TSB Bank plc
Annual Report and Accounts 2019

Registered in Scotland
Company Number: SC095237

TSB Bank plc

Annual report and consolidated financial statements
For the year ended 31 December 2019

Overview

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

Contents

Directors and Company Secretary

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

Chairman:	Richard Meddings (independent on appointment)
Executive Directors:	Debbie Crosbie (Chief Executive. Appointed on 1 May 2019)
	Ralph Coates (Chief Financial Officer)
Independent Non-executive Directors:	Paulina Beato
	Dame Sandra Dawson*
	Graeme Hardie
	Stephen Page
	Andy Simmonds
	Polly Williams
Non-executive Directors:	Miquel Montes (Resigned on 14 November 2019)
	Tomás Varela
	David Vegara (Appointed on 22 January 2020)
Company Secretary:	Keith Hawkins (Appointment effective from 1 January 2019)

* Senior Independent Director.

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TSB Bank plc
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EH2 4LH

Strategic report

Review of business performance

A new chapter for TSB
It is six years since TSB returned to the High Street. In this time, TSB has established itself as a purpose-led, full-service challenger bank, drawing on the heritage of a trusted brand and driven by a workforce striving to make banking better for UK customers. The issues encountered when TSB migrated from legacy IT systems to a modern banking platform in 2018 have been well documented. However, that difficult time is now behind the Bank and it is back to doing what it knows best – serving the everyday banking needs of TSB customers now and into the future. TSB operates in a challenging environment facing low interest rates, fast changing customer behaviours towards online platforms, regulatory intensity often requiring implementation of significant system changes, the competitive impact of ring-fencing, and additional responsibilities, such as open banking.

Progress through the year
This time last year, TSB was focused on three key priorities to underpin confidence in the future: stabilising its technology systems, compensating every customer impacted by migration and establishing its business banking offer. The Bank has delivered on each of these:

- The banking platform is stable and offering customers more functionality than ever before. The most recent data from the Financial Conduct Authority shows IT incidents at TSB are now in line with, or better than, the levels of other UK banks. A further £120 million investment has been announced in digital capabilities to deliver ever better solutions to customers so that they can access services from TSB on the go.

- All customer complaints relating to migration were addressed and compensated by April 2019 and the number of new complaints now being received has dropped to within industry standard levels.

- Given TSB's well-established network, business product range and national presence, it was disappointed in not winning any of the RBS remedies. This said, TSB is now established as a competitive and distinct new player in Business Banking. The Bank has seen steady growth in customer numbers throughout the year, including 2,600 joining through the Incentivised Switching Scheme.

On 1 May 2019, Debbie Crosbie joined TSB as the new Chief Executive Officer. Debbie has brought considerable experience and knowledge to the role, as well as real dynamism. She has already put in place a strong new leadership team who, together with her, have unveiled an ambitious new strategy for taking the business forward with long-term growth.

At the Half Year, TSB announced that it was tracking well against three key areas: serving customers well; harnessing the technology platform; and focusing on efficiency. All were essential steps to lay the foundations for a new three-year strategy and a renewed focus on customers.

Customers were beginning to see real benefits from the Bank's new platform, including a faster mortgage application process, the introduction of new digital capabilities such as identity verification on our mobile app and the roll-out of the Image Clearing System for cheques across the branch network.

As outlined above, TSB has continued to grow its Business Banking proposition by providing market-leading offers such as 25 months free banking and introducing a 1% interest rate on savings accounts, and reducing the time taken to complete the business current account application process to 10 minutes. The Bank also announced a partnership with 'Square' to make card payments more accessible for TSB's Business Banking customers across the UK. It enables small business owners who bank with TSB and process payments with 'Square' to track their performance, for free, using a suite of real-time analytics, manage inventories and enjoy access to digital receipt or refund tools. The Bank also extended the number of drop-in advice clinics in branches which deliver face-to-face advice and support for TSB business customers, in partnership with Enterprise Nation.

TSB has taken a leading position to help protect customers and communities against the rise in the incidence of fraud, particularly as customers increasingly engage in online platforms. In launching the Fraud Refund Guarantee in April, a UK banking first, TSB is the only bank to offer this protection to its customers. The Bank has also forged partnerships with police forces to help them track down criminals faster and has hosted hundreds of community workshops across the country, to help prevent thousands of customers and members of the communities in which the Bank operates from becoming victims of fraud. This helps TSB stand apart from its competitors.

Strategic report (continued)

Review of business performance (continued)

Progress through the year (continued)
These developments and our ongoing growth will continue to be driven by a strong, skilled, motivated and diverse workforce. TSB is committed to diversity in the broadest sense and to make sure everyone in the business feels included; this remains an important part of TSB's culture.

TSB is investing in gender diversity through initiatives such as its TSB Aspiring Women network, Women Returners' Programme and HMT's Investing in Women Code[1]. More broadly, the Bank has inclusion affinity groups for LGBTQ+, BAME and Disability, all of which are sponsored and supported by members of the Executive Committee and senior leadership team. In 2019, TSB employees threw their support behind events such as Pride[2], and more recently, TSB signed up to the Valuable 500[3] where it has made three commitments, which includes putting disability on our Board agenda. Our most recent Partner Experience survey shows that TSB colleagues recognise these efforts, with diversity awareness at 84%. Our inclusive and supportive culture is one of the things that seeks to make TSB an inspiring place to work.

In November 2019, the Board published the Slaughter and May report into the IT migration to the new technology platform which it was hoped would offer important lessons on technology transformation not just for TSB, but for the wider industry. Although the report doesn't paint the full picture of migration, and there are aspects that that the Bank does not agree on, the Board was absolutely clear that it wanted to be transparent. This is why the decision was taken to publish the report in full. As made clear at the time, Slaughter and May's report is one of a number of reviews into the issues arising in the technology migration which have been carried out by external parties and by teams within TSB and Sabadell. These other reports have highlighted a number of aspects which are not fully reflected in Slaughter and May's report. These learnings have been taken into account and, in particular, TSB is now taking more direct control of its technology platform and suppliers, including IBM.

TSB's new purpose and strategy: Money Confidence. For Everyone. Every Day.
For the Bank to restore its competitiveness, it was key to revisit what drives TSB. Together, with its people and customers, TSB has designed a new blueprint to articulate why the Bank exists, and what it needs to do to transform in the coming years. With a new business purpose of 'Money Confidence. For Everyone. Every Day'. TSB believes it is well placed to become a simpler organisation to compete effectively, build deeper customer relationships and deliver compelling customer experiences. In November, a new strategic plan for 2020 to 2022 was unveiled. This is underpinned by three pillars:

- Customer focus. The starting point is always the customer. Following substantial research, opportunities were identified to improve the way we serve the 'Aspiring Middle' customer groups, who want a bank that removes unnecessary hassle from banking and helps them to manage their money and reduce unexpected worry. There are clear opportunities for TSB to deliver new and innovative products and services for these customers.

  To deliver the best customer experience, the Bank has announced a planned investment of over £120 million in digital channels while, also, refreshing lending products to provide new flexibility, address a broader range of customers' needs, and introduce individual customer lending decisioning and underwriting criteria.

  Branches remain an integral part of TSB's business and will complement the focus on digital services. However, TSB has more than double the UK average ratio of branches to customers and, as a result, the size of our branch network will be reshaped to meet the changing needs of customers. As part of this, TSB will continue to invest in flagship branches and, as a result, will continue to have an extensive branch footprint across the whole of the country.

- Simplification and efficiency. The second pillar is to become a simpler and more focused business. The new IT platform gives TSB a strong foundation for the future with multi-cloud and data capabilities that provide opportunities to use data driven insights and analytics to improve the TSB experience. The Bank will also optimise opportunities from open banking and third-party relationships to improve the offering to customers and selectively expand services where it matters to our customers most.

  TSB is working to reduce the time to open a current account from seven days to 10 minutes and allow customers to transact straight away. Customers will enjoy the convenience of self-service and access to all products and services from TSB's mobile platform with three quarters of TSB's customers expected to be digitally active by 2022.

[1] The Investing in Women Code is a commitment by financial services firms to improve female entrepreneurs' access to tools, resources and finance. https://www.gov.uk/government/publications/investing-in-women-code
[2] Members of the LGBTQ+ community and their allies celebrate Pride on an annual basis with parties, parades and festivals all over the world.
[3] The Valuable 500 is a global movement putting disability on the business leadership agenda: https://www.thevaluable500.com

Strategic report (continued)

Review of business performance (continued)

TSB's new purpose and strategy: Money Confidence. For Everyone. Every Day. (continued)

- <u>Operational Excellence</u>. The third pillar focuses on creating a more resilient and sustainable business through the safe and sound delivery of our strategic plan. TSB has a strong governance and risk management framework overseen by an experienced Executive team. Accountability for TSB's future conduct risk is clear with all customer banking experiences, both business and retail, owned by the Customer Banking Director. Management of our operational risk benefits from the same organisational clarity under the Chief Operating Officer.

  IT resilience and cyber security will be prioritised to make sure that they receive the appropriate level of resources. As part of this, the programme to take more direct control of technology, currently managed by Sabis under the Operating Services Agreement, has commenced with the signing of a new partnership with IBM. Increasingly, TSB will partner with a small number of larger industry leaders to bring significant cost savings and reduce risk. This is a joint programme of work with Sabadell, which is already significantly advanced and delivering value.

Financial summary
As detailed in the review of financial performance on page 9, the Bank generated a statutory profit before tax of £45.4 million in 2019, including a £39.6 million increase in the expected recovery under warranties in the respective migration and IT service related agreements. This compared to a statutory pre-tax loss of £101.0 million in 2018.

Over 200,000 customers opened a new bank account or switched their account to TSB in 2019 which helped to generate the 3.7% increase in customer deposit balances from £29.1 billion to £30.2 billion. Mortgage gross new lending of £5.8 billion supported net growth in customer loan balances of 3.6% from £30.0 billion to £31.1 billion.

Outlook and conclusion
TSB continues to operate amidst economic uncertainty as geopolitical instability limits GDP growth, interest rates have remained low for much longer than expected and continued growth in the 'gig economy' and 'generation rent'. The Bank faces intense competition with mortgage margin compression and the repayment of the Bank of England's Term Funding Scheme driving funding cost pressures. This is taking place at a time when customers continue to change the way they bank, preferring a more digital way of managing their money, and a range of new Fintechs entering the market intensifying competition.

UK banking is a highly regulated industry which, at a point of increasing regulatory intervention brings its own challenges, individually and cumulatively, such as the high cost of credit review, the ongoing evolution of capital regulation, and increased competition brought about by UK ringfencing.

TSB remains one of the most strongly capitalised banks in the UK, with a common equity Tier 1 capital (CET1) ratio of 20.7% at 31 December 2019 and holds a healthy liquidity reserve. It is well positioned to weather economic uncertainty or shocks and also to deploy its financial reserves in further growth. TSB's strategic plan is self-financed, requiring no additional capital from Sabadell. However, expected organic lending growth and the adoption of the regulatory change to a 90-day definition of default on the mortgage portfolio, required for all UK banks by the end of 2020, is expected to result in a reduction in the CET1 ratio to circa 16% in 2020.

This has been a turnaround year for TSB. The Bank has returned to profit, has stable modern systems, is forward looking and has real confidence in its ability to provide excellent service to its customers.

The Bank is confident that through the partnership between the new Executive team and its people, combined with the focus of the new strategy, real value will be unlocked in TSB.

Strategic report (continued)

Purpose and Section 172 statement

Our purpose
TSB is a UK bank with a multi-channel, national distribution model, including branch coverage across Great Britain and a full digital (internet and mobile) and telephony capability. TSB offers a range of retail banking services and products to individuals and small business banking customers throughout Great Britain.

There is an opportunity for TSB to serve Britain better by supporting the '*Aspiring Middle*' customer groups. They want a bank that removes the hassle from banking and provides access to people who can give them confidence in, and remove the stress and worry from, managing their money. By leveraging the new IT platform, and using digital-led propositions, TSB has opportunities to serve these customers better.

It is the importance of this opportunity and how we serve our customers every day that will make the difference at TSB. At TSB we call this purpose '*Money confidence. For everyone. Every day*.'

Section 172 statement
In overseeing delivery of TSB's revised purpose and strategy, TSB's directors have always been mindful of their duties under the Companies Act 2006, including as set out in section 172. The Board recognises that TSB's long-term success is only possible through engagement with, and having regard to, the interests of key stakeholders, which for TSB includes employees, customers, wider communities and regulators. The Board's governance framework is critical in ensuring that stakeholder considerations are properly and fairly considered in decision making. The effectiveness of the Board was reviewed by the Senior Independent Director whose subsequent report identified areas for further development. In addition, during 2019, TSB enhanced its Board and committee paper writing methodology to bring into sharper focus the consideration of stakeholder interests. This approach has been embedded throughout the business, not only at Board level, but also at executive level.

More broadly, the Board monitors and challenges progress in the delivery of strategic initiatives through its review of balanced scorecard metrics which are structured around TSB's primary corporate objectives. These metrics, which form the basis of the KPIs reported on page 8, together with a wider dashboard of management information, are reviewed and discussed at the Executive Committee every month and at each Board meeting. In addition, the Remuneration Committee reviews a sub-set of metrics at least twice a year to support its decision making on variable remuneration outcomes. In this way variable remuneration outcomes are directly linked to metrics that support the delivery of TSB's strategic objectives.

The proactive oversight and challenge provided by the Board was central in the development of TSB's revised purpose and strategy, which was led by the Chief Executive, and included taking into account the interests of each of TSB's shareholder groups as further discussed below.

- <u>TSB's ultimate shareholder, Sabadell</u>. Given Sabadell's 100% ownership interest in TSB, it is natural that the promotion of the long term success of TSB, including through the development of a clear purpose and strategy, is aligned with the interests of Sabadell. Sabadell's interests are represented at Board by two shareholder appointed Non-executive Directors. Any circumstances where shareholder and TSB interests are not aligned are managed through the disclosure and management of any such potential conflict. Sabadell's interests are further represented through the UK Steering & Coordination Committee. TSB's Chief Executive, Chief Financial Officer and Chief Risk Officer presented the revised strategy and financial forecasts to the Sabadell Board prior to final review and approval by the TSB Board.

- <u>Customers and wider community</u>. The starting point in the development of strategy was the customer. Customer, and non customer interests were reflected by undertaking over 6,000 interviews and holding 120 focus groups across Great Britain. The Board received regular updates on the findings of this outreach and it was noted in particular that many customers are not confident in managing their money. The exercise concluded that people do not, naturally, turn to banks for help, but that TSB is seen as a credible, helpful and friendly bank, which creates opportunities for the Bank. More specifically, within the development of strategy, the decision to close certain TSB branches involved consideration of customer interests and the wider impact on communities.

  The Board also took account of customer interests through regular reviews of key scorecard measures such as NPS and requested regular reports from Board Risk Committee to oversight and challenge the approach to managing customer harm and to ensure that the needs of vulnerable customers are properly and fairly taken into account.

Purpose and Section 172 statement (continued)

Section 172 statement (continued)

- Employees. The Board is proud of the commitment of our employees and the collaborative culture we have in TSB. During a challenging period, employees have continued to support each other and work together to deliver for our customers.

  'The Link', a forum for employees across all levels and all parts of TSB with five regional groups covering Great Britain, gathers and builds on employee feedback and enables meaningful dialogue between employees, the Executive leadership and, from 2019, the Board on a wide range of topics. Throughout 2019, the role of the 'Link' supported the development of the revised strategy, gathering employee feedback on TSB's new purpose. The outputs from every Link meeting are presented to the Executive Committee to help inform TSB's decision making and the direction of our bank. In 2019, the Board established a process by which the Link present directly to the Board on a semi-annual basis with the first such presentation taking place in July 2019. This has facilitated more direct engagement between the Board and employees.

  More broadly, the Board has established a framework that takes account of the interests of our employees, including:
  - promoting the role of recognised trade unions in independently representing the interest of employees;
  - the appointment of a Board level whistleblowing champion;
  - providing challenge, through the auspices of the Remuneration Committee, to ensure that remuneration policy is appropriate for all employees, as well as executives, and provides for competitive remuneration strongly aligned to the delivery of TSB's strategic goals.

  TSB's success will be driven by a strong, skilled, motivated and inclusive culture. The Board plays an active role in promoting and challenging progress in establishing a truly diverse and inclusive culture at TSB and carries out regular succession planning reviews to ensure continuity of skilled employees.

- Suppliers. Operational excellence is one of the pillars of TSB's new strategic plan and, as part of this, TSB will work more closely with certain key suppliers, taking direct control of some relationships currently managed by Sabis, the current supplier of TSB's outsourced IT services. TSB believes that establishing a closer relationship with suppliers (including a clear accountability framework) will improve business resilience and reduce risk. The Board regularly reviews progress of this programme of work and, following an update to procurement policy, approves outsourcing strategy annually, together with any changes to the boundaries of outsourced critical services.

- Regulators. Open and honest engagement with regulators is a cornerstone principle of the UK regulatory environment. The Chief Risk Officer reports regularly to the Board and Board Risk Committee on material matters of regulatory liaison and TSB's assessment of the quality of the relationship with each regulator. Certain Board members maintain a direct relationship with the FCA and PRA through the framework of 'proactive engagement and continuous assessment' meetings and report on key themes discussed through Board and committee meetings as appropriate. As part of Board discussion of the new strategy and purpose, the Chief Executive reported on the related engagement that had taken place with regulators.

Other non-financial disclosures

TSB does not currently have a formal environmental policy, although we plan to launch a corporate responsibility programme later this year covering environmental impact amongst other issues. We are committed to reducing our environmental impact and using resources in a more responsible way as outlined in the Directors' report on page 16.

TSB has a moral, legal and regulatory duty to prevent, detect and deter financial crime and maintains a financial crime framework. This framework is supported and reinforced by TSB behaviours which puts the customer at the heart of every interaction. TSB promotes an environment which is hostile to illicit activity to protect its customers, employees, and communities from financial crime. TSB's compliance with requirements of the financial crime framework is monitored via ongoing control testing; assurance; audit and the provision of management information at senior governance committees.

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 employees and customers are treated with dignity and respect. This includes 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.

Strategic report (continued)

Business model and key performance indicators

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

Component	Description	Financial statements	Key performance indicator
Customer confidence	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 purpose '*Money confidence. For everyone. Every day.*' through which we will invest in digital capabilities and customer led service strategies. Our brand is based on transparent and straightforward behaviours 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	**Customer advocacy (Net Promoter Score)** **2019** / **2018** 10 / (9) **Total digital active customers (%)** **2019** / **2018** 63.4% / 61.3%
Sources of funding and capital	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 TSB's shareholder who also provides funding in the form of equity capital in the business.	Page 25	**Share of personal bank account gross flow (%)** **2019** / **2018** 3.9% / 3.6% **Share of PCA stock (%)** **2019** / **2018** 4.4% / 4.5%
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.	Page 30	**Mortgages gross lending (£m)** **2019** / **2018** 5,838.1 / 4,803.5
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 41	**Net interest margin (%)** **2019** / **2018** 2.75% / 2.87%
Charges	Charges we incur include the costs of paying our TSB employees, 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 43	**Cost:income ratio (%)** **2019** / **2018** 89.3% / 102.1% **Asset quality ratio (£m)** **2019** / **2018** 0.20% / 0.24%

Risk management

Effective risk management underpins TSB's business model. The Board sets an appetite for risk and monitors the risks arising from delivery of TSB's strategy through its business model to ensure the bank remains liquid, solvent, operationally stable, trusted and compliant. The Board in turn determines whether to return any profits made by the bank to the shareholder by way of dividend or to reinvest the profit to support the future growth of the bank.

Strategic report (continued)

Review of financial performance
The Bank's performance is presented on a statutory basis and structured in a manner consistent with the key elements of The Bank's business model as explained on page 8.

Details of the basis of preparation of TSB's financial statements is set out on page 18. This includes a description of changes to accounting policies in respect of accounting for leases, to reflect the adoption of IFRS 16 'Leases' and, in respect of hedge accounting, to reflect the early adoption of 'Interest Rate Benchmark Reform – Amendments to IFRS 9, IAS 39 and IFRS 7' (the Amendment). The adoption of IFRS 16 did not have a material impact on the financial statements. The adoption of the Amendment has enabled TSB to retain effective hedge accounting relationships in respect of interest rate swaps and issued debt securities that currently reference LIBOR and have a maturity beyond the end of 2021, when benchmark inter-bank offered rates are expected to be phased out. An assessment of changes required to these instruments is currently underway to address the forthcoming replacement of LIBOR.

Income statement and profitability

	2019 £ million	2018 £ million
Net interest income	**841.1**	884.8
Other income	**146.1**	410.5
Total income	**987.2**	1,295.3
Operating expenses	**(881.3)**	(1,323.0)
Impairment	**(60.5)**	(73.3)
Statutory profit/(loss) before taxation	**45.4**	(101.0)
Taxation	**(19.2)**	41.9
Statutory profit/(loss) for the year	**26.2**	(59.1)

TSB's statutory profit before tax for 2019 was £45.4 million, including a £39.6 million increase in the expected recovery under warranties in the respective contracts for migration and IT services (taking the total expected recovery to £192.6 million (2018: £153.0 million) reflecting the maximum recovery amount under the contracts).

This compared to a loss before tax of £101.0 million in 2018 which had been significantly affected by the costs to deliver TSB's IT migration and the costs of the subsequent post migration service disruption, partially offset by the recognition of a contribution from Lloyds Banking Group (reported within other income in 2018) and the, then, estimated recovery of £153.0 million of post migration charges under the respective MSA and OSA contracts.

Total income
Net interest income decreased by 5% to £841.1 million. This was due to competitive pressure on mortgage margins and lower levels of higher margin unsecured lending. Other income decreased by 64% to £146.1 million driven by the recognition in 2018 of £318.3 million of income from LBG as a result of exiting the Transitional Services Agreement on migration to the new IT platform. Excluding this, the increase in other income was primarily due to the recognition of fees in respect of changes to TSB's card servicing arrangements and the cessation in 2019 of payments to customers for making contactless and direct debit payments from their personal current accounts.

Operating expenses
Operating expenses decreased by 33% primarily reflecting the non-recurrence of £417.3 million of costs in preparing for the migration in 2018. The decrease also reflected a £147.7 million reduction in the net effect of charges associated with the post migration service disruption and the accrued estimated recovery from Sabis under the migration and outsourced services agreements.

These reductions were partially offset by higher one off items, which in 2019 reflected the costs of restructuring the Bank, including £21.9 million in respect of costs of the branch closures announced in November 2019 and £16.6 million relating to the reorganisation of head office functions.

	2019 £ million	2018 £ million
Operating expenses excluding additional post migration charges, volatility and one off items	**847.6**	770.6
Post migration charges	**35.6**	296.7
Recovery of post migration charges	**(39.6)**	(153.0)
Costs of preparing for TSB's migration	**-**	417.3
Banking volatility	**(2.5)**	-
One off items	**40.2**	(8.6)
Statutory basis operating expenses	**881.3**	1,323.0

Excluding these factors, costs increased by £77.0 million (10%) to £847.6 million as opportunities were taken to increase investment in the business in 2019 following a period in which TSB focused almost exclusively on completing IT migration activity. The increase in costs also reflected higher employee related costs (largely reflecting, in 2018, the absence of variable reward costs combined with the reversal of earlier year accruals for previously awarded but unvested SPA awards), and higher IT servicing and license costs.

Strategic report (continued)

Review of financial performance (continued)

Balance sheet, funding and capital

TSB's balance sheet remained strong with the loan to deposit ratio and capital ratios remaining broadly stable and TSB maintaining liquid assets in excess of regulatory requirements and internal risk limits.

	2019 £ million	2018 £ million
Customer deposits	**30,182.4**	29,084.3
Non-customer funding	**6,555.7**	9,087.8
Borrowings from the Bank of England	**4,483.5**	6,482.2
Debt securities in issue	**1,676.3**	1,122.6
Subordinated liabilities	**395.9**	398.2
Repurchase agreements	**-**	1,084.8
Shareholder's equity	**1,900.8**	1,878.9
Sources of funding	**38,638.9**	40,051.0
Other liabilities	**897.0**	1,087.6
Total equity and liabilities	**39,535.9**	41,138.6
Loans and advances to customers	**31,075.8**	30,008.5
Liquid asset portfolio(1)	**6,764.4**	9,438.9
Loans and liquid assets	**37,840.2**	39,447.4
Other assets	**1,695.7**	1,691.2
Total assets	**39,535.9**	41,138.6

(1) Comprises balances at central banks of £4,427.3 million (2018: £6,954.9 million), debt securities of £2,136.0 million (2018: £2,484.0 million) and reverse repurchase agreements of £201.1 million (2018: nil). Balances at central banks are combined with other cash balances and demand deposits of £165.5 million (2018: £181.0 million) when shown on the balance sheet on page 21.

Source of funding

Total sources of funding decreased by 4% to £38.6 billion. Customer deposits increased by £1.1 billion to £30.2 billion. Aggregate retail customer deposits grew by £0.8 billion to £28.7 billion with continued growth in both savings and current account balances. A successful ISA season helped retail savings balances to grow by 2.0% to £17.9 billion, while retail current account balances also contributed to growth with a 4.8% increase to £10.9 billion. Business banking deposit balances grew by 21.0% to £1.4 billion driven by the RBS Incentivised Switching Scheme campaign and a competitive savings proposition.

Non-customer funding decreased by £2.5 billion to £6.6 billion due, largely, to a cumulative repayment of £2.0 billion of borrowings under the Bank of England's Term Funding Scheme. The remaining £0.5 billion reduction was due to the absence of repurchase agreement balances at the end of December 2019, partially offset by a net increase in secured debt securities in issue following the issuance of £750 million of covered bonds in 2019.

TSB's capital position has remained above risk appetite threshold with a Common Equity Tier 1 (CET 1) capital ratio of 20.7% and a leverage ratio of 4.6% on a fully loaded basis. The CET 1 capital ratio increased by 1.2% primarily due to lower risk weighted assets.

Loans and liquid assets

Loans to customers increased by £1.1 billion to £31.1 billion. Mortgages returned to growth in 2019, partially offset by reductions in unsecured lending. The growth in mortgage balances is mainly due to higher origination activity driven by competitive pricing and improved customer retention as customer appetite to remortgage away reduced, offset by the expected reduction in the closed Whistletree portfolio. New mortgage lending increased to £5.8 billion (2018: £4.8 billion). Unsecured and business banking balances reduced by 10% to £1.9 billion as functionality to support online sales of new unsecured personal loan and credit card lending was re-established in May and November 2019, respectively. Further information about the credit risk of TSB's loans is set out in note 20 to the consolidated financial statements.

TSB's liquidity portfolio comprises highly liquid assets, primarily cash deposits at the Bank of England, UK gilts, supranational, development bank bonds and covered bonds, which are available and immediately accessible to meet potential cash outflows. TSB's liquidity position is managed centrally by TSB's Treasury function and is available for deployment at immediate notice, subject to complying with regulatory requirements. The decrease in the liquidity portfolio largely reflects the partial repayment during 2019 of borrowings under the Bank of England's Term Funding Scheme.

Strategic report (continued)

Principal risks and uncertainties

Approach to risk
TSB seeks to remain liquid, solvent, operationally stable, trusted, and compliant at all times. The objective of TSB risk management is to ensure these outcomes are maintained. The processes to identify, measure and control the risks inherent in its business model are fully embedded in TSB's risk management framework. Risks faced by TSB in delivering its business strategy are managed to protect the interests of customers, employees, and our shareholder. TSB's approach to managing these risks is described by an overarching Risk Management Framework described below. TSB's principal risks and uncertainties are described on pages 13 to 14.

Risk management framework
The risk management framework (RMF) creates coherent standards and practices for all 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. TSB has reviewed its risk management framework in 2019, and updated the risks at the top of the hierarchy to include Financial Crime risk. The five principal risk categories are shown in the table below.

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.
Financial Crime risk	The risk that systems and controls are not adequate to manage financial crime within TSB's risk appetite and regulatory framework.

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).

First line of defence	• Identifies and manages risks in line with prescribed TSB risk management standards. • Designs and implements control frameworks, preventative measures, processes and strategies to mitigate risks in line with risk appetite. • Reports on their business unit and risk category risk profile and the effectiveness of control frameworks. • Applies TSB risk management standards and embeds throughout the business through its policies, governance and control frameworks. • Operates day-to-day control activities, tests and monitors the effectiveness of controls and compliance with policies and standards including business performance reviews, quality checking, and scenario analysis.
Second line of defence	• Sits within TSB's Risk Division. • Maintains TSB's Risk Management Framework and sets enterprise wide standards for risk management activity. • Provides independent 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 provide an enterprise wide view of TSB's risk profile and risk appetite to Board and Executive committees.
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.

Employees 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
TSB's risk culture encourages employees' accountability for risk management. 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. Employees 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 employees in keeping within 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 employees.

Strategic report (continued)

Principal risks and uncertainties (continued)

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, the Board 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 is not a specialist lender and does not seek to differentiate itself as a provider of niche products. At the highest level, TSB aligns its risk appetite to UK mainstream retail banking. Risk appetite is calibrated to ensure it remains within the range of mainstream retail banking peers on every significant measure of risk. TSB aligns its risk appetite to a statement of its attitude to each of its five risk categories. These, along with appetite measures and thresholds, are articulated in the Risk Appetite Statement. TSB has a clearly defined and proportionate risk appetite that supports its strategic objectives and seeks to provide confidence to its customers, regulators and shareholder.

Risk governance
Clear risk ownership and reporting lines are established through TSB's risk committees, which are aligned to the five principal types of risk as described in the table below. Each committee is responsible for monitoring TSB's risk profile and challenging risk exposures across the relevant risk type in line with the risk appetite set by the Board.

This committee structure enables fast, efficient decision making, providing clear escalation and reporting of risk to senior management and the Board which is responsible for providing oversight of the effectiveness of the risk management framework.

Financial Risk (ALCO)
Chaired by the Chief Financial Officer, the 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.
Credit Risk Committee
Chaired by the Chief Risk Officer, the 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 committee is responsible for 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 Customer Banking Director, the committee is responsible for ensuring the delivery of substantially fair customer outcomes, that TSB 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.
Financial Crime Risk Committee
Chaired by the Chief Risk Officer, the committee is responsible for ensuring that the risk of criminal conduct relating to money or financial services or markets is appropriately managed across TSB. The committee monitors and challenges the financial crime risk profile including key financial crime risks and controls, ensuring appropriate upward escalation and visibility of relevant breaches, losses and events relating to the financial crime risk categories.

In addition the Model Governance Committee, chaired by the Chief Risk Officer, is responsible for the development, implementation and effectiveness of the model governance framework (embracing policies, methodologies, systems, processes, procedures and people). This includes articulating the extent and type of model risk to which TSB is exposed, acting as the Designated Committee as required by the Capital Requirements Regulation.

Principal risks and uncertainties (continued)

Principal risks and uncertainties arising from TSB's business model

In 2018 TSB reported a heightened risk profile caused by the instability of its IT platform and Brexit. TSB's IT service has improved during 2019, providing an acceptable level of customer service and operational stability through most of the year.

Brexit is treated as a financial, credit and operational risk to the bank. TSB does not anticipate significant disruption as a result of the UK's negotiations over its withdrawal from the EU but continues to monitor developments and regularly assesses potential impacts against its readiness plans. Should any risks materialise, these would be managed through TSB's risk management framework to ensure operational continuity. In addition, the most extreme outcome, a 'cliff-edge Brexit', has been considered as a specific scenario in the assessment of expected credit loss.

Day-to-day risk management is aggregated to provide a view at an enterprise-level of the principal risks and uncertainties that have the potential to materially impact execution of TSB's strategy. These risks, which have been considered by the Board in 2019, are detailed below.

Description	Mitigation	Change in 2019	Risk Category
1. Threats to profit resilience			
The risk to profit arising from; increased costs of running IT services, lower interest rates for longer, regulatory intervention in key TSB markets, delays in delivery of products or services and or slower business as usual cost reduction than planned.	TSB's new strategy is incorporated into its financial plan with an improved profit resilience risk profile. Emerging risks to the plan are monitored along with profit performance against risk appetite.	There has been no material change to TSB's profit resilience risk profile.	• Financial • Operational
2. Emergence of a systemic crisis			
The risk that TSB is unable to identify and respond quickly to the emergence of a new financial crisis. This risk is heightened as TSB continues to prioritise deploying resource to its IT remediation plan.	TSB has adequate capital and liquidity reserves and operational stability is improving, with steady progress being made in returning data and controls to normal operation.	Remains a key risk as TSB begins its strategic transformation.	• Financial • Operational • Conduct
3. IT platform stability deterioration			
The risk of control weaknesses causing the performance of the IT platform to deteriorate and fall outside of risk appetite.	The performance of the IT platform, and the service provided by third party IT suppliers, is monitored against risk appetite and management actions are in place to address control weaknesses.	TSB's risk exposure is reducing as the performance of its IT platform stability improves.	• Financial • Operational
4. Business transformation execution			
The inherent design and execution risks arising from TSB's significant change programmes. The number of programmes underway that will have a deep impact on the organisation, including implementing the new strategy and a cost review.	Management are taking care to engage the Board and all three lines of defence, seeking to ensure the successful execution of these changes.	A key risk associated with the delivery of TSB's strategic outcomes.	• Financial • Operational
5. Risk of significant customer data loss			
Along with the risk of customer harm and regulatory fine, there is a heightened reputation risk for TSB from a significant loss of sensitive customer data such as a cyber-attack.	TSB continues to improve its IT resilience and strengthen its control framework. The Chief Information Security Officer (CISO) monitors the cyber threat and works with other firms, enforcement agencies, and government/industry experts to make the best use of intelligence and technology to identify and prevent suspicious activity.	This risk will continue to reduce in line with a strengthening of TSB's information security controls.	• Financial • Operational • Conduct

Strategic report (continued)

Principal risks and uncertainties (continued)

Principal risks and uncertainties arising from TSB's business model (continued)

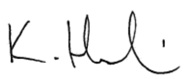
Description	Mitigation	Change in 2019	Category
6. Inadequate management of customer harm			
The risk of TSB's conduct risk framework failing to keep pace with market standards, and the increasing societal and regulatory expectations for higher standards of diligent and proactive management of potential customer harm, for all stages of the customer lifecycle.	The ongoing development and enhancement of TSB's risk management framework, organisation design changes and maturing conduct risk management, contribute to the more effective proactive management of customer harm.	Whilst TSB has always considered customer impacts, the reporting of customer harm is a relatively new concept in the industry and best practice is evolving.	• Conduct
7. Maintaining adequate skills and resources to deal with complexity and change			
The risk of TSB's failure to attract and retain skilled employees could impact TSB's ability to deliver its ambitious transformative programmes.	Recent executive appointments have underlined TSB's continuing ability to attract highly credible leaders. TSB's new strategy will provide a renewed purpose and direction for all employees.	With continued stabilisation of its IT systems, and communication of variable remuneration, this is likely to reduce retention risks.	• Operational

Emerging risks

The key emerging risks 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, employees and shareholder. These risks are considered as part of the business planning cycle. The top risks emerging in 2019 are as follows:

Description	Mitigation	Category
1. Global economic and political instability		
Losses arising from credit risk 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 sensitivity of TSB's profits and capital to alternative economic scenarios is explained in note 10 to the consolidated financial statements. TSB is appropriately prepared for the impact of the UK's planned withdrawal from the EU, with robust plans to remain liquid and solvent in all plausible scenarios, including a 'no deal'. The financial risks from a high interest rate, 'cliff-edge' Brexit scenario are considered in TSB's 2019 ICAAP scenarios and expected credit loss provisions.	•Financial •Credit •Operational
2. Climate change		
The financial risks resulting from the process of adjustment towards a lower carbon economy and the potential for the impairment of asset values, impacts on employees, and interruptions to services.	TSB is taking action to undertake an assessment of its exposure to the financial risks from climate change together with identifying and implementing controls as appropriate. The risks related to climate change will be managed within the existing governance model, and as such will be embedded within the Banks risk management processes ensuring focus and appropriate Board visibility.	•Financial •Credit •Operational
3. Increased competition with failed differentiation		
FinTech and other technological advances create alternatives to the traditional value chain and ways in which banks currently operate and service customers.	TSB's IT system is an enabler of its business model and leveraging it to improve digital services is a core part of TSB's new strategy. TSB has identified its core customer base and is developing new products, services and experiences that are aimed specifically at meeting those customers' needs.	•Financial •Operational
4. 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.	•Conduct •Operational

Strategic report on pages 3 to 14 approved, by order of the Board



Keith Hawkins
Company Secretary, 30 January 2020

Directors' report

Introduction
The Directors of TSB Bank plc (the 'Company') present their report and audited consolidated financial statements for the year ended 31 December 2019, in accordance with section 415 of the Companies Act 2006.

Principal activities and results
The principal activities and review of the Company are set out in the Strategic report on pages 3 to 14.

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

Directors
The Directors who served during the year are shown on page 2.

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 Debbie Crosbie and David Vegara, the indemnities were in place throughout 2019. The indemnity for Debbie Crosbie was executed on 21 May 2019 and for David Vegara on 28 January 2020. Each of the indemnities remain in force at the date of signing these financial statements and are available for inspection at the Company's registered office.

Corporate governance
Information on the Company's corporate governance arrangements can be found on pages 22 to 28 of the annual report and accounts of the Company's parent, TSB Banking Group plc, which is available at www.tsb.co.uk.

Future developments
The development of the Company is set out in the context of the Company's business model on page 8.

Employee information
Encouraging Employee collaboration and feedback
Collaboration and two-way communication is encouraged at all levels and is key to TSB's strategy. The 'The Link' gathers and builds on employee feedback and enables meaningful dialogue between employees and the executive leadership. The Executive Committee members and other senior leaders also run regular TSB wide 'town hall' meetings and site-specific meetings. Employees can use our new digital workplace platform to connect directly with leaders, posting questions or joining discussions. We also continue to work closely with our recognised unions, Accord and Unite, to build strong relationships. Our annual Employee Experience Survey provides all employees the opportunity to feedback on working at TSB and we continue to use this feedback to target improvements to our employee experience. In 2019 we discussed the TSB strategy and our new long term objectives with all employees. We also transitioned from a set of corporate values to a simplified description of expected behaviours. We have developed a thorough engagement strategy which incorporates a commitment to simplify ways of working.

Training and development
To ensure that our culture and business strategies are aligned, we provide a range of training such as the TSB Experience, a transformational programme for all employees which focuses on how they behave with customers and each other. We have set ambitious plans for the development of future skills, including a commitment to deliver 100,000 hours of training over the next three years. Every employee is also encouraged to have a personal development plan which they review regularly with their line manager. All employees who are new to TSB are given an induction, Welcome to TSB, and our behavioural standards form a central part of that induction. The Source (our Learning Management System) guides employees 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.

Recognition and reward
Not only do we give a voice to our employees, but we also encourage the recognition and celebration of their contribution. This is demonstrated in the Say Thank You scheme which gives employees the opportunity to recognise the contribution of fellow employees who demonstrate appropriate TSB behaviours. TSB's approach to reward seeks to differentiate us from other banks. It is driven by our core strategy 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 and the rest of the executive team. This enables all employees to be recognised for the important role they play in the success of our business.

Directors' report (continued)

Employee information (continued)

Diversity
Three years ago, TSB set an ambitious target of 45-55% of our senior roles to be held by women by 1 January 2020 when we signed up to the Women in Finance Charter. Importantly for TSB, this exceeded the targets set across the financial services industry. At the date of this report:

- 36% of members of the Board are women, just ahead of the Government's target of 33%, including the Senior Independent Director (who also chairs the Remuneration Committee) and the Chair of the Audit Committee; and
- 20% of the Executive Committee are female reflecting the appointments of Debbie Crosbie as Chief Executive and Liz Ashford as HR Director. We also have senior women running some of our largest functions and people leadership roles in the Bank.

However, despite this, we have not made progress at the rate at which we had aspired. At the date of this report, 39% of our senior roles are held by women, albeit that this is ahead of the industry average Women in Finance statistics (March 2019) which shows female representation in senior management roles at 31%, with average targets of 38%.

In December 2019, we extended the period to have between 45-55% of our senior roles held by women to 2025. Our progress against this target will be tracked against interim targets to ensure that we remain on track, and our aspiration is to achieve this ahead of schedule.

Gender diversity is critical to the success of our business. We will continue to promote women into roles that have a genuine impact on how we run our business, create role models, change cultural norms and unconscious bias across our business. TSB is investing in initiatives such as our Aspiring Women network, Women Returners' Programme and Investing in Women Code and are committed to diversity in the broadest sense. We are committed to make sure every employee in our business feels included.

TSB also participates in the Stonewall Workplace Equality Index, ensuring it is continually assessing and improving TSB's achievements and progress on LGBT+ equality. TSB is a member of Business in the Community and a signatory of the Race at Work Charter with the objective of ensuring ethnic minority employees are represented at all levels of the organisation. TSB promotes tailored mentoring programmes for BAME employees to support progression.

Our employees with disabilities are treated fairly and can compete on equal terms for career progression. TSB's 'employees with Disabilities' policy is designed to inform employees of the support available to those with disabilities (including employees 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 and in 2019, TSB joined the Valuable 500, joining other leading businesses committed to ensuring disability is on the board agenda and creating a workplace culture that encourages inclusion and equality.

Environmental information
As part of Sabadell's overall environmental work, TSB is committed to being a responsible user of resources. We continue to consider ways we can improve our environmental impact by looking at our energy consumption, carbon emissions from traveling, and reducing the use of plastic in our work places. In 2019, TSB invested in reducing our energy consumption through new LED lighting in corporate sites and more efficient air conditioning and boiler units in branches. In 2020, we plan to launch a new corporate responsibility programme to support the delivery of our business strategy and improve our social and environmental impact, and set new ambitions and targets to optimise our contribution to national and international goals.

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

Financial instruments
Information on financial risk management objectives and policies in relation to the use of financial instruments can be found on pages 48 to 62 of the financial statements.

Principal risks and uncertainties
The principal risks and uncertainties faced by the Company are set out on pages 13 to 14.

Post balance sheet events
There are no significant events affecting the Company that have arisen between 31 December 2019 and the date of this report that require disclosure.

Directors' report (continued)

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

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

Registered office
The registered office address for TSB Bank plc is Henry Duncan House, 120 George Street, Edinburgh, EH2 4LH.

Appointment of external auditor
PwC has held the position of external auditor of TSB Bank plc since 1997 as part of the wider historical audit relationship with Lloyds Banking Group, the Company's previous shareholder. As previously noted in the 2018 annual report, the Board accepted the Audit Committee's recommendation to appoint KPMG for the provision of external audit services for the year ending 31 December 2020 following a mandatory tender process. Consequently, a resolution to appoint KPMG for the audit of the financial statements for the year ending 31 December 2020 will be proposed at the 2020 Annual General Meeting.

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

Going concern
The Directors recognise their responsibility to make an assessment of the Company's ability to continue as a going concern, for a period of at least 12 months from the date the financial statements are approved The Directors are satisfied that adequate funding, liquidity and capital resources will be in place to allow the Company's financial statements to continue being prepared on a going concern basis and are not aware of any material uncertainties that may cast significant doubt upon the Company's ability to continue as a going concern.

Statement of directors' responsibilities in respect of the financial statements
The Directors are responsible for preparing the annual report and the financial statements in accordance with applicable law and regulation.

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

- select suitable accounting policies and then apply them consistently;
- state whether applicable IFRSs as adopted by the European Union have been followed in the Bank 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 the Bank and the Company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Bank's and the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Bank and the Company and enable them to ensure that the consolidated financial statements comply with the Companies Act 2006 and, as regards the Bank's financial statements, Article 4 of the IAS Regulation. The Directors are also responsible for safeguarding the assets of the Bank and the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

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

By order of the Board

K. H

Keith Hawkins
Company Secretary, 30 January 2020

Financial statements

Basis of preparation
These consolidated financial statements of TSB Bank plc comprise the results of the TSB Bank plc (the 'Company') consolidated with those of its subsidiaries (together the 'Bank'). Details of subsidiary undertakings are provided in note 26 to the financial statements on page 67. 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 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 the Bank'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 the Company has control. The Company controls an entity when it is exposed to, or has rights to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Bank and are deconsolidated from the date that control ceases. Inter-company transactions, balances and unrealised gains and losses on transactions between the Bank companies are eliminated.

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

Changes to accounting policies
The accounting policies are consistent with those applied in the 2018 Annual Report and Accounts with the exception of new accounting policies in respect of IFRS 16 *'Leases'* and 'Interest Rate Benchmark Reform – Amendments to IFRS 9, IAS 39 and IFRS 7 both of 'which TSB adopted with effect from 1 January 2019.

Leases
IFRS 16 replaced IAS 17 'Leases' and requires the Bank to recognise both a 'right-of-use' asset and a corresponding lease liability on the balance sheet in respect of most leases, primarily property leases, where it is the lessee. The change in the accounting policy also resulted in the Bank recognising lease liabilities in relation to leases which had previously been classified as 'operating leases' under the principles of IAS 17 '*Leases'*. These liabilities were measured at the present value of the remaining lease payments, discounted using the Bank's incremental borrowing rate at 1 January 2019.

The adoption of IFRS 16 at 1 January 2019 resulted in an increase of £163.0 million in property and equipment, reflecting the initial recognition of 'right of use' assets. This was offset by an increase of £171.9 million in lease liabilities less an £8.9 million reduction in other liabilities. The adoption of IFRS 16 had no impact on shareholder's equity at 1 January 2019. Details of the new accounting policies applied in respect of leases are set out on page 63. As permitted by the transitional provisions of IFRS 16, the Bank has elected not to restate comparative figures for 2018 and these adjustments are therefore recognised in the opening balance sheet as at 1 January 2019.

In applying IFRS 16 for the first time, the Bank, in using the following practical expedients permitted by the standard, has:

- applied a single discount rate to leases with similar remaining lease terms;
- used previous onerous lease assessments as an alternative to performing an impairment review, which reduced the right of use asset at 1 January 2019 by £1.5 million;
- excluded initial direct costs for the measurement of the right-of-use asset at the date of initial application, and
- accounted for leases with a remaining lease term of less than 12 months at 1 January 2019 as short-term leases.

Financial statements (continued)

Changes to accounting policies (continued)

Leases (continued)

The table below sets out the movement between the Bank's operating lease commitments at 31 December 2018 (as disclosed under the principles of IAS 17) and lease liabilities recognised at 1 January 2019:

Bank and Company	£ million
Operating lease commitments at 31 December 2018	188.1
Less: Impact of discounting (using a weighted average rate of 1.0% at 1 January 2019)	**(15.3)**
Less: Short-term leases not recognised as a liability	**(0.9)**
Lease liability at 1 January 2019	**171.9**

The associated right-of-use assets for these leases were measured at the amount equal to the lease liability, adjusted to reflect prepaid and accrued lease payments and onerous lease provisions recognised in the balance sheet as at 31 December 2018.

The impact of the adoption of IFRS 16 on the financial statements at 1 January 2019 are set out the table below:

			Bank			Company
	Property and equipment £ million	Lease liabilities £ million	Other liabilities £ million	Property and equipment £ million	Lease liabilities £ million	Other liabilities £ million
At 31 December 2018	163.1	-	(495.7)	163.1	-	(685.0)
Changes on adoption of IFRS 16	163.0	(171.9)	8.9	163.0	(171.9)	8.9
At 1 January 2019	**326.1**	**(171.9)**	**(486.8)**	**326.1**	**(171.9)**	**(676.1)**

Hedge accounting

In 2019, the IASB issued 'Interest Rate Benchmark Reform – Amendments to IFRS 9, IAS 39 and IFRS 7' (the Amendment) which is effective from 1 January 2020, with early adoption permitted. The Amendment is in response to changes to inter-bank offered rate (IBOR) benchmark interest rates which are expected to be phased out by the end of 2021. In assessing cash flow hedge effectiveness and in assessing whether forecast transactions are expected to occur, the Amendment permits entities to assume that the interest rate benchmark on which the hedged cash flows and the hedging instruments are based is not altered as a result of interest rate benchmark reform.

TSB has elected to early adopt the Amendment, applying it retrospectively to its hedge accounting relationships, and providing the required disclosures (see note 23). This has enabled TSB to retain effective cash flow hedge accounting relationships in respect of certain variable rate debt securities in issue that reference LIBOR and have a maturity beyond 2021. This avoids the accelerated recycling of £6.0 million of post-tax debit balances from the cash flow hedging reserve to the income statement.

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, shown in the table below.

Significant accounting estimates	**Financial statement note**
Allowance for credit impairment losses on financial assets at amortised cost	Note 10
Customer remediation provisions	Note 31
Restructuring provisions	Note 31
Recovery of post migration charges	Note 32
Significant judgements	
Recoverability of deferred tax asset	Note 19
Assessment of exposure to regulatory investigations	Note 25(i)

Index to the consolidated financial statements

The Bank's primary consolidated financial statements are presented on pages 21 to 73. The notes to these consolidated financial statements are structured to follow the Bank's business model as set out on page 8 and are listed below.

Balance sheets

as at 31 December 2019

	Note	Bank 2019 £ million	Bank 2018 £ million	Company 2019 £ million	Company 2018 £ million
Assets					
Cash, cash balances at central banks and other demand deposits		**4,592.8**	7,135.9	**4,592.8**	7,135.9
Financial assets at fair value through profit or loss					
Derivative financial assets	23	**111.5**	88.4	**111.5**	88.4
Equity instruments		–	1.4	**–**	1.4
Financial assets at fair value through other comprehensive income	6	**1,587.4**	2,387.8	**1,587.4**	2,387.8
Financial assets at amortised cost:					
Debt Securities	6	**548.6**	96.2	**548.6**	96.2
Loans to central banks		**96.1**	87.8	**96.1**	87.8
Loans to credit institutions	7	**373.2**	370.6	**–**	–
Loans and advances to customers	8	**31,075.8**	30,008.5	**31,075.8**	30,008.5
Reverse repurchase agreements		**201.1**	–	**201.1**	**–**
Other advances	9	**279.6**	381.4	**279.6**	381.4
Hedging derivative financial assets	23	**93.4**	106.6	**49.8**	43.1
Fair value adjustments for portfolio hedged risk		**20.5**	(37.3)	**20.5**	(37.3)
Property and equipment	27	**293.2**	163.1	**293.2**	163.1
Intangible assets	29	**20.3**	18.4	**20.3**	18.4
Current tax assets		**(0.2)**	19.7	**(0.2)**	19.7
Deferred tax assets	19	**96.1**	113.0	**96.1**	113.0
Other assets	30	**146.5**	197.1	**146.5**	197.1
Total assets		**39,535.9**	41,138.6	**39,119.1**	40,704.5
Liabilities					
Financial liabilities at fair value through profit or loss:					
Derivative financial liabilities	23	**127.9**	93.1	**127.9**	93.1
Financial liabilities at amortised cost:					
Borrowings from central banks		**4,483.5**	6,482.2	**4,483.5**	6,482.2
Deposits from credit institutions		**0.7**	3.4	**0.7**	3.5
Customer deposits	1	**30,182.4**	29,094.3*	**30,182.4**	29,094.3*
Repurchase agreements	4	–	1,084.8	**–**	1,084.8
Debt securities in issue	2	**1,676.3**	1,122.6	**1,249.8**	498.4
Subordinated liabilities	3	**395.9**	398.2	**395.9**	398.2
Lease liabilities	28	**141.8**	–	**141.8**	–
Other financial liabilities		**80.0**	66.4	**80.0**	66.4
Hedging derivative financial liabilities	23	**288.5**	346.0	**288.5**	346.0
Fair value adjustments for portfolio hedged risk		**52.2**	9.4*	**52.2**	9.4*
Provisions	31	**51.8**	63.6	**51.8**	63.6
Other liabilities	32	**154.1**	495.7	**163.6**	685.0
Total liabilities		**37,635.1**	39,259.7	**37,218.1**	38,824.9
Equity					
Share capital	24	**79.4**	79.4	**79.4**	79.4
Share premium	24	**195.6**	195.6	**195.6**	195.6
Merger reserve	24	**412.8**	412.8	**412.8**	412.8
Retained profits brought forward	24	**1,175.7**	1,234.8	**1,175.7**	1,234.8
Profit/(loss) attributable to the shareholder for the current year	24	**26.2**	(59.1)	**26.2**	(59.1)
Valuation adjustments:					
Fair value reserve	24	**13.6**	18.6	**13.6**	18.6
Cash flow hedging reserve	24	**(2.5)**	(3.2)	**(2.3)**	(2.5)
Shareholder's equity		**1,900.8**	1,878.9	**1,901.0**	1,879.6
Total equity and liabilities		**39,535.9**	41,138.6	**39,119.1**	40,704.5

* Comparative information has been re-presented to be consistent with the current year. As a result, fair value hedge accounting adjustments of £(10.0) million, previously included in customer deposits have been presented in fair value adjustments for portfolio hedged risk.

The accompanying notes are an integral part of the consolidated financial statements. The consolidated financial statements on pages 21 to 73 were approved by the Board of Directors on 30 January 2020 and signed on its behalf by:

Debbie Crosbie
Chief Executive

Ralph Coates
Chief Financial Officer

Consolidated statement of comprehensive income

for the year ended 31 December 2019

Income statement:	Note	Bank 2019 £ million	Bank 2018 £ million
Interest and similar income:			
Interest income calculated using the effective interest method	12	**1,050.6**	1,072.2
Other interest income	12	**(5.8)**	(2.0)
Total interest and similar income		**1,044.8**	1,070.2
Interest and similar expense	12	**(203.7)**	(185.4)
Net interest income	12	**841.1**	884.8
Fee and commission income	13	**159.8**	122.1
Fee and commission expense	13	**(41.5)**	(46.7)
Net fee and commission income	13	**118.3**	75.4
Net gains/(losses) on financial assets and liabilities:			
Gains on derecognition of financial assets measured at fair value through other comprehensive income		**24.6**	21.4
Gains on equity instruments at fair value through profit or loss		**–**	1.4
Losses on derivative financial assets at fair value through profit or loss		**(15.3)**	(31.8)
Gains from hedge accounting	23	**20.8**	23.3
(Losses)/gains on derecognition of non-financial assets		**(3.5)**	1.1
Other operating income:			
Migration related income from Lloyds Banking Group	14	**–**	318.3
Other operating income	14	**1.2**	1.4
Other income		**146.1**	410.5
Total income		**987.2**	1,295.3
Operating expenses excluding costs of preparing for migration	15	**(881.3)**	(905.7)
Costs of preparing for migration	15	**–**	(417.3)
Total operating expenses	15	**(881.3)**	(1,323.0)
Operating profit/(loss) before impairment losses and taxation		**105.9**	(27.7)
Impairment losses on loans and advances to customers	10	**(60.9)**	(72.8)
Impairment credit/(loss) on loan commitments	31	**0.4**	(0.5)
Total impairment losses		**(60.5)**	(73.3)
Profit/(loss) before taxation		**45.4**	(101.0)
Taxation	18	**(19.2)**	41.9
Profit/(loss) for the year	24	**26.2**	(59.1)
Other comprehensive income/(loss):			
Items that may be subsequently reclassified to profit or loss:			
Change in fair value reserve:			
Change in fair value		**17.3**	9.6
Gains transferred to profit or loss on disposal		**(24.6)**	(7.3)
Taxation thereon	19	**2.3**	(0.6)
	24	**(5.0)**	1.7
Change in cash flow hedging reserve:			
Change in the fair value of derivatives in cash flow hedges		**(24.4)**	(3.8)
Transfers to the income statement		**24.4**	1.1
Taxation thereon	19	**0.7**	
	24	**0.7**	(2.7)
Other comprehensive loss for the year, net of taxation		**(4.3)**	(1.0)
Total comprehensive income/(loss) for the year		**21.9**	(60.1)

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

Statements of changes in equity
for the year ended 31 December 2019

Bank	Share capital £ million	Share premium £ million	Merger reserve £ million	Fair value reserve £ million	Cash flow hedging reserve £ million	Retained profit £ million	Shareholder's equity £ million
Balance at 1 January 2018	79.4	195.6	412.8	16.9	(0.5)	1,234.8	1,939.0
Comprehensive loss:							
Loss for the year	–	–	–	–	–	(59.1)	(59.1)
Other comprehensive income/(loss)	–	–	–	1.7	(2.7)	–	(1.0)
Total comprehensive income/(loss)	–	–	–	1.7	(2.7)	(59.1)	(60.1)
Balance at 31 December 2018	79.4	195.6	412.8	18.6	(3.2)	1,175.7	1,878.9
Comprehensive income/(loss):							
Profit for the year	**–**	**–**	**–**	**–**	**–**	**26.2**	**26.2**
Other comprehensive (loss)/income	**–**	**–**	**–**	**(5.0)**	**0.7**	**–**	**(4.3)**
Total comprehensive (loss)/income	**–**	**–**	**–**	**(5.0)**	**0.7**	**26.2**	**21.9**
Balance at 31 December 2019	**79.4**	**195.6**	**412.8**	**13.6**	**(2.5)**	**1,201.9**	**1,900.8**

Company	Share capital £ million	Share premium £ million	Merger reserve £ million	Fair value reserve £ million	Cash flow hedging reserve £ million	Retained profit £ million	Shareholder's equity £ million
Balance at 1 January 2018	79.4	195.6	412.8	16.9	–	1,234.8	1,939.5
Comprehensive loss:							
Loss for the year	–	–	–	–	–	(59.1)	(59.1)
Other comprehensive income/(loss)	–	–	–	1.7	(2.5)	–	(0.8)
Total comprehensive income/(loss)	–	–	–	1.7	(2.5)	(59.1)	(59.9)
Balance at 31 December 2018	79.4	195.6	412.8	18.6	(2.5)	1,175.7	1,879.6
Comprehensive income/(loss):							
Profit for the year	**–**	**–**	**–**	**–**	**–**	**26.2**	**26.2**
Other comprehensive (loss)/income	**–**	**–**	**–**	**(5.0)**	**0.2**	**–**	**(4.8)**
Total comprehensive loss/income	**–**	**–**	**–**	**(5.0)**	**0.2**	**26.2**	**21.4**
Balance at 31 December 2019	**79.4**	**195.6**	**412.8**	**13.6**	**(2.3)**	**1,201.9**	**1,901.0**

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

Cash flow statements

for the year ended 31 December 2019

	Note	Bank 2019 £ million	Bank 2018* £ million	Company 2019 £ million	Company 2018* £ million
Cash flows from operating activities					
Profit/(loss) before taxation		**45.4**	(101.0)	**45.4**	(101.0)
Adjustments for:					
Change in operating assets and liabilities	33	**(596.3)**	(352.3)	**(614.2)**	(312.0)
Non-cash and other items	33	**170.1**	152.4	**190.3**	148.1
Taxation received/(paid)		**20.5**	(7.0)	**20.5**	(7.0)
Net cash used in operating activities		**(360.3)**	(307.9)	**(358.0)**	(271.9)
Cash flows from investing activities					
Purchase of property, equipment		**(18.0)**	(15.8)	**(18.0)**	(15.8)
Purchase and development of intangible assets		**(7.6)**	(11.8)	**(7.6)**	(11.8)
Purchase of debt securities		**(994.9)**	(1,757.0)	**(994.9)**	(1,757.0)
Sale of debt securities		**1,424.3**	1,358.9	**1,424.3**	1,358.9
Proceeds on disposal of Visa Inc. convertible preferred stock		**–**	9.2	**–**	9.2
Interest received		**53.2**	77.0	**53.2**	77.0
Net cash used in investing activities		**457.0**	(339.5)	**457.0**	(339.5)
Cash flows from financing activities					
Proceeds from borrowings from central banks		**–**	850.0	**–**	850.0
Repayments of borrowings from central banks		**(1,995.0)**	–	**(1,995.0)**	–
Issue of debt securities in issue		**750.0**	–	**750.0**	–
Repayment of debt securities in issue		**(177.5)**	(197.9)	**–**	(0.2)
Repayments of repurchase agreements		**(1,084.5)**	(361.9)	**(1,084.5)**	(361.9)
Net securitisation funding		**–**	–	**(179.8)**	(241.7)
Lease payments		**(38.8)**	–	**(38.8)**	–
Interest paid		**(94.0)**	(70.3)	**(94.0)**	(62.3)
Net cash provided by financing activities		**(2,639.8)**	219.9	**(2,642.1)**	183.9
Change in cash and cash equivalents		**(2,543.1)**	(427.5)	**(2,543.1)**	(427.5)
Cash and cash equivalents at 1 January	33	**7,135.9**	7,563.4	**7,135.9**	7,563.4
Cash and cash equivalents at 31 December	33	**4,592.8**	7,135.9	**4,592.8**	7,135.9

* Comparative information for 2018 has been reclassified to align with the current year presentation. This has resulted in cash outflows from the purchase and development of intangible assets of £11.8 million being reclassified from operating activities to investing activities and cash inflows from the sale of Sabadell shares of £0.9 million being reclassified from investment activities to operating activities. The overall effect was a reduction in net cash used in operating activities of £10.9 million, with a corresponding increase in net cash used in investing activities.

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. Our shareholder also provides some funding in the form of equity capital in the business.(see notes 22 and 24)

Accounting policies relevant to sources of funding

(a) Financial liabilities

Financial liabilities is the term used to describe the Bank's deposits and funding. It includes customer deposits, deposits from credit institutions, borrowings from central banks, debt securities in issue, subordinated liabilities, other financial liabilities and derivative financial liabilities (see accounting policy (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 the Bank has discharged its obligations, the contract is cancelled or the contract expires.

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

1. Customer deposits

	Bank 2019 £ million	Bank 2018* £ million	Company 2019 £ million	Company 2018* £ million
Bank accounts	**10.860.9**	10,376.3	**10.860.9**	10,376.3
Instant access saving deposits	**14,952.8**	15,237.7	**14,952.8**	15,237.7
Deposits with agreed maturity	**2,934.5**	2,290.0	**2,934.5**	2,290.0
Business banking deposits	**1,434.2**	1,190.3	**1,434.2**	1,190.3
Total customer deposits	**30,182.4**	29,094.3	**30,182.4**	29,094.3

* Comparative information has been re-presented to be consistent with the current year. As a result, fair value hedge accounting adjustments of £(10.0) million, previously included in bank accounts have been presented in fair value adjustments for portfolio hedged risk.

2. Debt securities in issue

2019 Bank	Balance at 1 Jan 2019 £ million	(Repayments)/ Issues £ million	Exchange and other adjustments £ million	Balance at 31 Dec 2019 £ million
Securitisation programmes:				
Duncan Funding 2015-1 plc	**418.6**	**(48.2)**	**(14.7)**	**355.7**
Duncan Funding 2016-1 plc	**205.6**	**(129.3)**	**(5.5)**	**70.8**
	624.2	**(177.5)**	**(20.2)**	**426.5**
Covered bond programme:				
Series 2017-1 Covered Bonds	**498.4**		**0.5**	**498.9**
Series 2019-1 Covered Bonds		**750.0**	**0.9**	**750.9**
Total debt securities in issue	**1,122.6**	**572.5**	**(18.8)**	**1,676.3**

2018 Bank	Balance at 1 Jan 2018 £ million	(Repayments)/ Issues £ million	Exchange and other adjustments £ million	Balance at 31 Dec 2018 £ million
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
Debt securities issues in an EU Member State not requiring filing of a prospectus				
Total debt securities in issue	1,318.7	(196.4)	0.3	1,122.6

Notes to the consolidated financial statements

Sources of Funding (continued)

2. Debt Securities in issue (continued)

Bank	Date of issue	Amount 31 Dec 2019 £ million	Amount 31 Dec 2018 £ million	Interest rate at 31 Dec 2019	Maturity date	Issue currency	Target of offering
Issuing entity							
Duncan Funding 2015-1 plc	11/2015	**101.5**	149.5	1.49%	09/2020	GBR	Institutional
Duncan Funding 2015-1 plc	11/2015	**254.2**	269.1	0.08%	09/2020	EUR	Institutional
Duncan Funding 2016-1 plc	05/2016	**15.8**	48.1	–	04/2021	EUR	Institutional
Duncan Funding 2016-1 plc	05/2016	**55.0**	157.5	1.56%	04/2021	GBR	Institutional
TSB Bank plc	12/2017	**498.9**	498.4	1.02%	12/2022	GBR	Institutional
TSB Bank plc	02/2019	**750.9**	-	1.58%	02/2024	GBR	Institutional
Total debt securities in issue		**1,676.3**	1,122.6				

Company	Balance at 1 Jan 2019 £ million	Issues/ (Repayments) £ million	Exchange rate and other adjustments £ million	Balance at 31 Dec 2019 £ million
Series 2017-1 Covered Bonds	**498.4**		**0.5**	**498.9**
Series 2019-1 Covered Bonds	**-**	**750.0**	**0.9**	**750.9**
Total debt securities in issue	**498.4**	**750.0**	**1.4**	**1,249.8**

Company	Balance at 1 Jan 2018 £ million	Issues/ (Repayments) £ million	Exchange rate and other adjustments £ million	Balance at 31 Dec 2018 £ million
Series 2017-1 Covered Bonds	498.0	–	0.4	498.4
Total debt securities in issue	498.0	–	0.4	498.4

Company	Date of issue	Amount 31 Dec 2019 £ million	Amount 31 Dec 2018 £ million	Interest rate at 31 Dec 2019	Maturity date	Issue currency	Target of offering
Issuing entity							
TSB Bank plc	12/2017	**498.9**	498.4	1.02%	12/2022	GBR	Institutional
TSB Bank plc	02/2019	**750.9**	-	1.58%	02/2024	GBR	Institutional
Total debt securities in issue		**1,249.8**	498.4				

Securitisation programmes

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

The Bank'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.

Bank	31 December 2019 Loans and advances securitised[(1)] £ million	31 December 2019 Liability £ million	31 December 2018 Loans and advances securitised[(1)] £ million	31 December 2018 Liability £ million
Securitisation programmes:				
Duncan Funding 2015-1 plc	**1,191.7**	**1,293.5**	1,370.9	1,486.4
Duncan Funding 2016-1 plc	**2,086.6**	**2,241.7**	2,386.1	2,546.1
	3,278.3	**3,535.2**	3,757.0	4,032.5
Less held by the Bank		**(3,108.7)**		(3,408.3)
Total securitisation notes		**426.5**		624.2

(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.

Notes to the consolidated financial statements

Sources of Funding (continued)

2. Debt Securities in issue (continued)

Securitisation programmes (continued)
Cash deposits of £342.5 million (2018: £342.3 million) held by the Bank are restricted in use to repayment of the debt securities issued by the structured entities and other legal obligations. The Bank recognises the full liabilities associated with its securitisation programmes within debt securities in issue, although the obligations of the Bank are limited to the cash flows generated from the underlying assets.

Covered bond programmes
Loans and advances to customers of £1,802.2 million (2018: £1,311.5 million) have been assigned to a limited liability partnership to provide security for issues of covered bonds by the Bank. The Bank retains all of the risks and rewards associated with these loans and the partnership is consolidated fully with the loans retained on the Bank's balance sheet, and the related covered bonds in issue included within debt securities in issue.

Cash deposits of £30.7 million (2018: £28.3 million) held by the Bank are restricted in use to repayment of the term advances related to covered bonds and other legal obligations. At 31 December 2019, the Bank had over-collateralised the covered bond programmes in order to: meet the programme terms; secure the rating of the covered bonds; and to provide operational flexibility. The obligations of the Bank to provide collateral may increase due to the formal requirements of the programmes. The Bank may also voluntarily contribute collateral to support the ratings of the covered bonds.

3. Subordinated liabilities

	Bank 2019 £ million	Bank 2018 £ million	Company 2019 £ million	Company 2018 £ million
Fixed/floating rate reset callable subordinated Tier 2 notes due May 2026	**384.6**	384.4	**384.6**	384.4
Accrued interest	**3.4**	3.4	**3.4**	3.4
Fair value hedge accounting adjustments	**7.9**	10.4	**7.9**	10.4
Total subordinated liabilities	**395.9**	398.2	**395.9**	398.2

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

4. Repurchase agreements

As part of its liquidity management activities, from time to time the Company enters in to repurchase agreements that transfer 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 are not derecognised from the consolidated balance sheet as substantially all of the rewards, including interest income, and risks, including credit and interest rate risks, are retained by the Bank. In all cases, the transferee has the right to sell or repledge the gilts concerned, subject to delivering the securities at the repurchase date. The table below presents the carrying values, including accrued interest, of the transferred gilts and the associated repurchase agreement liabilities. The associated liabilities represent the Company's TSB's obligation to repurchase the transferred assets.

Bank and Company	Carrying amount of transferred assets 2019 £ million	Carrying amount of associated liabilities 2019 £ million	Carrying amount of transferred assets 2018 £ million	Carrying amount of associated liabilities 2018 £ million
Repurchase agreements with non-credit institutions	**–**	**–**	1,084.5	1,084.8
Repurchase agreements	**–**	**–**	1,084.5	1,084.8

Notes to the consolidated financial statements

Sources of Funding (continued)

5. Fair value of financial liabilities

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

Bank	Note	2019 Carrying value £ million	2019 Fair value £ million	2018 Carrying value £ million	2018 Fair value £ million
Financial liabilities					
Customer deposits	1	**30,182.4**	**30,214.6**	29,094.3	29,096.4
Debt securities in issue	2	**1,676.3**	**1,684.4**	1,122.6	1,121.4
Subordinated liabilities	3	**395.9**	**398.3**	398.2	381.1
Derivative liabilities at fair value through profit or loss	23	**127.9**	**127.9**	93.1	93.1
Hedging derivative liabilities	23	**288.5**	**288.5**	346.0	346.0

Company	Note	2019 Carrying value £ million	2019 Fair value £ million	2018 Carrying value £ million	2018 Fair value £ million
Financial liabilities					
Customer deposits	1	**30,182.4**	**30,214.6**	29,094.3	29,096.4
Debt securities in issue	2	**1,249.8**	**1,257.3**	498.4	496.5
Subordinated liabilities	3	**395.9**	**398.3**	398.2	381.1
Derivative liabilities at fair value through profit or loss	23	**127.9**	**127.9**	93.1	93.1
Hedging derivative liabilities	23	**288.5**	**288.5**	346.0	346.0

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.

The fair values of the Bank's financial liabilities that are traded in active markets are based on current offer prices. For those instruments which do not have an active market, fair values have been determined using valuation techniques which include reference to recent arm's length transactions, or reference to other instruments with characteristics similar to those of the instruments held by the Bank. Valuation techniques used include discounted cash flow analysis and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by the Bank.

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

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

Level 1 - Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities.
Level 2 - Level 2 valuations are those where quoted market prices are not available, for example where the instrument is traded in a market that is not considered to be active or valuation techniques are used to determine fair value and where these techniques use inputs that are based significantly on observable market data.
Level 3 - Level 3 portfolios are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data.

Notes to the consolidated financial statements

Sources of Funding (continued)

5. Fair value of financial liabilities (continued)

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

Bank	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2019					
Customer deposits	**–**	**30,214.6**	**–**	**30,214.6**	**30,182.4**
Debt securities in issue	**1,684.4**	**–**	**–**	**1,684.4**	**1,676.3**
Subordinated liabilities	**–**	**398.3**	**–**	**398.3**	**395.9**
Derivative liabilities at fair value through profit or loss		**127.9**	–	**127.9**	**127.9**
Hedging derivative liabilities		**288.5**	–	**288.5**	**288.5**
At 31 December 2018					
Customer deposits	–	29,096.4	–	29,096.4	29,094.3
Debt securities in issue	1,121.4	–	–	1,121.4	1,122.6
Subordinated liabilities	–	381.1	–	381.1	398.2
Derivative liabilities at fair value through profit or loss	–	93.1	–	93.1	93.1
Hedging derivative liabilities	–	346.0	–	346.0	346.0

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

Company	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2019					
Customer deposits	**–**	**30,214.6**	**–**	**30,214.6**	**30,182.4**
Debt securities in issue	**1,257.3**	**–**	**–**	**1,257.3**	**1,249.8**
Subordinated liabilities	**–**	**398.3**	**–**	**398.3**	**395.9**
Derivative liabilities at fair value through profit or loss		**127.9**	–	**127.9**	**127.9**
Hedging derivative liabilities		**288.5**	–	**288.5**	**288.5**
At 31 December 2018					
Customer deposits	–	29,096.4	–	29,096.4	29,094.3
Debt securities in issue	496.5	–	–	496.5	498.4
Subordinated liabilities	–	381.1	–	381.1	398.2
Derivative liabilities at fair value through profit or loss	–	93.1	–	93.1	93.1
Hedging derivative liabilities	–	346.0	–	346.0	346.0

Notes to the consolidated financial statements

Loans and liquid assets

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

Accounting policies effective for the year ended December 2019

(b) Classification and measurement of financial assets

Financial assets is the term used to describe the Bank's loans to customers and other institutions. It includes loans and advances to customers, 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 (j) 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 the Bank's business model for managing the financial assets and whether the cash flows represent solely payments of principal and interest.

The Bank 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. The Bank 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. The Bank'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 (j) 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 and liquid assets (continued)

Accounting policies effective for the year ended December 2019 (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. The Bank policy is not to rebut the presumption in IFRS 9 that loans which are more than 90 days past due are in default.

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. 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. The main factor that is considered by The Bank is an increase in the residual lifetime Probability of Default (PD) since initial recognition. A loan will be considered to have experienced a significant increase in credit risk, and be transferred from stage 1 to stage 2 if the residual lifetime PD has increased by a factor of 2 times the origination PD and the increase is at least 10 bps (for mortgages) and between 30 and 100 bps for unsecured products. As a secondary assessment criterion, financial assets that are in forbearance but not credit impaired are considered to have experienced significant increase in credit risk and will be in stage 2. As a backstop, The Bank does not rebut the presumption in IFRS 9 that all financial assets that are more than 30 days past due have experienced a significant increase in credit risk.

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

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. The Bank assesses a loan as stage 3 when contractual payments of either principal or interest are past due for more than 90 days, the debtor is assessed as unlikely to pay, or the loan is otherwise considered to be in default.

Notes to the consolidated financial statements

Loans and liquid assets (continued)

Accounting policies effective for the year ended December 2019 (continued)

(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 The Bank 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

The allowance for ECLs is 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.

ECL is calculated by multiplying the PD (12 month or lifetime depending on the staging of the loan), LGD and EAD. In respect of TSB's mortgages and unsecured personal loans, ECL is calculated from the initial recognition of the loan for the maximum contractual period that TSB is exposed to credit risk. However, in respect of revolving loans, such as overdrafts and credit cards, TSB's exposure to credit risk is not limited to the contractual period and therefore the expected life is calculated based on the estimated behavioural life of the loan and associated undrawn facility. The measurement of ECL also takes in to account all reasonable and supportable information, including forward looking economic scenarios to calculate a probability weighted forward looking estimate.

(d) Derecognition of financial assets

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

Securitisations

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

Repurchase agreements

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

Notes to the consolidated financial statements

Loans and liquid assets (continued)

6. Debt securities

Bank and Company

Fair value through other comprehensive income (FVOCI)	2019 £ million	2018 £ million
UK Gilts	**1,171.4**	1,962.5
Supranational and development bank bonds	**416.0**	425.3
Total debt securities at FVOCI	**1,587.4**	2,387.8

Amortised cost	2019 £ million	2018 £ million
UK Gilts	**102.9**	96.2
Supranational and development bank bonds	**279.4**	–
Covered bonds	**166.3**	–
Total debt securities at amortised cost	**548.6**	96.2

Debt securities of £1,587.4 million (2018: £2,387.8 million) are held as part of the 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, a second portfolio of liquid assets was established, which at 31 December 2019 held £548.6 million (2018: £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 2019 UK gilts at FVOCI with a carrying value, including accrued interest, of £nil million (2018: £1,084.5 million) were subject to repurchase agreements (note 4). A further £131.7 million had been pledged as collateral (2018: £37.0 million).

7. Loans to credit institutions

	Bank 2019 £ million	Bank 2018 £ million	Company 2019 £ million	Company 2018 £ million
Cash deposits held	**373.2**	370.6	–	–
Total loans to credit institutions	**373.2**	370.6	–	–

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

Notes to the consolidated financial statements

Loans and liquid assets (continued)

8. Loans and advances to customers

	Bank 2019 £ million	Bank 2018 £ million	Company 2019 £ million	Company 2018 £ million
Secured (retail)	**29,189.2**	27,930.3	**29,189.2**	27,930.3
Unsecured and business banking [(1)]	**1,986.2**	2,214.7	**1,986.2**	2,214.7
Valuation adjustments [(2)]	**63.4**	62.2	**63.4**	62.2
Gross loans and advances to customers	**31,238.8**	30,207.2	**31,238.8**	30,207.2
Allowance for credit impairment losses [(3)] (note 10)	**(163.0)**	(198.7)	**(163.0)**	(198.7)
Loans and advances to customers	**31,075.8**	30,008.5	**31,075.8**	30,008.5

(1) Comprises unsecured lending of £1,855.1 million (2018: £2,067.5 million) and business banking lending of £131.1 million (2018: £147.2 million).
(2) Valuation adjustments comprise of accrued interest and effective interest rate adjustments.
(3) Comprises allowance for credit impairment losses on secured lending of £34.7 million (2018: £36.5 million), unsecured lending of £125.1 million (2018: £160.2 million) and business banking lending of £3.2 million (2018: £2.0 million).

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

	Bank 2019 £ million	Bank 2018 £ million	Company 2019 £ million	Company 2018 £ million
Credit cards	**2,697.5**	2,661.8	**2,697.5**	2,661.8
Mortgage offers made	**1,164.5**	1,030.0	**1,164.5**	1,030.0
Current accounts and other lending	**1,091.6**	1,086.3	**1,091.6**	1,086.3
Total commitments	**4,953.6**	4,778.1	**4,953.6**	4,778.1

(1) Includes Whistletree of £280.8 million (2018: £282.8 million).

The credit impairment provision in respect of total loan commitments was £2.6 million (2018: £3.0 million) as set out in note 31 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 10.

Of the amounts shown above, £1,471 million (2018: £1,312.9 million) was irrevocable. Commitments to lend to customers of £4,718.6 million (2018: £4,540.1 million) had a contractual maturity of less than one year.

9. Other advances

	Bank 2019 £ million	Bank 2018 £ million	Company 2019 £ million	Company 2018 £ million
Items in the course of collection from credit institutions	**16.6**	27.6	**16.6**	27.6
Items in the course of collection from non-credit institutions	**0.4**	14.8	**0.4**	14.8
Collateral placed at central clearing houses	**257.3**	326.2	**257.3**	326.2
Collateral placed with credit institutions	**5.3**	12.8	**5.3**	12.8
Total other advances	**279.6**	381.4	**279.6**	381.4

Notes to the consolidated financial statements

Loans and liquid assets (continued)

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

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

TSB	Stage 1 Gross Loans £ million	Stage 1 Allow. for credit impairment losses £ million	Stage 2 Gross Loans £ million	Stage 2 Allow. for credit impairment losses £ million	Stage 3 Gross Loans £ million	Stage 3 Allow. for credit impairment losses £ million	POCI [1] Gross Loans £ million	POCI [1] Allow. for credit impairment losses £ million	Total Gross Loans £ million	Total Allow. for credit impairment losses £ million
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 impairment losses:										
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 Dec 2018 (incl. valuation adjustments)	26,732.5	**(50.8)**	**2,884.2**	**(69.7)**	**400.3**	**(71.0)**	**190.2**	**(7.2)**	**30,207.2**	**(198.7)**
Less: Valuation adjustments	(53.7)	**–**	(6.3)	**–**	(2.0)	**–**	(0.2)	**–**	(62.2)	**–**
At 31 December 2018	26,678.8	(50.8)	2,877.9	(69.7)	398.3	(71.0)	190.0	(7.2)	30,145.0	(198.7)
Changes reflected in impairment losses:										
Increases due to originations	**6,206.7**	**(23.3)**	**34.8**	–	**11.2**	–	**5.7**	–	**6,258.4**	**(23.3)**
Decreases due to repayments	**(4,400.8)**	**10.5**	**(612.7)**	**3.4**	**(72.4)**	**2.2**	**(34.4)**	**0.1**	**(5,120.3)**	**16.2**
Changes in credit risk [2]	–	**75.1**	–	**(82.5)**	–	**(23.7)**	–	**4.9**	–	**(26.2)**
Amounts written off	**(0.1)**	**–**	**(0.8)**	**0.7**	**(106.8)**	**68.3**	–	–	**(107.7)**	**69.0**
Transfers between stages:	**(302.9)**	**(63.8)**	**150.7**	**87.3**	**152.2**	**(23.5)**	–	–	–	–
To stage 1	**3,433.0**	**(80.6)**	**(3,413.5)**	**77.4**	**(19.5)**	**3.2**	**–**	**–**	**–**	**–**
To stage 2	**(3,710.8)**	**16.2**	**3,784.3**	**(22.2)**	**(73.5)**	**6.0**	**–**	**–**	**–**	**–**
To stage 3	**(25.1)**	**0.6**	**(220.1)**	**32.1**	**245.2**	**(32.7)**	**–**	**–**	**–**	**–**
At 31 December 2019	**28,181.7**	**(52.3)**	**2,449.9**	**(60.8)**	**382.5**	**(47.7)**	**161.3**	**(2.2)**	**31,175.4**	**(163.0)**

(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 recognised in the income statement of £60.9 million comprise of changes reflected in impairment losses and amounts written off gross loans and allowance for credit impairment losses, as set out in the table above, offset by amounts charged directly to the income statement, primarily cash recoveries.

During 2019, stage 1 balances increased reflecting net lending, primarily in the secured portfolio. Stage 2 balances decreased by £428.0 million to £2,449.9 million, primarily reflecting ongoing repayments by customers of principal and interest.

Stage 3 balances decreased by £15.8 million to £382.5 million. Transfers from stage 2 were in part due to a temporary increase in secured arrears earlier in 2019. While secured arrears subsequently improved, the reduction in stage 3 balances was muted by the effect of TSB's policy to apply a six month probation period before permitting stage 3 loans to transfer back to stage 2. Write offs increased in 2019, particularly in unsecured balances, following a temporary cessation during the post migration period in 2018.

Notes to the consolidated financial statements

Loans and liquid assets (continued)

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

The tables below set out movements 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 impairment losses £ million	Gross Loans £ million	Allow. for credit impairment losses £ million	Gross Loans £ million	Allow. for credit impairment losses £ million	Gross Loans £ million	Allow. for credit impairment losses £ million	Gross Loans £ million	Allow. for credit impairment 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 Dec 2018 (incl. valuation adjustments)	25,231.7	(17.6)	2,251.2	(4.4)	287.4	(7.5)	190.0	(7.0)	27,960.3	(36.5)
Less: Valuation adjustments	(29.4)		(0.3)		(0.1)		(0.2)		(30.0)	
At 31 December 2018	25,202.3	(17.6)	2,250.9	(4.4)	287.3	(7.5)	189.8	(7.0)	27,930.3	(36.5)
Changes reflected in imp. loss:										
Increases due to originations	**5,823.1**	**(18.3)**	**6.3**	–	**3.0**	–	**3.4**	–	**5,835.8**	**(18.3)**
Decreases due to repayments	**(4,054.6)**	**9.7**	**(425.6)**	**0.8**	**(62.8)**	**1.0**	**(32.0)**	–	**(4,575.0)**	**11.5**
Changes in credit risk	–	**12.8**	–	(7.7)	–	**(1.4)**	–	**4.9**	–	**8.6**
Amounts written off	**–**	**–**	**–**	**–**	**(1.9)**	**–**	**–**	**–**	**(1.9)**	**–**
Transfers between stages	**(223.4)**	**(2.9)**	**145.3**	**3.8**	**78.1**	**(0.9)**	**–**	**–**	**–**	**–**
To stage 1	**2,776.5**	**(5.6)**	**(2,762.9)**	**5.5**	**(13.6)**	**0.1**	**–**	**–**	**–**	**–**
To stage 2	**(2,990.1)**	**2.7**	**3,055.7**	**(3.9)**	**(65.6)**	**1.2**	**–**	**–**	**–**	**–**
To stage 3	**(9.8)**		**(147.5)**	**2.2**	**157.3**	**(2.2)**	**–**	**–**	**–**	**–**
At 31 December 2019	**26,747.4**	**(16.3)**	**1,976.9**	**(7.5)**	**303.7**	**(8.8)**	**161.2**	**(2.1)**	**29,189.2**	**(34.7)**

Unsecured and business banking	Gross Loans £ million	Allow. for credit impairment losses £ million	Gross Loans £ million	Allow. for credit impairment losses £ million	Gross Loans £ million	Allow. for credit impairment losses £ million	Gross Loans £ million	Allow. for credit impairment losses £ million	Gross Loans £ million	Allow. for credit impairment losses £ 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 Dec 2018 (incl. valuation adjustments)	1,500.8	(33.2)	633.0	(65.3)	112.9	(63.5)	0.2	(0.2)	2,246.9	(162.2)
Less: Valuation adjustment	(24.3)		(6.0)		(1.9)		0.0		(32.2)	
At 31 December 2018	1476.5	(33.2)	627.0	(65.3)	111.0	(63.5)	0.2	(0.2)	2,214.7	(162.2)
Changes reflected in imp. loss:										
Increases due to originations	**383.6**	**(5.0)**	**28.5**	–	**8.2**	–	**2.3**	–	**422.6**	**(5.0)**
Decreases due to repayments	**(346.2)**	**0.8**	**(187.1)**	**2.6**	**(9.6)**	**1.2**	**(2.4)**	**0.1**	**(545.3)**	**4.7**
Changes in credit risk	–	**62.3**	–	**(74.8)**	–	**(22.3)**	–	–	–	**(34.8)**
Amounts written off	**(0.1)**	**–**	**(0.8)**	**0.7**	**(104.9)**	**68.3**	–	–	**(105.8)**	**69.0**
Transfers between stages	**(79.5)**	**(60.9)**	**5.4**	**83.5**	**74.1**	**(22.6)**	**–**	**–**	**–**	**–**
To stage 1	**656.5**	**(75.0)**	**(650.6)**	**71.9**	**(5.9)**	**3.1**	**–**	**–**	**–**	**–**
To stage 2	**(720.7)**	**13.5**	**728.6**	**(18.3)**	**(7.9)**	**4.8**	**–**	**–**	**–**	**–**
To stage 3	**(15.3)**	**0.6**	**(72.6)**	**29.9**	**87.9**	**(30.5)**	**–**	**–**	**–**	**–**
At 31 December 2019	**1,434.3**	**(36.0)**	**473.0**	**(53.3)**	**78.8**	**(38.9)**	**0.1**	**(0.1)**	**1,986.2**	**(128.3)**

Gross loans written off during 2019 of £105.8 million (2018: £51.9 million) continued to be subject to enforcement action.

Loans and liquid assets (continued)

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

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

The measurement of ECL is complex and involves the use of significant judgement and estimation. Including the application of multiple forward-looking economic conditions into ECL. 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 2019, the allowance of £163.0 million (2018: £198.7 million) included PMAs of £57.6 million (2018: £51.4 million). These comprised of adjustments to secured impairment models of £30.0 million (2018: £30.9 million) and adjustments to unsecured and business banking impairment models of £27.6 million (2018: £20.5 million). The most significant adjustments to modelled outputs reflect management's judgement of risks associated with (i) interest only mortgage redemptions, (ii) customers' ability to service their borrowings in a higher interest rate environment, and (iii) estimating future discounts on realising collateral. PMAs are, themselves, primarily models in nature, where the methodology and output is subject to regular oversight. PMAs in respect of interest only mortgages are allocated to stages based on the relative proportion of risk weighted assets. The impairment models continue to be developed, including work to align with changes to capital models to adopt the required regulatory change in 2020 to a 90 day definition of default on the secured portfolio. These changes are expected to reduce the proportion of the allowance comprising of PMAs.

Methodology
TSB currently uses five 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. Key scenario assumptions are set using forecasts from external economists, including data published by the Bank of England, helping to ensure the IFRS 9 scenarios are unbiased and reflect 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 composition and severity of the other scenarios, the key variables are considered in the context of the Bank of England's forecast distribution and 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 represents the most likely economic forecast and is consistent with the central scenario used in TSB's medium term financial plan. It features a relatively hard, but smooth, Brexit where supply and demand remain balanced. Moderate GDP growth, consistent with recent experience at sub 2% is forecast over the period 2020-24. This scenario features a steady circa 4% unemployment rate with house prices trending gently higher in real terms and the Bank of England base rate remaining at historical lows, peaking at 1.25%.
- Upside – assumes a higher increase in productivity growth than the base case without the development of serious inflation and provides a more favourable interest rate environment for banks' earnings. Unemployment shows a steady decline to a low of 3%, marking a historical UK low. Wage growth supports faster house price growth.
- Mild downside – introduced in 2019 to capture the effects of a managed 'no deal' Brexit. This scenario assumes the UK economy endures a short, shallow recession. The employment market weakens to a degree with unemployment peaking at 5.1% which drives lower house prices with a peak to trough decline of 14.0%. While economic activity recovers quickly, the imposition of trade barriers with the EU contributes to weaker long run economic growth than the base case.
- Downside - assumes a rapid tightening of UK and global financial conditions that are 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 20.5% and unemployment peaking at 6.3%. 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.
- Severe downside – designed to capture a high impact, low probability extreme scenario consistent with a disorderly 'cliff edge no deal' Brexit. This scenario features a sharp increase in inflation, promoted by a severe decline in sterling. In response, interest rates increase, peaking at 4%, precipitating a sharp peak to trough decline in house prices of 34.5%.

Notes to the consolidated financial statements

Loans and liquid assets (continued)

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

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

The table below summarises the forecast economic scenarios applied in measuring ECL at 31 December 2019.

		At 31 December 2019				
		Base case %	**Upside %**	**Mild Down %**	**Downside**	**Severe Down %**
Scenario weighting		**40**	**10**	**20**	**25**	**5**
Unemployment	Peak rate	**3.8**	**3.8**	**5.1**	**6.3**	**9.2**
House prices	Peak-to-trough fall	**+ve**	**+ve**	**(14.0)**	**(20.5)**	**(34.5)**
Interest rates	Most extreme rate	**0.75**	**2.0**	**0.25**	**0.0**	**4.0**

		At 31 December 2018				
		Base case %	Upside %	Mild Down %	Downside	Severe Down %
Scenario weighting		65	15	-	20	-
Unemployment	Peak rate	4.2	4.2	-	6.4	-
House prices	Peak-to-trough fall	(3.1)	(3.1)	-	(25.6)	-
Interest rates	Most extreme rate	2.0	2.5	-	3.3	-

(1) The most extreme rate is the interest rate furthest from the current rate, either positive or negative.

Key variables in each of the scenarios are forecast over the period 2020-24. Beyond this, they are assumed to revert to a long term constant rate over a period of up to two years after the end of the initial forecast period. At 31 December 2019, the long term rates were assumed to be: unemployment at 3.6%; interest rates at 1.25%; and house price growth of 3.75% per annum.

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 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 19% higher (2018: 9% higher) than the ECL prepared using only base scenario assumptions.

The impairment provision is sensitive to alternative economic scenarios and weightings. At 31 December 2019, a 10% increase in the weighting of the downside scenario (from 25% to 35%), coupled with a 10% decrease in the weighting of the base scenario (from 40% to 30%) would result in an increase of £5 million in the impairment provision. Applying a weighting of 100% to the 2019 downside scenario would result in an increase in the impairment allowance of approximately £21 million.

At the end of 2018, a 10% switch to the downside from the base scenario would have increased the allowance by £11 million. Applying a 100% weighting to the 2018 downside scenario would have would have increased the allowance by £81 million.

Notes to the consolidated financial statements

Loans and liquid assets (continued)

11. Fair value of financial assets

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

Bank	Note	2019 Carrying value £ million	2019 Fair value £ million	2018 Carrying value £ million	2018 Fair value £ million
Financial assets					
Debt securities at amortised cost		**548.6**	**549.9**	96.2	95.1
Loans and advances to customers	8	**31,075.8**	**31,040.7**	30,008.5	29,962.0
Financial assets at fair value through other comprehensive income	6	**1,587.4**	**1,587.4**	2,387.8	2,387.8
Derivative financial assets at fair value through profit or loss	24	**111.5**	**111.5**	88.4	88.4
Hedging derivative financial assets	24	**93.4**	**93.4**	106.6	106.6
Financial assets at fair value through profit or loss		**–**	**–**	1.4	1.4

Company	Note	2019 Carrying value £ million	2019 Fair value £ million	2018 Carrying value £ million	2018 Fair value £ million
Financial assets					
Debt securities at amortised cost	6	**548.6**	**549.9**	96.2	95.1
Loans and advances to customers	8	**31,075.8**	**31,040.7**	30,008.5	29,962.0
Financial assets at fair value through other comprehensive income	6	**1,587.4**	**1,587.4**	2,387.8	2,387.8
Derivative financial assets at fair value through profit or loss	23	**111.5**	**111.5**	88.4	88.4
Hedging derivative financial assets	23	**49.8**	**49.8**	43.1	43.1
Financial assets at fair value through profit or loss	17	**–**	**–**	1.4	1.4

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.

11. 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.

Bank and Company	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
Debt securities at amortised cost	**549.9**	**–**	**–**	**549.9**	**548.6**
Loans and advances to customers	**–**	**–**	**31,040.7**	**31,040.7**	**31,075.8**
At 31 December 2019	**549.9**	**–**	**31,040.7**	**31,590.6**	**31,624.4**
At 31 December 2018	95.1	–	29,962.0	30,057.1	30,104.7

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

Notes to the consolidated financial statements

Loans and liquid assets (continued)

11. Fair value of financial assets (continued)

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

Bank	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2019					
Financial assets at fair value through other comprehensive income	**1,587.4**	**–**	**–**	**1,587.4**	**1,587.4**
Derivative assets at fair value through profit or loss	**–**	**111.5**	**–**	**111.5**	**111.5**
Hedging derivative assets	**–**	**93.4**	**–**	**93.4**	**93.4**
Total	**1,587.4**	**204.9**	**–**	**1,792.3**	**1,792.3**
At 31 December 2018					
Financial assets at fair value through other comprehensive income	2,387.8	–	–	2,387.8	2,387.8
Derivative assets at fair value through profit or loss	–	88.4	–	88.4	88.4
Hedging derivative assets	–	106.6	–	106.6	106.6
Financial assets at fair value through profit or loss	1.4	–	–	1.4	1.4
Total	2,389.2	195.0	–	2,584.2	2,584.2

Company	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2019					
Financial assets at fair value through other comprehensive income	**1,587.4**	**–**	**–**	**1,587.4**	**1,587.4**
Derivative assets at fair value through profit or loss	**–**	**111.5**	**–**	**111.5**	**111.5**
Hedging derivative assets	**–**	**49.8**	**–**	**49.8**	**49.8**
Total	**1,587.4**	**161.3**	**–**	**1,748.7**	**1,748.7**
At 31 December 2018					
Financial assets at fair value through other comprehensive income	2,387.8	–	–	2,387.8	2,387.8
Derivative assets at fair value through profit or loss	–	88.4	–	88.4	88.4
Hedging derivative assets	–	43.1	–	43.1	43.1
Financial assets at fair value through profit or loss	1.4	–	–	1.4	1.4
Total	2,389.2	131.5	–	2,520.7	2,520.7

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

	Bank	Bank	Company	Company
Level 3 financial assets	2019 £ million	2018 £ million	2019 £ million	2018 £ million
Balance at 1 January	**–**	7.0	**–**	7.0
Gains recognised on financial assets at fair value through profit or loss	**–**	2.2	**–**	2.2
Disposal of Visa Inc convertible preferred stock	**–**	(9.2)	**–**	(9.2)
Balance at 31 December	**–**	–	**–**	–

Gilts and supranational and development bank bonds are valued using quoted market prices and are therefore classified as Level 1 assets. 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. As such derivative financial instruments are classified as Level 2 assets.

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 2019

(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 the bank that are an integral part of the overall return, direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument and all other premiums or discounts. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss (see accounting policy (c) on impairment of financial assets).

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 over time as the service is provided and TSB satisfies 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)

12. Net interest income

Bank	2019 £ million	2018 £ million
Interest and similar income		
Interest income calculated using the effective interest method:		
Cash, cash balances at central banks and other demand deposits	**47.0**	38.2
Financial assets at fair value through other comprehensive income	**24.5**	34.3
Debt securities at amortised cost	**4.3**	0.2
Loans to credit institutions	**2.1**	2.5
Loans and advances to customers	**972.7**	997.0
	1,050.6	1,072.2
Derivative financial instruments	**(5.8)**	(2.0)
Total interest and similar income	**1,044.8**	1,070.2
Interest and similar expense		
Interest expense calculated using the effective interest method:		
Borrowings from central banks	**(46.0)**	(38.5)
Deposits from credit institutions	**(0.2)**	(0.3)
Customer deposits	**(116.4)**	(121.4)
Repurchase agreements	**(1.8)**	(3.8)
Debt securities in issue	**(21.8)**	(13.0)
Subordinated liabilities	**(22.4)**	(22.4)
Lease liabilities	**(1.6)**	
	(210.2)	(199.4)
Derivative financial instruments	**6.5**	14.0
Total interest and similar expense	**(203.7)**	(185.4)
Net interest income	**841.1**	884.8

Included within interest and similar income is £18.7 million (2018: £16.2 million) in respect of impaired financial assets.

13. Net fee and commission income

Bank	2019 £ million	2018 £ million
Fee and commission income		
Bank accounts	**47.8**	46.1
Credit and debit card fee income	**85.7**	55.4
Insurance commission income	**11.0**	11.9
Other	**15.3**	8.7
Total fee and commission income	**159.8**	122.1
Fee and commission expense		
Bank accounts	**(28.2)**	(36.6)
Credit and debit card fee expense	**(0.2)**	(3.5)
Other	**(13.1)**	(6.6)
Total fee and commission expense	**(41.5)**	(46.7)
Net fee and commission income	**118.3**	75.4

Fees and commissions which are an integral part of the EIR are recognised in net interest income. Net fee and commission income includes £22.0 million (2018: £nil) in respect of changes made in 2019 to card servicing arrangements.

14. Other operating income

Bank	2019 £ million	2018 £ million
Migration related income from Lloyds Banking Group	**–**	318.3
Rental income	**0.8**	1.0
Dividend income	**–**	0.2
Other income	**0.4**	0.2
Total other operating income	**1.2**	319.7

Migration related income from LBG was recognised in 2018 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 employees, 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, the Bank complies with its tax obligations to HMRC.

Accounting policies relevant to recognising charges

(g) Pensions and other post-retirement benefits

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

(h) Share-based compensation

The Bank operates a number of cash settled share-based compensation plans, in respect of services received from certain of its employees. 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 a 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)

15. Operating expenses

Bank	2019 £ million	2018 £ million
Staff costs		
Wages and salaries	**260.0**	263.5
Social security costs	**26.6**	27.2
Other pension costs	**34.4**	35.1
Severance costs	**34.3**	
Share-based payments (note 17)	**1.3**	(2.7)
Other staff costs	**11.7**	10.2
Total staff costs	**368.3**	333.3
Premises expenses		
Rent	**5.4**	32.1
Rates, maintenance and other premises expenses	**48.3**	46.4
Total premises expenses	**53.7**	78.5
Other expenses		
IT servicing and license costs	**194.1**	178.8[2]
Regulatory, legal and consultancy costs	**72.7**	63.7
Marketing	**40.3**	55.4
Other expenses [1]	**131.6**	146.6[2]
Migration related other expenses:		
Post migration customer redress and rectification	**–**	125.2
Post migration related fraud and operational losses	**–**	49.1
Recovery of additional post migration charges	**(39.6)**	(153.0)
Total other expenses	**399.1**	465.8
Depreciation of property and equipment	**26.3**	24.6
Depreciation of right of use asset	**28.2**	–
Amortisation of intangible assets	**5.7**	3.5
Operating expenses excluding the costs of preparing for TSB's migration	**881.3**	905.7
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	**881.3**	1,323.0

(1) Other expenses primarily comprise of the costs of various operational contracts, costs of non-staff contractors, fraud and operational losses.
(2) In order to align with the current year presentation £13.5 million has been reclassified from other expenses to IT servicing and license costs.

Significant estimate

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 provisional agreement, subject to mutual reservation of rights while negotiations are concluded, where TSB will recover an aggregate of £192.6 million (2018: £153.0 million) under the respective contracts, reflecting the maximum recovery amount under the contracts. Consequently, in light of this provisional agreement, post migration charges were reduced by recovery of £39.6 million in 2019 (2018: £153.0 million) under the MSA and OSA contracts.

Notes to the consolidated financial statements

Charges (continued)

15. Operating expenses (continued)

The monthly average number of employees on a headcount basis during the year was 8,198 (2018: 8,439), all of whom were employed in the UK. Included in employee costs is remuneration paid to key management personnel as set out in note 26(i).

Included in other expenses are fees paid to the Bank's auditors in respect of work carried out for the Bank of £4.4 million (2018: £4.5 million). Of this amount, £4.2 million (2018: £4.4 million) was in respect of the audit of the Bank's and Company's financial statements and £0.2 million (2018: £0.1 million) was in respect of non-audit services. In addition to the above fees payable to TSB's auditors, £0.4 million was paid to LBG in 2018 in respect of a review by their auditors of controls undertaken on TSB's behalf under the former Transitional Services Agreement with Lloyds Banking Group.

16. Directors' emoluments

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

	2019 £ 000	2018 £ 000
Remuneration paid to Directors in respect of qualifying services	**2,892**	2,474
Cash received under long-term incentive arrangements	**481**	–
Notice payments	–	1,239
Total	**3,373**	3,713

The aggregate remuneration, including cash received under long-term incentive arrangements, of the highest paid director was £1,442,660 (2018: £903,897) for qualifying services as a TSB director.

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

	2019 Number	2018 Number
Exercised share options	–	–
Received shares under long term incentive schemes	**1**	1
Accrued pension benefits under defined contribution pension schemes	**2**	1

17. Share-based payments

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

Bank	2019 £ million	2018 £ million
Share options – TSB Sharesave	**(1.8)**	0.2
Other share based compensation arrangements	**3.1**	(2.9)
	1.3	(2.7)

During 2019 and 2018, TSB operated a Sharesave scheme and a Share Incentive Plan (SIP), both of which provide all TSB employees with the opportunity to own shares in Sabadell and, in a limited number of instances, granted shares to certain senior employees as part of their recruitment arrangements. As all share-based compensation arrangements 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 increase in the share based payment expense reflects the net effect of accrual releases in 2018.

At 31 December 2019, £5.4 million (2018: £4.9 million) was recognised in respect of share-based payment liabilities

Notes to the consolidated financial statements

Charges (continued)

17. Share-based payments (continued)

Sharesave scheme

Eligible employees had the opportunity 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 employees may take the accumulated savings balance as a cash payment. Movements in the number of Sharesave options outstanding are set out below

Bank	2019		2018	
	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	11,990	77.68	13,001	77.68
Granted	–	–	–	–
Exercised	**(2,619)**	**77.68**	(197)	77.68
Forfeited	**(780)**	**77.68**	(499)	77.68
Cancelled	**(636)**	**77.68**	(315)	77.68
Outstanding at 31 December	**7,955**	**77.68**	11,990	77.68
Exercisable at 31 December	**7,955**	**77.68**	–	–

The options vested on 1 October 2019 and employees have until 31 March 2020 to exercise. At 31 December 2019, the fair value of the options, determined using a Black Scholes option pricing model, was 8.0 pence (2018: 17.0 pence) and a liability of £0.6 million (2018: £2.5 million) was recognised on the consolidated balance sheet.

Economic hedging of share based compensation liability
An explanation of the instruments transacted to economically hedge TSB's exposure to share based payment liabilities is set out in note 26(ii).

18. Taxation

The table below sets out the (charge)/credit to UK corporation tax recognised in the income statement:

Bank	2019 £ million	2018 £ million
UK corporation tax		
Current tax (charge)/credit on profit/(loss) for the year	–	23.1
Adjustments in respect of prior years	**0.7**	(2.8)
Current tax credit/(charge)	**0.7**	20.3
Deferred tax (note 19)		
Origination and reversal of temporary differences:		
Deferred tax charge on business transfers	**(20.9)**	(19.3)
Accelerated capital allowances	**0.5**	0.6
Adjustments in respect of prior years	**(0.7)**	3.4
Deferred tax credit in relation to trading losses	**3.8**	37.8
Other	**(2.6)**	(0.9)
Deferred tax (charge)/credit	**(19.9)**	21.6
Taxation (charge)/credit	**(19.2)**	41.9

Notes to the consolidated financial statements

Charges (continued)

18. Taxation (continued)

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

Bank	2019 £ million	2018 £ million
Profit/(loss) before taxation	**45.4**	(101.0)
Taxation (charge)/credit at applied UK corporation tax rate of 27.0% (2018: 27.0%)	**(12.3)**	27.3
Factors affecting charge:		
Disallowed costs	**(6.1)**	(85.8)
Non-taxable items	**–**	104.3
Changes to UK corporation tax rates	**(0.7)**	(4.5)
Adjustments in respect of prior years	**(0.1)**	0.6
Taxation (charge)/credit	**(19.2)**	41.9

The applied UK corporation tax rate of 27% for 2019 includes the 8% bank surcharge on profits in excess of £25 million together with the average UK corporation tax rate of 19%. Disallowed costs in 2019 primarily reflect restructuring costs. Disallowed costs and non-taxable items in 2018 primarily reflect costs incurred under the MSA and migration related income from LBG respectively.

19. Deferred tax assets

The movement in deferred tax assets is as follows:

	Bank 2019 £ million	Bank 2018 £ million	Company 2019 £ million	Company 2018 £ million
At 1 January	113.0	92.0	113.0	92.0
Income statement charge (note 18)	**(19.9)**	21.6	**(19.9)**	21.6
Amounts charged to equity:				
Movements in fair value reserve	**2.3**	(0.6)	**2.3**	(0.6)
Movements in cash flow hedge reserve	**0.7**	–	**0.7**	–
At 31 December	**96.1**	113.0	**96.1**	113.0

Deferred tax assets are comprised as follows:

	Bank 2019 £ million	Bank 2018 £ million	Company 2019 £ million	Company 2018 £ million
Deferred tax arising on business transfers	**38.0**	58.9	**38.0**	58.9
Deferred tax arising on carried forward trading losses	**46.0**	37.8	**46.0**	37.8
Deferred tax in respect of the transition to IFRS 9	**19.3**	21.7	**19.3**	21.7
Revaluations of financial assets at fair value through other comprehensive income	**(4.6)**	(6.9)	**(4.6)**	(6.9)
Deferred tax arising on cash flow hedge reserve	**0.7**	–	**0.7**	–
Other temporary differences	**(3.3)**	1.5	**(3.3)**	1.5
Total deferred tax assets	**96.1**	113.0	**96.1**	113.0

Significant judgement

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

Notes to the consolidated financial statements

Managing financial risk

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

Accounting policies relevant to managing financial risk

(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' 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.

Notes to the consolidated financial statements

Managing financial risk (continued)

20. Credit risk

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

(i) Maximum credit exposure

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

	Bank 2019 £ million	Bank 2018 £ million	Company 2019 £ million	Company 2018 £ million
Loans and advances to customers	**31,075.8**	30,008.5	**31,075.8**	30,008.5
Debt securities at fair value through other comprehensive income	**1,587.4**	2,387.8	**1,587.4**	2,387.8
Debt securities at amortised cost	**548.6**	96.2	**548.6**	96.2
Loans to central banks	**96.1**	87.8	**96.1**	87.8
Loans to credit institutions	**373.2**	370.6	–	–
Reverse repurchase agreements	**201.1**	–	**201.1**	–
Other advances	**279.6**	381.4	**279.6**	381.4
Financial assets subject to impairment requirements	**34,161.8**	33,332.3	**33,788.6**	32,961.7
Derivative financial assets a fair value through profit or loss	**111.5**	88.4	**111.5**	88.4
Hedging derivative financial assets	**93.4**	106.6	**49.8**	43.1
Total on balance sheet balance	**34,366.7**	33,527.3	**33,949.9**	33,093.2
Lending commitments	**4,953.6**	4,778.1	**4,953.6**	4,778.1
Maximum credit risk exposure	**39,320.3**	38,305.4	**38,903.5**	37,871.3

(ii) Quality of credit risk exposures

Debt securities and loans to central banks are with counterparties rated at least A (2018: AA). Loans to credit institutions are with counterparties rated at least A+ (2018: A+). Reverse repurchase agreements are with a counterparty rated AA-. The net uncollateralised balance of derivative financial instruments of £43.4 million (2018: £63.5 million) as set out in Note 23 is with counterparties rated A+ (2018: A+).

Loans and advances to customers

In assessing the credit quality of loans and advances to customers, 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 (including in default)	11-13

Notes to the consolidated financial statements

Managing financial risk (continued)

20. Credit risk (continued)

Secured (retail)

					2019					2018
	Stage 1 £ million	**Stage 2 £ million**	**Stage 3 £ million**	**POCI* £ million**	**Total £ million**	Stage 1 £ million	Stage 2 £ million	Stage 3 £ million	POCI* £ million	Total £ million
Excellent quality	**26,712.4**	**1,725.7**	**–**	**–**	**28,438.1**	25,200.2	1,988.1	13.1	–	27,201.4
Good quality	**29.2**	**102.2**	**–**	**–**	**131.4**	27.8	150.8	11.8	–	190.4
Satisfactory quality	**2.2**	**108.8**	**–**	**–**	**111.0**	2.1	97.1	24.9	–	124.1
Lower quality	**–**	**15.0**	**–**	**–**	**15.0**	0.3	8.3	6.7	–	15.3
Below standard (including in default)	**3.7**	**25.2**	**303.6**	**161.2**	**493.7**	1.3	6.9	230.9	190.0	429.1
Gross carrying amount	**26,747.5**	**1,976.9**	**303.6**	**161.2**	**29,189.2**	25,231.7	2,251.2	287.4	190.0	27,960.3

* Purchased or originated as credit impaired

Unsecured and business banking

					2019					2018
	Stage 1 £ million	**Stage 2 £ million**	**Stage 3 £ million**	**POCI* £ million**	**Total £ million**	Stage 1 £ million	Stage 2 £ million	Stage 3 £ million	POCI* £ million	Total £ million
Excellent quality	**524.6**	**59.9**	**0.8**	**–**	**585.3**	685.7	65.5	0.8	–	752.0
Good quality	**772.0**	**241.9**	**2.4**	**–**	**1,016.3**	677.0	395.9	2.5	–	1,075.4
Satisfactory quality	**123.2**	**119.2**	**3.3**	**–**	**245.7**	120.4	105.7	3.5	–	229.6
Lower quality	**9.5**	**22.1**	**1.8**	**–**	**33.4**	9.7	24.7	1.8	–	36.2
Below standard (including in default)	**5.1**	**29.7**	**70.6**	**0.1**	**105.5**	8.0	41.2	104.3	0.2	153.7
Gross carrying amount	**1,434.4**	**472.8**	**78.9**	**0.1**	**1,986.2**	1,500.8	633.0	112.9	0.2	2,246.9

Commitments

The table below sets out the credit quality, by stage, of lending commitments 31 December 2019. Comparative data for December 2018 was not available in the same format and is not presented.

					2019					2018
Commitments	**Stage 1 £ million**	**Stage 2 £ million**	**Stage 3 £ million**	**POCI £ million**	**Total £ million**	Stage 1 £ million	Stage 2 £ million	Stage 3 £ million	POCI £ million	Total £ million
Excellent quality	**4,037.5**	**461.1**	**2.1**	**–**	**4,500.7**	3,980.5	319.5	2.4	–	4,302.4
Good quality	**220.0**	**76.7**	**1.5**	**–**	**298.2**	256.6	79.3	1.7	–	337.6
Satisfactory quality	**51.4**	**29.3**	**1.0**	**–**	**81.7**	34.5	32.6	1.3	–	68.4
Lower quality	**1.2**	**11.2**	**0.4**	**–**	**12.8**	1.8	13.0	0.7	–	15.5
Below standard (including in default)	**0.5**	**3.3**	**36.7**	**19.7**	**60.2**	4.4	3.6	27.6	18.4	54.0
Total	**4,310.6**	**581.6**	**41.7**	**19.7**	**4,953.6**	4,277.8	448.0	33.7	18.4	4,777.9

(iii) Collateral held as security for financial assets

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

An analysis by loan-to-value (LTV) ratio of the Bank's 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.

				2019	**2018**
LTV of Secured (retail)	**Stage 1 £ million**	**Stage 2 £ million**	**POCI £ million**	**Stage 3 £ million**	**Stage 3 £ million**
Less than 70%	**18,880.4**	**1,593.0**	**114.0**	**211.8**	200.9
70% to 80%	**4,476.4**	**212.4**	**25.2**	**48.3**	45.1
80% to 90%	**2,839.2**	**125.2**	**14.5**	**24.4**	24.8
90% to 100%	**537.6**	**35.2**	**5.4**	**9.7**	11.6
Greater than 100%	**13.8**	**11.1**	**2.1**	**9.5**	5.0
Secured (retail)	**26,747.4**	**1,976.9**	**161.2**	**303.7**	287.4

Notes to the consolidated financial statements

Managing financial risk (continued)

20. Credit risk (continued)

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

Secured lending

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

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

The Bank operates a number of schemes to assist borrowers who are experiencing financial difficulties. Forbearance solutions may offer relief in the form of reductions to contractual payments, and for customers who have longer term financial difficulties, term extensions and 'repair' approaches such as capitalisation of arrears. At 31 December 2019, total forborne loans were £301.8 million (2018: £310.3 million), of which £163.4 million (2018: £182.4 million) were impaired. At 31 December 2019, the allowance for loan losses held in respect of forborne loans was £20.2 million (2018: £27.4 million).

21. Liquidity risk

Definition and exposure

Liquidity risk is the risk that the Bank is unable to meet its liabilities as they fall due, or is unable to maintain regulator, investor, customer or stakeholder confidence that this will be achieved. Liquidity risk is managed, monitored and measured from both an internal and regulatory perspective.

Sources of funding

The Bank's funding 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.

Risk appetite

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

Measurement and monitoring

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

Notes to the consolidated financial statements

Managing financial risk (continued)

21. Liquidity risk (continued)

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

Bank At 31 December 2019	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	**8.5**	**–**	**10.0**	**4,465.0**	**–**	**4,483.5**
Deposits from credit institutions	**0.7**	**–**	**–**	**–**	**–**	**0.7**
Customer deposits	**27,325.5**	**220.3**	**1,094.9**	**1,541.7**		**30,182.4**
Repurchase agreements	**–**	**–**	**–**	**–**	**–**	**–**
Debt securities in issue	**–**	**44.5**	**383.3**	**1,248.5**	**–**	**1,676.3**
Subordinated liabilities	**–**	**–**	**3.4**	**392.5**	**–**	**395.9**
Lease liabilities	**2.1**	**4.3**	**17.8**	**55.0**	**62.6**	**141.8**
Other financial liabilities	**80.0**	**–**	**–**	**–**	**–**	**80.0**
Derivative liabilities at fair value through profit or loss	**0.1**	**0.4**	**3.3**	**65.6**	**58.5**	**127.9**
Hedging derivative liabilities	**–**	**–**	**6.0**	**15.9**	**266.6**	**288.5**
Other liabilities [(1)]	**205.9**	**–**	**–**	**–**	**52.2**	**258.1**
Total liabilities	**27,622.8**	**269.5**	**1,518.7**	**7,784.2**	**439.9**	**37,635.1**

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

Assets						
Financial assets at amortised cost:						
Debt securities	**1.1**	**0.2**	**1.1**	**119.4**	**426.8**	**548.6**
Loans to central banks	**96.1**	**–**	**–**	**–**	**–**	**96.1**
Loans to credit institutions	**–**	**247.8**	**64.6**	**60.8**	**–**	**373.2**
Loans and advances to customers	**903.6**	**289.7**	**1,242.2**	**5,608.3**	**23,032.0**	**31,075.8**
Other advances	**279.6**	**–**	**–**	**–**	**–**	**279.6**
Reverse Repos	**–**	**201.1**	**–**	**–**	**–**	**201.1**
Financial assets at fair value through other comprehensive income	**0.3**	**1.9**	**8.4**	**–**	**1,576.8**	**1,587.4**
Derivative assets at fair value through profit or loss	**0.2**	**0.7**	**3.1**	**72.6**	**34.9**	**111.5**
Hedging derivative assets	**–**	**–**	**46.5**	**26.2**	**20.7**	**93.4**
Other assets [(2)]	**4,740.5**	**2.4**	**10.5**	**81.8**	**334.0**	**5,169.2**
Total assets	**6,021.4**	**743.8**	**1,376.4**	**5,969.1**	**25,425.2**	**39,535.9**

(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)

21. Liquidity risk (continued)

Bank 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	26,875.6	175.0	798.3	1,245.4	–	29,094.3
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
Derivative liabilities at fair value through profit or loss	0.3	0.3	1.2	32.7	58.6	93.1
Hedging derivative liabilities	–	2.6	0.8	27.3	315.3	346.0
Other liabilities	549.3	–	–	–	19.4	568.7
Total liabilities	28,592.0	231.6	934.2	9,108.6	393.3	39,259.7
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	381.4	–	–	–	–	381.4
Financial assets at fair value through other comprehensive income	0.3	1.0	10.9	48.0	2,327.6	2,387.8
Derivative assets at fair value through profit or loss	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	7,335.9	2.9	32.7	95.5	144.3	7,611.3
Total assets	8,792.1	466.7	1,032.9	6,408.4	24,438.5	41,138.6

Notes to the consolidated financial statements

Managing financial risk (continued)

21. 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 of the Bank by relevant contractual maturity grouping on an undiscounted future cash flow basis based on the remaining period at the balance sheet date.

Bank At 31 December 2019	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Financial liabilities						
Financial liabilities measured at amortised cost:						
Borrowings from central banks	**8.5**	–	**10.0**	**4,465.0**	–	**4,483.5**
Deposits from credit institutions	**0.7**	–	–	–	–	**0.7**
Customer deposits	**27,348.6**	**224.7**	**1,110.9**	**1,561.3**	–	**30,245.5**
Repurchase agreements	–	–	–	–	–	–
Debt securities in issue	**30.4**	**15.8**	**354.9**	**1,298.9**	–	**1,700.0**
Subordinated liabilities	–	–	**22.1**	**396.1**	–	**418.2**
Lease liabilities	**2.6**	**5.1**	**21.1**	**61.0**	**68.0**	**157.8**
Other financial liabilities	**80.6**	–	–	–	–	**80.6**
Total non-derivative financial liabilities	**27,471.4**	**245.6**	**1,519.0**	**7,782.3**	**68.0**	**37,086.3**
Gross settled derivative – outflows	**20.5**	**63.8**	**154.6**	**422.1**	**370.7**	**1,031.7**
Gross settled derivative – inflows	**(15.7)**	**(23.0)**	**(97.5)**	**(261.6)**	**(201.8)**	**(599.6)**
Total financial liabilities	**27,476.2**	**286.4**	**1,576.1**	**7,942.8**	**236.9**	**37,518.4**

Bank 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
Financial 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	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 settled derivative – outflows	14.9	19.6	158.4	549.7	545.9	1,288.5
Gross settled derivative – inflows	(13.2)	(16.8)	(100.5)	(332.1)	(359.2)	(821.8)
Total financial liabilities	28,173.8	226.4	1,021.1	9,251.5	186.7	38,859.5

Notes to the consolidated financial statements

Managing financial risk (continued)

21. Liquidity risk (continued)

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

Company At 31 December 2019	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Financial liabilities						
Financial liabilities measured at amortised cost:						
Borrowings from central banks	**8.5**	–	**10.0**	**4,465.0**	–	**4,483.5**
Deposits from credit institutions	**0.7**	–	–	–	–	**0.7**
Customer deposits	**27,348.6**	**224.7**	**1,110.9**	**1,561.3**	–	**30,245.5**
Repurchase agreements	–	–	–	–	–	–
Debt securities in issue	–	**4.3**	**12.7**	**1,298.9**	–	**1,315.9**
Subordinated liabilities	–	–	**22.1**	**396.1**	–	**418.2**
Lease liabilities	**2.6**	**5.1**	**21.1**	**61.0**	**68.0**	**157.8**
Other financial liabilities	**80.6**	–	–	–	–	**80.6**
Total non-derivative financial liabilities	**27,441.0**	**234.1**	**1,176.8**	**7,782.3**	**68.0**	**36,702.2**
Gross settled derivative - outflows	**20.5**	**63.8**	**154.6**	**422.1**	**370.7**	**1,031.7**
Gross settled derivative - inflows	**(15.7)**	**(23.0)**	**(97.5)**	**(261.6)**	**(201.8)**	**(599.6)**
Total financial liabilities	**27,445.8**	**274.9**	**1,233.9**	**7,942.8**	**236.9**	**37,134.3**

Company 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
Financial 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	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 settled derivative - outflows	14.9	20.5	158.4	549.7	545.9	1,289.4
Gross settled derivative - 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

22. Capital resources

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

	Bank 2019 £ million	Bank 2018 £ million	Company 2019 £ million	Company 2018 £ million
Shareholder's equity	**1,900.8**	1,878.9	**1,901.0**	1,879.6
Regulatory deductions	**(66.5)**	(58.3)	**(62.7)**	(59.0)
Common Equity Tier 1/Total Tier 1 capital	**1,834.3**	1,820.6	**1,838.3**	1,820.6
Tier 2 capital	**393.5**	390.6	**393.5**	390.6
Total capital resources	**2,231.8**	2,211.2	**2,231.8**	2,211.2

Notes to the consolidated financial statements

Managing financial risk (continued)

23. Market risk

Definition and exposure

Market risk is the risk of a reduction in earnings, value or reserves caused by changes in the prices of financial instruments. The Bank's market risk consists primarily of exposure to changes in interest rates. Interest rate risk is the risk that the net value of, or net income arising from, the firm's assets and liabilities is impacted as a result of changes to interest rates. Interest rate risk can arise as a result of changes in customer behaviour, which may affect the maturity profiles of the Bank's assets and liabilities. The Bank's exposure to changes in interest rates includes the margin between customer and market rates. This includes the potential impact on earnings and value that could occur when, if rates fall, liabilities cannot be re-priced as quickly or by as much as assets.

Management and measurement

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

A 12 month view of the sensitivity of net interest income is calculated on the basis of The Bank's current consolidated balance sheet with re-pricing dates adjusted according to behavioural assumptions. At 31 December 2019, 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 £12.8 million (2018: £20.3 million) from a 25bps increase in rates, and a decrease of £13.1 million (2018: £0.7 million) from a 25bps decrease. The measure assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount and does not take into account potential management actions.

Derivative financial instruments

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

Bank and Company	2019				2018			
Derivative financial instruments at fair value through profit or loss	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	**22,917.2**	**110.7**	**(127.9)**	**(14.7)**	18,301.0	86.5	(92.6)	(27.3)
Foreign exchange forwards	**–**	**–**	**–**	**0.4**	27.0	–	(0.5)	0.4
Equity options	**6.5**	**0.8**	**–**	**(1.0)**	8.7	1.9	–	(4.9)
Total	**22,923.7**	**111.5**	**(127.9)**	**(15.3)**	18,336.7	88.4	(93.1)	(31.8)

Bank and Company	2019				2018			
Hedging derivative financial 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	**14,292.8**	**44.6**	**(281.1)**	**(82.0)**	16,602.4	43.1	(343.5)	9.3
Interest rate and credit risk (Cash flow hedges)								
Forward settlement contracts	**190.0**	**2.9**	**–**	**1.8**	205.0	–	(2.5)	(2.5)
Interest rate (Cash flow hedges)								
Interest rate swaps	**404.9**	**2.3**	**(7.4)**	**(6.1)**	**–**	**–**	**–**	**–**
Foreign exchange risk (Cash flow hedges)[1]								
Cross currency rate swaps	**270.1**	**43.6**	**–**	**(20.0)**	317.6	63.5	–	(1.3)
Total	**15,157.8**	**93.4**	**(288.5)**	**(106.3)**	17,125.0	106.6	(346.0)	5.5

(1) Foreign exchange risk is only in respect of the bank and is not included in the Company financial statements

Notes to the consolidated financial statements

Managing financial risk (continued)

23. 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 'fair value through profit or loss'.

The Bank transacts derivatives largely to economically hedge interest rate risk. The loss on derivatives at fair value through profit or loss in respect of interest rate risk of £14.7 million (2018: £27.3 million) is largely offset by the gain of £18.2 million (2018: £25.3 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 described below.

Interest rate risk (fair value hedges)

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 as, together, they do not lead to significant income statement volatility. 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.

The Bank 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. The Group'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 a 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 swaps with a notional of £11,771.3 million currently reference LIBOR, and are designated fair value hedges of fixed rate exposures. An assessment of changes required to these instruments is currently underway. As noted on page 19, TSB has early adopted 'Interest Rate Benchmark Reform – Amendments to IFRS 9, IAS 39 and IFRS 9' and, therefore, it has been assumed that a change in the LIBOR interest rate benchmark arrangements would not be considered a modification to the hedging instrument and would not impact the hedge relationship.

Interest rate and credit risk (cash flow hedges)

The Bank seeks to minimise interest rate and credit risk arising on purchased debt securities, accounted for at fair value through other comprehensive income, using forward settlement contracts, accounted for as derivatives 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, the Group uses the hypothetical derivative method. Hedge ineffectiveness may occur due to credit valuation adjustments on the hedging instrument which are not matched on the hedged item.

Notes to the consolidated financial statements

Managing financial risk (continued)

23. Market risk (continued)

Interest rate and credit risk (cash flow hedges) (continued)

At 31 December 2019, forward settlement agreements with a notional amount of £190.0 million (2018: £205.0 million) were expected to mature within one year (2018: within one year) at a price of 123% of the notional amount (2018: 124%).

Interest rate risk on floating rate covered bonds (cash flow hedges)

The Group hedges the interest rate risk on floating rate covered bonds it has issued via interest rate swaps that exchange floating rate cash flows for fixed rate cash flows. During 2019, hedge accounting relationships were established in respect of swaps with a notional amount of £404.9 million. Hedge effectiveness is determined at inception of the hedge relationship using a dollar offset analysis. To validate the effectiveness of the ongoing hedge relationship, TSB uses the hypothetical derivative method. At 31 December 2019, these interest rates swaps were due to mature after five years.

Interest payments on covered bonds with a carrying amount of £292.0 million currently reference LIBOR. An assessment of changes required to these instruments, and the associated interest rate swaps, to address forthcoming replacement of LIBOR from the end of 2021 is currently underway. As TSB has early adopted 'Interest Rate Benchmark Reform – Amendments to IFRS 9, IAS 39 and IFRS 9', it has been assumed that, in assessing forecast cash flows for hedge accounting purposes, the existing LIBOR interest rate benchmark arrangements continue in respect of the covered bond and the associated interest rate swaps.

Foreign exchange on foreign currency debt (cash flow hedges)

The Group has issued euro denominated floating rate securitisation notes and as a result is exposed to foreign currency risk as the Group's functional currency is in pound sterling. The Group 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.

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, the Group uses the hypothetical derivative method. Hedge ineffectiveness may occur due to credit valuation adjustments on the swaps which are not matched on the secured issuance.

At 31 December 2019, cross currency swaps with a notional amount of £270.7 million (2018: £317.6 million) were expected to mature within 1 year (2018: between 1 and 2 years). The average exchange rate applicable to these cross currency swaps was £1/€1.14 (2018: £1/€1.13).

Notes to the consolidated financial statements

Managing financial risk (continued)

23. Market risk (continued)

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

Bank and Company 2019	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)					
Portfolio hedged risk:					
Demand deposits	**(6,335.9)**	**(52.2)**	**Customer deposits**	**53.6**	**n/a**
Fixed rate mortgages	**6,309.2**	**20.5**	**Loans & adv to customers**	**(48.0)**	**n/a**
Individual hedged risk:					
Fixed rate subordinated liabilities	**(395.9)**	**(7.9)**	**Subordinated liabilities**	**(2.5)**	**n/a**
Debt securities	**1,354.7**	**–**	**Financial assets at FVOCI**	**(78.6)**	**n/a**
Debt securities	**317.3**	**11.4**	**Financial assets at amortised cost**	**(9.1)**	**n/a**
	1,249.4	**(28.2)**		**(84.6)**	**n/a**
Interest rate / credit risk (Cash flow hedges)					
Debt securities	**232.8**	**n/a**	**n/a**	**(6.1)**	**(2.9)**
Interest rate (Cash flow hedges)					
Debt securities in issue (covered bond)	**404.9**	**n/a**	**n/a**	**2.9**	**5.8**
Foreign exchange risk (Cash flow hedges) (1)					
Debt securities in issue (securitisation notes)	**270.1**	**n/a**	**n/a**	**20.0**	**(0.2)**

(1) Foreign exchange risk is only in respect of the Bank and is not included in the Company financial statements.

Notes to the consolidated financial statements

Managing financial risk (continued)

23. Market risk (continued)

Exposures covered by hedging accounting strategies (continued)

Bank and Company 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)					
Portfolio hedged risk:					
Demand deposits	(6,248.8)	(9.4)	Customer deposits	18.6	n/a
Fixed rate mortgages	8,181.6	(37.3)	Loans & adv to customers	(25.7)	n/a
Individual hedged risk:					
Fixed rate subordinated liabilities	(398.2)	(10.4)	Subordinated liabilities	7.4	n/a
Debt securities	2,128.3	–	Financial assets at FVOCI	(14.1)	n/a
Debt securities	96.2	2.2	Financial assets at amortised cost	2.2	n/a
	3,759.1	(54.9)		(11.6)	n/a
Interest rate / credit risk (Cash flow hedges)					
Debt securities	259.5	n/a	n/a	2.5	(2.5)
Foreign exchange risk (Cash flow hedges) (1)					
Debt securities in issue	(317.6)	n/a	n/a	1.3	(0.7)

(1) Foreign exchange risk is only in respect of the Bank and is not included in the Company financial statements.

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 £21.0 million (2018: £57.3 million).

Hedge accounting ineffectiveness

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

Bank and Company				Amounts reclassified from reserves to P&L as:	
2019	**Hedge ineffectiveness recognised in P&L £ million**	**Gain/(loss) recognised in OCI £ million**	**P&L line item that includes hedge ineffectiveness**	**Hedged item affected P&L £ million**	**P&L line item that includes reclassified amount £ million**
Interest rate risk (Fair value hedges)	**2.6**	**–**	Gains from hedge accounting	**n/a**	
Interest rate / credit risk (Cash flow hedges)	**–**	**1.8**	n/a	**3.6**	**n/a**
Interest rate (Cash flow hedges)	**–**	**(6.2)**	n/a	**0.3**	**Other income**
Foreign exchange risk (Cash flow hedges) (1)	**–**	**(20.0)**	n/a	**20.5**	**Other income**
	2.6	**(24.4)**	n/a	**24.4**	**Other income**
2018					
Interest rate risk (Fair value hedges)	(2.3)	–	Gains from hedge accounting	–	n/a
Interest rate / credit risk (Cash flow hedges)	–	(2.5)	n/a	–	–
Foreign exchange risk (Cash flow hedges) (1)	–	(1.3)	n/a	1.1	Other income
	(2.3)	(3.8)		1.1	

(1) Foreign exchange risk is only in respect of the Bank and is not included in the Company financial statements.

Gains from hedge accounting in the income statement of £20.8 million (2018: £23.3 million) comprise hedge ineffectiveness of £2.6 million (2018: £(2.3) million) and £18.2 million (2018: £25.6 million) of amortisation of de-designated cash flow hedges and fair value hedge adjustments on hedged items for which hedge accounting had previously been discontinued.

Notes to the consolidated financial statements

Managing financial risk (continued)

23. Market risk (continued)

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:

Bank and Company	2019 Fair value reserve £ million	2019 Cash flow hedge reserve[(1)] £ million	2018 Fair value reserve £ million	2018 Cash flow hedge reserve[(1)] £ million
Balance as at 1 January	18.6	(3.2)	16.9	(0.5)
Amounts recognised in other comprehensive income:				
Interest rate risk (Fair value hedge)				
Changes in fair value of purchased debt securities	**95.9**	**n/a**	9.6	n/a
Accumulated fair value hedge adjustment	**(78.6)**	**n/a**	14.1	n/a
Net amounts reclassified to profit or loss	**(24.6)**	**n/a**	(21.4)	n/a
Taxation	**2.3**	**n/a**	(0.6)	n/a
Interest rate and credit risk (Cash flow hedges)				
Effective portion of changes in fair value of forward contracts	**n/a**	**1.8**	n/a	(2.5)
Amounts reclassified from reserves to profit or loss	**n/a**	**3.6**	n/a	–
Taxation	**n/a**	**(0.7)**	n/a	–
Interest rate (Cash flow hedges)				
Effective portion of changes in fair value of interest rate swaps	**n/a**	**(6.2)**	n/a	–
Amounts reclassified from reserves to profit or loss	**n/a**	**0.3**	n/a	–
Taxation	**n/a**	**1.4**	n/a	–
Foreign exchange risk (Cash flow hedges)				
Effective portion of changes in fair value of cross currency swaps	**n/a**	**(20.0)**	n/a	(1.3)
Amounts reclassified from reserves to profit or loss	**n/a**	**20.5**	n/a	1.1
Balance as at 31 December	**13.6**	**(2.5)**	18.6	(3.2)

(1) The cash flow hedge reserve in respect of the Company had a balance of £(2.3) million (2018: £(2.5) million. Movements during 2019 are set out in the table above with the exception of foreign exchange risk.

Notes to the consolidated financial statements

Managing financial risk (continued)

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

Bank				Related amounts where set off in the balance sheet is not permitted		
At 31 December 2019	Gross amounts £ million	Amounts offset £ million	Net amounts reported on the balance sheet £ million	Related financial instrument amounts not offset £ million	Cash collateral received/ pledged[1] £ million	Potential net amount £ million
Derivative financial assets	**204.9**	**–**	**204.9**	**(157.9)**	**(3.6)**	**43.4**
Reverse repurchase agreements	**201.1**	**–**	**201.1**	**(190.7)**	**(0.4)**	**10.0**
Total assets	**406.0**	**–**	**406.0**	**(348.6)**	**(4.0)**	**53.4**
Derivative financial liabilities	**(416.4)**	**–**	**(416.4)**	**157.9**	**258.5**	**–**
Repurchase agreements	**–**	**–**	**–**	**–**	**–**	**–**
Other liabilities (note 32)	**(195.2)**	**192.6**	**(2.6)**	**–**	**–**	**–**
Total liabilities	**(611.6)**	**192.6**	**(419.0)**	**157.9**	**258.5**	**–**
At 31 December 2018						
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 32)	(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)

(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.

Offsetting financial assets and financial liabilities

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

Company				Related amounts where set off in the balance sheet is not permitted		
At 31 December 2019	Gross amounts £ million	Amounts offset £ million	Net amounts reported on the balance sheet £ million	Related financial instrument amounts not offset £ million	Cash collateral received/ pledged[1] £ million	Potential net amount £ million
Derivative financial assets	**161.3**	**–**	**161.3**	**(157.6)**	**(3.6)**	**0.1**
Reverse repurchase agreements	**201.1**	**–**	**201.1**	**(190.7)**	**(0.4)**	**10.0**
Total assets	**362.4**		**362.4**	**(348.3)**	**(4.0)**	**10.1**
Derivative financial liabilities	**(416.4)**	**–**	**(416.4)**	**157.6**	**258.8**	**–**
Repurchase agreements	**–**	**–**	**–**	**–**	**–**	**–**
Other liabilities (note 32)	**(195.2)**	**192.6**	**(2.6)**	**–**	**2.6**	**–**
Total liabilities	**(611.6)**	**192.6**	**(419.0)**	**157.6**	**261.4**	**–**
At 31 December 2018						
Derivative financial assets	131.4	–	131.4	(129.6)	(1.9)	(0.1)
Total assets	131.4	–	131.4	(129.6)	(1.9)	(0.1)
Derivative financial liabilities	(439.2)	–	(439.2)	129.6	308.9	(0.7)
Repurchase agreements	(1,084.8)	–	(1,084.8)	1,084.5	0.3	–
Other liabilities (note 32)	(355.5)	153.0	(202.5)	–	–	(202.5)
Total liabilities	(1,879.5)	153.0	(1,726.5)	1,214.1	309.2	(203.2)

(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.

Other important disclosures

Accounting policies relevant to this section

(k) 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.

(l) Provisions and contingent liabilities and assets
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) Premises 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 premises and leasehold right of use assets: 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) Leases
At inception of a contract TSB Group assesses whether a contract is, or contains a lease. A contract is, or contains a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. To assess whether a contract conveys the right to control the use of an identified asset, TSB Group assess whether: (a) the contract involves the use of an identified asset; (b) TSB Group has the right to substantially all of the economic benefits from use of the asset throughout the period of use; and (c) TSB Group has the right to direct the use of the asset.

At inception or on reassessment of a contract that contains a lease component, TSB Group allocates the consideration in the contract to each lease component on the basis of their relative stand-alone prices.

TSB Group recognises a right-of-use asset and a lease liability at the lease commencement date. The right-of-use asset is initially measured at cost, which comprises the initial amount of the lease liability adjusted for any lease payments made at or before the commencement date.

The right-of-use asset is subsequently depreciated using the straight-line method from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. The estimated useful lives of right-of-use assets are determined on the same basis as those of property and equipment. In addition, the right-of-use asset is periodically reduced by any impairment losses and adjusted for certain remeasurements of the lease liability.

Notes to the consolidated financial statements

Other important disclosures (continued)

Accounting policies relevant to this section (continued)

(n) Leases (continued)

The lease liability is initially measured at the present value of the lease payments that are not paid at the commencement date, discounted using TSB Group's incremental borrowing rate. The lease liability is measured at amortised cost using the effective interest method. It is remeasured when there is a change in future lease payments. When the lease liability is remeasured in this way, a corresponding adjustment is made to the carrying amount of the right-of-use asset, or is recognised in the consolidated income statement if the carrying amount of the right-of-use asset has been reduced to zero.

Policy applicable before 1 January 2019

Leases contracts entered into before 1 January 2019 where TSB Group was lessee were accounted for as operating leases. Operating lease rentals payable were charged to the income statement on a straight-line basis over the period of the lease. When an operating lease was terminated before the end of the lease period, any payment made to the lessor by way of penalty was 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.

24. Shareholder's equity

Bank	**Share capital £ million**	**Share premium £ million**	**Capital reserve £ million**	**Fair value reserve £ million**	**Cash flow hedging reserve £ million**	**Retained profit £ million**
Balance at 1 January 2018	79.4	195.6	412.8	16.9	(0.5)	1,234.8
Net change in fair value reserve	–	–	–	1.7	–	–
Net change in cash flow hedging reserve	–	–	–	–	(2.7)	–
Loss for the year	–	–	–	–	–	(59.1)
Balance at 31 December 2018	79.4	195.6	412.8	18.6	(3.2)	1,175.7
Net change in fair value reserve	**–**	**–**	**–**	**(5.0)**	**–**	**–**
Net change in cash flow hedging reserve	**–**	**–**	**–**	**–**	**0.7**	**–**
Profit for the year	**–**	**–**	**–**	**–**	**–**	**26.2**
At 31 December 2019	**79.4**	**195.6**	**412.8**	**13.6**	**(2.5)**	**1,201.9**

Company	**Share capital £ million**	**Share premium £ million**	**Capital reserve £ million**	**Fair value reserve £ million**	**Cash flow hedging reserve £ million**	**Retained profit £ million**
Balance at 1 January 2018	79.4	195.6	412.8	16.9	–	1,234.8
Net change in fair value reserve	–	–	–	1.7	–	–
Net change in cash flow hedging reserve	–	–	–	–	(2.5)	–
Loss for the year	–	–	–	–	–	(59.1)
Balance at 31 December 2018	79.4	195.6	412.8	18.6	(2.5)	1,175.7
Net change in fair value reserve	**–**	**–**	**–**	**(5.0)**	**–**	**–**
Net change in cash flow hedging reserve	**–**	**–**	**–**	**–**	**0.2**	**–**
Profit for the year	**–**	**–**	**–**	**–**	**–**	**26.2**
At 31 December 2019	**79.4**	**195.6**	**412.8**	**13.6**	**(2.3)**	**1,201.9**

Notes to the consolidated financial statements

Other important disclosures (continued)

24. Shareholder's equity (continued)

At 31 December 2019 and 2018, TSB Bank plc had in issue 7,945,000,100 one pence ordinary shares authorised, allotted and fully paid up.

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

The 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.

25. 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 of 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.

Notes to the consolidated financial statements

Other important disclosures (continued)

26. Related party transactions

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

(i) Key management personnel

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

	Bank 2019 £ 000	Bank 2018 £ 000	Company 2019 £ 000	Company 2018 £ 000
Short term employee benefits	**7,448**	6,260	**7,448**	6,260
Post-employment benefits	**808**	807	**808**	807
Other long term benefits	**765**	(4,760)	**765**	(4,760)
Share-based payments	**1,084**	(1,996)	**1,084**	(1,996)
Payments for loss of office	**1,170**	1,541	**1,170**	1,541
Total	**11,275**	1,852	**11,275**	1,852

The increase in compensation payable to key management personal in 2019 largely reflects the absence, in 2018 of variable reward costs, combined with the reversals of early year accruals for previously awarded which lapsed

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

	Bank 2019 £ 000	Bank 2018 £ 000	Company 2019 £ 000	Company 2018 £ 000
Loans				
At 1 January	**5**	238	**5**	238
Advances (includes key management personnel appointed during the year)	**87**	128	**87**	128
Interest charged during the year	**–**	3	**–**	3
Repayments (includes key management personnel who resigned during the year)	**(81)**	(364)	**(81)**	(364)
At 31 December	**11**	5	**11**	5

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 (2018: £nil).

	Bank 2019 £ 000	Bank 2018 £ 000	Company 2019 £ 000	Company 2018 £ 000
Deposits				
At 1 January	**1,377**	1,340	**1,377**	1,340
Deposits (includes key management personnel appointed during the year)	**5,900**	3,451	**5,900**	3,451
Interest expense on deposits	**6**	4	**6**	4
Repayments (includes key management personnel who resigned during the year)	**(5,486)**	(3,418)	**(5,486)**	(3,418)
At 31 December	**1,797**	1,377	**1,797**	1,377

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

Notes to the consolidated financial statements

Other important disclosures (continued)

26. Related party transactions (continued)

(ii) Transactions and balances with TSB Group companies
Amounts due from TSB Banking Group plc totalled £14.9 million (2018: £15.0 million) primarily arise from the payment and recharge, in the normal course of business, of certain costs of TSB Banking Group plc, the Company's immediate parent company. Amounts due from TSB Banking Group Employee Share Trust (EST) totalled £3.6 million (2018: £1.9 million) reflecting an interest free loan to enable the EST to acquire shares in respect of the Bank's share based compensation schemes. Amounts due by the Company to other TSB Group companies of £10.4 million (2018: £189.6 million) arise from the Bank's securitisation programmes.

(iii) Transactions and balances with Sabadell Group companies

Operating expenses include VAT inclusive amounts of £167.0 million (2018: £106.5 million) in respect of services provided to TSB by Sabis under the OSA for running the new banking platform. In the prior year, operating expenses of £249.0 million were incurred under the Migration Services Agreement with Sabis for services provide to TSB in preparing for the migration in 2018.

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 £192.6 million (2018: £153.0 million), reflecting the maximum recovery amount under the contracts.

TSB intends to settle on a net basis and consequently, the residual MSA liability of £100.0 million (2018: £249.0 million) has been presented on the statement of financial position net of the recovery of £100.0 million (2018: £100.0 million). Amounts payable to Sabis in respect of the OSA and other changes services of £95.2 million (2018: £106.5 million) is presented net of recovery of £92.6 million (2018: £53.0 million). Together, the aggregate liability to Sabis recognised on the consolidated balance sheet is £2.6 million (2018: £202.5 million (note 32).

In December 2019, as part of the strategy to take direct management of suppliers of IT services, TSB entered into an agreement with IBM to provide IT services to TSB. The contract is effective from 1 January 2020 and these services will become operational on a phased basis throughout 2020. These services were previously provided by Sabis under the OSA. TSB and Sabis have agreed that the OSA will be amended to remove the relevant services from the scope of the OSA with effect from the date that IBM's service becomes operational.

Economic hedging of share based compensation liability
At 31 December 2019, TSB holds options from Sabadell to acquire 8.3 million (2018: 11.2 million) Sabadell shares at an exercise price of 77.68p in order to hedge the risk associated with the TSB Sharesave scheme. These options had a fair value of £0.8 million (2018: £1.9 million) and Sabadell had placed cash collateral with TSB of £1.4 million (2018: £3.1 million).

Other transactions and balances
Sabadell acts as an intermediary for TSB in respect of international payments and the Bank has nostro accounts as a result of this arrangement which had a net balance due from Sabadell of £4.9 million (2018: £0.9 million).

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

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

Notes to the consolidated financial statements

Other important disclosures (continued)

27. Property and equipment

Bank and Company	Property £ million	Equipment £ million	Right of use leasing asset £ million	Total £ million
Cost				
At 1 January 2018	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
Change on adoption of IFRS 16	–	–	163.0	163.0
Balance at 1 January 2019	**231.7**	**111.7**	**163.0**	**506.4**
Additions	**17.1**	**4.7**	**13.7**	**35.5**
Disposals	**(3.0)**	**(5.0)**	**–**	**(8.0)**
Lease term remeasurement	**–**	**–**	**(6.6)**	**(6.6)**
Write-offs	**–**	**–**	**(2.8)**	**(2.8)**
At 31 December 2019	**245.8**	**111.4**	**167.3**	**524.5**
Accumulated depreciation				
At 1 January 2018	92.3	66.0	–	158.3
Depreciation charge for the year (note 15)	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
Depreciation charge for property and equipment (note 15)	**19.1**	**7.2**	**–**	**26.3**
Depreciation charge for right of use asset (note 15)	**–**	**–**	**28.2**	**28.2**
Write-offs	**(1.4)**	**(1.6)**	**(0.5)**	**(3.5)**
At 31 December 2019	**125.8**	**77.8**	**27.7**	**231.3**
Carrying amount				
At 31 December 2018	123.6	39.5	–	163.1
Change on adoption of IFRS 16	–	–	163.0	163.0
At 1 January 2019	123.6	39.5	163.0	326.1
At 31 December 2019	**120.0**	**33.6**	**139.6**	**293.2**

Notes to the consolidated financial statements

Other important disclosures (continued)

28. Lease liabilities

TSB Group's leasing activity primarily reflects leases of various offices and bank branch properties. TSB does not operate as a lessor. These lease arrangements will often contain renewal options and rent escalation clauses, although the effect of these is not material. No arrangements have been entered into for contingent rental payments. The tables below set out details of the amounts recognised in the financial statements in respect of leases:

Lease liability	Property 2019 £ million
Balance at 31 December 2018	–
Change on adoption of IFRS 16	171.9
Balance at 1 January 2019	**171.9**
Additions	**13.7**
Lease term remeasurement	**(6.6)**
Interest expense for the year	**1.6**
Lease payments made in the year	**(38.8)**
Carrying amount at 31 December 2019	**141.8**

29. Intangible assets

Bank and Company	2019 £ million	2018 £ million
Cost		
At 1 January	**22.9**	11.1
Additions	**7.6**	11.8
At 31 December	**30.5**	22.9
Accumulated amortisation		
At 1 January	**4.5**	1.0
Amortisation charge for the year (note 15)	**5.7**	3.5
At 31 December	**10.2**	4.5
Carrying amount	**20.3**	18.4

30. Other assets

	Bank 2019 £ million	Bank 2018 £ million	Company 2019 £ million	Company 2018 £ million
Other assets and prepayments	**113.6**	165.6	**113.6**	165.6
Amounts recoverable under customer remediation indemnity (note 31)	**14.4**	14.6	**14.4**	14.6
Amounts due from other TSB Group companies (note 26)	**18.5**	16.9	**18.5**	16.9
Total other assets	**146.5**	197.1	**146.5**	197.1

Other important disclosures (continued)

31. Provisions

Bank and Company	Restructuring provision £ million	Migration redress provision £ million	Other customer redress provision £ million	Operational losses provision £ million	Credit impaired provision £ million	Total £ million
At 1 January 2019	–	41.1	15.0	4.5	3.0	63.6
Charge/(reversals) to income statement	**38.1**	**6.3**	**5.3**	**–**	**(0.4)**	**49.3**
Utilisations	**(9.6)**	**(43.8)**	**(4.3)**	**(3.4)**	**–**	**(61.1)**
Total provision	**28.5**	**3.6**	**16.0**	**1.1**	**2.6**	**51.8**

Significant estimates – migration and other customer redress

Restructuring provision

At 31 December 2019, TSB carried provisions of £28.5 million (2018: £nil) in respect of restructuring activity designed to support delivery of TSB's strategy. This includes the estimated costs of previously announced branch closures that are planned for 2020 which includes estimates of employee severance costs and of the costs of exiting the properties. It also includes estimated severance costs arising from organisational change across a number of head office functions.

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 £16.0 million (2018: £15.0 million) is carried. A recoverable of £14.4 million (2018: £14.6 million) has been recognised under the indemnity provided by Lloyds Bank plc (note 30). The size of the liability follows an assessment of emerging themes in customer complaints, an assessment of broader industry commentary and discussions with regulators. The ultimate cost and timing of payments are uncertain as a result of the inherent difficulties in estimating factors such as future levels of customer complaints and remediation settlements. The provision represents management's current best estimate.

Notes to the consolidated financial statements

Other important disclosures (continued)

32. Other liabilities

Bank	2019 £ million	2018 £ million
Amounts due to Sabadell Group companies (note 26)	**2.6**	202.5
Amounts due to other TSB Group companies	**0.7**	0.1
Accruals and deferred income	**70.1**	230.4
Share-based payments liability	**5.4**	4.9
Other creditors	**75.3**	57.8
Total other liabilities	**154.1**	495.7

Company	2019 £ million	2018 £ million
Amounts due to Sabadell Group companies (note 26)	**2.6**	202.5
Amounts due to other TSB Group companies (note 26)	**10.4**	189.6
Accruals and deferred income	**70.1**	230.4
Share-based payments liability	**5.4**	4.9
Other creditors	**75.1**	57.6
Total other liabilities	**163.6**	685.0

Significant estimate – MSA and OSA contract liabilities

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 provisional agreement, subject to mutual reservation of rights while negotiations are concluded, where TSB will recover an aggregate of £192.6 million (2018: £153.0 million) under the respective contracts.

Amounts payable to Sabis under the MSA and OSA contracts are presented on the statement of financial position net of the estimated recovery of £192.6 million (2018: £153.0 million).

Notes to the consolidated financial statements

Other important disclosures (continued)

33. Notes to the consolidated cash flow statement

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

	Bank 2019 £ million	Bank 2018[1] £ million	Company 2019 £ million	Company 2018[1] £ million
Increase in loans to central banks	**(8.3)**	(31.8)	**(8.3)**	(31.8)
Increase in loans to credit institutions	**(2.6)**	(41.4)	**–**	–
(Increase)/decrease in loans and advances to customers	**(1,132.8)**	679.9	**(1,132.8)**	679.9
Increase in reverse purchase agreements	**(201.1)**	–	**(201.1)**	–
Decrease in other advances	**101.8**	514.6	**101.8**	514.6
Net change in derivative financial instruments and fair value adjustment for portfolio hedged risk	**(161.7)**	(145.0)	**(182.1)**	(146.3)
Decrease in other assets	**52.3**	64.4	**52.3**	64.4
(Decrease)/increase in deposits from credit institutions	**(2.7)**	3.4	**(2.8)**	3.5
Increase/(decrease) in customer deposits	**1,089.9**	(1,459.1)	**1,089.9**	(1,459.1)
Increase/(decrease) in other financial liabilities	**13.6**	(180.9)	**13.6**	(180.9)
(Decrease)/increase in provisions	**(11.8)**	29.1	**(11.8)**	29.1
(Decrease)/increase in other liabilities	**(332.9)**	214.5	**(332.9)**	214.6
Change in operating assets and liabilities	**(596.3)**	(352.3)	**(614.2)**	(312.0)
Depreciation and amortisation	**60.2**	28.1	**60.2**	28.1
Impairment losses on loans and advances to customers	**60.9**	73.3	**60.9**	73.3
Other non-cash items	**49.0**	51.0	**69.2**	46.7
Non-cash and other items	**170.1**	152.4	**190.3**	148.1
Analysis of cash and cash equivalents as shown in the balance sheet				
Cash	**160.1**	160.3	**160.1**	160.3
Balances with central banks[2]	**4,427.3**	6,954.9	**4,427.3**	6,954.9
On demand deposits	**5.4**	20.7	**5.4**	20.7
Total cash and cash equivalents	**4,592.8**	7,135.9	**4,592.8**	7,135.9

(1) Comparative information for 2018 has been re-presented on a basis consistent with the current year.

(2) 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 and are not included in cash and cash equivalents.

Change in liabilities arising from financing activities

Bank	Borrowings from central banks £ million	Debt securities in issue £ million	Subordinated liabilities £ million	Repurchase agreements £ million	Amounts due from other TSB Group companies £ million	Total non customer funding £ million
At 1 January 2018	5,625.7	1,318.7	405.3	1,446.4	–	8,796.1
Borrowings under the BoE Term Funding Scheme	850.0	–	–	–	–	850.0
Repayments securitisation funding	–	(197.9)	–	–	–	(197.9)
Proceeds from repurchase agreements (net)	–	–	–	(361.9)	–	(361.9)
Non-cash movements	6.5	1.8	(7.1)	0.3	–	1.5
At 31 December 2018	6,482.2	1,122.6	398.2	1,084.8	–	9,087.8
Repayment of borrowings from central banks (net)	**(1,995.0)**	–	–	–	–	**(1,995.0)**
Repayments securitisation funding	–	**(198.0)**	–	–	–	**(198.0)**
Issuance of covered bonds	–	**750.0**	–	–	–	**750.0**
Proceeds from repurchase agreements (net)	–	–	–	**(1,084.8)**	–	**(1,084.8)**
Non-cash movements	**(3.7)**	**1.7**	**(2.3)**	–	–	**(4.3)**
At 31 December 2019	**4,483.5**	**1,676.3**	**395.9**	–	–	**6,555.7**

Notes to the consolidated financial statements

Other important disclosures (continued)

33. Notes to the consolidated cash flow statement

Company	Borrowings from central banks £ million	Debt securities in issue £ million	Subordinated liabilities £ million	Repurchase agreements £ million	Amounts due from other TSB Group companies £ million	Total non customer funding £ million
At 1 January 2018	5,625.7	498.0	405.3	1,446.4	426.6	8,402.0
Borrowings under the BoE Term Funding Scheme	850.0	–	–	–	–	850.0
Repayments securitisation funding	–	–	–	–	(237.0)	(237.0)
Proceeds from repurchase agreements (net)	–	–	–	(361.9)	–	(361.9)
Non-cash movements	6.5	0.4	(7.1)	0.3	–	0.1
At 31 December 2018	6,482.2	498.4	398.2	1,084.8	189.6	8,653.2
Repayment of borrowings from central banks (net)	**(1,995.0)**					**(1,995.0)**
Repayments of securitisation funding					**(179.2)**	**(179.2)**
Issuance of covered bonds		**750.0**				**750.0**
Proceeds from repurchase agreements (net)				**(1,084.8)**		**(1,084.8)**
Non-cash movements	**(3.7)**	**(1.4)**	**(2.3)**			**(4.6)**
At 31 December 2019	**4,483.5**	**1,249.8**	**395.9**		**10.4**	**6,498.0**

34. Approval of the consolidated financial statements

These consolidated financial statements were approved by the Board of Directors of TSB Bank plc on 30 January 2020.

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

Independent auditors’ report to the members of TSB Bank plc

Report on the audit of the financial statements

Opinion
In our opinion, TSB Bank plc’s (the ‘Bank’) consolidated financial statements and Company financial statements (the ‘financial statements’):

- give a true and fair view of the state of the Bank’s and of the Company’s affairs as at 31 December 2019 and of the Bank’s profit and the Bank’s and the Company’s cash flows for the year then ended;
- have been properly prepared in accordance with 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 Bank’s financial statements, Article 4 of the IAS Regulation.

We have audited the financial statements included within the Annual Report and Accounts 2019 (the ‘Annual Report’), which comprise: the consolidated and Company balance sheets as at 31 December 2019; the consolidated statement of comprehensive income, the consolidated and Company statements of changes in equity, and 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 15 to the financial statements, we have provided no non-audit services to the Group or the Company in the period from 1 January 2019 to 31 December 2019.

Our audit approach

Context
The Bank's profitability continues to be impacted by the IT issues post migration and the costs of the subsequent post migration service disruption. As part of its strategy to restore the Bank’s competitiveness, management have committed to simplifying the business, which has led to material restructuring and severance costs being incurred in 2019. As a result, we have elected to use the same materiality benchmark as last year, which was based on average absolute profit/loss before tax over the period from 2016 to 2018. We concluded that using current year results, the calculated materiality would be significantly lower than amounts which, if impacting reported profits, could influence decisions made by the users of the financial statements, given the scale of the Bank’s operations and balance sheet. We have also continued to adopt a more substantive testing approach due to the immaturity of the control environment in some areas.

Independent auditors’ report to the members of TSB Bank plc (continued)

Overview	
Materiality	• Overall Bank materiality: £8.0 million (2018: £8.1 million), based on 5% of average absolute profit/loss before tax from 2016 to 2018, rounded down to £8.0 million • Overall Company materiality: £8.0 million (2018: £8.1 million), based on 1% of total assets, capped at the lower materiality of the Bank.
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 any 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 recoverability of costs associated with the Migration Services Agreement and Outsourced Services Agreement, and • 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. In addition, we have included a key audit matter in relation to IT access and change management, given the pervasiveness of the impact on our audit approach of the issues found in these areas. *Significant changes in our approach* In our 2019 report the following changes to the key audit matters identified have been made, compared with our 2018 report: • We no longer consider completeness and accuracy of the data transfer at the date of IT system migration to be a key audit matter as this was a one-off event in the prior year; • We have refined the risk in relation to IFRS 9 to exclude the accuracy of critical inputs to the calculations given this was primarily a risk following the IT system migration; and • We have refined the risk in relation to judgemental costs arising from the migration to only apply to intragroup costs, rather than customer remediation and potential regulatory fines.

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 Bank 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 both reduce costs and inflate operating profit, 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 implementation of management’s new strategy. Audit procedures performed by the engagement team included, but were not limited to:

- Discussions with management, internal audit and the Bank’s legal advisors, including consideration of known or suspected instances of non-compliance with laws and regulations and fraud;
- Evaluation of the operating effectiveness of management’s controls designed to prevent and detect irregularities;
- Assessment of matters reported on the Bank’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);
- Challenging management on the assumptions used in the Medium Term Plan approved by the Board on 23 October 2019. We also considered the impact of bonus incentives, as well as the skills and competencies of the individuals involved in the governance and assumption-setting process, to determine whether management incentives to manipulate results exist; and
- Identifying and testing journal entries, in particular any journal entries posted with understatement of costs, journals that are backdated or posted by senior management.

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

Capability of the audit in detecting irregularities, including fraud (continued)

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.

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 recoverability of costs associated with the Migration Services Agreement and Outsourced Services Agreement

Nature of key audit matter

The Bank's IT systems have been developed, and are maintained, by Sabadell Information Systems Limited ('Sabis'), a subsidiary of the Banco Sabadell Group. The Bank started to utilise these IT systems in 2018 when they entered into a Migration Services Agreement ('MSA') and an Outsourced Services Agreement ('OSA') with Sabis.

Upon migration, TSB experienced a number of significant issues, which in turn gave rise to a number of judgmental costs, a proportion of which TSB are seeking to recover from Sabis under the non-performance terms of these agreements.

The amounts recoverable remain unfinalised given the ongoing regulatory investigations and discussions with insurance providers, but management's best estimate of the recovery is £192.6 million. This is a key audit matter due to the continuing judgemental nature of the recoveries of costs under these agreements, and the ongoing nature of negotiations with parties including insurance companies. 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 32.

Matters discussed with the Audit Committee

We discussed our scope and plan for testing the recoverability assumption with the Audit Committee, highlighting our focus on the intergroup agreement of the amounts payable to Sabis including confirmation of symmetrical accounting and correspondence with regulators.

We confirmed that whilst negotiations with Sabis are ongoing, both management and members of the Audit Committee believe that the position to record the recovery of post migration charges of £192.6 million represents the best estimate of the aggregate recovery from Sabis under the terms of both the MSA and the OSA. Given that this is a significant judgement and is a best estimate, we discussed the need to have full and transparent disclosure.

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

Procedures performed to support conclusions

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

- We confirmed that the Bank has the contractual right to recover costs incurred from Sabis under the terms of the MSA and OSA.
- We tested the schedule of costs which the Bank has used as the basis of the best estimate calculation, and confirmed that the Company has incurred costs related to the migration in excess of the recoveries recognised under both agreements.
- We have challenged management that the recovery represents the best estimate of the claimable costs as at 31 December 2019 through reviewing correspondence from external counsel and obtaining written and verbal confirmation from the Audit Committee and Chief Financial Officer of the Bank and the Banco Sabadell Group Chief Financial Officer.
- We have received confirmation from both Sabadell and PwC Spain that Sabis have recorded an equal and opposite entries in respect of the recovery recognised on TSB's balance sheet.
- 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.

Relevant references in the Annual Report and Accounts 2019

Note 32 - Other liabilities

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

The continued appropriateness of the staging thresholds used to determine a significant increase in credit risk, forward looking economic assumptions and significant Expert Credit Judgement ('ECJ') assumptions as they relate to expected credit loss ('ECL') provisioning

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 ECL provision.

This is the second year that ECL have been reported under IFRS 9 and therefore management's processes and controls have further matured. In particular, the extent of model monitoring has increased, given there is more historical data and experience now available to backtest management's models. However, certain key judgements remain, in particular caused by continued uncertainty in the future path of the UK economy and how this will impact ECL. Our audit work will focus on the key judgemental areas, being:

- The continued appropriateness of staging thresholds to determine a significant increase in credit risk;
- Forward looking economic assumptions (specifically interest rates, unemployment and house price growth, given that these assumptions are most sensitive to ECL) and the weightings assigned to scenarios (specifically the base and downside scenarios, as these scenarios have the highest weights assigned to them); and
- Assumptions in significant ECJs recognised by management to mitigate model weaknesses or emerging risks (specifically risks around interest only mortgages, loan affordability and judgement in determining forced sale discounts).

Matters discussed with the Audit Committee

We discussed with the Committee a number of matters in relation to ECL during the year including the results of management's validation of the staging thresholds as well as the results of our independent audit work on those key judgements.

We presented to the Committee the results of our benchmarking of management's key forward looking economic assumptions and how they compared to external consensus forecasts, including the latest Bank of England published scenarios.

We also discussed the continued reliance on ECJ allowances made in addition to the core impairment models and management's plans to incorporate more of these into core models going forward, where it is possible to do so.

Procedures performed to support conclusions

- We tested management's monitoring controls including the sufficiency of the model validation activities undertaken and re-performed a number of monitoring tests independently.
- We tested the key assumptions in significant ECJ's 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.
- We assessed the reasonableness and likelihood of the forward looking economic assumptions and weightings assigned to the scenarios using our economic experts. For the base and downside economic scenarios, their reasonableness was assessed against known or likely economic, political and other relevant events, including potential risks from the UK's exit from the European Union. The severity and magnitude of the scenarios were compared to external forecasts and data from historical economic downturns, and the sensitivities of the scenarios on the ECL were considered. We found that the assumptions adopted and assigned weightings to the scenarios were reasonable.
- We tested the accuracy and completeness of critical data inputs used by the impairment models on a sample basis to supporting documentation.
- We tested that the credit risk disclosures made by management were compliant with IFRS 9 and agreed the disclosures to source data without exception.

Relevant references in the Annual Report and Accounts 2019

Note 10 - Allowance for credit impairment losses on financial assets at amortised cost

IT access and change management

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 Bank. During our 2018 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 Bank continues to work on improving the control environment through their IT remediation and stabilisation programmes.

As a result of issues identified in the IT control environment, we continue to be unable to rely on automated and IT dependent manual controls for the 2019 audit. This has led us to perform a largely substantive audit and increase the number of procedures in several areas.

Matters discussed with the Audit Committee

In April, we informed the Audit Committee that we would be conducting a fully substantive audit for 2019 unless significant improvements were made before the end of Q2.

In July, we confirmed with management that remediation would not be completed in time to allow controls to embed, and therefore we would continue to plan for a largely substantive audit, being the most efficient approach.

Procedures performed to support conclusions

- We conducted substantive procedures across all business areas where IT access and change management controls could not be relied upon. We also increased our sample sizes in certain areas of the audit, including testing of customer origination documents for existence purposes, and increased sample sizes for testing of inputs to the impairment models.
- We also assessed IT deficiencies identified by other parties including external consultants and internal audit. Deficiencies identified by other parties corroborated our own views that a fully substantive audit approach was most appropriate.

Relevant references in the Annual Report and Accounts 2019

Not applicable

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

The Bank is the consolidation of TSB Bank plc and its subsidiaries. For the year ended 31 December 2019, we have scoped the audit by disaggregating the Bank 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.

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 Bank plc (continued)

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

	Consolidated financial statements	*Company financial statements*
Overall materiality	£8.0 million (2018: £8.1 million).	£8.0 million (2018: £8.1 million).
How we determined it	5% of average absolute profit/loss before tax from 2016 to 2018, rounded down to £8.0 million.	1% of total assets.
Rationale for benchmark applied	We have concluded it to be appropriate to determine materiality with reference to the Bank's historical profitability as we consider the Bank's most recent profitability is not reflective of normal profitability as the Bank continues to undergo a transformation process following the impact of the IT migration issues in the prior year.	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 Bank.

For each component in the scope of our Bank audit, we allocated a materiality that is less than our overall Bank materiality. The range of materiality allocated across components was between £0.52 million and £4.55 million.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £0.4 million (Bank audit) (2018: £0.4 million) and £0.4 million (Company audit) (2018: £0.4 million) as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

Conclusions relating to going concern
ISAs (UK) require us to report to you when:

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

We have nothing to report in respect of the above matters. However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Bank's and Company's ability to continue as a going concern. For example, the terms on which the United Kingdom may withdraw from the European Union are not clear, and it is difficult to evaluate all of the potential implications on the Bank's trade, customers, suppliers and the wider economy.

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.

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

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 2019 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

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

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

In preparing the financial statements, the directors are responsible for assessing the Bank's and the Company's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Bank 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 1997 to audit the financial statements for the year ended 31 December 1997 and subsequent financial periods. The period of total uninterrupted engagement is 23 years, covering the years ended 31 December 1997 to 31 December 2019.

Laura Needham (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London, 30 January 2020

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