit or loss	17.2	–	–	17.2	17.2
Total	2,133.5	214.8	7.0	2,355.3	2,355.3

A description of the fair value levels is included in note 5.

Level 3 financial assets	2018 £ million	2017 £ million
Balance at 1 January	**7.0**	5.2
Gains recognised on financial assets at fair value through profit or loss	**2.2**	–
Disposal of Visa Inc. convertible preferred stock	**(9.2)**	–
Gains recognised in ‘changes in fair value’ in other comprehensive income	–	1.8
Balance at 31 December	–	7.0

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 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 78. 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

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 effective for the year ended December 2018 – IFRS 9

(e) Interest income and expense

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

The effective interest rate is calculated on initial recognition of the financial asset or liability, estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts paid or received by TSB 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).

For financial assets, interest income is calculated by applying the effective interest rate to the gross carrying amount of the financial asset. There are two exceptions to this as follows:

(i) Interest income in respect of financial assets that have become credit impaired (stage 3) subsequent to their initial recognition is calculated by applying the effective interest rate to their amortised cost, net of expected loss provision.

(ii) Interest income in respect of financial assets classified as purchased or originated credit impaired (POCI) is calculated by applying the original credit adjusted effective interest rate to the amortised cost of the financial asset.

Derivative financial instruments
Interest income and expense on derivative financial instruments in qualifying hedge accounting relationships, where the hedged item is a financial asset, is recognised in interest income. Where the hedged item is a financial liability, the derivative interest income or expense is recognised in interest expense. Interest income and expense on derivatives classified as held for trading is recognised in interest income.

(f) Other operating income
Other operating income, including fees and commissions, which are not an integral part of the EIR are generally recognised when the service has been provided and TSB has satisfied its performance obligations.

Renewal commission income is recognised when TSB 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.

Notes to the consolidated financial statements

Income (continued)

Accounting policies effective for the year ended December 2017 – IAS 39

Interest income and expense

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

The effective interest rate is calculated on initial recognition of the financial asset or liability, estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts paid or received by TSB 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).

Fees and commission income and expense

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

13. Net interest income

	2018 £ million	2017* £ million
Interest and similar income		
Interest income calculated using the effective interest method:		
Cash, cash balances at central banks and other demand deposits	**38.2**	13.5
Financial assets at fair value through other comprehensive income	**34.3**	–
Available-for-sale financial assets	**–**	44.7
Loans to credit institutions	**2.5**	0.9
Loans and advances to customers	**997.2**	1,054.8
	1,072.2	1,113.9
Derivative financial instruments	**(2.0)**	(26.4)
Total interest and similar income	**1,070.2**	1,087.5
Interest and similar expense		
Interest expense calculated using the effective interest method:		
Borrowings from central banks	**(38.5)**	(12.1)
Deposits from credit institutions	**(0.3)**	(0.4)
Customer deposits	**(121.4)**	(120.5)
Repurchase agreements	**(3.8)**	(8.0)
Debt securities in issue	**(13.0)**	(11.9)
Subordinated liabilities	**(22.4)**	(22.4)
	(199.4)	(175.3)
Derivative financial instruments	**14.0**	13.7
Total interest and similar expense	**(185.4)**	(161.6)
Net interest income	**884.8**	925.9

* Interest on derivatives held for trading (and entered into as economic hedges) of £20.6 million in 2017 has been reclassified to 'interest income' from 'losses on financial assets and liabilities held for trading'. Further, £13.7 million of interest income on derivatives in hedging accounting relationships where the hedged item was a financial liability have been reclassified from 'interest income' to 'interest expense'. These align with the accounting policy on page 84.

Included within interest and similar income is £16.2 million (2017: £9.1 million) in respect of impaired financial assets.

Notes to the consolidated financial statements

Income (continued)

14. Net fee and commission income

	2018 £ million	2017 £ million
Fee and commission income		
Bank accounts	**46.1**	84.5
Credit and debit card fee income	**55.4**	66.5
Insurance commission income	**11.9**	19.1
Other	**8.7**	23.2
Total fee and commission income	**122.1**	193.3
Fee and commission expense		
Bank accounts	**(36.6)**	(84.7)
Credit and debit card fee expense	**(3.5)**	(13.3)
Other	**(6.6)**	(11.6)
Total fee and commission expense	**(46.7)**	(109.6)
Net fee and commission income	**75.4**	83.7

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

15. Other operating income

	2018 £ million	2017 £ million
Migration related income from LBG	**318.3**	–
Rent receivable	**1.0**	1.2
Dividend income	**0.8**	0.2
Other income	**0.2**	0.2
Total other operating income	**320.3**	1.6

Migration related income from LBG was recognised as a result of exiting the Transitional Services Agreement on migration to the new IT platform.

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, paying for advertising and marketing, and in 2018, the costs of preparing for the migration and the subsequent service disruption. Occasionally, our customers' circumstances change and they are unable to repay the money they borrow from us causing us to incur impairment losses. Finally, TSB complies with its tax obligations to HMRC.

Accounting policies relevant to recognising charges

(g) Pensions and other post-retirement benefits

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

(h) Share-based compensation

TSB 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.

(i) Taxation

Current corporation tax which is payable or receivable on taxable profits or losses is recognised as tax expense or credit in the period in which the profits or losses 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

	2018 £ million	2017 £ million
Partner (staff) costs		
Wages and salaries	**263.5**	262.7
Social security costs	**27.2**	29.7
Other pension costs	**35.1**	32.7
Share-based payments (note 18)	**(2.7)**	6.4
Other staff costs	**10.2**	38.9
Total staff costs	**333.3**	370.4
Premises and equipment expenses		
Rent	**32.1**	30.8
Rates	**14.2**	14.7
Other	**32.2**	31.3
Total premises and equipment expenses	**78.5**	76.8
Other expenses		
Post migration customer redress	**107.3**	–
Post migration customer rectification	**17.9**	–
Migration related fraud and operational losses	**49.1**	–
Outsourcing costs	**165.3**	213.8
Professional fees	**63.7**	27.2
Advertising and promotion	**55.4**	59.0
Financial Services Compensation Scheme levy	**(1.4)**	0.3
Other	**161.5**	84.0
Recovery of additional post migration charges	**(153.0)**	–
Total other expenses	**465.8**	384.3
Depreciation of property plant and equipment	**24.6**	27.5
Amortisation of intangible assets	**3.5**	0.3
Operating expenses excluding the costs of preparing for TSB's migration	**905.7**	859.3
Costs of preparing for TSB's migration		
Migration Services Agreement costs	**249.0**	–
Other migration programme related costs	**168.3**	–
Total costs of preparing for TSB's migration	**417.3**	–
Total operating expenses	**1,323.0**	859.3

Post migration charges of £296.7 million (page 17) include customer redress and associated operational costs of £107.3 million, customer rectification and associated costs of £17.9 million, fraud and operational losses of £49.1 million and incremental resource and advisory costs of £122.4 million to support TSB's remediation programme (of which £19.2 million are included in staff costs, £2.0 million in premises and equipment expenses, and £101.2 million is included in other expenses).

Significant judgement

The MSA and OSA contracts provide TSB with the right to seek recovery of eligible losses for breach of contract up to the level of liability caps in each agreement. The parties have reached agreement, subject to mutual reservation of rights while negotiations are concluded, where TSB will recover an aggregate of £153.0 million under the respective contracts. Consequently, in light of this agreement, post migration charges were reduced by recovery of £153.0 million under the MSA and OSA contracts. Whilst this represents the current best estimate of the recovery, this may change as the negotiations conclude.

Notes to the consolidated financial statements

Charges (continued)

16. Operating expenses (continued)

The monthly average number of Partners on a headcount basis during the year was 8,439 (2017: 8,583), 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).

Included in other expenses are fees paid to TSB's auditors as set out in the table below:

Auditors' remuneration	2018 £ million	2017 £ million
Fee for the audit of the financial statements of TSB Banking Group plc	**0.1**	0.1
Fee for the audit of TSB's subsidiaries	**4.4**	2.2
Non-audit fees	**0.1**	0.3
Total fees payable to TSB's auditors	**4.6**	2.6

The 2018 fee for the audit of TSB's subsidiaries includes additional fees in respect of changes to the IT platform and associated control environment following migration. In addition to the above fees payable to TSB's auditors, £0.4 million (2017: £1.1 million) paid to LBG in respect of a review by their auditors of controls undertaken on TSB's behalf under the TSA.

17. Directors' emoluments

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

	2018 £ 000	2017 £ 000
Remuneration paid to Directors in respect of qualifying services	**2,474**	3,008
Cash received under long-term incentive arrangements	**–**	83
Notice payments	**1,239**	–
Total	**3,713**	3,091

Details of the highest paid Director, including a description of notice payments, are set out on page 52 in the Remuneration review. The table below presents the number of Directors who:

	2018 Number	2017 Number
Exercised share options	**–**	1
Received shares under long term incentive schemes	**1**	1
Accrued pension benefits under defined contribution pension schemes	**1**	1

18. Share-based payments

Operating expenses in respect of TSB's share-based compensation schemes, all of which are accounted for as cash-settled share-based compensation schemes are set out below:

	2018 £ million	2017 £ million
Share options – TSB Sharesave	**0.2**	2.2
Share grants – TSB Sustainable Performance Award	**(4.0)**	2.8
Other share-based compensation arrangements	**1.1**	1.4
	(2.7)	6.4

During 2018 and 2017, TSB operated a Sharesave scheme and a Share Incentive Plan (SIP), both of which provide all TSB 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 monthly, with changes recognised in operating expenses, to reflect the latest Sabadell share price and the estimated number of shares expected to vest.

The credit recognised in operating expenses in 2018 reflects that the unvested SPA awards due to vest in March 2019 will not vest due to performance against the pre-determined financial target not being achieved. At 31 December 2018, £4.9 million (2017: £10.1 million) was recognised in respect of share-based payments liability (see note 33). TSB's remuneration is more fully explained in the Remuneration review starting on page 50.

Charges (continued)

18. Share-based payments (continued)

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 2018, 2,464,434 Sabadell shares (2017: 2,938,753 Sabadell shares), with a fair value, calculated using the market price at 31 December 2018, of £2.2 million (2017: £4.3 million), were awarded to certain senior Partners under the SPA in respect of the 2017 performance year. The carrying amount of the liability in respect of the SPA at 31 December 2018 was £nil (2017: £6.3 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:

	2018		2017	
	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	**13,001**	**77.68**	13,974	77.68
Granted	**–**	**–**	–	–
Exercised	**(197)**	**77.68**	(65)	77.68
Forfeited	**(499)**	**77.68**	(554)	77.68
Cancelled	**(315)**	**77.68**	(354)	77.68
Outstanding at 31 December	**11,990**	**77.68**	13,001	77.68
Exercisable at 31 December	**–**	**–**	–	–

The remaining contractual life of the options outstanding at 31 December 2018 was nine months. At 31 December 2018, the fair value of the options, determined using a Black Scholes option pricing model, was 17.0 pence (2017: 32.0 pence) and a liability of £2.5 million (2017: £2.3 million) was recognised on the consolidated balance sheet.

Economic hedging of share based compensation liability
At 31 December 2018, £2.2 million (2017: £17.2 million) of Sabadell shares were held for the purpose of hedging TSB's obligations under the SPA and other share based compensation arrangements. As set out in note 28(ii), TSB holds options from Sabadell to acquire Sabadell shares to satisfy obligations under the Sharesave scheme and, during 2018, entered into a forward purchase agreement with Sabadell to acquire shares to satisfy obligations under the SPA and other share based compensation arrangements. At 31 December 2018, the option had a fair value of £1.9 million (2017: £6.9 million) and the forward purchase agreement had a fair value of £0.8 million (2017: £nil). These instruments are measured at fair value through profit or loss on the consolidated balance sheet and reduce the accounting mismatch arising from the volatility of marking to market the share-based payment liability.

19. Taxation

	2018 £ million	2017 £ million
UK corporation tax		
Current tax credit/(charge) on (loss)/profit for the year	**23.6**	(20.4)
Adjustments in respect of prior year	**(2.8)**	2.7
Current tax credit/(charge)	**20.8**	(17.7)
Deferred tax (note 20)		
Origination and reversal of temporary differences:		
Deferred tax charge on business transfers	**(19.3)**	(23.8)
Accelerated capital allowances	**0.6**	1.7
Adjustments in respect of prior years	**3.4**	(4.2)
Deferred tax credit in relation to trading losses	**37.8**	–
Other	**(0.9)**	–
Deferred tax credit/(charge)	**21.6**	(26.3)
Taxation credit/(charge)	**42.4**	(44.0)

Notes to the consolidated financial statements

Charges (continued)

19. Taxation (continued)

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

	2018 £ million	2017 £ million
(Loss)/profit before taxation	**(105.4)**	162.7
Taxation credit/(charge) at applied UK corporation tax rate of 27.0% (2017: 27.25%)	**28.5**	(44.3)
Factors affecting charge:		
Disallowed costs	**(86.5)**	(1.2)
Non-taxable items	**104.3**	1.0
Changes to UK corporation tax rates	**(4.5)**	–
Taxable profits not subject to 8% bank surcharge	**–**	2.0
Adjustments in respect of prior years	**0.6**	(1.5)
Taxation credit/(charge)	**42.4**	(44.0)

The applied UK corporation tax rate of 27% for 2018 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%. Disallowed costs and non-taxable items primarily reflect costs incurred under the MSA and migration related income from LBG respectively.

20. Deferred tax assets

The movement in deferred tax assets is as follows:

	£ million
At 1 January 2017	99.6
Income statement charge (note 19)	(26.3)
Amounts charged to equity:	
Movements in available-for-sale reserve	(4.7)
At 31 December 2017	68.6
Change on adoption of IFRS 9	25.0
Change on adoption of IFRS 15	(1.6)
At 1 January 2018	**92.0**
Income statement charge (note 19)	**21.6**
Amounts charged to equity:	
Movements in fair value reserve	**(0.6)**
At 31 December 2018	**113.0**

Deferred tax assets are comprised as follows:

	2018 £ million	2017 £ million
Deferred tax impact of business transfers	**58.9**	78.2
Deferred tax impact of trading losses	**37.8**	–
Deferred tax in respect of transition to IFRS 9	**21.7**	–
Revaluations of financial assets at fair value through other comprehensive income	**(6.9)**	–
Revaluations of available-for-sale financial assets	–	(7.0)
Other temporary differences	**1.5**	(2.6)
Total deferred tax assets	**113.0**	68.6

Notes to the consolidated financial statements

Profits and returns to the shareholder

The Board reviews TSB's performance. It decides whether profits are put aside for future investment in the business, for protection against the uncertainties that TSB 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

(j) Share capital

Shares are classified as equity instruments when there is no contractual obligation to deliver cash or other assets to another entity and the shares present a residual interest in the net assets of the issuer. Ordinary shares are classified as equity.

21. Shareholder's equity

	Share capital £ million	Share premium £ million	Merger reserve £ million	Capital reorg-anisation reserve £ million	Capital reserve £ million	Fair value reserve £ million	Available-for-sale reserve £ million	Cash flow hedging reserve £ million	Retained profits £ million
Balance at 1 January 2017	5.0	965.1	616.5	(1,311.6)	410.0	–	5.9	0.4	1,173.7
Net movement in available-for-sale reserve	–	–	–	–	–	–	12.8	–	–
Net movement in cash flow hedging reserve	–	–	–	–	–	–	–	(0.9)	–
Profit for the year	–	–	–	–	–	–		–	118.7
At 31 December 2017	5.0	965.1	616.5	(1,311.6)	410.0	–	18.7	(0.5)	1,292.4
Change on adoption of IFRS 9	–	–	–	–	–	16.9	(18.7)	–	(70.1)
Change on adoption of IFRS 15	–	–	–	–	–	–	–	–	4.3
Balance at 1 January 2018	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**16.9**	**–**	**(0.5)**	**1,226.6**
Net movement in fair value reserve	**–**	**–**	**–**	**–**	**–**	**1.7**	**–**	**–**	**–**
Net movement in cash flow hedging reserve	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**(2.7)**	**–**
Loss for the year	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**(63.0)**
At 31 December 2018	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**18.6**	**–**	**(3.2)**	**1,163.6**

At 31 December 2018, TSB Banking Group plc had in issue 500.0 million (2017: 500.0 million) one pence ordinary shares authorised, allotted and fully paid up.

The merger reserve and capital reorganisation reserves were established in 2014 upon TSB Banking Group plc issuing new shares in exchange for the acquisition of the entire share capital of TSB Bank plc. The issuance was recorded at the carrying amount of the net assets of TSB Bank plc at the date of acquisition and resulted in a transfer to the share premium reserve of a minimum amount required by the Companies Act 2006. The difference between the amount transferred to share capital and share premium and the carrying amount of the net assets of TSB Bank plc was transferred to the merger reserve. The capital reorganisation reserve was established at this time to reflect the effect of TSB Banking Group plc becoming the new holding company of TSB by means of this share for share exchange.

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

The fair value reserve represents the unrealised change in the value of financial assets at fair value through other comprehensive income since the instrument's 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.

Managing financial risk

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

Accounting policies relevant to managing financial risk

(k) 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.

TSB has elected to continue to apply the hedge accounting requirements of IAS 39 on adoption of IFRS 9. Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of such instruments. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item and the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge relationship in offsetting changes in the fair value of the hedged risk. In its application of the hedge accounting policy, TSB 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. TSB designates certain derivatives as either hedges of the fair value of recognised assets or liabilities (fair value hedges) or hedges of highly probable future cash flows attributable to recognised assets or liabilities (cash flow hedges).

Fair value hedges

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

Cash flow hedges

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

Managing financial risk (continued)

22. Credit risk – IFRS 9

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

The maximum exposure to credit risk for financial assets that are subject to impairment requirements is set out below:

	2018 £ million
Loans to central banks	**87.8**
Loans to credit institutions	**370.6**
Loans and advances to customers - secured (retail) (1)	**27,923.8**
Loans and advances to customers – unsecured and business banking (1) (2)	**2,084.7**
Financial assets at fair value through other comprehensive income	**2,387.8**
Other advances	**42.4**
Financial assets not subject to impairment requirements:	**195.0**
Total on balance sheet balance	**33,092.1**
Lending commitments – secured (retail)	**1,030.0**
Lending commitments – unsecured and business banking	**3,748.1**
Maximum credit risk exposure	**37,870.2**

(1) Amounts shown are net of related allowances for credit impairment losses.
(2) Comprises unsecured lending balances of £1,972.4 million and business banking of £112.3 million.

Notes to the consolidated financial statements

Managing financial risk (continued)

22. Credit risk – IFRS 9 (continued)

(ii) Quality of credit risk exposures

Internal rating scales

In assessing the credit quality of the loan portfolio TSB uses an internal rating scale based on a customer's 12 month expected default probability.

	Internal grading
Excellent quality	1-4
Good quality	5-6
Satisfactory quality	7-9
Lower quality	10
Below standard	11-13

Secured (retail)

	Stage 1 £ million	Stage 2 £ million	Stage 3 £ million	Purchased credit impaired £ million	2018 total £ million
Excellent quality	**25,200.2**	**1,988.1**	**13.1**	**–**	**27,201.4**
Good quality	**27.8**	**150.8**	**11.8**	**–**	**190.4**
Satisfactory quality	**2.1**	**97.1**	**24.9**	**–**	**124.1**
Lower quality	**0.3**	**8.3**	**6.7**	**–**	**15.3**
Below standard	**1.3**	**6.9**	**230.9**	**190.0**	**429.1**
Gross carrying amount	**25,231.7**	**2,251.2**	**287.4**	**190.0**	**27,960.3**

Unsecured and business banking

	Stage 1 £ million	Stage 2 £ million	Stage 3 £ million	Purchased credit impaired £ million	2018 total £ million
Excellent quality	**685.7**	**65.5**	**0.8**	**–**	**752.0**
Good quality	**677.0**	**395.9**	**2.5**	**–**	**1,075.4**
Satisfactory quality	**120.4**	**105.7**	**3.5**	**–**	**229.6**
Lower quality	**9.7**	**24.7**	**1.8**	**–**	**36.2**
Below standard	**8.0**	**41.2**	**104.3**	**0.2**	**153.7**
Gross carrying amount	**1,500.8**	**633.0**	**112.9**	**0.2**	**2,246.9**

(iii) Collateral held as security for financial assets

TSB 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.

Secured (retail)

An analysis by loan-to-value (LTV) ratio of TSB's credit impaired (stage 3) retail 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.

LTV of Stage 3 Secured (retail)	2018 Stage 3 £ million	2017 Impaired (IAS 39) £ million
Less than 70%	**200.9**	48.8
70% to 80%	**45.1**	14.5
80% to 90%	**24.8**	9.4
90% to 100%	**11.6**	5.9
Greater than 100%	**5.0**	2.8
Total secured (retail)	**287.4**	81.4

Managing financial risk (continued)

22. Credit risk – IFRS 9 (continued)

(iii) Collateral held as security for financial assets (continued)

TSB 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.

Unsecured lending and business banking

No collateral is 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.

(iv) Forbearance and loan modifications

TSB 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 2018, total forborne loans were £310.3 million (2017: £363.1 million), of which £182.4 million (2017: £59.2 million) were impaired. At 31 December 2018, the allowance for loan losses held in respect of forborne loans was £27.4 million (2017: £13.2 million).

Notes to the consolidated financial statements

Managing financial risk (continued)

23. Credit risk – IAS 39

(i) Credit quality of assets – IAS 39 basis

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.

	Loans and advances to customers			Other loans and receivables[(1)]
At 31 December 2017	Mortgages[(2)] £ million	Unsecured lending and business banking £ million	Total £ million	£ million
Neither past due nor impaired	27,988.5	2,425.2	30,413.7	385.2
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	385.2
Allowance for impairment losses (note 11)	(25.7)	(45.9)	(71.6)	–
Net loans and receivables	28,368.0	2,486.2	30,854.2	385.2

(1) Other loans and receivables comprise loans to central banks and loans to credit institutions.
(2) Includes commercial mortgages with gross balances of £46.8 million and allowance for impairment losses of £0.3 million.

Loans and receivables which are neither past due nor impaired

	Loans and advances to customers			Other loans and receivables
31 December 2017	Mortgages £ million	Unsecured lending and business banking £ million	Total £ million	£ million
Good quality	27,939.2	2,108.6	30,047.8	385.2
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	385.2

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

Loans and receivables which are past due but not impaired

	Loans and advances to customers			Other loans and receivables
31 December 2017	Mortgages £ million	Unsecured lending and business banking £ million	Total £ million	£ 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	–

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 – IAS 39 (continued)

(ii) Collateral held as security for financial assets

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

Mortgages

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

31 December 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

Unsecured lending and business banking

At 31 December 2017, unimpaired unsecured and business banking lending amounted to £2,485.5 million. At 31 December 2017, impaired unsecured and business banking lending amounted to £0.7 million, net of an impairment allowance of £45.9 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.

TSB 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.

24. Liquidity risk

Definition and exposure

Liquidity risk is the risk that TSB 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 risk is managed, monitored and measured from both an internal and regulatory perspective.

Sources of funding

TSB'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. At 31 December 2018, TSB's primary liquidity portfolio totalled £9,438.9 million (2017: £9,536.2 million). Further information regarding sources of funding is available on pages 12 to 15.

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Liquidity risk (continued)

Risk appetite

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

Measurement and monitoring

A series of measures are used across TSB to monitor both short term and long term liquidity risk. Liquidity risk 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.

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

At 31 December 2018	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:						
Borrowings from central banks	12.2	–	–	6,470.0	–	6,482.2
Deposits from credit institutions	3.4	–	–	–	–	3.4
Customer deposits	26,865.6	175.0	798.3	1,245.4	–	29,084.3
Repurchase agreements	1,084.8	–	–	–	–	1,084.8
Debt securities in issue	–	53.7	130.5	938.4	–	1,122.6
Subordinated liabilities	–	–	3.4	394.8	–	398.2
Other financial liabilities	66.4	–	–	–	–	66.4
Trading derivative liabilities	0.3	1.2	1.2	32.7	58.6	94.0
Hedging derivative liabilities	–	2.6	0.8	27.3	315.3	346.0
Other liabilities (1)	559.0	–	–	–	19.4	578.4
Total liabilities	**28,591.7**	**232.5**	**934.2**	**9,108.6**	**393.3**	**39,260.3**

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

At 31 December 2018	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Assets						
Financial assets at amortised cost:						
Debt securities	–	1.1	–	–	95.1	96.2
Loans to central banks	87.8	–	–	–	–	87.8
Loans to credit institutions	–	246.3		64.6	59.7	370.6
Loans and advances to customers	985.9	214.2	978.6	6,054.5	21,775.3	30,008.5
Other advances	382.1	–	–	–	–	382.1
Financial assets at fair value through other comprehensive income	0.3	1.0	10.9	48.0	2,327.6	2,387.8
Trading derivative assets	0.8	0.9	6.1	50.6	30.0	88.4
Hedging derivative assets	–	0.3	4.6	95.2	6.5	106.6
Other assets (2)	7,320.2	2.9	33.4	95.5	144.3	7,596.3
Total assets	**8,777.1**	**466.7**	**1,033.6**	**6,408.4**	**24,438.5**	**41,124.3**

(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)

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:						
Borrowings from central banks	5,625.7	–	–	–	–	5,625.7
Customer deposits	26,680.8	669.7	2,087.8	1,082.3	–	30,520.6
Repurchase agreements	1,446.4	–	–	–	–	1,446.4
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	320.5	0.1	(2.7)	9.5	34.5	361.9
Total liabilities	34,338.8	733.3	2,240.5	2,631.7	585.6	40,529.9

Assets						
Financial assets at amortised cost						
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	7,805.6	–	10.9	57.7	177.8	8,052.0
Total assets	9,852.6	466.5	1,343.5	6,331.4	24,531.5	42,525.5

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

At 31 December 2018	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:						
Borrowing from central banks	**12.2**	**–**	**–**	**6,470.0**	**–**	**6,482.2**
Deposits from credit institutions	**3.4**	**–**	**–**	**–**	**–**	**3.4**
Customer deposits	**27,005.3**	**177.5**	**809.7**	**1,263.1**	**–**	**29,255.6**
Repurchase agreements	**1,084.8**	**–**	**–**	**–**	**–**	**1,084.8**
Debt securities in issue	**–**	**46.1**	**131.4**	**882.6**	**–**	**1,060.1**
Subordinated liabilities	**–**	**–**	**22.1**	**418.2**	**–**	**440.3**
Other financial liabilities	**66.4**	**–**	**–**	**–**	**–**	**66.4**
Total non-derivative financial liabilities	**28,172.1**	**223.6**	**963.2**	**9,033.9**	**–**	**38,392.8**
Gross settle derivatives - outflows	**14.9**	**20.5**	**158.4**	**549.7**	**545.9**	**1,289.4**
Gross settle derivatives - inflows	**(13.2)**	**(16.8)**	**(100.5)**	**(332.1)**	**(359.2)**	**(821.8)**
Total financial liabilities	**28,173.8**	**227.3**	**1,021.1**	**9,251.5**	**186.7**	**38,860.4**

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:						
Borrowings 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 settle derivatives - outflows	16.7	16.8	161.3	753.4	605.9	1,554.1
Gross settle derivatives - 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

25. Capital resources

TSB 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 TSB's regulatory capital resources.

	2018 £ million	2017 £ million
Shareholder's equity	**1,864.0**	1,995.6
Regulatory deductions	**(58.5)**	(97.5)
Common Equity Tier 1/Total Tier 1 capital	**1,805.5**	1,898.1
Tier 2 capital	**390.6**	384.1
Total capital resources	**2,196.1**	2,282.2

Further information on capital resources is available on pages 12 and 13 in the Financial performance in 2018 section of the Strategic report.

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. TSB'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 TSB's assets and liabilities. TSB'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 TSB 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 risk appetite.

A 12 month view of the sensitivity of net interest income is calculated on the basis of TSB Group's current consolidated balance sheet with re-pricing dates adjusted according to behavioural assumptions. At 31 December 2018, 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 £20.3 million (2017: £10.2 million) from a 25bps increase in rates, and a decrease of £0.7 million (2017: £18.3 million) from a 25bps decrease. The measure assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount and does not take into account potential management actions.

Derivative financial instruments

TSB holds derivative financial instruments in the normal course of its banking business for interest rate risk management and margin stabilisation purposes. The fair values and notional amounts of derivative instruments are presented in the following table:

	2018				2017			
Trading derivative instruments	Contract/ notional amount £ million	Assets fair value £ million	Liabilities fair value £ million	Gain/(loss) recognised in profit or loss £ million	Contract/ notional amount £ million	Assets fair value £ million	Liabilities fair value £ million	Gain(loss) recognised in profit or loss £ million
Interest rate swaps	**18,301.0**	**86.5**	**(92.7)**	**(27.3)**	21,039.2	104.2	(37.1)	(17.4)
Foreign exchange forwards	**27.0**	**–**	**(0.5)**	**0.4**	30.5	–	(0.4)	(0.2)
Equity options	**11.4**	**1.9**	**(0.8)**	**(7.1)**	8.7	6.9	–	3.6
Total	**18,339.4**	**88.4**	**(94.0)**	**(34.0)**	21,078.4	111.1	(37.5)	(14.0)

	2018				2017			
Hedging derivative instruments	Contract/ notional amount £ million	Assets fair value £ million	Liabilities fair value £ million	Change in fair value used for calculating hedge ineffectiveness £ million	Contract/ notional amount £ million	Assets fair value £ million	Liabilities fair value £ million	Change in fair value used for calculating hedge ineffectiveness £ million
Interest rate risk (Fair value hedges)								
Interest rate swaps	**16,602.4**	**43.1**	**(343.5)**	**9.3**	13,668.8	38.9	(566.5)	55.4
Interest rate and credit risk (Cash flow hedges)								
Forward settlement contracts	**205.0**	**–**	**(2.5)**	**(2.5)**	–	–	–	–
Foreign exchange risk (Cash flow hedges)								
Cross currency interest rate swaps	**317.6**	**63.5**	**–**	**(1.3)**	348.4	64.8	–	8.4
Total	**17,125.0**	**106.6**	**(346.0)**	**5.5**	14,017.2	103.7	(566.5)	63.8

Notes to the consolidated financial statements

Managing financial risk (continued)

26. Market risk (continued)

Risk management
Derivatives are recognised at fair value, with changes in the fair value recognised in the income statement. Where all relevant criteria are met, hedge accounting is applied to remove the accounting mismatch between the hedging instrument and the hedged item. Where derivatives do not meet the hedge accounting criteria they are classified as 'held for trading' (as defined by IAS 39 Financial Instruments).

TSB transacts derivatives largely to economically hedge interest rate risk. The loss on trading derivatives of £27.2 million (2017: £17.8 million) is partially offset by the gain of £25.3 million (2017: £32.6 million) from the amortisation of accumulated adjustments on the hedged items for which hedge accounting no longer applies, resulting from TSB's dynamic hedging strategies.

Interest rate risk (fair value hedge)
The profile of interest risk being managed is dynamic, changing as the day to day business activities of TSB evolve. TSB manages incremental risk via derivative contracts as and when it arises. For operational simplicity, not all derivatives are hedge accounted. Where such derivatives are hedge accounted, pay fixed, receive floating interest rate swaps are typically designated as a portfolio fair value hedge of fixed rate mortgage assets. Conversely, receive fixed, pay floating derivatives are typically designated as a portfolio fair value hedge of fixed rate customer deposits. As interest rate risk management is dynamic, hedge accounting relationships are frequently discontinued and restarted.

TSB has issued fixed rate subordinated debt and purchased fixed rate debt securities as part of its Treasury management activities. These items are economically hedged with derivative contracts. Hedge accounting designations are made on the same terms as the economic hedging; typically, with the notional of the hedged item matching that of the notional of the hedging instrument.

Hedge effectiveness is determined at the inception of the hedge relationship, through periodic retrospective effectiveness assessments, and finally at hedge termination (elective or otherwise) to ensure that a demonstrable relationship existed between the hedged item and hedging instrument. TSB's policy is to fully hedge interest rate risk. Hedge relationships are considered effective where changes in the fair value of the hedged item offset changes in the hedging instrument to within an 80% to 125% ratio. Ineffectiveness arising on hedge relationships can arise due to number of factors which include, but are not limited to, basis mismatch in the benchmark rate used to discount cash flows of the hedged item and hedging instrument, maturity mismatch between the hedged item and hedging instrument, and cash flow timing mismatch between the hedged item and hedging instrument.

The provisions of the EU endorsed version of IAS 39 mean that ineffectiveness arising due to unexpected prepayments need not be recognised though profit or loss, so long as hedge designations are made in such a way to minimise their impact. For hedged items recognised at amortised cost, only fair value changes related to interest rate risk are recognised. For hedged items recognised at fair value, all market factors are recognised in the items' carrying value, however only changes in fair value attributable to interest rate risk are used for assessing hedge effectiveness.

Interest rate and credit risk (cash flow hedge)
TSB minimises interest rate and credit risk arising on purchased debt securities, accounted for at fair value through other comprehensive income, with forward settlement contracts, accounted for as a derivative at fair value through profit or loss. The forward contracts hedge the repricing risks of the underlying security. The forward is the hedging instrument and the sale proceeds are determined to be the hedged item in a hedge relationship. Hedge effectiveness is determined at inception of the hedge relationship by demonstrating that the critical terms of the hedged item match exactly the critical terms of the hedging instrument. To validate the effectiveness of the ongoing hedge relationship, TSB uses the hypothetical derivative method. The economic hedge relationship was 100% effective during the year. Hedge ineffectiveness may occur due to credit valuation adjustments on the hedging instrument which are not matched on the hedged item.

Foreign exchange on foreign currency debt (cash flow hedge)
TSB has issued euro denominated floating rate securitisation notes and as a result is exposed to foreign currency risk as TSB's functional currency is in pound sterling. TSB hedges the foreign currency exposure via cross currency interest rate swaps that exchange floating rate euro cash flows and principal for floating rate sterling cash flows and principal. The swaps are structured such that the euro component matches the critical terms of the hedged securitisation issuance.

Managing financial risk (continued)

26. Market risk (continued)

Foreign exchange on foreign currency debt (cash flow hedge) (continued)
Hedge effectiveness is determined at inception of the hedge relationships by demonstrating that the critical terms of the hedged item match exactly the critical terms of the hedging instrument. To validate the effectiveness of the ongoing hedge relationship, TSB uses the hypothetical derivative method. The economic hedge relationship was 100% effective during the year. Hedge ineffectiveness may occur due to credit valuation adjustments on the swaps which are not matched on the secured issuance.

At 31 December 2018, cross currency swaps of £317.6 million (2017: £348.4 million) were expected to mature between 2 and 3 years (2017: between 3 and 4 years). The average exchange rate applicable to these cross currency swaps was £1/€1.13 (2017: £1/€1.14).

Exposures covered by hedging accounting strategies
The following table contains details of the hedged exposures covered by TSB's hedging strategy:

2018	Carrying amount of hedged item assets/(liability) £ million	Accumulated fair value hedge adj. on hedged item £ million	Balance sheet line item that includes the hedged item	Change in fair value for calculating hedge ineffectiveness £ million	Cash flow hedge reserve Continuing hedges £ million
Interest rate risk (Fair value hedges)					
Demand deposits	**(6,248.8)**	**(9.4)**	**Customer deposits**	**18.6**	**n/a**
Fixed rate subordinated liabilities	**(398.2)**	**(10.4)**	**Subordinated liabilities**	**7.4**	**n/a**
Fixed rate mortgages	**8,181.6**	**(35.2)**	**Loans & adv to customers**	**(25.7)**	**n/a**
Debt securities	**2,387.8**	**–**	**Financial assets at FVOCI**	**(14.1)**	**n/a**
Debt securities	**96.2**	**2.2**	**Financial assets at amortised cost**	**2.2**	**n/a**
	4,018.6	**(52.8)**		**(11.6)**	**n/a**
Interest rate and credit risk (Cash flow hedges)					
Debt securities	**–**	**n/a**	**n/a**	**2.5**	**(2.5)**
Foreign exchange risk (Cash flow hedges)					
Debt securities in issue	**(317.6)**	**n/a**	**n/a**	**1.3**	**(0.7)**
2017					
Interest rate risk (Fair value hedges)					
Demand deposits	(4,739.4)	(44.9)	Customer deposits	2.8	n/a
Fixed rate subordinated liabilities	(405.3)	(17.8)	Subordinated liabilities	8.3	n/a
Fixed rate mortgages	7,020.5	(17.9)	Loans & adv to customers	(30.6)	n/a
Debt securities	2,116.3	–	Available-for-sale financial assets	(44.0)	n/a
	3,992.1	(80.6)		(63.5)	
Interest rate and credit risk (Cash flow hedges)					
Debt securities	–	n/a	n/a	–	–
Foreign exchange risk (Cash flow hedges)					
Debt securities in issue	(348.4)	n/a	n/a	(8.4)	(0.5)

The amount of fair value hedge adjustments remaining on the balance sheet for hedged items that have ceased to be adjusted for hedging losses is £57.3 million (2017: £63.0 million)

Notes to the consolidated financial statements

Managing financial risk (continued)

26. Market risk (continued)

Hedge accounting ineffectiveness

The following table contains information regarding the effectiveness of the hedging relationships designated by TSB, as well as the impacts on profit or loss and other comprehensive income:

2018	Hedge ineffectiveness recognised in P&L £ million	Gain/(loss) recognised in OCI £ million	P&L line item that includes hedge ineffectiveness	Amounts reclassified from reserves to P&L as: Hedged item affected P&L £ million	P&L line item that includes reclassified amount £ million
Interest rate risk (Fair value hedges)	**(2.3)**	**–**	Gains from hedge accounting	**–**	**n/a**
Interest rate and credit risk (Cash flow hedges)	**–**	**(2.5)**	**n/a**	**–**	**n/a**
Foreign exchange risk (Cash flow hedges)	**–**	**(1.3)**	**n/a**	**1.1**	Other income
	(2.3)	**(3.8)**		**1.1**	

2017					
Interest rate risk (Fair value hedges)	(8.1)	–	Gains from hedge accounting	–	n/a
Interest rate and credit risk (Cash flow hedges)	–	–	–	–	n/a
Foreign exchange risk (Cash flow hedges)	–	8.4	–	(9.3)	Other income
	(8.1)	8.4		(9.3)	

There have been no discontinued cash flow hedges in 2018 (2017: nil).

Gains from hedge accounting in the income statement of £23.3 million (2017: £24.5 million) comprise hedge ineffectiveness of £(2.3) million (2017: £(8.1) million) and £25.6 million (2017: £32.6 million) of amortisation of fair value hedge adjustments on hedged items for which hedge accounting had previously been discontinued.

Reconciliation of reserves in respect of hedge accounting

The following table shows a reconciliation of each component of equity and an analysis of other comprehensive income in respect of hedge accounting:

	2018 Fair value reserve £ million	2018 Cash flow hedge reserve £ million	2017 Available-for-sale reserve £ million	2017 Cash flow hedge reserve £ million
Balance as at 1 January	**16.9**	**(0.5)**	5.9	0.4
Amounts recognised in other comprehensive income:				
Interest rate risk (Fair value hedge)				
Changes in fair value of purchased debt securities	**9.6**	**n/a**	(4.5)	n/a
Accumulated fair value hedge adjustment	**14.1**	**n/a**	44.0	n/a
Net amounts reclassified to profit or loss	**(21.4)**	**n/a**	(22.0)	n/a
Taxation	**(0.6)**	**n/a**	(4.7)	n/a
Interest rate and credit risk (Cash flow hedges)				
Effective portion of changes in fair value of forward contracts	**n/a**	**(2.5)**	n/a	–
Amounts reclassified from reserves to profit or loss	**n/a**	**–**	n/a	–
Foreign exchange risk (Cash flow hedges)				
Effective portion of changes in fair value of cross currency swaps	**n/a**	**(1.3)**	n/a	8.4
Amounts reclassified from reserves to profit or loss	**n/a**	**1.1**	n/a	(9.3)
Balance as at 31 December	**18.6**	**(3.2)**	18.7	(0.5)

Notes to the consolidated financial statements

Managing financial risk (continued)

26. Market risk (continued)

Offsetting financial assets and financial liabilities

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

At 31 December 2018	Gross amounts £ million	Amounts offset £ million	Net amounts reported on the balance sheet £ million	Related amounts where set off in the balance sheet is not permitted: Related financial instrument amounts not offset £ million	Related amounts where set off in the balance sheet is not permitted: Cash collateral received/ pledged[1] £ million	Potential net amount £ million
Derivative financial assets	**195.0**	**–**	**195.0**	**(129.6)**	**(1.9)**	**63.5**
Total assets	**195.0**	**–**	**195.0**	**(129.6)**	**(1.9)**	**63.5**
Derivative financial liabilities	**(440.0)**	**–**	**(440.0)**	**129.6**	**309.6**	**(0.8)**
Repurchase agreements	**(1,084.8)**	**–**	**(1,084.8)**	**1,084.5**	**0.3**	–
Other liabilities (note 33)	**(355.5)**	**153.0**	**(202.5)**	–	–	**(202.5)**
Total liabilities	**(1,880.3)**	**153.0**	**(1,727.3)**	**1,214.1**	**309.9**	**(203.3)**
At 31 December 2017						
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)

(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.

Notes to the consolidated financial statements

Other important disclosures

Accounting policies relevant to this section

(l) Provisions and contingent liabilities

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

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

Contingent assets are possible assets that arise from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within TSB'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.

(m) 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:

- 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.
- 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.

(n) Operating leases

The leases entered into by TSB 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.

(o) Intangible assets

Intangible assets held by TSB consist of internally developed computer software which is held at cost less accumulated amortisation and impairment. Software development costs are capitalised if it is probable that the asset created will generate future economic benefits. Costs incurred to establish technological feasibility or to maintain existing levels of performance are recognised as an expense.

Computer software intangible assets are amortised using the straight line method over their estimated useful lives of between 3 and 5 years. Amortisation commences when the assets are ready for their intended use. Estimated useful lives are reviewed annually and adjusted, if appropriate, in the light of technological developments, usage and other relevant factors.

Computer software is reviewed for indicators of impairment at each reporting date and whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Where the carrying amount is not recoverable the asset is written down immediately to the estimated recoverable amount, based on value in use calculations.

Notes to the consolidated financial statements

Other important disclosures (continued)

27. Contingent liabilities

(i) Migration related investigations

Significant judgement

During 2018, the FCA and PRA commenced a formal joint investigation in connection with the handling of the migration data and IT systems. This investigation is ongoing and it is not currently possible to make a reliable assessment of any potential findings. There is a possibility of a financial penalty in relation to this investigation, which may or may not be material. It is not currently practicable to reliably estimate and therefore no provision has been recognised in these financial statements.

(ii) Other legal and regulatory matters

During the ordinary course of business, TSB 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 TSB incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required to settle the obligation at the relevant balance sheet date. In some cases it will not be possible to form a view, either because the facts are unclear or because further time is needed to properly assess the merits of the case and no provisions are held against such matters. However, TSB 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

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

(i) Key management personnel

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

	2018 £ 000	2017 £ 000
Short term Partner benefits	**6,260**	7,500
Post-employment benefits	**807**	892
Other long term benefits	**(4,760)**	4,645
Share-based payments	**(1,996)**	1,333
Payments for loss of office	**1,541**	30
Total	**1,852**	14,400

The reduction in compensation paid to key management reflects the business performance in 2018. As more fully explained in the Remuneration review starting on page 50, the Remuneration committee determined that no TSB Award or Sustainable Performance Award (SPA) will be made for 2018 performance, and SPA awards previously granted will not vest, resulting in the reversal the liability accrued since the relevant SPA was granted.

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.

	2018 £ 000	2017 £ 000
Loans		
At 1 January	**238**	211
Advances (includes key management personnel appointed during the year)	**128**	242
Interest charged during the year	**3**	5
Repayments (includes key management personnel who resigned during the year)	**(364)**	(220)
At 31 December	**5**	238

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).

Notes to the consolidated financial statements

Other important disclosures (continued)

28. Related party transactions (continued)

	2018 £ 000	2017 £ 000
Deposits		
At 1 January	**1,340**	819
Deposits (includes key management personnel appointed during the year)	**3,451**	4,892
Interest expense on deposits	**4**	–
Repayments (includes key management personnel who resigned during the year)	**(3,418)**	(4,371)
At 31 December	**1,377**	1,340

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

(ii) Transactions and balances with Sabadell Group companies

Migration related transactions
Operating expenses include £249.0 million payable under the Migration Services Agreement with Sabis for services provided to TSB in preparing for the migration in April 2018. TSB and Sabis entered into an Outsourced Services Agreement (OSA) which became effective from migration and under which Sabis provides services in running the new banking platform. During 2018, TSB incurred operating expenses under the OSA of £106.5 million.

The MSA and OSA contracts provide TSB with the right to seek recovery of eligible losses for breach of contract up to the level of liability caps in each agreement. The respective parties have reached provisional agreement, subject to mutual reservations of rights while negotiations are concluded, to recognise an aggregate estimated recovery under the agreements of £153.0 million. No amounts have been paid by TSB in respect of the MSA and OSA in the year to 31 December 2018. TSB intends to settle on a net basis and consequently, the MSA liability of £249.0 million has been presented on the statement of financial position net of the recovery of £100.0 million and the OSA liability of £106.5 million is presented net of the recovery of £53.0 million (note 33).

At 31 December 2017, TSB had deferred £124.5 million of IT Migration Programme costs incurred at that point and which were recognised in the income statement on the completion of the migration in April 2018.

Economic hedging of share based compensation liability
TSB holds options from Sabadell to acquire 11.2 million (2017: 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 2018, the options had a fair value of £1.9 million (2017: £6.9 million) and Sabadell had placed cash collateral with TSB of £3.1 million (2017: £7.3 million).

During 2018, TSB entered into a forward purchase agreement with Sabadell to acquire 8.3 million Sabadell shares to satisfy estimated requirements under the SPA and other share based compensation arrangements. Subsequently, revised estimates of the number of shares expected to vest resulted in a reduction of 5.7 million shares under this agreement with Sabadell. At 31 December 2018, the forward purchase agreement was in respect of 2.6 million Sabadell shares and had a liability fair value of £0.8 million. At 31 December 2018, Sabadell had placed cash collateral with TSB of £0.7 million.

Other transactions and balances
During 2017, Sabadell was appointed as a Joint Lead Manager in relation to TSB's first covered bond issue, which completed in December 2017 for which a fee of £0.3 million was paid by TSB.

Sabadell acts as an intermediary in respect of international payments and TSB has nostro accounts as a result of this arrangement which, at 31 December 2018, had a net balance due from Sabadell of £0.9 million.

Notes to the consolidated financial statements

Other important disclosures (continued)

29. Property, plant and equipment

	Premises £ million	Equipment £ million	Total £ million
Cost			
At 1 January 2017	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
Additions	**6.3**	**10.1**	**16.4**
Disposals	**(1.3)**	**0.1**	**(1.2)**
Write-offs	**(2.1)**	**(0.7)**	**(2.8)**
At 31 December 2018	**231.7**	**111.7**	**343.4**
Accumulated depreciation			
At 1 January 2017	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
Depreciation charge for the year (note 16)	**18.1**	**6.5**	**24.6**
Disposals	**(0.5)**	**0.1**	**(0.4)**
Write-offs	**(1.8)**	**(0.4)**	**(2.2)**
At 31 December 2018	**108.1**	**72.2**	**180.3**
Carrying amount			
At 31 December 2018	**123.6**	**39.5**	**163.1**
At 31 December 2017	136.5	36.2	172.7

At 31 December 2018, there was no capital expenditure authorised and contracted for but not provided or incurred (2017: £nil).

Operating lease commitments

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

	2018 £ million	2017 £ million
Not later than 1 year	**30.9**	32.4
Later than 1 year and no later than 5 years	**72.2**	100.1
Later than 5 years	**85.0**	85.3
Total operating lease commitments	**188.1**	217.8

Operating lease payments represent rental payable by TSB 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.

Notes to the consolidated financial statements

Other important disclosures (continued)

30. Intangible assets

	Total £ million
Cost	
At 1 January 2017	3.1
Additions	8.0
At 31 December 2017	11.1
Additions	**11.8**
At 31 December 2018	**22.9**
Accumulated amortisation	
At 1 January 2017	0.7
Amortisation charge for the year (note 16)	0.3
At 31 December 2017	1.0
Amortisation charge for the year (note 16)	**3.5**
At 31 December 2018	**4.5**
Carrying amount	
At 31 December 2018	**18.4**
At 31 December 2017	10.1

31. Other assets

	2018 £ million	2017 £ million
Prepaid migration costs	**–**	124.5
Other assets and prepayments	**165.9**	83.1
Amounts recoverable under customer remediation indemnity (note 32)	**14.6**	34.2
Total other assets	**180.5**	241.8

As discussed in note 28(ii) on page 109, as at 31 December 2017, TSB had deferred £124.5 million of IT migration programme costs which were recognised in the income statement as operating expenses on the completion of the migration in April 2018.

32. Provisions

	Migration related redress provision £ million	Other customer redress provision £ million	Operational losses provision £ million	Credit impaired provision £ million	Total £ million
At 31 December 2017	–	34.5	–	–	34.5
Change in initial application or IFRS 9	–	–	–	2.5	2.5
At 1 January 2018	–	34.5	–	2.5	37.0
Charge/(reversals) to income statement	**125.1**	**(10.1)**	**6.0**	**0.5**	**121.5**
Utilisations	**(84.0)**	**(9.4)**	**(1.5)**	**–**	**(94.9)**
Total provision	**41.1**	**15.0**	**4.5**	**3.0**	**63.6**

Significant estimates – migration and other customer redress

Migration related redress provision

In assessing the adequacy of the provision at December 2018, judgement was required in estimating the number of complaints, the complexity and expected redress cost of each complaint, including the proportion that might be referred to the Financial Ombudsman Service, and the incremental operational and personnel costs required to undertake the redress programme. A total of 223,000 complaints are forecast to be received in total which are expected to be resolved by the end of March 2019. At 30 January 2019, circa 204,000 complaints had been received of which around 90% had been resolved. An additional 10,000 complaints leading to an extension of the programme by 2 weeks would increase the provision by an estimated £6 million.

Notes to the consolidated financial statements

Other important disclosures (continued)

32. Provisions (continued)

Significant estimates – migration and other customer redress (continued)

Other customer redress provisions
TSB is protected from losses arising from historic misconduct under an indemnity provided by Lloyds Bank plc. However, TSB retains the primary liability for the alleged misconduct to its customers and a provision for customer remediation of £15.0 million has been recognised at 31 December 2018 (2017: £34.5 million). A recoverable of £14.6 million (2017: £34.2 million) has been recognised under the indemnity provided by Lloyds Bank plc (note 31). The size of the liability follows an assessment of emerging themes in customer complaints, an assessment of broader industry commentary and discussions with regulators. The ultimate cost and timing of payments are uncertain as a result of the inherent difficulties in estimating factors such as future levels of customer complaints and remediation settlements. The provision represents management's current best estimate.

33. Other liabilities

	2018 £ million	2017 £ million
Amounts payable under the MSA and OSA contracts	**202.5**	–
Accruals and deferred income	**230.4**	216.8
Share-based payments liability	**4.9**	10.1
Other creditors	**57.6**	51.5
Total other liabilities	**495.4**	278.4

Significant judgement – MSA and OSA contract liabilities

The MSA liability of £249.0 million and the OSA liability of £106.5 million are presented on the statement of financial position net of the £153.0 million of aggregate estimated recovery of eligible losses under the MSA and OSA contracts. Further information is set out in note 16 on page 88 and in the Audit Committee report on page 42.

34. Notes to the consolidated cash flow statement

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

	2018 £ million	2017 £ million
Change in loans to credit institutions	**440.7**	99.5
Change in loans and advances to customers	**679.9**	(1,478.0)
Change in derivative assets	**19.8**	32.7
Change in other operating assets	**49.6**	(132.0)
Change in operating assets	**1,190.0**	(1,477.8)
Change in deposits from credit institutions	**(177.5)**	16.4
Change in customer deposits	**(1,459.1)**	1,104.9
Change in derivative liabilities	**(164.0)**	(22.7)
Change in other operating liabilities	**243.9**	76.8
Change in operating liabilities	**(1,556.7)**	1,175.4
Depreciation and amortisation	**28.1**	27.8
Allowance for loan losses	**73.3**	77.8
Other non-cash items	**50.1**	8.4
Non-cash and other items	**151.5**	114.0
Analysis of cash and cash equivalents as shown in the balance sheet		
Cash	**160.3**	143.0
Balances with central banks	**6,954.9**	7,419.9
On demand deposits	**20.8**	0.9
Total cash and cash equivalents	**7,136.0**	7,563.8

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

Other important disclosures (continued)

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

Change in liabilities arising from financing activities

	Borrowings from central banks £ million	Repurchase agreements £ million	Debt securities in issue £ million	Subordinated liabilities £ 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
Repayment of 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**
Borrowings under the BoE Term Funding Scheme	**850.0**	**–**	**–**	**–**	**850.0**
Repayment of securitisation funding	**–**	**–**	**(197.9)**	**–**	**(197.9)**
Repayments of repurchase agreements (net)	**–**	**(361.9)**	**–**	**–**	**(361.9)**
Non-cash movements	**6.5**	**0.3**	**1.8**	**(7.1)**	**1.5**
At 31 December 2018	**6,482.2**	**1,084.8**	**1,122.6**	**398.2**	**9,087.8**

35. Future accounting developments

TSB will apply IFRS 16 *Leases* from 1 January 2019 and its requirements have not been applied in preparing these consolidated financial statements. IFRS 16 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.

At initial adoption on 1 January 2019, TSB will be required to recognise a lease liability, and a corresponding right-of-use asset, in respect of leases of properties and branches. These amounts will be measured by discounting the future lease payments over the lease term, or earlier period if management expect to exit the lease early. The adoption of IFRS 16 is expected to result in the recognition of a lease liability of £174 million, a related right-of-use asset of £164 million, a reduction in other liabilities of £10 million (in respect of a provision for onerous leases and rent free periods). This is expected to result in no impact to shareholder's equity. Subsequent to its initial adoption, the effect of IFRS 16 on the income statement recognition profile of TSB's property leases is not expected to be material.

36. Approval of the consolidated financial statements

These consolidated financial statements were approved by the Board of Directors of TSB Banking Group plc on 31 January 2019.

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

Company balance sheet

As at 31 December 2018

Company Number: 08871766

	Note	2018 £ million	2017 £ million
Assets			
Non-current assets:			
Investments in subsidiaries	4	**1,589.4**	1,589.4
Loans to subsidiaries	4	**387.8**	387.5
		1,977.2	1,976.9
Current assets:			
Amounts due from subsidiaries		**0.1**	0.1
Other advances		**0.7**	–
Current tax asset		**0.7**	0.1
Total assets		**1,978.7**	1,977.1
Liabilities			
Non-current liabilities:			
Subordinated liabilities	2	**387.8**	387.5
Current liabilities:			
Derivative financial liabilities	5	**0.8**	–
Amounts due to subsidiaries	4	**15.0**	12.9
Total liabilities		**403.6**	400.4
Equity			
Share capital	3	**5.0**	5.0
Share premium	3	**965.1**	965.1
Merger reserve	3	**616.5**	616.5
Loss for the year		**(1.6)**	(0.1)
Accumulated losses brought forward		**(9.9)**	(9.8)
Shareholder's equity		**1,575.1**	1,576.7
Total equity and liabilities		**1,978.7**	1,977.1

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

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

The Company financial statements on pages 114 to 119 were approved by the Board of Directors on 31 January 2019 and signed on its behalf by:

Richard Meddings

Richard Meddings
Executive Chairman

Ralph Coates
Chief Financial Officer

Company statement of changes in equity

for the year ended 31 December 2018

	Share capital £ million	Share premium £ million	Merger reserve £ million	Accumulated losses £ million	Shareholder's equity £ million
Balance at 1 January 2017	5.0	965.1	616.5	(9.8)	1,576.8
Comprehensive expense					
Total comprehensive expense for the year	–	–	–	(0.1)	(0.1)
Balance at 31 December 2017	5.0	965.1	616.5	(9.9)	1,576.7
Balance at 1 January 2018	**5.0**	**965.1**	**616.5**	**(9.9)**	**1,576.7**
Comprehensive expense					
Total comprehensive expense for the year	**–**	**–**	**–**	**(1.6)**	**(1.6)**
Balance at 31 December 2018	**5.0**	**965.1**	**616.5**	**(11.5)**	**1,575.1**

Company cash flow statement

for the year ended 31 December 2018

	2018 £ million	2017 £ million
Cash flows from operating activities		
Loss before taxation	**(2.2)**	(0.1)
Adjustments for:		
Change in current liabilities	**2.9**	0.1
Change in current assets	**(1.3)**	–
Non-cash and other items	**0.6**	–
Net cash provided by operating activities	**–**	**–**
Cash flows from investing activities		
Interest received on financial assets	**22.4**	22.1
Net cash provided by investing activities	**22.4**	22.1
Cash flows from financing activities		
Interest paid on subordinated liabilities	**(22.4)**	(22.1)
Net cash used in financing activities	**(22.4)**	(22.1)
Change in cash and cash equivalents	–	–
Cash and cash equivalents at 1 January	–	–
Cash and cash equivalents at 31 December	**–**	**–**

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

Notes to the Company financial statements

1. Basis of preparation

The financial statements of TSB Banking Group plc (the Company), a public limited company (limited by shares), are prepared on a going concern basis and in accordance with IFRS as adopted by the EU. IFRS comprises accounting standards prefixed IFRS issued by the IASB and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the IFRS Interpretations Committee. The Company's financial statements are presented in accordance with the Companies Act 2006. The Company is incorporated and domiciled in the UK and registered in England and Wales. The registered office is 20 Gresham Street, London, EC2V 7JE. The financial statements are prepared on the historical cost basis.

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

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

The adoption of IFRS 9 and IFRS 15 did not have a material impact on the financial statements of the Company. The future accounting developments, set out in note 35 to the consolidated financial statements are not expected to have a material impact on the financial statements of the Company.

2. Subordinated liabilities

	2018 £ million	2017 £ million
Fixed/floating rate reset callable subordinated Tier 2 notes due May 2026	**384.4**	384.1
Accrued interest	**3.4**	3.4
Total subordinated liabilities	**387.8**	387.5

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

3. Share capital, share premium and merger reserve

Details of the Company's share capital, share premium and merger reserve are set out in note 21 to the consolidated financial statements

4. Related party transactions

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

(i) Key management personnel
The key management personnel of TSB and the Company are the same. The relevant disclosures are set out in note 28 to the consolidated financial statements. The Company has no employees.

(ii) Investment in subsidiaries
The Company's only legal subsidiary undertaking is TSB Bank plc, a banking business incorporated and registered in Scotland whose registered office is Henry Duncan House, 120 George Street, Edinburgh, EH2 4LH. The Company holds 100% of the ordinary share capital and voting rights of TSB Bank plc and carried this investment at its cost of £1,589.4 million (2017: £1,589.4 million).

Notes to the Company financial statements

4. Related party transactions (continued)

In addition, TSB Banking Group plc Employee Share Trust is accounted for as a subsidiary of the Company and the registered office of this entity is 26 New Street, St Helier, Jersey, JE 3RA.

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.

(iii) Loans to subsidiaries

	2018 £ million	2017 £ million
Loans to subsidiaries	**387.8**	387.5
Total loans to subsidiaries	**387.8**	387.5

On 1 May 2014, the Company subscribed for fixed/floating rate reset callable subordinated Tier 2 notes due May 2026 issued by its principal subsidiary, TSB Bank plc. At 31 December 2018, the allowance for credit impairment losses on this 'stage 1' loan was £nil.

(iv) Other related party transactions

At 31 December 2018, amounts due by the Company to subsidiary companies were £15.0 million (2017: £12.9 million). Amounts due from subsidiary companies were £0.1 million (2017: £0.1 million).

Detail of other related party transactions is given in note 28 to the consolidated financial statements.

5. Financial instruments

(i) Measurement basis of financial instruments

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

At 31 December 2018	Held for trading £ million	Financial assets at amortised cost £ million	Held at amortised cost £ million	Total £ million
Financial assets				
Loans to subsidiaries	**–**	**387.8**	**–**	**387.8**
Total financial assets	**–**	**387.8**	**–**	**387.8**
Financial liabilities				
Subordinated liabilities	**–**	**–**	**387.8**	**387.8**
Derivative financial liabilities	**0.8**	**–**	**–**	**0.8**
Total financial liabilities	**0.8**	**–**	**387.8**	**388.6**
At 31 December 2017				
Financial assets				
Loans to subsidiaries	–	387.5	–	387.5
Total financial assets	–	387.5	–	387.5
Financial liabilities				
Subordinated liabilities	–	–	387.5	387.5
Total financial liabilities	–	–	387.5	387.5

Notes to the Company financial statements

5. Financial instruments (continued)

(ii) Fair value of financial assets and liabilities

At 31 December	2018 Carrying value £ million	2018 Fair value £ million	2017 Carrying value £ million	2017 Fair value £ million
Financial assets				
Loans to subsidiaries	**387.8**	**381.1**	387.5	427.3
Financial liabilities				
Subordinated liabilities	**387.8**	**381.1**	387.5	427.3
Derivative financial liabilities	**0.8**	**0.8**	–	–

The valuation techniques for the Company's financial assets and liabilities are set out in notes 5 and 12 to the consolidated financial statements.

(iii) Valuation hierarchy of financial assets and liabilities

The table below analyses the fair values of the financial assets and liabilities of the Company.

At 31 December 2018	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
Financial assets					
Loans to subsidiaries	**–**	**381.1**	**–**	**381.1**	**387.8**
Financial liabilities					
Subordinated liabilities	**–**	**381.1**	**–**	**381.1**	**387.8**
Derivative financial liabilities	**–**	**0.8**	**–**	**0.8**	**0.8**
At 31 December 2017					
Financial assets					
Loans to subsidiaries	–	427.3	–	427.3	387.5
Financial liabilities					
Subordinated liabilities	–	427.3	–	427.3	387.5

(iv) Credit risk

The Company's credit risk arises solely from amounts due from its wholly owned subsidiary, TSB Bank plc. At 31 December 2018, the Company held no financial assets that were either past due or impaired (2017: £nil).

(v) Liquidity risk

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

At 31 December 2018	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Subordinated liabilities	**–**	**–**	**22.1**	**440.3**	**–**	**462.4**
Total non-derivative financial liabilities	**–**	**–**	**22.1**	**440.3**	**–**	**462.4**
Gross settled derivatives – outflows	**–**	**0.8**	**–**	**–**	**–**	**0.8**
Total	**–**	**0.8**	**22.1**	**440.3**	**–**	**463.2**
At 31 December 2017						
Subordinated liabilities	–	–	22.1	440.3	–	462.4
Total	–	–	22.1	440.3	–	462.4

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

Report on the audit of the financial statements

Opinion

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

- give a true and fair view of the state of the Group's and of the Company's affairs as at 31 December 2018 and of the consolidated Group's loss and the Group's and the Company's cash flows for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union and, as 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 consolidated financial statements, Article 4 of the IAS Regulation.

We have audited the financial statements included within the Annual Report and Accounts 2018 (the "Annual Report"), which comprise: the Consolidated and Company balance sheets as at 31 December 2018; the Consolidated statement of comprehensive income for the year then ended; the Consolidated and Company statements of changes in equity for the year then ended; the Consolidated 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 Group 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 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 Group or the Company.

Other than those disclosed in note 16 to the financial statements, we have provided no non-audit services to the Group or the Company in the period from 1 January 2018 to 31 December 2018.

Our audit approach

Context

2018 has been a difficult year for the Group due to the challenges arising following migration of the IT systems, and the complexity of the subsequent associated issues. While not all the issues had a direct impact on the financial statements, there has been a negative impact on the profitability of the Group in 2018, largely due to the costs to rectify the migration issues and the costs of customer redress under the 'Putting Things Right' programme. As we explain further below, this has resulted in us considering average historical profitability as our benchmark for materiality, rather than current year profitability as we have in previous years, and has led us to adopting a more substantive testing approach due to the immaturity of the control environment in some areas.

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

Overview	
Materiality	• Overall Group materiality: £8.1 million (2017: £13.4 million), based on 5.5% of average profit before tax over the past 3 years • Overall Company materiality: £8.1 million (2017: £13.4 million), based on 1% of total assets, capped at overall Group materiality.
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).
Key audit matters	The areas of focus for our audit which involved the greatest allocation of our resources and effort were: • The completeness and accuracy of the judgemental costs arising from the migration, including but not limited to the costs of the customer redress programme; • The appropriateness of the assumptions used in the calculation of material Expert Credit Judgements (ECJ), Multiple Economic Scenarios (MES) and the significant increase in credit risk relating to loan loss provisioning; and the accuracy of critical inputs to the calculations; • The completeness and accuracy of the data transfer at the date of IT system migration; and • IT access and change management following the migration.

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.

Capability of the audit in detecting irregularities, including fraud

Based on our understanding of the Group and the industry, we identified that the principal risks of non-compliance with laws and regulations related to breaches of banking regulations such as, but not limited to, the Consumer Credit Act and unethical and prohibited business practices, and we considered the extent to which non-compliance might have a material effect on the financial statements. We also considered those laws and regulations that have a direct impact on the financial statements such as the Companies Act 2006. We evaluated management's incentives and opportunities for fraudulent manipulation of the financial statements (including the risk of override of controls), and determined that the principal risks were related to posting inappropriate journal entries to increase revenue or reduce expenditure, and management bias in accounting estimates. In the current year we have also performed procedures to specifically address the incentives and opportunities posed by the IT system migration. Audit procedures performed by the engagement team included:

- Discussions with management, internal audit and the Group's legal advisors, including consideration of known or suspected instances of non-compliance with laws and regulation and fraud;
- Evaluation of the operating effectiveness of management's controls designed to prevent and detect irregularities;
- Assessment of matters reported on the Group's whistleblowing helpline and the results of management's investigation of such matters;
- Reading key correspondence with regulatory authorities such as the Financial Conduct Authority and the Prudential Regulation Authority in relation to compliance with banking regulations;
- Challenging assumptions and judgements made by management in their significant accounting estimates, in particular in relation to valuation of the impairment provision (see related key audit matter below); and
- Identifying and testing journal entries, in particular any journal entries posted with unusual account combinations or posted by senior management.

There are inherent limitations in the audit procedures described above and the further removed non-compliance with laws and regulations is from the events and transactions reflected in the financial statements, the less likely we would become aware of it. Also, 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.

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

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.

The completeness and accuracy of the judgemental costs arising from the migration, including but not limited to the estimation of costs of the customer redress programme

Nature of key audit matter

This is a key audit matter as there is a high degree of judgement related to the costs arising from the migration in April 2018. We considered the following three specific aspects to be judgemental:

Accounting for customer remediation

Following the issues associated with the migration, management have recognised a provision for the costs associated with the Putting Things Right ('PTR') programme. This reflects the Group's best estimate of the remaining cost of customer redress payments and the operational costs involved in making those payments.

We focused on the key assumptions in the estimate of remaining costs, the most significant of which include the volume of forecast complaints, the complexity and expected redress costs of each complaint, the proportion that might be referred to the Financial Ombudsman Service, and the complaint handler productivity assumptions. This estimate is disclosed in note 32.

Accounting for intragroup costs associated with migration

The IT systems have been developed and are maintained by Sabis, a subsidiary of the Banco Sabadell Group. TSB Bank plc has entered into a Migration Services Agreement ('MSA') and an Outsourced Services Agreement ('OSA') with Sabis, both of which include clauses which allow TSB Bank plc to reclaim certain costs incurred as a result of non performance by Sabis.

The amounts recoverable are not finalised given the ongoing investigations, but management's best estimate of the recovery is £153 million. This amount may change as the agreement is completed. We have therefore focused on how the amounts recoverable from Sabis have been estimated and the estimate disclosed in the annual report. This is disclosed in note 33.

Accounting for potential regulatory fines

On 30 May 2018 the Financial Conduct Authority (FCA) announced that they, alongside the Prudential Regulation Authority (PRA), would start a joint investigation into the migration. Management has determined that there is currently insufficient information available to reasonably estimate the outcome of the investigation, and so no provision for a potential regulatory fine has been recorded as at 31 December 2018. This is disclosed in note 27 (i).

Matters discussed with the Audit Committee

We discussed our scope and plan for testing the costs associated with the migration with the Audit Committee, highlighting our focus on completeness of customer complaints, the intergroup agreement of the amounts payable to Sabis and correspondence with regulators.

Additionally, we communicated how we understood and challenged management's estimate of future redress claims and operational costs to resolve the additional complaints relating to migration.

We confirmed that whilst negotiations with Sabis are ongoing, both management and members of the Committee believe that the position to record the recovery of post migration charges of £153 million represents the best estimate of the aggregate recovery from Sabis under the terms of the MSA and OSA. Given that this is a significant judgement and is a best estimate, we discussed the need to have full and transparent disclosure, including that the final amount could be materially different.

We shared our conclusions that the judgements, estimates and total provisions at the year end are reasonable.

The completeness and accuracy of the judgemental costs arising from the migration, including but not limited to the estimation of costs of the customer redress programme (continued)

Procedures performed to support our discussions and conclusions

Accounting for customer remediation

We performed the following procedures around the measurement of the provision recognised:

- We understood and challenged the methodology and underlying assumptions used by management. For example, we challenged the assumption around the forecast complaints volumes by considering the trend in complaints volumes through 2018 and the likelihood of whether the downward trend experienced would continue into the future or whether it would increase.
- We understood the nature of complaints received and assessed whether complaints and the associated redress payments were correctly categorised within the Distress & Inconvenience (D&I) framework established by management to determine average redress costs.
- We tested a sample of complaints resolved to case notes and compensation history, and compared the complaints resolved in 2018 to the assumptions used for the unresolved complaints.
- We compared the forecast rate of referrals to the Financial Ombudsman Service to the historical referral rate since migration.
- We agreed the costs associated with hiring complaints handlers to invoices, understood the productivity assumptions used to estimate the remaining operational cost of making the payments and compared them to actual performance since the start of the PTR programme.
- We independently performed sensitivity analysis on all key assumptions and tested the formulae used within the provision model.
- Given the inherent uncertainty in the calculation of the provision and its judgemental nature, we evaluated the additional disclosures made in the financial statements.

Accounting for intragroup costs associated with migration

We performed the following procedures around the costs recoverable under the MSA and OSA:

- We confirmed that the Group has the contractual right to recover costs incurred from Sabis under the terms of the MSA and OSA.
- We reviewed the schedule of costs which the Group has used as the basis of the best estimate calculation, and confirmed that the TSB Bank plc has incurred costs related to the migration in excess of the recoveries recognised under both agreements.
- We confirmed that the recovery represents the best estimate of the claimable costs as at 31 December 2018 through reviewing correspondence from external counsel and obtaining written and verbal confirmation from the Audit Committee and Chief Financial Officer of TSB and the Banco Sabadell Group Chief Financial Officer.
- We ensured that Sabis have recorded the equal and opposite entries to recognise the expense and reduced receivable.
- Given the amount of the recovery is not finalised, we challenged the proposed disclosure to ensure that it clearly explains that it is an estimate at the year end, and may change as negotiations with Sabis continue and the agreement is concluded.

Accounting for potential regulatory fines

We performed the following procedures around the consideration of the potential regulatory fines:

- We have reviewed management's analysis, and concluded that it is consistent with IAS 37 Provisions, contingent liabilities and contingent assets as any potential fine would have to be reliably estimable, a hurdle that is not met in this instance.
- We have read the written correspondence with the FCA and PRA to assess whether the circumstances considered in management's analysis are consistent with that correspondence.
- We have also independently inquired of the FCA and PRA whether a fine will be imposed and both have confirmed to us that the investigations are ongoing and no conclusions have yet been reached.
- We have reviewed the disclosure of the contingent liability in note 27 (i) and confirmed that it adequately discloses the risk of a potential fine.

The appropriateness of the assumptions used in the calculation of material ECJs, MES and the significant increase in credit risk relating to loan loss provisioning; and the accuracy of critical inputs to the calculations

Nature of key audit matter

This is a key audit matter as retail impairment provisions require a high level of judgement to determine the size of the required expected credit loss provision.

2018 is the first year of adoption of IFRS 9, which introduces significant changes including new impairment models where losses are recognised on an expected, forward looking basis, reflecting the Group's view of potential future economic events. As a result, a new methodology encompassing new estimates and judgements are required to calculate impairment provisions under IFRS 9, and there are new disclosure requirements.

Our audit work in 2017 focused on the impact of IFRS 9 on transition. This work provided a foundation for our testing in 2018, which focused on the following four aspects for the Group's significant lending portfolios:

1. The assessment of Expert Credit Judgements, which management use to adjust core model outputs to take account of latent risks and known model limitations. We focused our work on the key assumptions in material expert credit judgements made by management, including the completeness of ECJs;
2. The appropriateness of the 'staging' thresholds selected by management to determine a significant increase in credit risk, and hence whether a 12 month or lifetime loss provision is recorded;
3. The application of forward looking economic assumptions used in the models, including the appropriateness of management's assumptions to address potential risks from the UK's exit from the European Union; and
4. The accuracy of critical inputs to the impairment models given known data limitations following the migration of the Group's data to a new IT platform.

Matters discussed with the Audit Committee

We discussed the appropriateness of management's assumptions to address potential risks from the UK's exit from the European Union, including how management's assumptions compared to third party forecasts, including those published by the Bank of England. We discussed the market uncertainty with the committee and the judgments applied by management, but noted that we considered management's forecasts to be supportable in the context of other third party forecasts.

We also discussed the extent of disclosure made by management in relation to the forward looking economic assumptions, given these are a critical accounting estimate in the financial statements of the Group. In particular we highlighted that management had made additional disclosure in relation to the sensitivities of changing the probabilities assigned to management's forward looking scenarios which we found to be transparent.

Procedures performed to support our discussions and conclusions

- We understood and critically assessed the methodology applied in the impairment models, using modelling specialists to confirm that the implemented methodology was compliant with IFRS 9, and tested key assumptions and judgements used in the calculation of provisions.
- We tested the key assumptions in material expert credit judgments made by management and considered the completeness of adjustments to core models to take account of latent risks and known model limitations.
- To test management's 'staging' thresholds, we re-performed key aspects of management's testing and performed independent back testing to confirm that the criteria selected by management were reasonable. When testing the application of forward looking information, we tested the accuracy and completeness of the model, and compared the forward looking assumptions to publically available benchmarks. We also considered the reasonableness of management's downside assumptions and assigned probability weighting to take account of potential risks from the UK's exit from the European Union and found that the assumptions adopted and assigned probability weight assigned were reasonable.
- We tested the accuracy of critical data inputs used by the impairment models on a sample basis to supporting documentation.
- We tested management's monitoring controls including the sufficiency of the model validation activities undertaken during 2018 and re-performed a number of monitoring tests independently.
- We tested that the credit risk disclosures made by management were compliant with IFRS 9 and agreed the disclosures to source data without exception.

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

Completeness and accuracy of the data transfer at the date of IT system migration

Nature of key audit matter

This is a key audit matter as the data transfer from Lloyds Banking Group (LBG) systems to the Group's new IT systems included data that is relevant to the financial reporting process.

This specific risk relates to the completeness and accuracy of the data transfer at the date of migration.

We focused on the financial reporting impact of the migration only. We assessed the design of the migration related controls, specifically related to user testing, defect monitoring and data transfer.

We concluded that we could rely on controls in relation to testing and defect monitoring, and performed substantive procedures to test the data transfer between LBG and the Group's systems.

Matters discussed with the Audit Committee

We discussed our scope and plan for migration testing with the Audit Committee, highlighting our focus on testing, defect monitoring and reconciliations of the financial data between LBG and the Group's IT systems.

We shared our conclusion that data in relation to financial reporting had migrated completely and accurately with the Audit Committee.

Procedures performed to support our discussions and conclusions

We performed the following procedures to test the completeness and accuracy of the data transfer:

- We reviewed the sign-offs and approvals prior to migration to ensure that all relevant parties were present to make the final go-live decision.
- We tested controls operated by the programme team over data migration and user testing relevant to our financial reporting scope.
- We performed substantive procedures for financial and operational reconciliations, including breaks resolution testing.
- We obtained an understanding of the key issues and incidents post migration and confirmed that these did not impact the completeness and accuracy of data used for financial reporting.
- We analysed reports produced by other parties including external consultants and Internal Audit to assess the impact of any deficiencies identified on the completeness and accuracy of data transfer.

IT access and change management following the migration

Nature of key audit matter

This is a key audit matter as mature controls over IT access and change management are critical to the overall IT control environment of the Group. During our interim audit, we identified IT access and change management issues in relation to the operation of certain applications, operating systems and data in the financial reporting process subsequent to the migration. The Group continue to work on improving the control environment through their PTR program.

As a result of issues identified in the IT control environment, we were unable to rely on automated and IT dependent manual controls following migration. This has led us to perform a largely substantive audit and increase the amount of procedures in several areas.

Matters discussed with the Audit Committee

Following the migration, we informed the Audit Committee that we would be conducting a largely substantive audit for the post migration period due to the IT control deficiencies identified.

Management are in the process of remediating IT control deficiencies and we will discuss whether this is sufficient to change our audit approach as part of our 2019 half year audit.

IT access and change management following the migration (continued)

Procedures performed to support our discussions and conclusions

We have performed the following procedures following migration around IT access management and change management:

- We reviewed the design of IT General Controls (ITGCs) to understand how the new Group environment is organised, and tested the operating effectiveness of those controls related to financial reporting which were appropriately designed.
- We conducted substantive procedures across all business areas where ITGCs could not be relied upon. Specifically, this included increased sample sizes for testing of customer origination documents for existence purposes, and increased sample sizes for testing of inputs to the impairment models.
- We also assessed ITGC deficiencies identified by other parties including external consultants and Internal Audit. Deficiencies identified by other parties corroborated our own views that a largely substantive audit approach was more appropriate.

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 and the company, the accounting processes and controls, and the industry in which they operate.

The Group is the consolidation of TSB Banking Group plc and its subsidiaries, including TSB Bank plc, for which we issue a separate audit report. For the year ended 31 December 2018, we have scoped the audit by disaggregating the Group by business unit (e.g. savings, mortgages, treasury). This allows us to perform a detailed analysis of the characteristics and contribution of each component to the overall results and position, and is aligned with management's internal analysis.

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.

We have determined that there is one significant component: mortgages, over which we have performed a full scope audit of all material primary statement account balances. Whilst not individually financially significant, the head office function has also been fully audited given its pervasiveness to the financial statements.

Until 20 April 2018, the Group used Lloyds Banking Group plc (LBG) IT platforms and therefore for the period prior to migration, we have taken comfort from the agreed-upon procedures in respect of controls over TSB financial reporting and IT systems operated by LBG, performed under International Standard on Related Services 4400, that is performed by LBG's external auditors. For the period post migration, while we have tested a number of management controls, we have adopted a largely substantive approach given the immaturity of the control framework.

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.

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

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

	Group financial statements	*Company financial statements*
Overall materiality	£8.1 million (2017: £13.4 million).	£8.1 million (2017: £13.4 million).
How we determined it	5.5% of average profit before tax over the past 3 years.	1% of total assets.
Rationale for benchmark applied	While the core performance of the business remains relatively stable, due to the implementation of the 'Putting Things Right' programme and other migration related costs, the Group has seen a drop in profitability in the current year, such that the result for the year is not reflective of the underlying performance of the business. We have therefore chosen to use an average of the absolute profit/loss before tax over the past three years to calculate materiality, in order to better reflect the underlying performance of the business.	As the Company is not profit orientated on a solo-entity basis, we have used 1% of total assets, but capped this to the lower materiality of the Group.

For each component in the scope of our Group audit, we allocated a materiality that is less than our overall Group materiality. The range of materiality allocated across components was between £4 million and £7.7 million.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £0.4 million (Group audit) (2017: £0.7 million) and £0.4 million (Company audit) (2017: £0.7 million) as well as misstatements below those amounts 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 Group'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 Group's and Company's ability to continue as a going concern.

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, Directors' Report and Corporate Governance Statement, 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 2018 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

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

In light of the knowledge and understanding of the Group 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 Directors' Responsibilities Statement, 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 Group'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.

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 2014 to audit the financial statements for the year ended 31 December 2014 and subsequent financial periods. The period of total uninterrupted engagement is 5 years, covering the years ended 31 December 2014 to 31 December 2018.

Laura Needham (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
31 January 2019

EDTF Recommendations

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

Type of risk	EDTF Ref	Description	TSB's approach
General	1	Risks to which TSB is exposed	A summary of TSB's principal risks and uncertainties is disclosed on pages 22 to 26. IFRS 9 impairment terminology and concepts are described on pages 74 and 75.
	2	Definition of risk terminology, principles and appetite	
	3	Top and emerging risks and changes during the reporting period	
	4	Analysis of future regulatory developments affecting the business model and profitability	
Risk governance and management	5	TSB's risk management organisation, process and key functions	Described in the Risk management in TSB section on pages 19 to 21 and in the Corporate governance statement on pages 29 to 36.
	6	Risk culture and risk governance and ownership	
	7	Description of the key risks that arise from the business model, risk appetite, and how TSB manages such risks.	TSB's principal risks and uncertainties that arise from the business model are explained on pages 22 to 26. Further explanation of financial risks is provided in the notes to the consolidated financial statements on pages 93 to 106.
	8	Stress testing and the underlying assumptions	
Capital adequacy	9	Minimum Pillar 3 disclosures requirements	Disclosed in the Sabadell Pillar 3 report*.
	10	Reconciliation of accounting balance sheet to regulatory balance sheet	Disclosed on page 12.
	11	Flow statement of movements in regulatory capital	Disclosed on page 13.
	12	Discussion of targeted level of capital and how this will be established	A description of TSB's capital composition and changes is provided on pages 12 and 13.
	13	Analysis of risk-weighted assets and how they relate to business activities	An analysis of risk-weighted assets is disclosed on page 13.
	14	Analysis of capital requirements for each Basel asset class	
	15	Analysis of credit risk for each Basel asset class	Disclosed in the Sabadell Pillar 3 report*.
	16	Flow statements reconciling movements in Risk Weighted Assets for each Risk Weighted Asset type	
	17	Discussion of Basel credit risk model performance	
Liquidity and funding	18	Analysis of TSB's liquid asset buffer	Details of the liquidity portfolio and encumbered assets are disclosed in the Financial performance in 2018 section of the strategic report on pages 14 and 15.
	19	Encumbered and unencumbered assets analysed by balance sheet category	
	20	TSB assets, liabilities and off balance sheet commitments analysed by remaining contractual maturity	An analysis of the contractual maturity of TSB's assets and liabilities is disclosed in note 24 to the consolidated financial statements.
	21	Analysis of TSB's sources of funding	TSB's sources of funding are set out in notes 1 to 5 of the consolidated financial statements.
Market risk	22	Relationship between market risk measures for trading and non-trading portfolios and the balance sheet	A summary of the sources, measurement and monitoring of market risk, including sources and sensitivity of net interest income to non-trading market risk is disclosed in note 26 to the consolidated financial statements. TSB has no trading market risk.
	23	Discussion of significant trading and non-trading market risk factors	
	24	VaR assumptions, limitations and validation	
	25	Description of the primary risk management techniques employed by TSB	
Credit risk	26	Analysis of the aggregate credit risk exposures	A table showing the maximum exposure to credit risk is disclosed in note 22 to the consolidated financial statements.
	27	Description of the policies for identifying impaired or non-performing loans including forbearance	TSB's policy for identifying impaired loans is disclosed on pages 74. A summary of forborne loans is set out on page 96.
	28	Reconciliation of the opening and closing balances of non-performing or impaired loans and the allowance for loan losses.	Disclosure of the movement in the allowance for credit impairment losses and movement in gross loans, including credit impaired loans (stage 3) is disclosed in note 11 to the consolidated financial statements.
	29	Analysis of counterparty credit risk that arises from derivative transactions	TSB's derivatives are set out in note 26 to the consolidated financial statements.
	30	Discussion of credit risk mitigation, including collateral held for all sources of risk	Credit risk mitigation and analysis of collateral held is disclosed in note 22 to the consolidated financial statements.
Other risks	31	Description of other risks	A description of principal and emerging risks is disclosed in the Risk management section of the strategic report on pages 22 to 26.
	32	Discussion of publicly known risks	

* As at the date of this report, the 2018 Sabadell Pillar 3 report has not been approved and is expected to be available in due course from www.grupbancsabadell.com/en/.

Glossary

Allowance for credit impairment losses	Provisions held on the balance sheet as a result of raising a charge against profit for expected credit losses in the loan book. The allowance may be either individual or collective.
Arrears	A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan is unpaid or overdue. Such a customer is also said to be in a state of delinquency and the entire outstanding balance is delinquent.
Asset Quality Ratio (AQR)	The impairment charge for the year in respect of loans and advances to customers expressed as a percentage of average loans and advances to customers, gross of impairment allowance.
Basel III	The capital reforms and introduction of a global liquidity standard proposed by the Basel Committee on Banking Supervision in 2010 and due to be phased in, through CRD IV, from 1 January 2015 onward. This was further enhanced in December 2017 to refine the capital framework and introduce new elements including the output capital floor. These revisions will come into force between 1 January 2022 and 1 January 2027.
Basis point (bps)	One hundredth of a per cent (0.01 per cent). 100 basis points is 1 per cent. Used in quoting movements in interest rates.
Capability and Innovation Fund	A £425 million fund formally approved in September 2017 as part of an alternative remedies package agreed between the European Commission and the UK Government. The package substitutes Royal Bank of Scotland plc's (RBS) commitment to divest its Williams & Glyn assets as required by the 2009 European Commission approval of state aid measures by the UK Government to RBS. The fund is available to certain qualifying entities and is aimed at promoting competition in the market for banking services to small and medium sized enterprises
Capital Requirements Directive (CRD) IV	On 27 June 2013, the European Commission published, through the official journal of the European Union, its legislation for a CRD and Capital Requirements Regulation (CRR), which form the CRD IV package. Amendments were subsequently made to the Regulation published on 30 November 2013. The package implements the Basel III proposals in addition to the inclusion of new proposals on sanctions for non-compliance with prudential rules, corporate governance and remuneration. The rules were implemented from 1 January 2015 onwards, with certain sections yet to be phased in.
Common Equity Tier 1 (CET1) capital	The highest quality form of regulatory capital under CRD IV that comprises common shares issued and related share premium, retained earnings and other reserves less specified regulatory adjustments.
Common Equity Tier 1 capital ratio	Common Equity Tier 1 capital as a percentage of risk-weighted assets.
Contractual maturities	Contractual maturity refers to the final payment date of a loan or other financial instrument, at which point all the remaining outstanding principal will be repaid and interest is due to be paid.
Coverage ratio	Impairment allowance as a percentage of impaired loans.
Customer deposits	Money deposited by account holders. Such funds are recorded as liabilities of TSB.
Encumbrance	The use of assets to secure liabilities, such as by way of a lien or charge.
Exposure at default	Exposure at default (EAD) represents the estimated exposure to a customer in the event of default. In determining EAD amounts, consideration is made of the extent to which undrawn commitments may be drawn down at the point of default and the application of credit risk mitigation (i.e. eligible financial collateral).
Financial Services Compensation Scheme (FSCS)	The Financial Services Compensation Scheme (FSCS) is the UK's independent statutory compensation fund for customers of authorised financial services firms and pays compensation if a firm is unable to pay claims against it. The FSCS is funded by management expenses levies and, where necessary, compensation levies on authorised firms.

Glossary (continued)

Forbearance	Forbearance takes place when a concession is made on the contractual terms of a loan in response to an obligor's financial difficulties.
Franchise	Franchise comprises TSB's UK retail banking business which offers a range of retail financial services including current accounts, savings products, personal loans, credit cards and mortgages.
Internal Capital Adequacy Assessment Process (ICAAP)	TSB's own assessment of the amount and type of capital it considers adequate to cover the level and nature of the risks to which it is or might be exposed.
Internal Liquidity Adequacy Assessment Process (ILAAP)	TSB's own assessment of the adequacy of its liquidity and funding resources to cover the level and nature of risks to which it is or might be exposed
Internal Ratings-Based approach (IRB)	A methodology of estimating the credit risk within a portfolio by utilising internal risk parameters to calculate credit risk regulatory capital requirements. There are two approaches to IRB: Foundation IRB and Advanced IRB.
IT Migration Programme	A programme designed to migrate our IT infrastructure from the one provided by LBG under a transitional outsourcing arrangement to one provided by our parent Sabadell.
Leverage ratio	Tier 1 capital divided by the exposure measure. Basel III reforms introduced a leverage ratio framework designed to reinforce risk based capital requirements with a simple, transparent, non-risk based 'backstop' measure.
Liquidity Coverage Ratio (LCR)	Measures the percentage of high quality liquid assets relative to expected net cash outflows over a 30 day period. High quality liquid assets should be unencumbered, liquid in markets during a time of stress and ideally, be central bank eligible.
Loan to deposit ratio	The ratio of loans and advances to customers net of allowance for impairment losses divided by customer deposits.
Loans past due	Loans are past due when a counterparty has failed to make a payment when contractually due.
Loan-to-value ratio (LTV)	The LTV ratio is a mathematical calculation which expresses the amount of a mortgage balance outstanding as a percentage of the total appraised value of the property. A high LTV indicates that there is less value to protect the lender against house price falls or increases in the loan if repayments are not made and interest is added to the outstanding balance of the loan.
Loss given default	Loss given default (LGD) represents the estimated proportion of an EAD amount that will be lost in the event of default. It is calculated after taking account of credit risk mitigation and includes the cost of recovery.
Master netting agreement	An agreement between two counterparties that have multiple derivative contracts with each other that provides for the net settlement of all contracts through a single payment, in a single currency, in the event of default on, or termination of, any one contract.
Mortgage Enhancement	A separate portfolio of mortgage assets which was assigned to TSB in 2014. The portfolio was returned early to LBG in 2017, having achieved its profit target,.

Glossary (continued)

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

Abbreviations

AQR	Asset quality ratio
BCBS	Basel Committee on Banking Supervision
BPS	Basis points
CET1	Common Equity Tier 1
CRD IV	Capital Requirements Directive IV
EDTF	Enhanced Disclosure Task Force
ECL	Expected Credit Loss
EIR	Effective interest rate
FCA	Financial Conduct Authority
HMRC	Her Majesty's Revenue and Customs
IAS	International Accounting Standards
ICAAP	Internal Capital Adequacy Assessment Process
IFRS IC	International Financial Reporting Standards Interpretations Committee
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IRB	Internal ratings based approach
LBG	Lloyds Banking Group
LCR	Liquidity Coverage Ratio
LTV	Loan to value
MSA	Migration Services Agreement
NPS	Net Promoter Score
OSA	Outsourced Services Agreement
PCA	Personal current account
POCI	Purchased or Originated Credit Impaired
PP	Percentage points
PRA	Prudential Regulatory Authority
SPA	Sustainable Performance Award
TSA	Transitional Services Agreement

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