TSB Bank plc
Annual Report and Accounts 2018

Registered in Scotland
Company Number: SC095237

TSB Bank plc

Annual report and consolidated financial statements
For the year ended 31 December 2018

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:

Executive Chairman:	Richard Meddings (independent on appointment)
Executive Directors:	Ralph Coates (Chief Financial Officer)
	Paul Pester* (left the Board by mutual agreement on 3 September 2018)
Independent Non-executive Directors:	Paulina Beato
	Dame Sandra Dawson**
	Graeme Hardie
	Sandy Kinney (resigned on 10 December 2018)
	Stephen Page
	Andy Simmonds (appointed on 11 July 2018)
	Polly Williams
Non-executive Directors:	Miquel Montes
	Tomás Varela
Company Secretary:	Keith Hawkins (appointment effective from 1 January 2019)
	Lorna Curry (resigned on 31 December 2018)

* Formerly Chief Executive Officer.
** Senior Independent Director.

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

Strategic report

Introduction

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

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

We want to say sorry again for the service disruption which followed the IT migration, and for letting our customers down. Thanks are also due to every TSB Partner for their dedication and service over the past 12 months. Despite our difficulties and the resulting short-term financial impact this has caused, with a statutory loss before tax of £101.0 million in 2018, we continue to make good progress as a challenger bank, and we are looking forward with real optimism and renewed ambition in 2019.

This year we believe TSB will start to re-emerge as the UK's leading challenger bank – firmly on the side of the customer. We have a truly customer-focused team, strong banking systems, and are back on a growth strategy. We will also have new leadership with Debbie Crosbie who joins us as Chief Executive in the Spring, subject to regulatory approval.

TSB's IT migration

On 22 April 2018 TSB moved to a new IT system developed and implemented by TSB's IT provider, Sabis (also a wholly owned subsidiary of Sabadell), with support from a range of telecommunications and technology firms. Whilst the migration of all customer records took place as planned, customers experienced problems in the initial period after migration in accessing their accounts online, with long wait times on the phone and slower transaction times in our branches. The large amount of publicity this created also precipitated an intense fraud attack on TSB's customers. We know how frustrated many customers have been by what happened. It was not the level of service our customers deserve and we have been working hard to put things right for them. Our Migration Report on pages 5 and 6 provides a more comprehensive analysis of the strategic case for the IT migration, the steps we took to prepare and how we have responded.

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

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

At the beginning of September, the TSB Board announced that Paul Pester was stepping down from his position as Chief Executive and leaving the Company. Notwithstanding the much-improved levels of service delivered since migration, Paul and the Board agreed that it was the right time for a change of CEO.

TSB's immediate priorities following the IT migration

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

At the date of this report, we have made very significant progress against each of these and achieved this at good pace.

Strategic report (continued)

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

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

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

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

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

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

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

Financial summary

TSB's 2018 financial performance was significantly impacted by the IT migration and subsequent service disruption. As a result, TSB incurred a statutory loss before tax of £101.0 million, a reduction of £260.1 million compared to the profit of £159.1 million in 2017. This was predominantly driven by additional charges associated with the post migration service disruption of £330.2 million. This includes customer compensation, fraud and operational losses, additional resource and advisory costs and foregone income predominantly as a result of waived overdraft fees and interest charges.

Strategic report (continued)

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

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

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

2018 has been TSB's most challenging year. Despite our difficulties, and the associated short-term financial impact TSB expects to re-emerge as the UK's leading challenger bank in 2019 – firmly on the side of the customer with a truly customer-focused team, strong banking systems, and back on a growth strategy under new leadership with Debbie Crosbie, subject to regulatory approval.

Migration report

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

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

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

A comprehensive assurance process was established for each area of TSB to confirm that it was ready to enter the migration process. This process was used to:
- confirm the adequacy and completeness of the system design, build and testing;
- confirm organisational readiness to use the new platform;
- confirm the availability of resources and processes to respond to post migration incidents;
- establish a process to manage the introduction of functionality that was scheduled to "go live" after the migration event; and
- assess plans to validate that the systems operated as expected post migration.

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

The Board Audit Committee was requested by the Board to oversee the management of the risks arising from the migration programme.

Migration report (continued)

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

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

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

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

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

As noted on page 3, internal analysis indicated that the design of the platform itself was sound, but that the deployment onto the technical infrastructure led to many of the problems. Primarily, the underlying issues related to aspects of three key inter-connected areas – the initial configuration and the capacity of the infrastructure, and also some aspects of coding. Configuration is important to enable technology systems to accurately reflect the designed functionality; capacity is required to support a volume of concurrent users; and coding influences the way customers and TSB interact with each other, for example determining how an unexpected error message is presented.

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

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

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

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

Strategic report (continued)

Business model and key performance indicators

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

What’s our purpose?

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What’s our strategy?

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

What are TSB’s principal activities?

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

Deposits

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

Residential mortgages

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

Unsecured lending

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

Business banking

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

Insurance products

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

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
Banking experience	We seek to deliver a banking experience that is the primary reason for customers to choose and remain with TSB, and which will increasingly set TSB apart from other banks and providers of financial services. Central to this is the development of our brand, investment in our branch, telephony and digital capabilities and customer led service ethos. Our brand is based on transparent and straightforward values which underpinned TSB when it was established more than 200 years ago for the purpose of helping local people, and the communities they lived in, to thrive together.	n/a	**Customer advocacy (Net Promoter Score)** **2018** (9); **2017** 27
Sources of funding	Money deposited by customers into their bank and savings accounts provides the majority of the funds we use to support lending to customers. We also raise funds from other sources, including wholesale funding markets, that diversify our funding profile and our shareholder also provides funding in the form of equity capital in the business.	Page 31	**Share of personal bank account gross flow (%)** **2018** 3.6; **2017** 6.2% **Share of PCA stock (%)** **2018** 4.5%; **2017** 4.6%
Loans	Funds deposited with TSB are used to support lending to customers who wish to borrow. A portion of funds are held in reserve, in the form of a liquidity portfolio, to meet any unexpected funding requirements.	Page 36	**Mortgages gross lending (£m)** **2018** 4,803.5; **2017** 7,001.5
Income	We earn income in the form of interest that we receive on the loans we make to customers and we pay interest to savings and bank account customers on the money they deposit with us. We also earn other income in the form of fees and charges for the provision of other banking services and commissions from the sale of certain products such as general insurance.	Page 48	**Net interest margin** **2018** 2.87%; **2017** 3.02%
Charges	Charges we incur include the costs of paying our TSB Partners, running our branches, investing in our business and paying for advertising and marketing. Occasionally, our customers are unable to repay the money they borrow from us; this is also a cost to the bank in the form of an impairment charge. Finally, TSB complies with its obligations to Her Majesty's Revenue and Customs (HMRC).	Page 50	**Cost:income ratio** **2018** 102.1%; **2017** 78.4% **Asset quality ratio (£m)** **2018** 0.24%; **2017** 0.25%
Profits and returns to the shareholder	The Board reviews all aspects of TSB's performance. It decides whether profits are put aside for future investment in the business, for protection against the uncertainties that TSB faces, or returned to the shareholder in the form of dividends.	Page 55	**Return on equity (%)** **2018** (3.3)%; **2017** 6.1%
Risk management	Banking is based on the effective evaluation of risks and ensuring an appropriate return is earned for taking them. The overall level of risk we are willing to take, our 'risk appetite', is determined by our Board, and robust systems and practices are in place to support TSB operating in line with these predetermined parameters. This helps protect both our customers' and the shareholder's interests.	Page 57	Not applicable

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.

Income statement and profitability

	2018 £ million	2017 £ million
Net interest income	**884.8**	925.9
Other income	**410.5**	170.2
Total income	**1,295.3**	1,096.1
Operating expenses	**(1,323.0)**	(859.2)
Impairment	**(73.3)**	(77.8)
Statutory (loss)/profit before taxation	**(101.0)**	159.1
Taxation	**41.9**	(44.0)
Statutory (loss)/profit for the year	**(59.1)**	115.1

TSB incurred a statutory loss before tax for 2018 of £101.0 million with our financial performance significantly affected by the IT migration resulting in a significant proportion of income, costs and resultant loss before taxation being derived from activities not forming part of TSB's core business model. The two key factors driving the loss before taxation were:

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

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

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

Other income increased by 141.2% to £410.5 million driven by the recognition of a £318.3 million of income from LBG as a result of exiting the Transitional Services Agreement on migration to the new IT platform. Partially offsetting this, other income decreased by 51.7% to £92.1 million. This was primarily due to the recognition in 2017 income of £46.1 million on the return of the Mortgage Enhancement portfolio to LBG in June 2017 and market volatility in the derivatives transacted to hedge interest rate risk and exposures under share schemes.

Operating Expenses
Operating expenses increased by £460.8 million or 53.6% to £1,323.0 million. This primarily reflected the costs of preparing for the migration of £417.3 million and charges associated with the post migration service disruption of £296.7 million, partially offset by the recognition of an accrued estimated recovery of £153.0 million from Sabadell under the MSA and OSA contracts.

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

The charges arising from post migration service disruption included customer redress and associated operational costs of £107.3 million, customer rectification and associated costs of £17.9 million, incremental resource and advisory costs of £122.4 million to support TSB's remediation programme, and fraud and operational costs of £49.1 million.

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

Strategic report (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.

	2018 £ million	2017 £ million
Customer deposits	**29,084.3**	30,520.6
Non-customer funding:		
Term Funding Scheme	**6,482.2**	5,625.7
Repurchase agreements	**1,084.8**	1,446.4
Debt securities in issue	**1,122.6**	1,318.7
Subordinated liabilities	**398.2**	405.3
Non-customer funding	**9,087.8**	8,796.1
	38,172.1	39,316.7
Shareholder's equity	**1,878.9**	2,006.6
Sources of funding	**40,051.0**	41,323.3
Other liabilities	**1,087.6**	1,213.4
Total equity and liabilities	**41,138.6**	42,536.7
Loans and advances to customers	**30,008.5**	30,854.2
Liquidity portfolio(1)	**9,438.9**	9,536.2
Loans and liquid assets	**39,447.4**	40,390.4
Other assets	**1,691.2**	2,146.3
Total assets	**41,138.6**	42,536.7

(1) Comprises balances at central banks of £6,954.9 million (2017: £7,419.9 million), gilts of £2,058.7 million (2017: £1,721.5 million) and supranational and development bank bonds of £425.3 million (2017: £394.8 million). Balances at central banks are combined with other cash balances and demand deposits of £181.0 million (2017: £143.5 million) when shown on the balance sheet on page 27.

Source of funding

Total sources of funding decreased by 3.1% to £40.1 billion, reflecting a decrease in customer deposits offset by a small increase in non-customer funding. Customer deposits decreased by £1.4 billion to £29.1 billion primarily due to a reduction in retail savings balances from £19.3 billion to £17.5 billion. This largely reflected the result of pricing decisions to manage ISA deposit volumes ahead of the 2018 'ISA season' given TSB's strong liquidity position. Retail current account deposits grew by £0.4 billion from £10.0 billion to £10.4 billion partially offsetting the above decrease, as TSB continued to attract new customers but at a slower rate than previously, opening 3.6% (2017: 6.2%) of all new and switching personal banks accounts in the UK during 2018.

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

TSB's capital position has remained above risk appetite threshold with a Common Equity Tier 1 (CET1) capital ratio of 19.5% and a leverage ratio of 4.4% on a fully loaded basis. Following application of IFRS 9, TSB and other UK banks are supervised by the PRA under IFRS 9 transitional rules following EBA guidelines. Based on these guidelines TSB's CET1 ratio is 19.8%, total capital ratio is 23.9% and leverage ratio is 4.4%. The effect of the transitional adjustment to own funds, capital requirement and leverage will be disclosed within Key Metrics and IFRS9 Comparison tables in the Significant Subsidiary Disclosures.

Loans and liquid assets

Loans to customers decreased by £0.9 billion to £30.0 billion. The decline in mortgage balances was due to customer repayments and the expected reduction in the closed Whistletree portfolio, in addition to lower origination activity than prior year. New mortgage lending decreased to £4.8 billion (2017: £7.0 billion) reflecting curtailed lending activity both pre and post migration as customer service levels were prioritised. The 17.7% decrease in unsecured balances was driven by lower unsecured personal loan balances as post migration operational constraints limited new lending. Further information about the credit risk of TSB's loans is set out in note 22 to the consolidated financial statements.

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

Strategic report (continued)

Principal risks and uncertainties

Approach to risk

TSB identifies, assesses and manages the risks inherent in its business model and strategy, seeking to ensure that the Bank remains liquid, solvent, operationally stable, trusted, and compliant. Risks faced by the Bank in delivering its business strategy are managed to protect the interests of customers, Partners, and our shareholder. TSB's principal risks and uncertainties are described starting on page 12.

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

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

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

- *TSB remained highly liquid* – The heightened risk of deposit outflows did not crystallise and was managed through more frequent reporting and monitoring of liquidity reserves. Liquidity has remained strong as outlined on page 10 and has remained within risk appetite throughout the year.

- *TSB remained highly solvent* – As described on page 9, financial performance in 2018 was impacted by migration related charges and slower than recent growth rates. This resulted in a statutory loss before tax of £101.0m. While capital resources reduced marginally during 2018, TSB remains well capitalised as outlined on page 10. Timely completion of the customer remediation programme and the relaunch of products and services are required to improve TSB's financial performance in 2019.

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

Organisational preparedness for the planned UK withdrawal from the EU

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

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

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

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

Principal risks and uncertainties (continued)

Principal risks arising from TSB's business model

Financial risk	
Principal financial risks	• **Capital adequacy:** The risk associated with the failure to retain sufficient reserves or quality of capital to cover TSB's statutory requirements, losses and support business strategy. • **Liquidity:** The risk that the TSB is unable to meet its liabilities that are expected to fall due, or is unable to maintain regulator, investor or stakeholder confidence that this will be achieved. • **Profit resilience:** The risk that TSB fails to realise planned profits by a significant margin, or that profits are the subject of excessive levels of volatility • **Interest rate:** The risk that the net value of, or net income arising from, the firm's assets and liabilities is impacted as a result of changes to interest rates.
How TSB manages its financial risks	• Capital adequacy: Regular stress testing, including the Internal Capital Adequacy Assessment Process (ICAAP) assessment of the adequacy of TSB's capital, and regulatory change impact assessments, seeks to ensure that TSB maintains sufficient capital for continuing growth. • Liquidity: TSB maintains a stable and diverse funding profile. It undertakes an Internal Liquidity Adequacy Assessment Process (ILAAP) assessment of the adequacy of liquidity and funding resources, retains sufficient liquidity to meet its financial obligations as they fall due and uses wholesale funding facilities. • Profit Resilience: Risk adjusted returns are monitored and used both as an input to TSB's pricing decisions and to inform our strategy and medium term plan. Our planned growth of the SME book will also create further opportunities for income diversification. • Interest Rate: Rates remain historically low resulting in continued margin pressures. TSB uses derivative financial instruments in the normal course of business to manage interest rate risk. The hedge effectiveness of these derivatives is monitored regularly.

Strategic report (continued)

Principal risks and uncertainties (continued)

Credit risk	
Principal credit risks	• **Retail credit risk:** The risk that borrowers fail to repay on time interest or principal arising from retail personal or non-personal lending, and the risk of credit application fraud. • **Wholesale credit:** The risk of credit losses arising from counterparty lending. This includes credit losses from wholesale financial instruments including swaps, hedges, securitised bonds and governments funding initiatives. • **Credit models:** The risk that models used to manage credit risk are inadequate, are used inappropriately, or perform ineffectively.
How TSB manages its credit risks	• TSB adopts decision making processes and systems geared to provide affordable lending. The assessment of a customer's creditworthiness is based on individual needs and circumstances at the time of application. This approach helps customers borrow well and limits the risks associated with non-repayment. • Credit risk appetite is set for responsible and controlled growth and has measures and limits in place to act as a mechanism to prevent the bank and its customers from overreaching their ability to manage their borrowing. These measures include loan-to-value thresholds, loan-to-income ratios and credit concentration limits. • Occasionally, customer circumstance can change which could impact their ability to repay borrowings. TSB understands this and works with its customers to improve their position by offering various treatment strategies and support. • TSB monitors economic developments and assesses the impact on credit impairment losses from various forecast economic scenarios. Further information on the scenarios considered in measuring the credit impairment loss allowance at 31 December 2018, and sensitivities to alternative assumptions, is set out in note 11 to the consolidated financial statements. • TSB manages its exposure to wholesale credit risk carefully, applying strict external counterparty credit quality thresholds including monitoring the rating of counterparties. • All material credit models utilised by TSB are subject to regular independent assessment and validation, which seeks to ensure that models operate as designed and provide the correct outcomes. Any unexpected outcomes are rectified or mitigated before the model becomes part of TSB's credit risk management strategy. As a result of Sabadell's acquisition of TSB, there is an inspection by the Single Supervisory Mechanism (SSM), driven by a material change in the Sabadell Group IRB framework from the consolidation of TSB into Sabadell Group reporting. This inspection is focusing on TSB's IRB framework.
Further information	• Further information on TSB's credit risk exposures and how these are managed can be found in note 22 to the consolidated financial statements.

Strategic report (continued)

Principal risks and uncertainties (continued)

Operational risk	
Principal operational risks	• **IT Service resilience:** The risk of interruption to significant functions and services due to inadequate capacity management, recovery strategies or continuity of systems, processes and controls. • **Sourcing and contracting:** The risks arising from supplier selection, the establishment of effective service agreements, and the ongoing management of material suppliers such as IT service provision by Sabis UK. • **Cyber/information security:** The risk associated with acquiring, retaining, using and destroying physical and electronic data. This includes maintaining the integrity and appropriate use of data, particularly customer data (Privacy) as well as the confidentiality, availability and protection of data from both internal and external cyber-attack (Security). Potential impacts could include IT service availability, internal/external fraud, and/or customer data loss. • **Fraud:** The risk of exposure to losses arising from criminal activity perpetrated to achieve financial gain at the expense of the firm and our customers and resulting in customer detriment or reputational damage.
How TSB manages its operational risks	• TSB operates an operational risk policy and framework to identify and assess its operational risks, understand their potential impacts, and take action to mitigate and control them. • To maintain its service, incident management systems and processes are in place to identify and respond quickly to customer issues arising from these risks in order to lessen their impact. Sabis UK is the primary supplier of IT services to TSB and the combined risk and control environment has continued to be assessed and strengthened since migration with the aim of delivering a stable and compliant service. • To successfully manage its third party deliverables TSB operates a sourcing and contracting framework to complete due diligence, aiming to ensure contractual terms are appropriate, and operates a supplier management framework to monitor and manage the ongoing relationship • The external criminal environment is continually evolving with new threats and attacks identified almost daily. TSB is committed to making customers' banking experience as safe as possible. Certain functions, including the Security Operations Centre, are led and operated by Sabadell at a Group level. Within TSB, the Chief Information Security Officer establishes TSB's requirements for this capability. • TSB is, on occasion, targeted by criminals attempting to defraud the business and/or customers. Systems pro-actively monitor and protect against suspicious activity and have continued to be strengthened since migration. TSB operates an online Fraud Prevention Centre to educate its customers about the potential risks and ways in which it can work with customers to prevent fraudulent activity. In the event of fraud occurring, TSB works with all parties with the aim of ensuring that a fair customer outcome is achieved.

Strategic report (continued)

Principal risks and uncertainties (continued)

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

Strategic report (continued)

Principal risks and uncertainties (continued)

Emerging risks

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

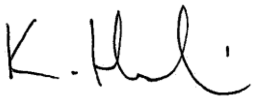
Principal risk	Overview of risk	Mitigating actions
Global economic and political trends	TSB is exposed to inherent risks from the macroeconomic environment and political uncertainty leading to adverse economic changes. These could have an impact on its business, customers and shareholder. TSB's credit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

Strategic report (continued)

Principal risks and uncertainties (continued)

Regulatory change (continued)	In December 2017, the Basel Committee on Banking Supervision (BCBS) finalised the ‘Basel III’ international regulatory capital framework for banks. In April 2017, the Bank of England recommended that the Sterling Overnight Index Average (SONIA) replaces LIBOR as their preferred risk-free rate for Sterling.	TSB has completed an assessment of its additional capital requirements under Basel III and is implementing the changes to its capital planning. In line with financial markets, TSB is working towards a transition to SONIA from the end of 2021

Strategic report on pages 3 to 17 approved, by order of the Board



Keith Hawkins
Company Secretary,
31 January 2019

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 2018, 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 17.

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
The Directors have the benefit of a deed of indemnity which constitutes a 'qualifying third party indemnity provision'. With the exception of Andy Simmonds the indemnities were in place throughout 2018. The indemnity for Andy Simmonds was executed on 7 August 2018. Each of the indemnities remain in force at the date of signing these financial statements and are available for inspection at the Company's registered office.

Corporate governance
Information on the Company's corporate governance arrangements can be found on pages 28 to 58 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 Bank's business model on pages 7 and 8.

Employee information
The Partners' report on pages 20 to 22 is an integral part of the Directors' report and provides information about the Company's Partners.

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

Financial instruments
Information on financial risk management objectives and policies in relation to the use of financial instruments can be found on pages 57 to 71 of the financial statements.

Principal risks and uncertainties
The principal risks and uncertainties faced by the Company are set out on pages 11 to 17.

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

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

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

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

Reappointment of external auditor
PricewaterhouseCoopers LLP, the auditors of the Company, have expressed their willingness to continue in office. A resolution proposing their reappointment as auditors of the Company will be considered at the 2019 Annual General Meeting.

Directors’ report (continued)

Disclosure of information to external auditors

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

Going concern

The Directors recognise their responsibility to make an assessment of the Company’s ability to continue as a going concern, for a period of at least twelve months from the date the financial statements are approved. The assessment is based on the Company having sufficient liquidity and capital, and includes consideration of its funding and capital plans and the Internal Liquidity Adequacy Assessment Process and the Internal Capital Adequacy Assessment Process approved annually by the Board. The Directors are satisfied that adequate funding and liquidity resources will be in place to allow the Company’s financial statements to continue being prepared on a going concern basis and are not aware of any material uncertainties that may cast significant doubt upon the Company’s ability to continue as a going concern.

Statement of Directors' responsibilities

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

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

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

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

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

By order of the Board

Keith Hawkins
Company Secretary,
31 January 2019

Partners' report

We are proud of the commitment of our Partners and the collaborative culture we have in TSB. During a challenging year the overwhelming feedback has been that TSB Partners have acted with determination, resilience and pride to put things right for our customers and support each other. We thank all of our Partners for helping our customers through the challenging period.

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

Encouraging Partner collaboration and feedback
Collaboration and two-way communication is encouraged at all levels and is key to TSB's strategy. 'The Link', a forum formed of Partners across all levels, gathers and builds on Partner feedback and enables meaningful dialogue between Partners and the executive leadership. There are five regional groups covering Britain, made up of Partners from every part of the business. The outputs from every meeting are presented to the Bank Executive Committee to help inform TSB's decision making and the direction of our bank. In 2019 they will also present directly to the Board.

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

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

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

Partner Wellbeing
Wellbeing was identified as an area for improvement by Partners in 2016 and throughout 2017 we had taken action to raise awareness of how Partners could find support from resources and tools available to them. This provided a solid foundation to ensure Partners were supported effectively during a challenging work environment experienced after the migration in 2018. Existing services include our Employee Assistance Programme, which gives all Partners free access to confidential counselling and professional advice, and an Occupational Health service which allows line managers to refer Partners for medical assessments and to ensure support is available to facilitate Partner recovery. In December 2018, TSB signed up to the TUC's *Dying to Work Charter* demonstrating our commitment to improving support at work for Partners who are living with terminal illnesses.

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

Partners' report (continued)

Diversity and inclusion

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

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

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

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

Gender balance

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

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

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

Our approach is improving gender balance:

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

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

Partners’ report (continued)

Training and development
To ensure that our culture and business strategies are aligned with our core values, we provide a range of training such as the TSB Experience, a transformational programme for all Partners which focuses on how they behave with customers and each other. Every Partner is also encouraged to have a personal development plan which they review regularly with their line manager. All Partners who are new to TSB are given an induction, Welcome to TSB, and our values form a key part of such induction. The Source (our new Learning Management System) guides Partners through all of the learning and development that is available, and a mentoring scheme encourages informal learning at all levels of experience. Our managers have extra responsibilities that involve managing people, so we give them special training, including sessions on Dignity and Respect at Work and Mental Health awareness.

Social responsibility
We are proud to be part of the community in hundreds of towns and cities across Britain. For instance, each bank branch and head office site chooses a local project or charity to support. Through TSB local volunteering, we encourage every Partner to spend at least eight hours each year supporting a local good cause with time and/or skills. We make it as easy, accessible and flexible as possible, so each of our Partners has the opportunity to take part, no matter what their role or location. Since moving to a local model, we have seen fundraising by Partners of over £500,000 each year for our charity partners.

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

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

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

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

Conclusion
We are proud of the strength of our culture and the extraordinary efforts of our Partners to put things right for our customers in 2018. We are also proud to have created a working environment where our Partners are able to be themselves regardless of gender, ethnicity, age or background. Going forward, we will continue building an organisation where our Partners are proud to work, whilst focusing on talent, succession and capability of our Partners.

Financial statements

Basis of preparation
These consolidated financial statements of TSB Bank plc comprise the results of the TSB Bank plc (the 'Company') consolidated with those of its subsidiaries (together the 'Bank'). Details of subsidiary undertakings are provided in note 28 to the financial statements. These consolidated financial statements have been prepared in accordance with the Companies Act 2006 and with International Financial Reporting Standards (IFRS), as adopted by the European Union (EU). IFRS comprises accounting standards prefixed IFRS, issued by the International Accounting Standards Board (IASB) and those prefixed IAS, issued by the IASB's predecessor body, as well as interpretations issued by the IFRS Interpretations Committee (IFRS IC) and its predecessor body. TSB applies the relaxations in hedge accounting requirements in the EU endorsed version of IAS 39 adopted by the EU (which are not available in the version issued by the IASB).

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

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

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

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

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

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

Details of the new accounting policies applied in respect of classification and measurement and impairment are set out on page 36 to 38. As permitted by the transitional provisions of IFRS 9, TSB has elected not to restate comparative figures for 2017. Adjustments to the carrying value of financial assets arising from the Bank's adoption of IFRS 9 were recognised in retained earnings as a 1 January 2018, the date of initial application. Consequently, for note disclosures, the consequential amendments to IFRS 7 '*Financial Instruments: Disclosures'* have only been applied to the current year. Details of the impact of the adoption of IFRS 9 are set out below.

Financial statements (continued)

Changes to accounting policies (continued)

IFRS 9 Financial Instruments (continued)
The classification and measurement of financial assets depend on how these are managed (the business model) and their contractual cash flow characteristics. The classification of the financial asset determines whether it is measured at amortised cost, fair value through other comprehensive income (FVOCI) or fair value through profit or loss (FVPL). The majority of the Bank's financial assets are loans and advances to customers previously classified, under IAS 39, as loans and receivables and held at amortised cost.

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

	IAS 39		IFRS 9	
	Measurement category	**Carrying amount £ million**	**Measurement category**	**Carrying amount £ million**
Financial assets:				
Cash, cash balances at central banks and other demand deposits	Loans and receivables (Amortised cost)	**7,563.4**	Amortised cost	**7,563.4**
Derivative financial assets	FVPL	**111.1**	FVPL	**111.1**
Equity instruments	FVPL	**1.3**	FVPL	**1.3**
Financial assets at fair value through profit or loss		**-**	FVPL	**7.0**
Available-for-sale financial assets	Available-for-sale	**2,123.3**	FVOCI	**2,116.3**
Loans to central banks	Loans and receivables	**56.0**	Amortised cost	**56.0**
Loans to credit institutions	Loans and receivables	**329.2**	Amortised cost	**329.2**
Loans and advances to customers	Loans and receivables	**30,854.2**	Amortised cost	**30,760.5**
Other advances	Loans and receivables	**896.0**	Amortised cost	**896.0**
Hedging derivative financial assets	FVPL	**103.7**	FVPL	**103.7**

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

	Loans and Advance to customers (Note 11) £ million	**Provisions for undrawn commitments (Note 32) £ million**	**Total £ million**
IAS 39 at 31 December 2017	71.6	–	71.6
Changes on adoption of IFRS 9	93.7	2.5	96.2
IFRS 9 at 1 January 2018 (note 11 and note 32)	**165.3**	**2.5**	**167.8**

IFRS 15 Revenue from Contracts with Customers
IFRS 15 replaces IAS 18 '*Revenue*' and other existing revenue recognition interpretations. It describes the principles an entity must follow to measure and recognise revenue using a five step approach. The standard requires revenue to be recognised when goods or services are transferred to customers and the entity has satisfied its performance obligations under the contract, and at an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. The standard does not apply to financial instruments or lease contracts.

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

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

Financial statements (continued)

Changes to accounting policies (continued)

Impact of the adoption of IFRS 9 and IFRS 15 at 1 January 2018
The following table summarises the adjustments to the Bank's balance sheet arising on adoption of IFRS 9 and IFRS 15.

	As at 31 Dec 2017 £ million	IFRS 9 Classification & Measurement £ million	IFRS 9 Impairment £ million	IFRS 15 £ million	As at 1 Jan 2018 £ million
Assets					
Cash, cash balances at central banks and other demand deposits	7,563.4	–	–	–	**7,563.4**
Financial assets held for trading:					
Derivative financial assets	111.1	–	–	–	**111.1**
Financial assets at fair value through profit or loss:	1.3	7.0	–	–	**8.3**
Financial assets at fair value through other comprehensive income	–	2,116.3	–	–	**2,116.3**
Available-for-sale financial assets	2,123.3	(2,123.3)	–	–	–
Financial assets at amortised cost:					
Loans to central banks	56.0	–	–	–	**56.0**
Loans to credit institutions	329.2	–	–	–	**329.2**
Loans and advances to customers	30,854.2	–	(93.7)	–	**30,760.5**
Other advances	896.0	–	–	–	**896.0**
Hedging derivative financial assets	103.7	–	–	–	**103.7**
Fair value adjustment for portfolio hedged risk	(22.2)	–	–	–	**(22.2)**
Property, plant and equipment	172.7	–	–	–	**172.7**
Intangible assets	10.1	–	–	–	**10.1**
Deferred tax assets	68.6	0.7	24.3	(1.6)	**92.0**
Other assets	269.3	–	–	5.9	**275.2**
Total assets	42,536.7	0.7	(69.4)	4.3	**42,472.3**
Provisions	34.5	–	2.5	–	**37.0**
Current tax liabilities	6.9	0.7	–	–	**7.6**
Other liabilities	40,488.7	–	–	–	**40,488.7**
Total liabilities	40,530.1	0.7	2.5	–	**40,533.3**
Share capital	79.4	–	–	–	79.4
Share premium	195.6	–	–	–	195.6
Other reserves	412.8	–	–	–	412.8
Retained profits	1,300.6	1.8	(71.9)	4.3	1,234.8
Valuation adjustments:					
Fair value reserve	-	16.9	–	–	16.9
Available-for-sale reserve	18.7	(18.7)	–	–	–
Cash flow hedging reserve	(0.5)	–	–	–	(0.5)
Shareholder's equity	2,006.6	–	(71.9)	4.3	**1,939.0**
Total equity and liabilities	42,536.7	0.7	(69.4)	4.3	**42,472.3**

Significant accounting estimates and judgements

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

The significant judgements made by management in applying accounting policies and the key sources of estimation uncertainty in these consolidated financial statements, which together are deemed critical to the results and financial position, are presented within the components of the Bank's business model as shown in the table below.

Significant accounting estimates	**Financial statement note**
Allowance for credit impairment losses on financial assets at amortised cost	Note 11
Provision for migration related customer remediation and rectification	Note 32
Customer remediation provisions	Note 32
Key judgements	
Recovery of post migration charges	Note 16
Assessment of exposure to regulatory investigations	Note 27(i)

Index to the consolidated financial statements

The Bank's primary consolidated financial statements are presented on pages 23 to 80. The notes to these consolidated financial statements are structured to follow the Bank's business model as set out on page 7 and are listed below.

Balance sheets

as at 31 December 2018

	Note	Bank 2018 £ million	Bank 2017 £ million	Company 2018 £ million	Company 2017 £ million
Assets					
Cash, cash balances at central banks and other demand deposits		**7,135.9**	7,563.4	**7,135.9**	7,563.4
Financial assets held for trading:					
Derivative financial assets	26	**88.4**	111.1	**88.4**	111.1
Financial assets at fair value through profit or loss	18	**1.4**	1.3	**1.4**	1.3
Financial assets at fair value through other comprehensive income	6	**2,387.8**	–	**2,387.8**	–
Available-for-sale financial assets	7	**–**	2,123.3	–	2,123.3
Financial assets at amortised cost:					
Debt Securities	6	**96.2**	–	**96.2**	–
Loans to central banks		**87.8**	56.0	**87.8**	56.0
Loans to credit institutions	8	**370.6**	329.2	–	–
Loans and advances to customers	9	**30,008.5**	30,854.2	**30,008.5**	30,854.2
Other advances	10	**381.4**	896.0	**381.4**	896.0
Hedging derivative financial assets	26	**106.6**	103.7	**43.1**	38.9
Fair value adjustments for portfolio hedged risk		**(37.3)**	(22.2)	**(37.3)**	(22.2)
Property, plant and equipment	29	**163.1**	172.7	**163.1**	172.7
Intangible assets	30	**18.4**	10.1	**18.4**	10.1
Current tax assets		**19.7**	–	**19.7**	–
Deferred tax assets	20	**113.0**	68.6	**113.0**	68.6
Other assets	31	**197.1**	269.3	**197.1**	269.3
Total assets		**41,138.6**	42,536.7	**40,704.5**	42,142.7
Liabilities					
Financial liabilities held for trading:					
Derivative financial liabilities	26	**93.1**	37.5	**93.1**	37.5
Financial liabilities at amortised cost:					
Borrowings from central banks		**6,482.2**	5,625.7	**6,482.2**	5,625.7
Deposits from credit institutions		**3.4**	–	**3.5**	–
Customer deposits	1	**29,084.3**	30,520.6	**29,084.3**	30,520.6
Repurchase agreements	4	**1,084.8**	1,446.4	**1,084.8**	1,446.4
Debt securities in issue	2	**1,122.6**	1,318.7	**498.4**	498.0
Subordinated liabilities	3	**398.2**	405.3	**398.2**	405.3
Other financial liabilities		**66.4**	247.3	**66.4**	247.3
Hedging derivative financial liabilities	26	**346.0**	566.5	**346.0**	566.5
Fair value adjustments for portfolio hedged risk		**19.4**	42.2	**19.4**	42.2
Current tax liabilities		**–**	6.9	–	6.9
Provisions	32	**63.6**	34.5	**63.6**	34.5
Other liabilities	33	**495.7**	278.5	**685.0**	704.7
Total liabilities		**39,259.7**	40,530.1	**38,824.9**	40,135.6
Equity					
Share capital	21	**79.4**	79.4	**79.4**	79.4
Share premium	21	**195.6**	195.6	**195.6**	195.6
Other reserves:					
Merger reserve	21	**412.8**	412.8	**412.8**	412.8
Retained profits brought forward	21	**1,234.8**	1,185.5	**1,234.8**	1,185.5
(Loss)/profit attributable to the shareholder for the current year	21	**(59.1)**	115.1	**(59.1)**	115.1
Valuation adjustments:					
Fair value reserve	21	**18.6**	–	**18.6**	–
Available-for-sale reserve	21	**–**	18.7	–	18.7
Cash flow hedging reserve	21	**(3.2)**	(0.5)	**(2.5)**	–
Shareholder's equity		**1,878.9**	2,006.6	**1,879.6**	2,007.1
Total equity and liabilities		**41,138.6**	42,536.7	**40,704.5**	42,142.7

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

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

The consolidated financial statements on pages 23 to 80 were approved by the Board of Directors on 31 January 2019 and signed on its behalf by:

Richard Meddings
Executive Chairman

Ralph Coates
Chief Financial Officer

Consolidated statement of comprehensive income

for the year ended 31 December 2018

Income statement:	Note	Bank 2018 £ million	Bank 2017* £ million
Interest and similar income:			
Interest income calculated using the effective interest method	13	**1,072.2**	1,113.9
Other interest income*	13	**(2.0)**	(26.4)
Total interest and similar income*		**1,070.2**	1,087.5
Interest and similar expense*	13	**(185.4)**	(161.6)
Net interest income	13	**884.8**	925.9
Fee and commission income	14	**122.1**	193.3
Fee and commission expense	14	**(46.7)**	(109.6)
Net fee and commission income	14	**75.4**	83.7
Net gains/(losses) on financial assets and liabilities:			
Gains on derecognition of financial assets measured at amortised costs		**–**	49.8
Gains on derecognition of financial assets measured at fair value through other comprehensive income		**21.4**	–
Gains on derecognition of available-for-sale financial assets		**–**	18.7
Gains on financial assets designated at fair value through profit or loss		**1.4**	0.1
Losses on financial assets and liabilities held for trading*		**(31.8)**	(14.0)
Gains from hedge accounting	26	**23.3**	24.5
Gains on derecognition of non-financial assets and liabilities		**1.1**	5.8
Other operating income:			
Migration related income from LBG	15	**318.3**	–
Other operating income	15	**1.4**	1.6
Other income		**410.5**	170.2
Total income		**1,295.3**	1,096.1
Operating expenses excluding costs of preparing for migration	16	**(905.7)**	(859.2)
Costs of preparing for migration	16	**(417.3)**	–
Total operating expenses	16	**(1,323.0)**	(859.2)
Operating (loss)/profit before impairment losses and taxation		**(27.7)**	236.9
Impairment losses on loans and advances to customers	11	**(72.8)**	(77.8)
Impairment losses on loan commitments	32	**(0.5)**	–
Total impairment losses		**(73.3)**	(77.8)
(Loss)/Profit before taxation		**(101.0)**	159.1
Taxation	19	**41.9**	(44.0)
(Loss)/Profit for the year	21	**(59.1)**	115.1
Other comprehensive (loss)/income:			
Items that may be subsequently reclassified to profit or loss:			
Change in available-for-sale reserve:			
Change in fair value		**–**	(4.5)
Gains transferred to profit or loss on disposal		**–**	22.0
Taxation thereon	20	**–**	(4.7)
	21	**–**	12.8
Change in fair value reserve:			
Change in the fair value of derivatives in cash flow hedges		**9.6**	–
Losses transferred to the income statement		**(7.3)**	–
Taxation thereon	20	**(0.6)**	–
	21	**1.7**	–
Change in cash flow hedging reserve:			
Change in the fair value of derivatives in cash flow hedges		**(3.8)**	8.4
Gains/(Losses) transferred to the income statement		**1.1**	(9.3)
	21	**(2.7)**	(0.9)
Other comprehensive (loss)/income for the year, net of taxation		**(1.0)**	11.9
Total comprehensive (loss)/income for the year		**(60.1)**	127.0

* Interest on derivatives held for trading (and entered into as economic hedges) of £20.6 million in 2017 has been reclassified to interest income from losses on financial instruments held for trading. Further, £13.7 million of interest income on derivatives in hedging accounting relationships where the hedged item was a liability has been reclassified from interest income to interest expense. The align with the accounting policy on page 48.

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

Statements of changes in equity
for the year ended 31 December 2018

Bank	Share capital £ million	Share premium £ million	Merger reserve £ million	Fair value reserve £ million	Available-for-sale reserve £ million	Cash flow hedging reserve £ million	Retained profit £ million	Share-holder's equity £ million
Balance at 1 January 2017	79.4	195.6	412.8	–	5.9	0.4	1,185.5	1,879.6
Comprehensive income:								
Profit for the year	–	–	–	–	–	–	115.1	115.1
Other comprehensive income/(loss)	–	–	–	–	12.8	(0.9)	–	11.9
Total comprehensive income	–	–	–	–	12.8	(0.9)	115.1	127.0
Balance at 31 December 2017	79.4	195.6	412.8	–	18.7	(0.5)	1,300.6	2,006.6
Change on initial application of IFRS 9				16.9	(18.7)		(70.1)	(71.9)
Change on initial application of IFRS 15							4.3	4.3
Balance at 1 January 2018	**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 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**

Company	Share capital £ million	Share premium £ million	Merger reserve £ million	Fair value reserve £ million	Available-for-sale reserve £ million	Cash flow hedging reserve £ million	Retained profit £ million	Share-holder's equity £ million
Balance at 1 January 2017	79.4	195.6	412.8	–	5.9	–	1,185.5	1,879.2
Comprehensive income:								
Profit for the year	–	–	–	–	–	–	115.1	115.1
Other comprehensive income/(loss)	–	–	–	–	12.8	–	–	12.8
Total comprehensive income	–	–	–	–	12.8	–	115.1	127.9
Balance at 31 December 2017	79.4	195.6	412.8	–	18.7	–	1,300.6	2,007.1
Change on initial application of IFRS 9				16.9	(18.7)		(70.1)	(71.9)
Change on initial application of IFRS 15							4.3	4.3
Balance at 1 January 2018	**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 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**

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

Cash flow statements

for the year ended 31 December 2018

	Note	Bank 2018 £ million	Bank 2017 £ million	Company 2018 £ million	Company 2017 £ million
Cash flows from operating activities					
(Loss)/profit before taxation		**(101.0)**	159.1	**(101.0)**	159.1
Adjustments for:					
Change in operating assets	34	**1,194.6**	(1,482.9)	**1,234.7**	(1,675.8)
Change in operating liabilities	34	**(1,557.8)**	1,173.8	**(1,557.6)**	1,174.4
Non-cash and other items	34	**152.4**	116.4	**148.1**	94.3
Taxation paid		**(7.0)**	(25.5)	**(7.0)**	(25.5)
Net cash provided by/(used in) operating activities		**(318.8)**	(59.1)	**(282.8)**	(273.5)
Cash flows from investing activities					
Purchase of property, plant and equipment		**(15.8)**	(15.8)	**(15.8)**	(15.8)
Purchase of financial assets		**(398.1)**	(62.9)	**(398.1)**	(62.9)
Interest received on financial assets		**76.6**	83.3	**76.6**	83.3
Proceeds on disposal of equity assets		**9.2**	–	**9.2**	–
Interest received on reverse repurchase agreements		**0.4**	0.4	**0.4**	0.4
(Sale)/Purchase of Sabadell shares		**(0.9)**	(0.9)	**(0.9)**	(0.9)
Net cash used in investing activities		**(328.6)**	4.1	**(328.6)**	4.1
Cash flows from financing activities					
Proceeds from borrowings from central banks		**850.0**	5,615.0	**850.0**	5,615.0
Interest paid on borrowings from central banks		**(32.0)**	(6.4)	**(32.0)**	(6.4)
Proceeds from debt securities in issue		–	497.5	**-**	497.7
Repayment of debt securities in issue		**(197.9)**	(2,128.4)	**(0.2)**	–
Interest paid on debt securities		**(12.4)**	(13.4)	**(4.4)**	–
Interest paid on subordinated liabilities		**(22.4)**	(22.1)	**(22.4)**	(22.1)
Net securitisation funding		–	–	**(241.7)**	(1,927.6)
(Repayment of)/Proceeds from repurchase agreements		**(361.9)**	36.9	**(361.9)**	36.9
Interest paid on repurchase agreements		**(3.5)**	(8.4)	**(3.5)**	(8.4)
Net cash provided by financing activities		**219.9**	3,970.7	**183.9**	4,185.1
Change in cash and cash equivalents		**(427.5)**	3,915.7	**(427.5)**	3,915.7
Cash and cash equivalents at 1 January	34	**7,563.4**	3,647.7	**7,563.4**	3,647.7
Cash and cash equivalents at 31 December		**7,135.9**	7,563.4	**7,135.9**	7,563.4

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

Notes to the consolidated financial statements

Sources of funding

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

Accounting policies relevant to sources of funding

(a) Financial liabilities

Financial liabilities is the term used to describe the Bank's deposits and funding. It includes customer deposits, deposits from credit institutions, borrowings from central banks, debt securities in issue, subordinated liabilities, other financial liabilities and derivative financial liabilities (see accounting policy (j) under Managing financial risk).

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

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

1. Customer deposits

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

2. Debt securities in issue

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

2017 Bank	Balance at 1 Jan 2017 £ million	(Repayments)/ Issues £ million	Exchange rate and other adjustments £ million	Balance at 31 Dec 2017 £ million
Debt securities issues in an EU Member State requiring filing of a prospectus:				
Securitisation programmes:				
Duncan Funding 2015-1 plc	514.9	(57.1)	10.4	468.2
Duncan Funding 2016-1 plc	510.9	(158.4)	–	352.5
	1,025.8	(215.5)	10.4	820.7
Covered bond programme:				
Series 2017-1 Covered Bonds	–	497.7	0.3	498.0
Debt securities issues in an EU Member State not requiring filing of a prospectus	1,914.3	(1,913.0)	(1.3)	–
Total debt securities in issue	2,940.1	(1,630.8)	9.4	1,318.7

Notes to the consolidated financial statements

Sources of Funding (continued)

2. Debt Securities in issue (continued)

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

Company	Balance at 1 Jan 2018 £ million	Issues/ (Repayments) £ million	Exchange rate and other adjustments £ million	Balance at 31 Dec 2018 £ million
Debt securities issued in an EU Member State requiring filing of a prospectus:				
Series 2017-1 Covered Bonds	**498.0**	**–**	**0.4**	**498.4**
Total debt securities in issue	**498.0**	**–**	**0.4**	**498.4**

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

Company	Date of issue	Amount 31 Dec 2018 £ million	Amount 31 Dec 2017 £ million	Interest rate at 31 Dec 2018	Maturity date	Issue currency	Target of offering
Issuing entity							
TSB Bank plc	12/2017	**498.4**	498.0	1.14650%	12/2022	GBR	Institutional
Total debt securities in issue		**498.4**	498.0				

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

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

Cash deposits of £342.3 million (2017: £313.0 million) held by 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.

Notes to the consolidated financial statements

Sources of Funding (continued)

2. Debt Securities in issue (continued)

Covered bond programmes

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

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

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

Cash deposits of £28.3 million (2017: £16.2 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 2018 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 2018 £ million	Bank 2017 £ million	Company 2018 £ million	Company 2017 £ million
Fixed/floating rate reset callable subordinated Tier 2 notes due May 2026	**384.4**	384.1	**384.4**	384.1
Accrued interest	**3.4**	3.4	**3.4**	3.4
Fair value hedge accounting adjustments	**10.4**	17.8	**10.4**	17.8
Total subordinated liabilities	**398.2**	405.3	**398.2**	405.3

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

4. Repurchase agreements

At 31 December 2018, the Company had entered into repurchase agreements that transferred legal title of certain UK gilts in return for cash, together with an agreement to repurchase the assets at a later date and at a predetermined price. The gilts were not derecognised from the consolidated balance sheet as substantially all of the rewards, including interest income, and risks, including credit and interest rate risks, are retained by the Bank. In all cases, the transferee has the right to sell or repledge the gilts concerned, subject to delivering the securities at the repurchase date.

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

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

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	2018 Carrying value £ million	2018 Fair value £ million	2017 Carrying value £ million	2017 Fair value £ million
Financial liabilities					
Customer deposits	1	**29,084.3**	**29,096.4**	30,520.6	30,558.9
Debt securities in issue	2	**1,122.6**	**1,121.4**	1,318.7	1,328.0
Subordinated liabilities	3	**398.2**	**381.1**	405.3	427.3
Trading derivative liabilities	26	**93.1**	**93.1**	37.5	37.5
Hedging derivative liabilities	26	**346.0**	**346.0**	566.5	566.5

Company	Note	2018 Carrying value £ million	2018 Fair value £ million	2017 Carrying value £ million	2017 Fair value £ million
Financial liabilities					
Customer deposits	1	**29,084.3**	**29,096.4**	30,520.6	30,558.9
Debt securities in issue	2	**498.4**	**496.5**	498.0	500.6
Subordinated liabilities	3	**398.2**	**381.1**	405.3	427.3
Trading derivative liabilities	26	**93.1**	**93.1**	37.5	37.5
Hedging derivative liabilities	26	**346.0**	**346.0**	566.5	566.5

The carrying amount of borrowings from central banks, deposits from credit institutions, repurchase agreements and other financial liabilities is a reasonable approximation of fair value, as these balances are either on demand or variable rate. Fair value is the price that would be paid to transfer a liability (or sell an asset) in an orderly transaction between market participants at the measurement date.

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 2018					
Customer deposits	–	**29,096.4**	–	**29,096.4**	**29,084.3**
Debt securities in issue	**1,121.4**	–	–	**1,121.4**	**1,122.6**
Subordinated liabilities	–	**381.1**	–	**381.1**	**398.2**
Trading derivative liabilities	–	**93.1**	–	**93.1**	**93.1**
Hedging derivative liabilities	–	**346.0**	–	**346.0**	**346.0**
At 31 December 2017					
Customer deposits	–	30,558.9	–	30,558.9	30,520.6
Debt securities in issue	1,328.0	–	–	1,328.0	1,318.7
Subordinated liabilities	–	427.3	–	427.3	405.3
Trading derivative liabilities	–	37.5	–	37.5	37.5
Hedging derivative liabilities	–	566.5	–	566.5	566.5

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

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

Company	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2018					
Customer deposits	–	**29,096.4**	–	**29,096.4**	**29,084.3**
Debt securities in issue	**496.5**	–	–	**496.5**	**498.4**
Subordinated liabilities	–	**381.1**	–	**381.1**	**398.2**
Trading derivative liabilities	–	**93.1**	–	**93.1**	**93.1**
Hedging derivative liabilities	–	**346.0**	–	**346.0**	**346.0**
At 31 December 2017					
Customer deposits	–	30,558.9	–	30,558.9	30,520.6
Debt securities in issue	500.6	–	–	500.6	498.0
Subordinated liabilities	–	427.3	–	427.3	405.3
Trading derivative liabilities	–	37.5	–	37.5	37.5
Hedging derivative liabilities	–	566.5	–	566.5	566.5

Notes to the consolidated financial statements

Loans

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

Accounting policies effective for the year ended 31 December 2018 – IFRS 9

(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 (k) under Managing financial risk), and other advances.

On initial recognition, financial assets are classified into one of three measurement categories, amortised cost, fair value through other comprehensive income, or fair value through profit or loss depending on 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 (k) under Managing financial risk). All equity instruments are measured at fair value through profit or loss. Dividends continue to be recognised in the income statement.

Loans (continued)

Accounting policies effective for the year ended 31 December 2018 – IFRS 9 (continued)

(c) Impairment of financial assets

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

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

Financial assets that are credit impaired at the date of their purchase or origination will be reported in a separate 'purchased or originated as credit impaired' (POCI) category until the loan is derecognised. The cumulative change in lifetime expected credit loss since the purchase or origination 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 and are not individually assessed. Given the predominant retail nature of TSB's loans, groupings are determined using product type, such as residential mortgages, personal loans, overdrafts, and credit card balances. The appropriateness of the groupings is monitored and reviewed on a periodic basis. TSB does not currently assess any material exposures on an individual basis.

Significant increase in credit risk

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

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

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

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 (continued)

Accounting policies effective for the year ended 31 December 2018 – IFRS 9 (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

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

For accounting purposes, the 12 month and lifetime PDs represent the probability of a default occurring over the next 12 months or the lifetime of the financial instruments, respectively, based on conditions existing at the balance sheet date and expected future economic conditions that affect credit risk.

The LGD represents losses expected on default, taking into account the mitigating effect of collateral, its expected value when realised and the time value of money and is discounted using the effective interest rate. The EAD represents the expected balance at default, taking into account the repayment of principal and interest from the balance sheet date to the default event together with any expected drawdown of a committed facility.

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

The measurement of ECL also requires the incorporation of multiple economic scenarios to calculate a probability weighted forward looking estimate. Further details on the approach and scenarios, together with sensitivity analysis is set out on pages 44 and 45.

(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 (continued)

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

Financial assets

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

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

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

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

(i) Loans and receivables

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

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

(ii) Available-for-sale financial assets

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

(iii) Repurchase agreements

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

Impairment of financial assets

(i) Accounted for at amortised cost

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

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

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

Notes to the consolidated financial statements

Loans (continued)

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

Impairment of financial assets (continued)

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

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

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

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

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

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

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

Notes to the consolidated financial statements

Loans (continued)

6. Debt Securities

Bank

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

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

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

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

Company

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

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

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

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

In June 2016, the Bank received Visa Inc. convertible preferred stock as partial consideration for the sale of its share in Visa Europe to Visa Inc. At 31 December 2017, the Bank's investment was recognised as a financial asset at fair value through other comprehensive income of £7.0 million. On 10 December 2018, this investment was sold to the parent company at its then fair value of £9.2m.

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

Loans (continued)

8. Loans to credit institutions

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

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

9. Loans and advances to customers

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

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

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

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

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

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

10. Other advances

	Bank 2018 £ million	Bank 2017 £ million	Company 2018 £ million	Company 2017 £ million
Items in the course of collection from credit institutions	**27.6**	252.6	**27.6**	252.6
Items in the course of collection from non-credit institutions	**14.8**	7.8	**14.8**	7.8
Collateral placed at central clearing houses	**326.2**	635.3	**326.2**	635.3
Collateral placed with credit institutions	**12.8**	0.3	**12.8**	0.3
Total other advances	**381.4**	896.0	**381.4**	896.0

Notes to the consolidated financial statements

Loans (continued)

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

(i) Allowance for credit impairment losses – IFRS 9

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

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

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

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

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

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

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

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

Notes to the consolidated financial statements

Loans (continued)

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

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

The adequacy of the allowance is estimated using models which use a variety of inputs, including recent historical experience to estimate the level of expected credit losses (ECL) in the portfolio. In certain circumstances adjustments are made to the modelled outcomes to reflect where, in management's judgement, the modelled outcomes are not sufficiently sensitive to current economic conditions. At 31 December 2018, the allowance included £51.4 million (2017 – IAS 39: £22.8 million) of post model adjustments. The most significant adjustments to modelled outputs reflect management's judgement as to the level of expected losses not captured by the impairment models arising from risks associated with interest only mortgage redemptions and customers that may not be able to service their borrowings in a higher interest rate environment. The recognition and measurement of ECL is highly complex and involves the use of significant judgement and estimation. This includes the formulation and incorporation of multiple forward-looking economic conditions into ECL to meet the measurement objective of IFRS 9.

Methodology

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

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

Forecast Economic Scenarios

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

- Base - This scenario features a relatively hard, but smooth, Brexit. Supply and demand remain balanced supporting GDP growth which remains consistent with recent experience at sub 2%, a lower rate than historically experienced. This scenario features a steady circa 4% unemployment rate with house prices trending gently higher in real terms and base rate remaining at historical lows, peaking at 2.0%.
- Downside – assumes a rapid tightening of UK and global financial conditions triggered by higher inflation and concerns about asset price valuations. These lead to reduced liquidity, higher risk premia and interest rates and weaker economic activity. This scenario features a peak to trough house price fall of 25.6%, unemployment and interest rate peaking at 6.4% and 3.3%, respectively. This scenario is considered to be reflective of a 'No Deal' Brexit but where the transition to WTO rules and future trading arrangements is more orderly than a 'cliff-edge' exit in March 2019.
- Upside – assumes an increase in productivity growth and continued loose financial conditions. These lead to faster growth relative to the base case without the development of serious inflation and provide a more favourable interest rate environment for banks' earnings. Unemployment shows a steady decline to a low of 3%, marking an historical UK low. Wage growth supports faster house price growth.

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

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

Notes to the consolidated financial statements

Loans (continued)

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

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

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

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

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

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

As explained on pages 23 to 25, with effect from 1 January 2018, TSB adopted IFRS 9 which had the effect of increasing the allowance for credit impairment losses by £93.7 million from £71.6 million at 31 December 2017 to £165.3 million at 1 January 2018.

12. Fair value of financial assets

The following table summarises the carrying values of financial assets presented on 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	2018 Carrying value £ million	2018 Fair value £ million	2017 Carrying value £ million	2017 Fair value £ million
Financial assets					
Debt Securities		**96.2**	**95.1**	–	–
Loans and advances to customers	9	**30,008.5**	**29,962.0**	30,854.2	30,854.0
Financial Assets at fair value through other comprehensive income	6	**2,387.8**	**2,387.8**	–	–
Available-for-sale financial assets	7	–	–	2,123.3	2,123.3
Trading derivative financial assets	26	**88.4**	**88.4**	111.1	111.1
Hedging derivative financial assets	26	**106.6**	**106.6**	103.7	103.7
Financial assets at fair value through profit or loss	18	**1.4**	**1.4**	1.3	1.3

Notes to the consolidated financial statements

Loans (continued)

12. Fair value of financial assets (continued)

Company	Note	2018 Carrying value £ million	2018 Fair value £ million	2017 Carrying value £ million	2017 Fair value £ million
Financial assets					
Debt Securities		**96.2**	**95.1**	–	–
Loans and advances to customers	9	**30,008.5**	**29,962.0**	30,854.2	29,250.3
Financial Assets at fair value through other comprehensive income	6	**2,387.8**	**2,387.8**	–	–
Available-for-sale financial assets	7	–	–	2,123.3	2,123.3
Trading derivative assets	26	**88.4**	**88.4**	111.1	111.1
Hedging derivative assets	26	**43.1**	**43.1**	38.9	38.9
Financial assets at fair value through profit or loss	18	**1.4**	**1.4**	1.3	1.3

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.

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	**95.1**	**–**	**–**	**95.1**	**96.2**
Loans and advances to customers	**–**	**–**	**29,962.0**	**29,962.0**	**30,008.5**
At 31 December 2018	**95.1**	**–**	**29,962.0**	**30,057.1**	**30,104.7**
At 31 December 2017	–	–	30,854.0	30,854.0	30,854.2

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.

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 2018					
Financial assets at fair value through other comprehensive income	**2,387.8**	–	–	**2,387.8**	**2,387.8**
Trading derivative assets	–	**88.4**	–	**88.4**	**88.4**
Hedging derivative assets	–	**106.6**	–	**106.6**	**106.6**
Financial assets at fair value through profit or loss	**1.4**	–	–	**1.4**	**1.4**
Total	**2,389.2**	**195.0**	–	**2,584.2**	**2,584.2**
At 31 December 2017					
Available-for-sale financial assets	2,116.3	–	7.0	2,123.3	2,123.3
Trading derivative assets	–	111.1	–	111.1	111.1
Hedging derivative assets	–	103.7	–	103.7	103.7
Financial assets at fair value through profit or loss	1.3	–	–	1.3	1.3
Total	2,117.6	214.8	7.0	2,339.4	2,339.4

Notes to the consolidated financial statements

Loans (continued)

12. Fair value of financial assets (continued)

Company	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2018					
Financial assets at fair value through other comprehensive income	**2,387.8**	–	–	**2,387.8**	**2,387.8**
Trading derivative assets	–	**88.4**	–	**88.4**	**88.4**
Hedging derivative assets	–	**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**
At 31 December 2017					
Available-for-sale financial assets	2,116.3	–	7.0	2,123.3	2,123.3
Trading derivative assets	–	111.1	–	111.1	111.1
Hedging derivative assets	–	38.9	–	38.9	38.9
Financial assets at fair value through profit or loss	1.3	–	–	1.3	1.3
Total	2,117.6	150.0	7.0	2,274.6	2,274.6

A description of the fair value levels is included in Note 6.

Level 3 financial assets	Bank 2018 £ million	Bank 2017 £ million	Company 2018 £ million	Company 2017 £ million
Balance at 1 January	**7.0**	5.2	**7.0**	5.2
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)**	–
Gains recognised in 'changes in fair value' in other comprehensive income	**–**	1.8	**–**	1.8
Balance at 31 December	**–**	7.0	**–**	7.0

Gilts and supranational and development bank bonds are valued using quoted market prices and are therefore classified as Level 1 assets. The only Level 3 financial asset carried at fair value at 31 December 2017 is the investment in Visa Inc. convertible preferred stock. A description of the valuation approach and the key unobservable inputs to the valuation are explained on page 41. Derivative financial assets are primarily interest rate swaps and are valued using a discounted cash flow model where the most significant input is interest yield curves which are developed from publicly quoted rates.

Notes to the consolidated financial statements

Income

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

Accounting policies effective for the year ended 31 December 2018 – IFRS 9

(e) Interest income and expense

Financial instruments classified as amortised cost and fair value through other comprehensive income

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

The effective interest rate is calculated on initial recognition of the financial asset or liability, estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts paid or received by 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 when the service has been provided and the Bank has satisfied its performance obligations.

Renewal commission income is recognised when the Bank satisfies its performance obligations under the relevant contract and management concludes that there is a high probability that there will be no significant reversal of the estimated income.

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

Interest income and expense

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

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

Fees and commission income and expense

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

Notes to the consolidated financial statements

Income (continued)

13. Net interest income

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

* Interest on derivatives held for trading (and entered into as economic hedges) of £20.6 million in 2017 has been reclassified to 'interest income' from 'losses on financial assets and liabilities held for trading'. Further, £13.7 million of interest income on derivatives in hedging accounting relationships where the hedged item was a financial liability have been reclassified from 'interest income' to 'interest expense'. These align with the accounting policy on page 48.

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

14. Net fee and commission income

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

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

15. Other operating income

Bank	2018 £ million	2017 £ million
Migration related income from LBG	**318.3**	–
Rent receivable	**1.0**	1.2
Dividend income	**0.2**	0.2
Other income	**0.2**	0.2
Total other operating income	**319.7**	1.6

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

Notes to the consolidated financial statements

Charges

Running a bank with 5 million customers comes with overheads. Charges we incur include the costs of paying our TSB Partners, running our branches, investing in our business, paying for advertising and marketing, and in 2018, the costs of preparing for the migration and the subsequent service disruption. Occasionally, our customers' circumstances change and they are unable to repay the money they borrow from us causing us to incur impairment losses. Finally, 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 Partners. The total expense is recognised over the vesting period, which is the period over which all of the specified vesting conditions are to be satisfied. A corresponding credit is recognised as a liability. In addition, in some circumstances employees may provide services in advance of the grant date and therefore the liability is estimated for the purposes of recognising the expense during the period between service commencement period and grant date.

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

(i) Taxation

Current corporation tax which is payable or receivable on taxable profits or losses is recognised as 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)

16. Operating expenses

Bank	2018 £ million	2017 £ million
Partner (staff) costs		
Wages and salaries	**263.5**	262.6
Social security costs	**27.2**	29.7
Other pension costs	**35.1**	32.7
Share-based payments (note 18)	**(2.7)**	6.4
Other staff costs	**10.2**	38.9
Total staff costs	**333.3**	370.3
Premises and equipment expenses		
Rent	**32.1**	30.8
Rates	**14.2**	14.7
Other	**32.2**	31.3
Total premises and equipment expenses	**78.5**	76.8
Other expenses		
Post migration customer redress	**107.3**	–
Post migration customer rectification	**17.9**	–
Migration related fraud and operational losses	**49.1**	–
Outsourcing costs	**165.3**	213.8
Professional fees	**63.7**	27.2
Advertising and promotion	**55.4**	59.0
Financial Services Compensation Scheme levy	**(1.4)**	0.3
Other	**161.5**	84.0
Recovery of additional post migration charges	**(153.0)**	–
Total other expenses	**465.8**	384.3
Depreciation of property plant and equipment	**24.6**	27.5
Depreciation of intangible assets	**3.5**	0.3
Total operating expenses excluding the costs of preparing for TSB's migration	**905.7**	859.2
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 expense	**1,323.0**	859.2

Post migration charges of £296.7 million (page 9) include customer redress and associated operational costs of £107.3 million, customer rectification and associated costs of £17.9 million, fraud and operational losses of £49.1 million and incremental resource and advisory costs of £122.4 million to support TSB's remediation programme (of which £19.2 million are included in staff costs, £2.0 million in premises and equipment expenses and £101.2 million is included in other expenses).

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

Notes to the consolidated financial statements

Charges (continued)

16. Operating expenses (continued)

The monthly average number of Partners on a headcount basis during the year was 8,439 (2017: 8,583), all of whom were employed in the UK. Included in Partner costs is remuneration paid to key management personnel as set out in note 28(i).

Included in other expenses are fees paid to the Bank's auditors in respect of work carried out for the Bank of £4.5 million (2017: £2.5 million). Of this amount, £4.4 million (2017: £2.2 million) was in respect of the audit of the Bank's and Company's financial statements and £0.1 million (2017: £0.3 million) was in respect of non-audit services. The 2018 fee for the audit of TSB includes additional fees in respect of changes to the IT platform and associated control environment following migration. In addition to the above fees payable to TSB's auditors, £0.4 million (2017: £1.1 million) was paid to LBG in respect of a review by their auditors of controls undertaken on TSB's behalf under the TSA.

17. Directors' emoluments

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

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

The aggregate remuneration, including cash received under long-term incentive arrangements, of the highest paid director was £903,897 (2017: £1,755,470) for qualifying services as a TSB director in the period to 3 September 2018. Notice payments of £437,720 were paid between 4 September and 31 December 2018 and £801,030 of notice payments are payable in 2019.

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

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

18. Share-based payments

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

During 2018 and 2017, the Bank operated a Sharesave scheme and a Share Incentive Plan (SIP), both of which provide all Bank Partners with the opportunity to own shares in Sabadell and the Sustainable Performance Award (SPA) scheme for more senior Partners. As all share-based compensation schemes involve an award of, or options over, Sabadell shares, these arrangements are accounted for as cash settled share-based payment arrangements resulting in the recognition of a liability. This liability is remeasured monthly, with changes recognised in operating expenses, to reflect the latest Sabadell share price and the estimated numbers of shares expected to vest.

The credit recognised in operating expenses in 2018 reflects that the unvested SPA awards due to vest in March 2019 will not vest due to performance against the pre-determined financial target not being achieved. At 31 December 2018, £4.9 million (2017: £10.1 million) was recognised in respect of share-based payments liability (see note 33).

Sustainable Performance Award (SPA)
The SPA is a discretionary long term incentive arrangement under which share grants vest between one and five years post grant (and between three and seven years post grant for certain senior executives) subject to the achievement of certain personal and corporate performance conditions. During 2018 2,464,434 Sabadell shares (2017: 2,938,753 Sabadell shares), with a fair value calculated using the market price at 31 December 2018, of £2.2 million (2017: £4.3 million), were awarded to certain senior Partners under the SPA in respect of the 2017 performance year. The carrying amount of the liability in respect of the SPA at 31 December 2018 was £nil (2017: £6.3 million).

Notes to the consolidated financial statements

Charges (continued)

18. Share-based payments (continued)

Sharesave scheme

Eligible Partners may choose to enter into a contract to save up to £500 per month and, at the maturity date, three years from the start of the savings contract, have the option to use these savings within six months to acquire shares in Sabadell at £0.7768, being a 20% discount to the average closing price and Sterling/Euro exchange rate on the date of the Sharesave invitation. Alternatively, eligible Partners may take the accumulated savings balance as a cash payment. Movements in the number of Sharesave options outstanding are set out below:

Bank	2018		2017	
	Number of options (Sabadell) (000's)	Weighted average exercise price (pence)	Number of options (Sabadell) (000's)	Weighted average exercise price (pence)
Outstanding at 1 January	**13,001**	**77.68**	13,974	77.68
Granted	–	–	–	–
Exercised	**(197)**	**77.68**	(65)	77.68
Forfeited	**(499)**	**77.68**	(554)	77.68
Cancelled	**(315)**	**77.68**	(354)	77.68
Outstanding at 31 December	**11,990**	**77.68**	13,001	77.68
Exercisable at 31 December	–	–	–	–

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

Economic hedging of share based compensation liability

At 31 December 2018, £1.4 million (2017: £1.3 million) of Sabadell shares were held for the purpose of hedging the Bank's obligations under share based compensation arrangements. As set out in note 28(ii), during 2018, the Bank entered into a forward purchase agreement with Sabadell to acquire shares to satisfy obligations under the SPA and other share based compensation arrangements which, at 31 December 2018, had a fair value of £1.9 million (2017: £6.9 million). The equity shares and the forward purchase agreement are each measured at fair value through profit or loss on the consolidated balance sheet and reduce the accounting mismatch arising from the volatility of marking to market the share-based payment liability.

19. Taxation

	2018 £ million	2017 £ million
UK corporation tax		
Current tax credit/(charge) on (loss)/profit for the year	**23.1**	(20.4)
Adjustments in respect of prior year	**(2.8)**	2.7
Current tax credit/(charge)	**20.3**	(17.7)
Deferred tax (note 20)		
Origination and reversal of temporary differences:		
Deferred tax charge on business transfers	**(19.3)**	(23.8)
Accelerated capital allowances	**0.6**	1.7
Adjustments in respect of prior years	**3.4**	(4.2)
Deferred tax credit in relation to trading losses	**37.8**	–
Other	**(0.9)**	–
Deferred tax credit/(charge)	**21.6**	(26.3)
Taxation credit/(charge)	**41.9**	(44.0)

Notes to the consolidated financial statements

Charges (continued)

19. Taxation (continued)

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

	2018 £ million	2017 £ million
(Loss)/Profit before taxation	**(101.0)**	159.1
Taxation credit/(charge) at applied UK corporation tax rate of 27.0% (2017: 27.25%)	**27.3**	(43.4)
Factors affecting charge:		
Disallowed costs	**(85.8)**	(1.2)
Non-taxable items	**104.3**	0.1
Changes to UK corporation tax rates	**(4.5)**	–
Taxable profits not subject to 8% bank surcharge	**–**	2.0
Adjustments in respect of prior years	**0.6**	(1.5)
Taxation credit/(charge)	**41.9**	(44.0)

The applied UK corporation tax rate of 27% for 2018 includes the 8% bank surcharge on profits in excess of £25 million that was effective from 1 January 2016 together with the average UK corporation tax rate of 19%. Disallowed costs and non-taxable items primarily reflect costs incurred under the MSA and migration related income from LBG respectively.

20. Deferred tax assets

The movement in deferred tax assets is as follows:

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

Deferred tax assets are comprised as follows:

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

Notes to the consolidated financial statements

Profits and returns to the shareholder

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

Accounting policies relevant to profits and returns to the shareholder

(j) Share capital

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

21. Shareholder's equity

Bank	Share capital £ million	Share premium £ million	Merger reserve £ million	Fair value reserve £ million	Available-for-sale reserve £ million	Cash flow hedging reserve £ million	Retained profit £ million
Balance at 1 January 2017	79.4	195.6	412.8	–	5.9	0.4	1,185.5
Net movement in available-for-sale reserve	–	–	–	–	12.8	–	–
Net movement in cash flow hedging reserve	–	–	–	–	–	(0.9)	–
Profit for the year	–	–	–	–	–	–	115.1
Balance at 31 December 2017	79.4	195.6	412.8	–	18.7	(0.5)	1,300.6
Change on adoption of IFRS 9	–	–	–	16.9	(18.7)	–	(70.1)
Change on adoption of IFRS 15	–	–	–	–	–	–	4.3
Balance at 1 January 2018	**79.4**	**195.6**	**412.8**	**16.9**	–	**(0.5)**	**1,234.8**
Net movement in fair value reserve	–	–	–	1.7	–	–	–
Net movement in cash flow hedging reserve	–	–	–	–	–	(2.7)	–
Loss for the year	–	–	–	–	–	–	(59.1)
At 31 December 2018	**79.4**	**195.6**	**412.8**	**18.6**	–	**(3.2)**	**1,175.7**

Company	Share capital £ million	Share premium £ million	Merger reserve £ million	Fair value reserve £ million	Available-for-sale reserve £ million	Cash flow hedging reserve £ million	Retained profit £ million
Balance at 1 January 2017	79.4	195.6	412.8	–	5.9	–	1,185.5
Net movement in available-for-sale reserve	–	–	–	–	12.8	–	–
Net movement in cash flow hedging reserve	–	–	–	–	–	–	–
Profit for the year	–	–	–	–	–	–	115.1
Balance at 31 December 2017	79.4	195.6	412.8	–	18.7	–	1,300.6
Change on initial application of IFRS 9	–	–	–	16.9	(18.7)	–	(70.1)
Change on initial application of IFRS 15	–	–	–	–	–	–	4.3
Balance at 1 January 2018	**79.4**	**195.6**	**412.8**	**16.9**	–	–	**1,234.8**
Net movement in fair value reserve	–	–	–	1.7	–	–	–
Net movement in cash flow hedging reserve	–	–	–	–	–	(2.5)	–
Loss for the year	–	–	–	–	–	–	**(59.1)**
At 31 December 2018	**79.4**	**195.6**	**412.8**	**18.6**	–	**(2.5)**	**1,175.7**

Notes to the consolidated financial statements

Profits and returns to the shareholder (continued)

21. Shareholder’s equity (continued)

Description of reserves

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.

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* adopted by the EU which are not available in the version issued by the IASB, specifically relating to hedging core deposits. The effectiveness of the hedging relationship is tested both at inception and throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its documented objective, hedge accounting is discontinued. TSB designates certain derivatives as either hedges of the fair value of recognised assets or liabilities (fair value hedges) or hedges of highly probable future cash flows attributable to recognised assets or liabilities (cash flow hedges).

Fair value hedges

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

Cash flow hedges

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

Notes to the consolidated financial statements

Managing financial risk (continued)

22. Credit risk – IFRS 9

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

(i) Maximum credit exposure

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

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

	Bank 2018 £ million	Company 2018 £ million
Loans to central banks	**87.8**	**87.8**
Loans to credit institutions	**370.6**	**–**
Loans and advances to customers – secured (retail)(1)	**27,923.8**	**27,923.8**
Loans and advances to customers – unsecured and business banking(1)(2)	**2,084.7**	**2,084.7**
Financial assets at fair value through other comprehensive income	**2,387.8**	**2,387.8**
Other advances	**42.4**	**42.4**
Financial assets not subject to impairment requirements	**195.0**	**195.0**
Total on balance sheet balance	**33,092.1**	**32,721.5**
Lending commitments – secured (retail)	**1,030.0**	**1,030.0**
Lending commitments – unsecured and business banking	**3,748.1**	**3,748.1**
Maximum credit risk exposure	**37,870.2**	**37,499.6**

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

Notes to the consolidated financial statements

Managing financial risk (continued)

22. Credit risk – IFRS 9 (continued)

(ii) Quality of credit risk exposures

Internal rating scales

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

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

Secured (retail)

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

Unsecured and business banking

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

(iii) Collateral held as security for financial assets

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.

Secured (retail)

An analysis by loan-to-value (LTV) ratio of the Bank's credit impaired (stage 3) retail mortgage lending is presented below. The value of collateral used in determining the LTV ratios has been estimated based upon the last actual valuation, adjusted to take into account subsequent movements in house prices.

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

Managing financial risk (continued)

22. Credit risk – IFRS 9 (continued)

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

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

Notes to the consolidated financial statements

Managing financial risk (continued)

23. Credit risk – IAS 39

(i) Credit quality of assets – IAS 39 basis

Loans and receivables

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

	Loans and advances to customers			Other loans and receivables[1]
At 31 December 2017	Mortgages[2] £ million	Unsecured lending and business banking £ million	Total £ million	£ million
Neither past due nor impaired	27,988.5	2,425.2	30,413.7	385.2
Past due but not impaired	323.8	34.2	358.0	–
Impaired – no provision required	46.3	27.1	73.4	–
Impaired - provision held	35.1	45.6	80.7	–
Gross loans and receivables	28,393.7	2,532.1	30,925.8	385.2
Allowance for impairment losses (note 11)	(25.7)	(45.9)	(71.6)	–
Net loans and receivables	28,368.0	2,486.2	30,854.2	385.2

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

Loans and receivables which are neither past due nor impaired

	Loans and advances to customers			Other loans and receivables
31 December 2017	Mortgages £ million	Unsecured lending and business banking £ million	Total £ million	£ million
Good quality	27,939.2	2,108.6	30,047.8	385.2
Satisfactory quality	41.3	252.8	294.1	–
Lower quality	5.1	30.4	35.5	–
Below standard, but not impaired	2.9	33.4	36.3	–
Total loans and receivables which are neither past due nor impaired	27,988.5	2,425.2	30,413.7	385.2

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

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

Loans and receivables which are past due but not impaired

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

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

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

Notes to the consolidated financial statements

Managing financial risk (continued)

23. Credit risk – IAS 39 (continued)

(ii) Collateral held as security for financial assets

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

Mortgages

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

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

Unsecured lending and business banking

At 31 December 2017, unimpaired unsecured and business banking lending amounted to £2,485.5 million. At 31 December 2017, impaired unsecured and business banking lending amounted to £0.7 million, net of an impairment allowance of £45.9 million. Non-mortgage retail lending is unsecured, with no collateral held in respect of retail credit cards, overdrafts, or unsecured personal loans.

For business banking lending, collateral primarily consists of second charges over commercial and residential property. Where collateral is held, lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on any collateral provided. Collateral values are assessed at the time of loan origination and reassessed if there is observable evidence of distress of the borrower. At 31 December 2017, credit risk is mitigated by collateral held totalling £159.1 million.

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

24. Liquidity risk

Definition and exposure

Liquidity risk is the risk that 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 and liquidity position is underpinned by its significant customer deposit base. The deposit base is made up of customer current and savings accounts which, although mostly repayable on demand, have historically provided a stable source of funding. At 31 December 2018, the Bank's primary liquidity portfolio totalled £9,438.9 million (2017: £9,536.2 million). This comprised £6,954.9 million (2017: £7,419.9 million) held on deposit with the Bank of England, a £2,058.7 million (2017: £1,721.5 million) portfolio of UK gilts (of which £1,084.5 million (2017: £1,444.7 million) had been sold under repurchase agreements) and £425.3 million (2017: £394.8 million) of supranational and development bank bonds.

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Liquidity risk (continued)

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.

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

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	**26,865.6**	**175.0**	**798.3**	**1,245.4**	–	**29,084.3**
Repurchase agreements	**1,084.8**	–	–	–	–	**1,084.8**
Debt securities in issue	–	**53.7**	**130.5**	**938.4**		**1,122.6**
Subordinated liabilities	–	–	**3.4**	**394.8**	–	**398.2**
Other financial liabilities	**66.4**	–	–	–	–	**66.4**
Trading derivative liabilities	**0.3**	**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 (1)	**559.3**	–	–	–	**19.4**	**578.7**
Total liabilities	**28,592.0**	**231.6**	**934.2**	**9,108.6**	**393.3**	**39,259.7**

(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**	–	–	**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**
Trading derivative assets	**0.8**	**0.9**	**6.1**	**50.6**	**30.0**	**88.4**
Hedging derivative assets	–	**0.3**	**4.6**	**95.2**	**6.5**	**106.6**
Other assets (2)	**7,335.9**	**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**

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

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Liquidity risk (continued)

Bank At 31 December 2017	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Liabilities						
Financial liabilities measured at amortised cost:						
Borrowings from central banks	5,625.7	–	–	–	–	5,625.7
Customer deposits	26,680.8	669.7	2,087.8	1,082.3	–	30,520.6
Repurchase agreements	1,446.4	–	–	–	–	1,446.4
Debt securities in issue	–	62.6	144.1	1,112.0	–	1,318.7
Subordinated liabilities	17.8	–	3.4	384.1	–	405.3
Other financial liabilities	247.3	–	–	–	–	247.3
Trading derivative liabilities	0.3	0.9	4.7	24.4	7.2	37.5
Hedging derivative liabilities	–	–	3.2	19.4	543.9	566.5
Other liabilities	320.7	0.1	(2.7)	9.5	34.5	362.1
Total liabilities	34,339.0	733.3	2,240.5	2,631.7	585.6	40,530.1
Assets						
Financial assets at amortised cost						
Loans to central banks	56.0	–	–	–	–	56.0
Loans to credit institutions	–	205.1	–	124.1	–	329.2
Loans and advances to customers	1,094.8	260.8	1,320.4	5,987.4	22,190.8	30,854.2
Other advances	896.0	–	–	–	–	896.0
Available-for-sale financial assets	–	–	–	–	2,123.3	2,123.3
Trading derivative assets	0.2	0.6	10.9	66.1	33.3	111.1
Hedging derivative assets	–	–	1.3	96.1	6.3	103.7
Other assets	7,833.0	–	10.9	57.7	161.6	8,063.2
Total assets	9,880.0	466.5	1,343.5	6,331.4	24,515.3	42,536.7

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Liquidity risk (continued)

Contractual maturities for financial liabilities form an important source of information for the management of liquidity risk. The tables below analyse 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 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**

Bank At 31 December 2017	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Financial liabilities						
Financial liabilities measured at amortised cost:						
Deposits from central banks	5,625.7	–	–	–	–	5,625.7
Deposits from credit institutions	–	–	–	–	–	–
Customer deposits	26,679.4	680.0	2,120.0	1,099.0	–	30,578.4
Repurchase agreements	1,296.2	–	150.2	–	–	1,446.4
Debt securities in issue	–	52.6	148.9	1,080.0	–	1,281.5
Subordinated liabilities	–	–	22.1	440.3	–	462.4
Other financial liabilities	247.3	–	–	–	–	247.3
Total non-derivative financial liabilities	33,848.6	732.6	2,441.2	2,619.3	–	39,641.7
Gross settled derivative - outflows	16.7	16.8	161.3	753.4	605.9	1,554.1
Gross settled derivative - inflows	(15.6)	(12.6)	(87.8)	(591.3)	(271.1)	(978.4)
Total financial liabilities	33,849.7	736.8	2,514.7	2,781.4	334.8	40,217.4

Notes to the consolidated financial statements

Managing financial risk (continued)

24. Liquidity risk (continued)

The tables below analyse 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 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**

Company At 31 December 2017	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Financial liabilities						
Financial liabilities measured at amortised cost:						
Deposits from central banks	5,625.7	–	–	–	–	5,625.7
Deposits from credit institutions	–	–	–	–	–	–
Customer deposits	26,679.4	680.0	2,120.0	1,099.0	–	30,578.4
Repurchase agreements	1,296.2	–	150.2	–	–	1,446.4
Debt securities in issue	–	0.9	2.9	515.3	–	519.1
Subordinated liabilities	–	–	22.1	440.3	–	462.4
Other financial liabilities	247.3	–	–	–	–	247.3
Total non-derivative financial liabilities	33,848.6	680.9	2,295.2	2,054.6	–	38,879.3
Gross settled derivative - outflows	8.7	16.0	136.1	497.1	605.9	1,263.8
Gross settled derivative - inflows	(6.7)	(12.5)	(61.8)	(271.0)	(271.1)	(623.1)
Total financial liabilities	33,850.6	684.4	2,369.5	2,280.7	334.8	39,520.0

25. Capital resources

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

	Bank 2018 £ million	Bank 2017 £ million	Company 2018 £ million	Company 2017 £ million
Shareholder's equity	**1,878.9**	2,006.6	**1,879.6**	2,007.1
Regulatory deductions	**(58.3)**	(97.5)	**(59.0)**	(97.5)
Common Equity Tier 1/Total Tier 1 capital	**1,820.6**	1,909.1	**1,820.6**	1,909.6
Tier 2 capital	**390.6**	384.1	**390.6**	384.1
Total capital resources	**2,211.2**	2,293.2	**2,211.2**	2,293.7

Notes to the consolidated financial statements

Managing financial risk (continued)

26. Market risk

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

Management and measurement
Risk exposure across the Bank is monitored monthly using, primarily, net interest income and earnings sensitivity. This methodology considers all re-pricing mismatches in the current balance sheet and calculates the change in net interest income that would result from a set of defined interest rate shocks. A limit structure exists to ensure that risks stemming from residual positions or from changes in assumptions about customer behaviour remain within 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 2018, the projected change in 12 month net interest income in response to an immediate parallel shift in all relevant interest rates, market and administered, would be an increase of £20.3 million (2017: £10.2 million) from a 25bps increase in rates, and a decrease of £0.7 million (2017: £18.3 million) from a 25bps decrease. The measure assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount and does not take into account potential management actions.

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

	2018				2017			
Trading derivative instruments	Contract/ notional amount £ million	Assets fair value £ million	Liabilities fair value £ million	Gain/(loss) recognised in profit or loss £ million	Contract/ notional amount £ million	Assets fair value £ million	Liabilities fair value £ million	Gain(loss) recognised in profit or loss £ million
Interest rate swaps	**18,301.0**	**86.5**	**(92.5)**	**(27.3)**	21,039.2	104.2	(37.1)	(17.4)
Foreign exchange forwards	**27.0**	–	**(0.5)**	**0.4**	30.5	–	(0.4)	(0.2)
Equity options	**8.7**	**1.9**	**–**	**(4.9)**	8.7	6.9	–	3.6
Total	**18,336.7**	**88.4**	**(93.1)**	**(31.8)**	21,078.4	111.1	(37.5)	(14.0)

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

Notes to the consolidated financial statements

Managing financial risk (continued)

26. Market risk (continued)

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

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

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

The Group 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 number of factors which include, but are not limited to, basis mismatch in the benchmark rate used to discount cash flows of the hedged item and hedging instrument, maturity mismatch between the hedged item and hedging instrument, and cash flow timing mismatch between the hedged item and hedging instrument.

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

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

Foreign exchange on foreign currency debt (cash flow hedge)
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.

Notes to the consolidated financial statements

Managing financial risk (continued)

26. Market risk (continued)

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

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

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

2018	Carrying amount of hedged item Assets/(Liability) £ million	Accumulated fair value hedge adj. on hedged item £ million	Balance sheet line item that includes the hedged item	Change in fair value for calculating hedge ineffectiveness £ million	Cash flow hedge reserve Continuing hedges £ million
Interest rate risk (Fair value hedges)					
Demand deposits	**(6,248.8)**	**(9.4)**	**Customer deposits**	**18.6**	**n/a**
Fixed rate subordinated liabilities	**(398.2)**	**(10.4)**	**Subordinated liabilities**	**7.4**	**n/a**
Fixed rate mortgages	**8,181.6**	**(35.2)**	**Loans & adv to customers**	**(25.7)**	**n/a**
Debt securities	**2,384.8**	**–**	**Financial assets at FVOCI**	**(14.1)**	**n/a**
Debt securities	**96.2**	**2.2**	**Financial assets at amortised cost**	**2.2**	**n/a**
	4,015.6	**(52.8)**		**(11.6)**	**n/a**
Interest rate and credit risk (Cash flow hedges)					
Debt securities	**–**	**n/a**	**n/a**	**2.5**	**(2.5)**
Foreign exchange risk (Cash flow hedges)					
Debt securities in issue	**(317.6)**	**n/a**	**n/a**	**1.3**	**(0.7)**
2017					
Interest rate risk (Fair value hedges)					
Demand deposits	(4,739.4)	(44.9)	Customer deposits	2.8	n/a
Fixed rate subordinated liabilities	(405.3)	(17.8)	Subordinated liabilities	8.3	n/a
Fixed rate mortgages	7,020.5	(17.9)	Loans & adv to customers	(30.6)	n/a
Debt securities	2,116.3	–	Available-for-sale financial assets	(44.0)	n/a
	3,992.1	(80.6)		(63.5)	
Interest rate and credit risk (Cash flow hedges)					
Debt securities	–	n/a	n/a	–	–
Foreign exchange risk (Cash flow hedges)					
Debt securities in issue	(348.4)	n/a	n/a	(8.4)	(0.5)

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

Notes to the consolidated financial statements

Managing financial risk (continued)

26. Market risk (continued)

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

2018	Hedge ineffectiveness recognised in P&L £ million	Gain/(loss recognised in OCI £ million	P&L line item that includes hedge ineffectiveness	Amounts reclassified from reserves to P&L as: Hedged item affected P&L £ million	P&L line item that includes reclassified amount £ million
Interest rate risk (Fair value hedges)	**(2.3)**	**–**	Gains from hedge accounting	**–**	**n/a**
Interest rate and credit risk (Cash flow hedges)	**–**	**(2.5)**	n/a	**–**	**n/a**
Foreign exchange risk (Cash flow hedges)	**–**	**(1.3)**	n/a	**1.1**	**Other income**
	(2.3)	**(3.8)**		**1.1**	
2017					
Interest rate risk (Fair value hedges)	(8.1)	–	Gains from hedge accounting	–	n/a
Interest rate and credit risk (Cash flow hedges)	–	–	–	–	n/a
Foreign exchange risk (Cash flow hedges)	–	8.4	–	(9.3)	Other income
	(8.1)	8.4		(9.3)	

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

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

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

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

Notes to the consolidated financial statements

Managing financial risk (continued)

26. Market risk (continued)

Offsetting financial assets and financial liabilities

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

Bank At 31 December 2018	Gross amounts £ million	Amounts offset £ million	Net amounts reported on the balance sheet £ million	Related amounts where set off in the balance sheet is not permitted: Related financial instrument amounts not offset £ million	Cash collateral received/ pledged[1] £ million	Potential net amount £ million
Derivative financial assets	**195.0**	–	**195.0**	**(129.6)**	**(1.9)**	**63.5**
Total assets	**195.0**	–	**195.0**	**(129.6)**	**(1.9)**	**63.5**
Derivative financial liabilities	**(440.0)**	–	**(440.0)**	**129.6**	**309.6**	**(0.8)**
Repurchase agreements	**(1,084.8)**	–	**(1,084.8)**	**1,084.5**	**0.3**	–
Other liabilities (note 33)	**(355.5)**	**153.0**	**(202.5)**	–	–	**(202.5)**
Total liabilities	**(1,880.3)**	**153.0**	**(1,727.3)**	**1,214.1**	**309.9**	**(203.3)**
At 31 December 2017						
Derivative financial assets	214.8	–	214.8	(143.1)	(6.9)	64.8
Total assets	214.8	–	214.8	(143.1)	(6.9)	64.8
Derivative financial liabilities	(604.0)	–	(604.0)	143.1	460.4	(0.5)
Repurchase agreements	(1,446.4)	–	(1,446.4)	1,444.7	1.7	–
Total liabilities	(2,050.4)	–	(2,050.4)	1,587.8	462.1	(0.5)

(1) Collateral amounts (cash and non-cash financial collateral) are reflected at their fair value and this amount is limited to the net balance sheet exposure in order to exclude any over collateralisation.

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 At 31 December 2018	Gross amounts £ million	Amounts offset £ million	Net amounts reported on the balance sheet £ million	Related amounts where set off in the balance sheet is not permitted: Related financial instrument amounts not offset £ million	Cash collateral received/ pledged[1] £ million	Potential net amount £ million
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 33)	**(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)**
At 31 December 2017						
Derivative financial assets	150.0	–	150.0	(143.1)	(6.9)	–
Total assets	150.0	–	150.0	(143.1)	(6.9)	–
Derivative financial liabilities	(604.0)	–	(604.0)	143.1	460.4	(0.5)
Repurchase agreements	(1,446.4)	–	(1,446.4)	1,444.7	1.7	–
Total liabilities	(2,050.4)	–	(2,050.4)	1,587.8	462.1	(0.5)

(1) Collateral amounts (cash and non-cash financial collateral) are reflected at their fair value and this amount is limited to the net balance sheet exposure in order to exclude any over collateralisation.

Notes to the consolidated financial statements

Other important disclosures

Accounting policies relevant to this section

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

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

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

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

- Freehold/long and short leasehold premises: shorter of 50 years or the remaining period of the lease.
- Leasehold improvements: shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease.
- Fixtures and furnishings: 0-10 years.
- Other equipment and motor vehicles: 2-8 years.

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

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

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

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

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

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

Notes to the consolidated financial statements

Other important disclosures (continued)

27. Contingent liabilities

(i) Migration related investigations

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

(ii) Legal and regulatory matters

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

28. Related party transactions

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

(i) Key management personnel

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

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

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

Notes to the consolidated financial statements

Other important disclosures (continued)

28. Related party transactions (continued)

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

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

The loans attracted interest at customer rates and were made in the ordinary course of business. No provisions have been recognised in respect of loans given to key management personnel (2017: £nil).

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

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

(ii) Transactions and balances with TSB Group companies

Amounts due from TSB Banking Group plc totalled £15.0 million (2017: £12.9 million) and arise from the payment and recharge, in the normal course of business, of certain costs of TSB Banking Group plc, the Company's immediate parent company. Amounts due from TSB Banking Group Employee Share Trust (EST) totalled £1.9 million (2017: £14.8 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 £189.6 million (2017: £426.6 million) arise from the Bank's securitisation programmes.

(iii) Transactions and balances with Sabadell Group companies

Migration related transactions

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

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

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

Notes to the consolidated financial statements

Other important disclosures (continued)

28. Related party transactions (continued)

Hedging of share based compensation liability
TSB holds options from Sabadell to acquire 11.2 million (2017: 11.2 million) Sabadell shares at an exercise price of 77.68p in order to hedge the risk associated with the TSB Sharesave scheme. At 31 December 2018, the options had a fair value of £1.9 million (2017: £6.9 million) and Sabadell had placed cash collateral with TSB of £3.1 million. (2017: £7.3 million).

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

Sabadell acts as an intermediary in respect of international payments and the Bank has nostro account balances as a result of this arrangement which at 31 December 2018 had a net balance due from Sabadell of £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.

29. Property, plant and equipment

Bank and Company	Premises £ million	Equipment £ million	Total £ million
Cost			
At 1 January 2017	210.4	94.5	304.9
Additions	26.3	11.1	37.4
Disposals	(4.3)	–	(4.3)
Write-offs	(3.6)	(3.4)	(7.0)
At 31 December 2017	**228.8**	**102.2**	**331.0**
Additions	**6.3**	**10.1**	**16.4**
Disposals	**(1.3)**	**0.1**	**(1.2)**
Write-offs	**(2.1)**	**(0.7)**	**(2.8)**
At 31 December 2018	**231.7**	**111.7**	**343.4**
Accumulated depreciation			
At 1 January 2017	79.0	57.6	136.6
Depreciation charge for the year (note 16)	16.8	10.7	27.5
Disposals	(2.2)	–	(2.2)
Write-offs	(1.3)	(2.3)	(3.6)
At 31 December 2017	**92.3**	**66.0**	**158.3**
Depreciation charge for the year (note 16)	**18.1**	**6.5**	**24.6**
Disposals	**(0.5)**	**0.1**	**(0.4)**
Write-offs	**(1.8)**	**(0.4)**	**(2.2)**
At 31 December 2018	**108.1**	**72.2**	**180.3**
Carrying amount			
At 31 December 2018	**123.6**	**39.5**	**163.1**
At 31 December 2017	136.5	36.2	172.7

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

Notes to the consolidated financial statements

Other important disclosures (continued)

29. Property, plant and equipment (continued)

Operating lease commitments

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

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

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

30. Intangible assets

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

31. Other assets

	Bank 2018 £ million	Bank 2017 £ million	Company 2018 £ million	Company 2017 £ million
Prepaid migration costs	–	124.5	–	124.5
Other assets and prepayments	**165.6**	82.9	**165.6**	82.9
Amounts recoverable under customer remediation indemnity (note 32)	**14.6**	34.2	**14.6**	34.2
Amounts due from other TSB Group companies (note 28)	**16.9**	27.7	**16.9**	27.7
Total other assets	**197.1**	269.3	**197.1**	269.3

As discussed in note 28(iii) on page 74, the Bank had deferred £124.5 million of IT migration programme costs which were recognised in the income statement as operating expenses on the completion of the migration in April 2018.

Notes to the consolidated financial statements

Other important disclosures (continued)

32. Provisions

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

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

Significant estimates – migration and other customer redress

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

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

Notes to the consolidated financial statements

Other important disclosures (continued)

33. Other liabilities

Bank	2018 £ million	2017 £ million
Amounts payable under the MSA and OSA contracts	**202.5**	–
Amounts due to other TSB Group companies (Note 28)	**0.1**	0.1
Accruals and deferred income	**230.4**	216.8
Share-based payments liability	**4.9**	10.1
Other creditors	**57.8**	51.5
Total other liabilities	**495.7**	278.5

Company	2018 £ million	2017 £ million
Amounts due to Sabadell Group companies (Note 28)	**202.5**	–
Amounts due to other TSB Group companies (Note 28)	**189.6**	426.6
Accruals and deferred income	**230.4**	216.8
Share-based payments liability	**4.9**	10.1
Other creditors	**57.6**	51.2
Total other liabilities	**685.0**	704.7

Significant judgement – MSA and OSA contract liabilities

The MSA liability of £249.0 million and the OSA liability of £106.5 million are presented on the statement of financial position net of the £153.0 million of aggregate estimated recovery of eligible losses under the MSA and OSA contracts.

Notes to the consolidated financial statements

Other important disclosures (continued)

34. Notes to the consolidated cash flow statement

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

	Bank 2018 £ million	Bank 2017 £ million	Company 2018 £ million	Company 2017 £ million
Change in loans to credit institutions	**441.4**	99.5	**482.8**	(101.9)
Change in loans and advances to customers	**679.9**	(1,478.0)	**679.9**	(1,478.0)
Change in derivative assets	**19.8**	32.7	**18.5**	41.2
Change in other operating assets	**53.5**	(137.1)	**53.5**	(137.1)
Change in operating assets	**1,194.6**	(1,482.9)	**1,234.7**	(1,675.8)
Change in deposits from credit institutions	**(177.7)**	16.4	**(177.6)**	16.4
Change in customer deposits	**(1,459.1)**	1,104.9	**(1,459.1)**	1,104.9
Change in derivative liabilities	**(164.8)**	(22.7)	**(164.8)**	(22.7)
Change in other operating liabilities	**243.8**	75.2	**243.9**	75.8
Change in operating liabilities	**(1,557.8)**	1,173.8	**(1,557.6)**	1,174.4
Depreciation and amortisation	**28.1**	27.8	**28.1**	27.8
Allowance for loan losses	**73.3**	77.8	**73.3**	77.8
Other non-cash items	**51.0**	10.8	**46.7**	(11.1)
Non-cash and other items	**152.4**	116.4	**148.1**	94.5
Analysis of cash and cash equivalents as shown in the balance sheet				
Cash	**160.3**	143.0	**160.3**	143.0
Balances with central banks	**6,954.9**	7,419.9	**6,954.9**	7,419.9
On demand deposits	**20.7**	0.5	**20.7**	0.5
Total cash and cash equivalents	**7,135.9**	7,563.4	**7,135.9**	7,563.4

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

Change in liabilities arising from financing activities

Bank	Borrowings from central banks £ million	Repurchase agreements £ million	Debt securities in issue £ million	Subordinated liabilities £ million	Amounts due from other TSB Group companies £ million	Total non customer funding £ million
At 1 January 2017	5.0	1,409.6	2,940.1	413.3	–	4,768.0
Borrowings under the BoE Term Funding Scheme	5,615.0	–	–	–	–	5,615.0
Issuance of covered bonds	–	–	497.7	–	–	497.7
Repayments securitisation funding	–	–	(2,128.5)	–	–	(2,128.5)
Proceeds from repurchase agreements (net)	–	36.8	–	–	–	36.8
Non-cash movements	5.7	–	9.4	(8.0)	–	7.1
At 31 December 2017	**5,625.7**	**1,446.4**	**1,318.7**	**405.3**	**–**	**8,796.1**
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**	**0.3**	**1.8**	**(7.1)**	–	**1.5**
At 31 December 2018	**6,482.2**	**1,084.8**	**1,122.6**	**398.2**	**–**	**9,087.8**

Notes to the consolidated financial statements

Other important disclosures (continued)

34. Notes to the consolidated cash flow statement

Company	Borrowings from central banks £ million	Repurchase agreements £ million	Debt securities in issue £ million	Subordinated liabilities £ million	Amounts due from other TSB Group companies £ million	Total non customer funding £ million
At 1 January 2017	5.0	1,409.6	–	413.3	2,354.2	4,182.1
Borrowings under the BoE Term Funding Scheme	5,620.7	–	–	–	–	5,620.7
Issuance of covered bonds	–	–	497.7	–	–	497.7
Repayments securitisation funding	–	–	–	–	(1,927.6)	(1,927.6)
Proceeds from repurchase agreements (net)	–	36.8	–	–	–	36.8
Non-cash movements	–	–	0.3	(8.0)	–	(7.7)
At 31 December 2017	**5,625.7**	**1,446.4**	**498.0**	**405.3**	**426.6**	**8,402.0**
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**	**0.3**	**0.4**	**(7.1)**	**–**	**0.1**
At 31 December 2018	**6,482.2**	**1,084.8**	**498.4**	**398.2**	**189.6**	**8,653.2**

35. Future accounting developments

The Bank will apply IFRS 16 *Leases* from 1 January 2019 and its requirements have not been applied in preparing these consolidated financial statements. IFRS 16 replaces IAS 17 Leases and brings most leases on-balance sheet for lessees under a single model, eliminating the distinction between operating and finance leases. IFRS 16 requires a lessee to recognise a 'right-of-use' asset and a lease liability.

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

36. Approval of the consolidated financial statements

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

The Company's ultimate parent company and ultimate controlling party is Banco de Sabadell, S.A. (incorporated in Spain), which is also the parent undertaking of the largest group of undertakings for which consolidated financial statements are drawn up and of which 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 2018 and of the consolidated Bank's loss 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 consolidated financial statements, Article 4 of the IAS Regulation.

We have audited the financial statements included within the Annual Report and Accounts 2018 (the "Annual Report"), which comprise: the Consolidated and Company balance sheets as at 31 December 2018; the Consolidated statement of comprehensive income for the year then ended; the Consolidated and Company statements of changes in equity for the year then ended; the Consolidated and Company cash flow statements for the year then ended; and the notes to the financial statements, which include a description of the significant accounting policies.

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

Basis for opinion

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

Independence

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

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

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

Our audit approach

Context

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

Independent auditors' report to the members of TSB Bank plc

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

The scope of our audit

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

Capability of the audit in detecting irregularities, including fraud

Based on our understanding of the 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 increase revenue or reduce expenditure, and management bias in accounting estimates. In the current year we have also performed procedures to specifically address the incentives and opportunities posed by the IT system migration. Audit procedures performed by the engagement team included:

- Discussions with management, internal audit and the Bank's legal advisors, including consideration of known or suspected instances of non-compliance with laws and regulation and fraud;
- Evaluation of the operating effectiveness of management's controls designed to prevent and detect irregularities;
- Assessment of matters reported on the 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); and
- Identifying and testing journal entries, in particular any journal entries posted with unusual account combinations or posted by senior management.

There are inherent limitations in the audit procedures described above and the further removed non-compliance with laws and regulations is from the events and transactions reflected in the financial statements, the less likely we would become aware of it. Also, the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion.

Independent auditors’ report to the members of TSB Bank plc

Key audit matters

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

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

Nature of key audit matter	***Matters discussed with the Audit Committee***
This is a key audit matter as there is a high degree of judgement related to the costs arising from the migration in April 2018. We considered the following three specific aspects to be judgemental: ***Accounting for customer remediation*** Following the issues associated with the migration, management have recognised a provision for the costs associated with the Putting Things Right (‘PTR’) programme. This reflects the Bank’s best estimate of the remaining cost of customer redress payments and the operational costs involved in making those payments. We focused on the key assumptions in the estimate of remaining costs, the most significant of which include the volume of forecast complaints, the complexity and expected redress costs of each complaint, the proportion that might be referred to the Financial Ombudsman Service, and the complaint handler productivity assumptions. This estimate is disclosed in note 32. ***Accounting for intragroup costs associated with migration*** The IT systems have been developed and are maintained by Sabis, a subsidiary of Sabadell. The Company has entered into a Migration Services Agreement (‘MSA’) and an Outsourced Services Agreement (‘OSA’) with Sabis, both of which include clauses which allow the Company to reclaim certain costs incurred as a result of non performance by Sabis. The amounts recoverable are not finalised given the ongoing investigations, but management’s best estimate of the recovery is £153 million. This amount may change as the agreement is completed. We have therefore focused on how the amounts recoverable from Sabis have been estimated and the estimate disclosed in the annual report. This is disclosed in note 33. ***Accounting for potential regulatory fines*** On 30 May 2018 the Financial Conduct Authority (FCA) announced that they, alongside the Prudential Regulation Authority (PRA), would start a joint investigation into the migration. Management has determined that there is currently insufficient information available to reasonably estimate the outcome of the investigation, and so no provision for a potential regulatory fine has been recorded as at 31 December 2018. This is disclosed in note 27 (i).	We discussed our scope and plan for testing the costs associated with the migration with the Audit Committee, highlighting our focus on completeness of customer complaints, the intergroup agreement of the amounts payable to Sabis and correspondence with regulators. Additionally, we communicated how we understood and challenged management’s estimate of future redress claims and operational costs to resolve the additional complaints relating to migration. We confirmed that whilst negotiations with Sabis are ongoing, both management and members of the Committee believe that the position to record the recovery of post migration charges of £153 million represents the best estimate of the aggregate recovery from Sabis under the terms of the MSA and OSA. Given that this is a significant judgement and is a best estimate, we discussed the need to have full and transparent disclosure, including that the final amount could be materially different. We shared our conclusions that the judgements, estimates and total provisions at the year end are reasonable.

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

Procedures performed to support our discussions and conclusions

Accounting for customer remediation

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

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

Accounting for intragroup costs associated with migration

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

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

Accounting for potential regulatory fines

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

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

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

Nature of key audit matter

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

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

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

1. The assessment of Expert Credit Judgements, which management use to adjust core model outputs to take account of latent risks and known model limitations. We focused our work on the key assumptions in material expert credit judgements made by management, including the completeness of ECJs;

2. The appropriateness of 'staging' thresholds selected by management to determine a significant increase in credit risk and hence whether a 12 month or lifetime loss provision is recorded;

3. The application of forward looking economic assumptions used in the models, including the appropriateness of management's assumptions to address potential risks from the UK's exit from the European Union; and

4. The accuracy of critical inputs to the impairment models given known data limitations following the migration of the Bank's data to a new IT platform.

Matters discussed with the Audit Committee (continued)

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

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

Procedures performed to support our discussions and conclusions

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

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

Nature of key audit matter

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

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

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

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

Matters discussed with the Audit Committee

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

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

Procedures performed to support our discussions and conclusions

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

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

IT access and change management following the migration

Nature of key audit matter

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

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

Matters discussed with the Audit Committee

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

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

IT access and change management following the migration (continued)

Procedures performed to support our discussions and conclusions

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

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

How we tailored the audit scope

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the structure of the group and the company, the accounting processes and controls, and the industry in which they operate.

The Bank is the consolidation of TSB Bank plc and its subsidiaries. For the year ended 31 December 2018, 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.

Until 20 April 2018, the Bank used Lloyds Banking Group plc (LBG) IT platforms and therefore for the period prior to migration, we have taken comfort from the agreed-upon procedures in respect of controls over the Bank's financial reporting and IT systems operated by LBG, performed under International Standard on Related Services 4400, that is performed by LBG's external auditors. For the period post migration, while we have tested a number of management controls, we have adopted a largely substantive approach given the immaturity of the control framework.

Materiality

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

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

	Bank financial statements	*Company financial statements*
Overall materiality	£8.1 million (2017: £13.4 million).	£8.1 million (2017: £13.4 million).
How we determined it	5.5% of average profit before tax over the past 3 years.	1% of total assets.
Rationale for benchmark applied	While the core performance of the business remains relatively stable, due to the implementation of the 'Putting Things Right' programme and other migration related costs, the Bank has seen a drop in profitability in the current year, such that the result for the year is not reflective of the underlying performance of the business. We have therefore chosen to use an average of the absolute profit/loss before tax over the past three years to calculate materiality, in order to better reflect the underlying performance of the business.	As the Company is not profit orientated on a solo-entity basis, we have used 1% of total assets, but capped this to the lower materiality of the Bank.

Independent auditors' report to the members of TSB Bank plc

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 £4 million and £7.7 million.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £0.4 million (Bank audit) (2017: £0.7 million) and £0.4 million (Company audit) (2017: £0.7 million) as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

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

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

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

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

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

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

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

Strategic report and Directors' report
In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic Report and Directors' Report for the year ended 31 December 2018 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

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

In preparing the financial statements, the directors are responsible for assessing the 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.

Independent auditors' report to the members of TSB Bank plc

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 22 years, covering the years ended 31 December 1997 to 31 December 2018.

Laura Needham (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
31 January 2019

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