annual report and accounts 2020

TSB Banking Group plc

Despite everything that has happened during 2020, our focus on customers never wavered. Our priority is continuing to deliver on our growth strategy and returning TSB to profitability.

Debbie Crosbie
Chief Executive, TSB

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Summary consolidated balance sheet

	2020 £ million	2019 £ million	Change %
Loans and advances to customers	**33,317.9**	31,075.8	7.2
Other assets	**9,088.8**	8,445.1	7.6
Total assets	**42,406.7**	39,520.9	7.3
Customer deposits	**34,375.3**	30,182.4	13.9
Other liabilities	**6,324.8**	7,452.5	(15.1)
Shareholder's equity	**1,706.6**	1,886.0	(9.5)
Total equity and liabilities	**42,406.7**	39,520.9	7.3

Summary consolidated statutory income statement

	2020 £ million	2019 £ million	Change %
Net interest income	**786.4**	841.1	(6.5)
Other income	**142.4**	146.7	(2.9)
Total income	**928.8**	987.8	(6.0)
Operating expenses	**(969.4)**	(881.3)	10.0
Impairment	**(164.0)**	(60.5)	171.1
Statutory (loss)/profit before taxation	**(204.6)**	46.0	(544.8)
Taxation	**44.9**	(19.7)	327.9
Statutory (loss)/profit for the year	**(159.7)**	26.3	(707.2)

Management basis (loss)/profit before taxation

	2020 £ million	2019 £ million	Change %
Management (loss)/profit before taxation	**(96.9)**	76.8	(226.2)
Restructuring costs and other one off items[(1)]	**(90.6)**	(43.7)	107.3
Collection and recovery conduct charges[(2)]	**(55.0)**	–	–
Net effect of migration related items[(3)]	**34.1**	4.0	752.5
Banking volatility[(4)]	**3.8**	8.9	(57.3)
Statutory (loss)/profit before taxation	**(204.6)**	46.0	(544.8)

Key performance indicators

Customer advocacy – Net Promoter Score (NPS)[(5)]	**(4)**	10	(14)
Share of new personal bank account gross flow[(6)]	**4.5%**	3.9%	0.6pp
Mortgage gross new lending (£ million)	**6,096.6**	5,838.1	4.4%
Loan to deposit ratio[(7)]	**97%**	103%	(6)pp
Common Equity Tier 1 Capital ratio (fully loaded)	**14.8%**	20.6%	(5.8)pp
Leverage ratio (fully loaded)	**3.7%**	4.6%	(0.9)pp
Net interest margin[(8)]	**2.47%**	2.75%	(28)bps
Asset quality ratio[(9)]	**0.51%**	0.20%	31bps

(1) Includes costs of the branch closures and the reorganisation of head office functions.
(2) As more fully described in note 30 to the consolidated financial statements on page 103.
(3) Relates to items arising from the IT migration undertaken in 2018 and includes related income from Lloyds Banking Group of £17.6m, insurance recoveries of £17.5m less additional post migration costs of £1.0 million.
(4) Banking volatility reflects gains on derivatives not in hedge accounting relationships, hedge accounting ineffectiveness, and volatility associated with share schemes.
(5) NPS is based on the question "On a scale of 0-10, where 0 is not at all likely and 10 is extremely likely, how likely is it that you would recommend TSB to a friend or colleague?" NPS is the percentage of TSB customers who give a score of 9 or 10 after subtracting the percentage who give a score 0 to 6. Calculated as a 3 month rolling average.
(6) Source: CACI Current and Savings Account Market Database which includes current, packaged, youth, student and basic bank accounts, and new account openings excluding account upgrades. Calculated on a 12 month rolling average basis. Data presented on a 2 month lag.
(7) Loans and advances to customers divided by customer deposits. Amounts as presented on the consolidated balance sheet on page 60.
(8) Net interest income divided by average loans and advances to customers, gross of impairment allowance.
(9) Impairment charge on loans and advances to customers divided by average loans and advances to customers, gross of impairment allowance.

Chairman’s letter

Introduction

A key responsibility of any Board is to help their organisation prepare for, and respond well to, the unexpected. Few Boards who met this time last year could possibly have imagined the events that were about to unfold during 2020.

I am extraordinarily proud of the way TSB employees have responded during the COVID-19 pandemic, displaying real customer focus in adversity. The Bank has been guided by our purpose – Money Confidence. For everyone. Every day – as well as the plans that were already underway as part of TSB’s three-year growth strategy, launched in November 2019.

Although our results reflect the scale of the financial costs of the pandemic, it is significant that, during this tumultuous year, key aspects of TSB’s trading performance have improved significantly, and that the pace of change within our business has accelerated rapidly. We have balanced a wide range of considerations and made good commercial decisions in running the bank prudently. In spite of everything, this has been one of the busiest and most productive years in TSB’s history.

A trusted brand, well placed to grow

In times of uncertainty, both trust and confidence are at a premium. At TSB we are well served by an established brand, backed by the experienced leadership team led by Debbie Crosbie, who, at the onset of the pandemic, chose to waive their annual bonuses for 2020.

The strength of the bank is underpinned by our modern banking platform, now run independently in the UK, that enables us to respond rapidly to the changing needs of our customers.

We remain a low risk, well capitalised bank with strong net interest margin and opportunities to grow. That potential for growth has been particularly significant in our lending to SMEs, where 40,000 new business accounts have been opened over the past year, compared to 14,000 in 2019. In our provision of the Bounce Back Loans Scheme (BBLS) loans we have provided over £0.5 billion to over 20,000 SMEs to help them adapt and remain operational during the pandemic.

Doing what matters for society

As the world’s first savings bank, TSB is rooted in social good and in helping to create social as well as economic value. Today, taking forward that commitment is more important than ever.

As outlined on page 12, we launched our Do What Matters plan in 2020, setting out new commitments to address challenges such as climate change, diversity and inclusion. These commitments have led us to become the first high street bank to be accredited by the Good Business Charter, become signatories of the UN Global Compact and begin to develop a strategic relationship with Citizens Advice.

The plan is focused on the areas where TSB can make its most meaningful contribution and its goals are aligned with national and international standards. It is well integrated in the running of our business: five members of the Executive Committee sponsor the key activities in it; hundreds of TSB employees were consulted to help finalise goals and actions; and the Board is kept updated on progress on a monthly basis.

Although doing the right thing has always been part of how we work at TSB, we have now embarked on a journey to align the business growth of TSB with our social and environmental contribution, and to set high benchmarks for others.

Chairman's letter (continued)

Doing what matters for society (continued)

I'm particularly proud of TSB's contribution to tackling fraud, including being the only bank to offer a Fraud Refund Guarantee. It is simply the right thing to do for customers. What we have learned over the past 18 months is that in putting right every customer who is an innocent victim of fraud, we not only prevent unnecessary harm to thousands of innocent people but also help educate the public on relevant threats of fraud, and help the police with timely evidence to catch the perpetrators.

As the debate intensifies on more effective and collaborative ways to tackle and reduce fraud, based on the TSB experience, I encourage those in my position at other banks to work collectively to better protect customers from fraud and to inspire leaders in other industries to develop further protections.

Board

There have been several changes to the Board over the past year. David Vegara, César González-Bueno, Lynne Peacock, Mark Rennison, and most recently, Libby Chambers have been appointed to the Board as non-executive directors. In addition, Adam Banks will join the Board on 8 February 2021. Graeme Hardie, Stephen Page and Dame Sandra Dawson retired from the Board in May, October and December, respectively, and Polly Williams and Paulina Beato plan to step down in February and March, respectively.

I would like to thank Graeme, Stephen, Dame Sandra, Polly and Paulina for all their support and service in helping to guide TSB through recent years. The focus of our Board today is supporting Debbie and the team as they steer TSB through the pandemic and capitalise on the significant growth opportunities we see for the business.

Towards the end of 2020, TSB's shareholder, Sabadell Group, announced that they would bring forward a strategic review in 2021, including reviewing their international businesses. The Board of TSB will ensure that TSB continues to focus on serving customers and revitalising the brand to deliver against its growth strategy. Any decision that results in a change of ownership or governance will be managed with the highest level of rigour and care.

Conclusion

The circumstances of this year have been one of the most challenging that I have known in my career – but it is evident that we have provided the support that our employees and customers need during a very difficult period. I feel tremendous gratitude and appreciation for our employees and the leadership team who have worked so hard to deliver for our business and our customers. If we display the same resolve over the coming twelve months, I believe the future will be extremely bright for TSB.

Richard Meddings
Chairman
2 February 2021

Chief Executive’s statement

Money confidence. For everyone. Every Day.

Eighteen months ago, shortly after I joined TSB, one of our colleagues asked me what we needed to do differently in the next chapter of TSB. I said that the answer was simple, but not easy: if we truly focus on what’s important to our customers, and adapt to what they genuinely value and need, we will succeed no matter what happens outside of TSB. That belief has never been more important than during the challenges of COVID-19.

Despite everything that has happened during 2020, our focus on customers never wavered. By understanding what customers need from TSB, we achieved more change in one year than any of us in the Executive Team thought possible. The speed and scale of transformation has been incredible.

In the face of adversity, TSB employees have gone out of their way to deliver on TSB’s purpose: Money Confidence. For everyone. Every day.

Accelerating our three-year strategy

Our three-year growth strategy, introduced in November 2019, has helped us navigate the challenges of 2020. Our goal is to restore the Bank’s competitiveness through a stronger focus on serving customers more effectively.

The strategy is built on three pillars: customer focus; simplification and efficiency, and operational excellence. All three have become even more important in the face of the economic disruption in the UK during 2020.

As changes in consumer behaviour increased, particularly the shift to online services and communications, we responded by accelerating the delivery of our strategy.

We launched TSB Smart Agent, our automated and live chatbot, in March 2020 to extend our support for customers. Working with Adobe, we have provided online alternatives for most of the services traditionally provided in person through branches. We’ve also introduced video banking pilots in our branches, enabling employees to support customers remotely.

We launched new products such as our Spend and Save current account, mortgages that have been tailored for first-time buyers, as well as ‘Fix and Flex’ mortgages that give customers a more flexible mortgage option combined with the certainty of fixed rates. In addition to our core offering we are broadening the services available to customers through new partnerships with fintechs such as ApTap and Wealthify.

Alongside expanding what we offer customers, we have also prioritised improving the quality of every customer experience, striving to compete better with our peers.

In September 2020, we announced further changes to our branch network, including the closure of 164 branches in 2021. These plans were already within our strategy, but we accelerated the pace of delivery as consumer behaviour changed during the pandemic. We remain committed to our branch network, and retain one of the largest in Britain, but we need to make these changes to be able to invest in all of our channels to serve customers more effectively over the coming years.

We completed the work to take direct control of our technology services from our parent through our partnership with IBM and, by operating on our UK-based, modern, multi-cloud platform underpinned by strong data capabilities, we can offer more services and introduce new features. As I write today, TSB has over two million digitally active customers, over 90% of transactions are through our digital or automated channels and over 70% of sales are through our digital channels.

Our core operational services are resilient and we have been able to deliver all our operational services flexibly from established locations, as well as from home. We are improving data and digital skills and capabilities within TSB. We have filled over 100 technology roles in our new technology hub in Edinburgh. Our apprenticeship scheme has been expanded to include digital and data skills.

Chief Executive's statement (continued)

Supporting customers during COVID-19

Despite all the challenges we faced, TSB continued to serve our five million customers through branches, telephone operations and digital channels throughout the pandemic. That was a result of the dedication and resilience of all TSB employees. I want to thank all of them for their extraordinary service and support to TSB.

As well as providing day-to-day banking services, we responded to what mattered most to customers and employees during this crisis.

We provided special help for our most vulnerable customers who we called to establish what they needed from TSB. To date, TSB has granted around 114,000 payment holidays, related to £5.9 billion of loans, to our customers as a result of the impact of COVID-19. We were also an early member of the schemes arranged by the Government to support businesses, and we have now provided over £0.5 billion in Bounce Back loans.

I was inspired by the many stories of how employees went out of their way to help customers during this difficult time, and I was pleased to be able to recognise the commitment of all employees on the front-line with a one-off payment of £500. This year we also launched new mental health support for employees, with the introduction of free access to Unmind.

Building on our brand and contributing to society

We continue to see improved reputation growth and our brand score is at a three year high. We will now develop our brand further as we enter the second year of our strategy. We observe customers turning to the safety of established providers and this affords opportunities to an established and well-known brand like TSB.

Our new brand proposition, Life Made More, encapsulates what we offer to our communities, and sets out a new identity and direction for TSB. We will continue to refurbish branches and invest in new advertising campaigns during 2021.

At the same time, we are significantly expanding our social and environmental strategy through the launch of the Do What Matters plan. The plan, outlined on pages 12 to 13, sets out how we will do more to help customers to be more money confident through our iconic and market leading Fraud Refund Guarantee, support small businesses, build a diverse and inclusive workplace, support communities, and reduce our environmental impact.

I was particularly proud that TSB became the first major retail bank to be accredited by the Good Business Charter during 2020 – a clear statement of our social and environmental ambitions.

Financial summary

Like many financial service businesses, the impact of the pandemic is clearly visible in our results for 2020. The statutory result, a loss before tax of £204.6 million, was impacted most significantly by credit impairment charges, which at £164.0 million have increased by £103.5 million compared to 2019. Those charges reflect the UK economic outlook, together with rising unemployment. In addition, our income was significantly reduced by supporting customers through the pandemic by waiving interest charges on certain products. Our results are further impacted by a provision for restructuring the Bank and the estimated charges relating to the treatment of some customers in arrears.

Importantly however, this is only part of the story. We continue to benefit from a relatively low risk balance sheet, with secured lending making up over 92% of all TSB loans. In key areas, the trading performance of the business has improved. Our loan book has grown strongly by £2.2 billion during 2020, as have customer deposits, with an increase of £4.2 billion this year.

As a result, our balance sheet remains strong as does our capital position, although we note that our capital ratios have reduced significantly in 2020 as a result of the business growth referred to above, current year losses and the adoption of new capital regulations. We have also made TSB more efficient. Despite having to invest in new operational measures as a result of the pandemic, our operating costs, measured on a management basis (as explained on page 19), are down on 2019.

As the Chairman notes in his letter, for all these reasons and many others, I strongly believe TSB is extremely well placed to achieve sustainable growth in the coming years.

Chief Executive's statement (continued)

Outlook

The UK enters 2021 in a deep economic downturn with ongoing challenges from the continuing impact of COVID-19, changes as a result of implementing Brexit and a low interest rate environment. But despite this challenging backdrop, I believe TSB is well positioned as we start a new financial year.

At the end of November 2020, TSB's shareholder, Sabadell Group, announced that they would be reviewing their strategy.

TSB is a ring-fenced UK bank and remains a low risk, well capitalised bank that has potential for significant value creation in the future. Our growth strategy is boosting competitiveness and sharpening our cost-to-serve ratio. Our enhanced digital offerings are underpinned by our modern IT platform and we are right-sizing and modernising our branch network to serve customers across the whole country.

With the changes we've made as part of our strategy, we've taken the action needed to ready ourselves for whatever may happen in 2021. As I said eighteen months ago to my colleague: if we keep focusing on serving customers in ways they truly value, we should have high hopes for what TSB can achieve. Our priority in 2021 is continuing to deliver on our growth strategy and returning TSB to profitability.

Debbie Crosbie
Chief Executive
2 February 2021

Our purpose and business model

Our purpose – Money confidence. For everyone. Every day

TSB offers a range of retail banking services and products to individuals and small business banking customers in the UK. TSB has a multi-channel model, including full digital (internet and mobile) and telephony capability and national branch coverage.

We believe that TSB's multi-channel presence creates an opportunity for TSB to serve customers better. They want a bank that removes the hassle from banking and provides access to both people and digital tools which give them confidence in managing their money. TSB continues to develop digital-led products and servicing capabilities that meet customers' needs, which have significantly enhanced how TSB better supports its customers. It is the importance of the digital opportunities in which TSB will continue to invest, together with the benefits of the multi-channel distribution model, and how we serve our customers every day that will make the difference at TSB. At TSB we call this purpose 'Money confidence. For everyone. Every day.'

Our business model is simple

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

Component	Description	2020 performance	Financial statements	Key performance indicator
Customer confidence	We seek to deliver a banking experience that is the primary reason for customers to choose and remain with TSB, and which will increasingly set TSB apart from other banks and providers of financial services. Central to this is the development of our purpose '*Money confidence. For everyone. Every day.*' through which we will invest in digital capabilities and customer led service strategies.	n/a	n/a	**Customer advocacy (Net Promoter Score)** **2020**: **(4)** / **2019**: 10 **Total digitally active customers** **2020**: **66.4%** / **2019**: 63.4%
Sources of funding and capital	Money deposited by customers into their bank and savings accounts provides the majority of the funds we use to support lending to customers. We also raise funds from other sources, including wholesale funding markets, that diversify our funding profile. Our shareholder also provides funding in the form of debt and equity capital.	Page 15	Page 63	**Share of personal bank account gross flow** **2020**: **4.5%** / **2019**: 3.9% **Share of PCA stock** **2020**: **4.3%** / **2019**: 4.4%
Loans and liquid assets	Funds deposited with TSB are used to support lending to customers who wish to borrow. A portion of funds are held in reserve, in the form of a liquidity portfolio, to meet any unexpected funding requirements.	Page 17	Page 67	**Mortgages gross lending (£m)** **2020**: **6,096.6** / **2019**: 5,838.1
Income	We earn income in the form of interest that we receive on the loans we make to customers and from our liquidity portfolio 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 18	Page 79	**Net interest margin** **2020**: **2.47%** / **2019**: 2.75%
Charges	The costs of running the Bank include paying our TSB employees, running our branches, investing in our business (such as developing digital opportunities) and paying for marketing. Occasionally, our customers are unable to repay the money they borrow from us; this is also a cost to the Bank in the form of an impairment charge. Finally, TSB complies with its tax obligations to Her Majesty's Revenue and Customs (HMRC).	Page 19	Page 81	**Cost:income ratio (management basis)** **2020**: **92.5%** / **2019**: 85.7% **Asset quality ratio** **2020**: **0.51%** / **2019**: 0.20%

Risk management (2020 performance on page 20; financial statements on page 86)

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

Section 172 statement

Overview
In overseeing delivery of TSB's purpose and strategy, TSB's directors are always mindful of their duties under the Companies Act 2006, including as set out in section 172. The Board recognises that TSB's long-term success is only possible through engagement with, and having regard to, the interests of key stakeholders, which for TSB includes our shareholder, customers, employees, wider communities and regulators.

TSB's governance framework seeks to ensure that the Board appropriately considers stakeholder considerations in decision making. The effectiveness of the Board was reviewed by the Senior Independent Director during the year and a summary of the findings from this exercise is outlined on page 32.

The Board monitors and challenges progress in the performance of the business through its review of balanced scorecard metrics which are structured around TSB's primary corporate objectives, monitoring performance against risk appetite and reviewing customer management information that measures the execution of customer conduct strategies. These metrics, which form the basis of the KPIs reported on page 8, together with a wider dashboard of management information, are reviewed and discussed. The latter includes a 'maturity matrix', which was developed in 2020 and enables the Board to stay abreast of progress in key strategic projects and initiatives. In addition, the Remuneration Committee reviews a sub-set of balanced scorecard metrics at least twice a year to support its decision making on variable remuneration outcomes. In this way, variable remuneration outcomes are directly linked to metrics that support the delivery of TSB's strategic objectives.

The proactive oversight and challenge provided by the Board is central to the ongoing development and execution of TSB's purpose and strategy, including the extent to which the interests of TSB's key stakeholder groups are listened to. This is further discussed below and demonstrated through the case study on page 10 of 'Consequences of the COVID-19 pandemic' and through a summary of the Bank's Do What Matters plan.

TSB's shareholder, Sabadell
Given Sabadell's 100% ownership of TSB, it is natural that the promotion of the long term success of TSB, through the development of a clear purpose and strategy, is aligned with the interests of Sabadell, including in the current circumstances where Sabadell is undertaking a strategic review of its international operations. Sabadell's interests are represented at Board by three shareholder appointed Non-executive Directors. Any circumstances where shareholder and TSB interests are not aligned are managed through the disclosure and management of any such potential conflict. Sabadell's interests are further represented through the UK Steering & Coordination Committee as outlined on page 28. During 2020, the Chief Executive presented the planned acceleration of TSB's strategy and financial forecasts, taking into account developments during the COVID-19 pandemic, to the Sabadell Board.

Customers and wider community
The Board takes account of customer interests through regular reviews of key scorecard measures such as NPS and customer conduct metrics. Two 'focus sessions' on vulnerable customers were held during 2020, providing the opportunity for the Board to interrogate and challenge management's plans to enhance the service being provided to such customers as part of the 'Money Confidence' programme. The Board has requested that the focus on vulnerable customers continues, with two further progress reports scheduled for the Board during 2021.

The interests of customers, as affected by the COVID-19 pandemic, particularly in respect of their ability to continue to access their products and services or to receive support where difficulties were experienced in meeting loan repayment obligations, have been fully considered as outlined in the COVID-19 response case study.

The Board also fully recognises its obligations to consider the interests of the wider communities in which TSB operates and this is demonstrated in its challenge and support of the Do What Matters plan as outlined on page 11.

Employees
The Board is proud of the commitment of our employees and the collaborative culture in TSB, particularly in 2020 when our employees, while adopting safe working practices, have adapted the way they work to ensure that customers have been supported throughout the COVID-19 pandemic (as further explained in the Directors' report on pages 45 and 46). During this challenging period, employees have continued to support each other and work together to deliver for our customers.

Section 172 statement (continued)

The Board operates a framework that takes account of the interests of our employees, including:

- Promoting the role of recognised trade unions in independently representing the interests of employees;
- The appointment of a Board level whistleblowing champion, as more comprehensively referred to on page 33 in the corporate governance statement;
- Providing challenge, through the auspices of the Remuneration Committee, to ensure that remuneration policy is appropriate for all employees, as well as executives, and provides for competitive remuneration strongly aligned to the delivery of TSB's strategic goals; and
- Undertaking semi-annual reviews of talent and succession, particularly in respect of leadership roles within TSB.

The Board also receives a presentation on an annual basis from The Link to facilitate a direct engagement between the Board and employees. The Link is a forum for employees across all levels and all parts of TSB with five regional groups across the country. It gathers and builds on employee feedback and enables meaningful dialogue between employees, the Executive leadership and the Board on a wide range of topics. Throughout 2020, The Link focused on areas such as the Do What Matters plan, new products and services, employee wellbeing, engagement and responding to COVID-19, including new ways of working. The outputs from every meeting of The Link are presented to the Executive Committee to help inform TSB's decision making.

As explained in the Nomination Committee report on page 36, the Board plays an active role in promoting and challenging progress in establishing a truly diverse and inclusive culture at TSB and carries out succession planning reviews to ensure continuity of skilled employees.

Suppliers

TSB believes that establishing a close relationship with suppliers (including a clear accountability framework) is a pre-requisite for resilient customer services. The Board approves the outsourcing strategy annually, together with any changes to the boundaries of outsourced critical services. Operational excellence is a critical pillar of TSB's strategic plan and, as part of this, TSB will work more closely with certain key suppliers, having taken direct control of key relationships formerly managed by Sabis, the previous supplier of TSB's outsourced IT services.

Case Study:
Consequences of the COVID-19 pandemic

The emergence of the COVID-19 pandemic in early 2020 and the consequential restrictions on daily life created very significant and unexpected challenges for our customers and our employees throughout the year.

The Board played a key role in monitoring and challenging the priorities set and steps taken by the Executive Committee to:

- Protect the safety and well-being of our employees while continuing to ensure that our products and services remained available for customers; and
- Make available the appropriate support to customers experiencing short term liquidity concerns or who found themselves in financial difficulty particularly in the provision of loan repayment holidays and Bounce Back loans.

TSB managed its response by invoking its highest category of incident management protocols with regular updates provided to the Board. The Board held regular update calls, on a weekly basis during the initial peak of the pandemic, so that its oversight, challenge and support was provided on a timely and regular basis.

The Board also reviewed, challenged and supported proposals from the Executive Committee to accelerate aspects of the strategy, previously approved in November 2019, where it was appropriate to do so following the emergence of the pandemic.

Most notably, the Board supported the proposal to accelerate the transformation of the branch network including the difficult decision to close a further 164 branches, announced on 30 September 2020. This proposal took account of the accelerated migration of customer activity from branch to digital and mobile channels.

The Board challenged the proposed plans to ensure that the appropriate support and options were available for employees placed at risk of redundancy and that the interests of vulnerable customers were properly addressed including a proactive outbound programme of calls tailored for individual customer needs.

Section 172 statement (continued)

Regulators

Open and honest engagement with regulators is a cornerstone principle of the UK regulatory environment. The Chief Risk Officer reports regularly to the Board Risk Committee and the Board on material matters of regulatory liaison and TSB's assessment of the quality of the relationship with each regulator. Certain Board members maintain a direct relationship with the FCA and PRA through the framework of 'proactive engagement and continuous assessment' meetings and report on key themes discussed through committee and Board meetings, as appropriate.

Stakeholders and society

The events of 2020 have reinforced the expectations of society on businesses to contribute positively and more widely in the communities in which they operate. Given its origins, TSB has always taken its role in society seriously and in July 2020 launched its Do What Matters plan. This sets out a clear framework of actions aligned to TSB's purpose and strategy that are intended to meet the expectations of stakeholders so that TSB contributes fully in the communities in which it operates. The Do What Matters plan is structured across five pillars as outlined on pages 12 and 13 where a fuller review is presented.

The Board reviewed and supported the Do What Matters plan and receives updates on progress on a monthly basis and intends to do so over the life of the plan.

TSB's Do What Matters plan formalises the Bank's commitment to reducing its impact on the environment while helping customers and employees do the same. This was agreed with the Board in June 2020 ahead of its launch. As part of this plan, we have committed to reduce our environmental impact and progress against our goals is outlined in the Directors' report on page 47.

Other non-financial disclosures

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

TSB's Modern Slavery Statement (which is available on our website) sets out the policies we apply and actions we take to ensure that our employees and customers are treated with dignity and respect. This includes raising awareness of issues that could put our customers at risk such as vulnerability and exploitation. The statement also explains how we ensure that TSB's values are applied within our supply chain including the due diligence we carry out on our suppliers.

TSB's Do What Matters plan

Introduction

As outlined in the Chairman's letter and the Chief Executive's statement, TSB launched the Do What Matters plan, our first responsible business plan, in 2020. The plan sets out everything TSB will do to contribute to a better society and is designed to align with our strategy and purpose. We continue to collaborate with key stakeholders to make sure the plan's five pillars, and related actions, remain focused on the most relevant and valuable contributions TSB can make.

We have set clear commitments, with measurable actions aligned to national and international targets, in each of the five areas of our three year plan to do what matters for customers, businesses, employees, communities and the environment. These steps have enabled us to become the first high street bank accredited by the Good Business Charter and commit to the UN Global Compact corporate responsibility initiative and its principles on human rights, labour, the environment and anti-corruption.

The Do What Matters plan has been embedded throughout TSB. The Board is updated on progress on a monthly basis and each of the five areas is sponsored by a TSB Executive Committee member. By the end of 2020, ten of the 20 initial actions had been achieved, as is set out in the summary below.

Helping people have money confidence
In 2020 we have focused on helping our customers improve their money confidence, particularly in supporting them through the challenges presented by COVID-19. This included:

1. Meeting our commitment to refund every TSB customer who is an innocent victim of fraud in 2020, reimbursing over 99% of authorised push payment fraud cases, compared to the industry-wide rate of 38%; and
2. Training all our customer-facing employees, so they are equipped to help customers explore what skills, services and products they want and need to boost their money confidence. We are on track to meet our longer-term ambition of one million 'Money Confidence' conversations by the middle of 2023.

Further support was provided to customers by:
- Keeping our branches open, often for longer hours than our competitors, during lockdown;
- Serving customers safely in new ways, through rapidly expanding our mobile and online channels and developing TSB Smart Agent within five days through our partnership with IBM;
- Leveraging our new strategic partnership with Citizens Advice to inform our approach to supporting vulnerable customers; and
- During the first lockdown, sending 50,000 ATM cards to passbook holders so they didn't need to come into a branch to withdraw cash and phoning 36,000 elderly and most vulnerable customers to 'check in'.

Treating businesses fairly and helping them grow
We are committed to treating businesses fairly and helping them grow through prompt payment of suppliers, providing access to business support, sharing advice and encouraging diversity. In 2020 we achieved the following initial actions:

3. Paying 96% of small and medium suppliers within seven days, and 99% of all suppliers within 30 days. TSB also became a signatory of the Prompt Payment Code, a Government backed voluntary code of practice; and
4. Engaging with 19,500 female business owners through our partnership with Enterprise Nation to help them start, grow and scale a business.

TSB was also pleased to participate in the Government's Bounce Back Loan and Coronavirus Business Interruption Loan (CBILS) schemes to support businesses through the COVID-19 crisis. In 2020 we provided over £0.5 billion of Bounce Back loans to over 20,000 small businesses, and over £4 million of CBILs to 139 businesses.

Creating a truly inclusive workplace
Our ambition is for TSB to be a truly inclusive organisation where everyone feels welcomed as they are, with access to equal opportunities. We used 2020 to better understand the demographic representation at TSB and to develop an integrated strategy to achieve truly diverse teams at TSB by 2025 as outlined on page 45. In 2020, we:

5. Ended the year with 40% of senior roles held by women, higher than the industry average of 33%;
6. Renewed our level 2 Disability Confident Employer status within the Government backed Disability Confidence scheme; and
7. Saw one in three employees sign up to UnMind, a work place mental health platform which supports their well-being.

In addition to the progress on our initial actions:
- We introduced new inclusive training and nearly half of TSB line managers completed unconscious bias and mental health awareness training over the course of the year;
- We developed a new social mobility strategy, informed by our participation in the Social Mobility Index in 2020, to help us support and drive social mobility at TSB and in the communities we operate in; and
- TSB's LGBTQ+ Network was awarded a top 10 place in the Global Diversity List 2020.

TSB’s Do What Matters plan (continued)

Working locally with our communities to help them thrive

While much of the Do What Matters plan develops new ambitions for TSB, our work to support the communities we serve builds on an existing area of strength. Since 2015, we’ve raised and donated over £3.5 million for hundreds of local causes. COVID-19 has brought about significant challenges for communities across the country. In 2020 we:

8. Launched the TSB Charity Partnership programme, shaped by input from hundreds of TSB employees, to support 68 charities across Britain, all of whom carry out crucial work in our communities to support vulnerable people, mental health, cancer care, homelessness and helping the disadvantaged.

We also:

- Launched the TSB Fundraising Hub, powered by JustGiving, which brings together all our charitable support on one platform and enables TSB employees and customers to donate online for the first time;
- Donated £250,000 to Citizens Advice and Citizens Advice Scotland, through our new partnership, to help them continue their work to provide support and advice to those that need it most; and
- Developed a new volunteering initiative, in partnership with Citizens Advice, matching TSB employee skills with Citizens Advice team skills gaps.

Reducing our environmental impact while helping customers and employees do the same

During 2020, TSB developed a baseline for emissions from our own operations, appointed a sustainability lead, and completed the necessary groundwork to have science-based goals for achieving net zero carbon produced from our own operations (known as Scope 1 and 2 emissions) by no later than 2030. TSB’s 2020 carbon emissions from our own operations were 8.3k tonnes, down from 10.0k tonnes in 2019. Initial steps to reduce emissions from sources not directly controlled by TSB (known as Scope 3 emissions) were taken in 2020.

9. TSB ends 2020 with 100% of our electricity sourced from renewable sources. The Directors’ report, on page 47, sets out the composition of our carbon emissions in more detail. We published plans setting out how we intend to achieve net zero for TSB’s Scope 1 and Scope 2 emissions in early 2021; and
10. For every home move where a TSB mortgage is provided, TSB arranged for a tree to be planted to help offset the carbon footprint of the house move for the customer. Almost 10,000 trees have been planted between the launch of the scheme in August and the end of 2020. In 2021, we will baseline our Scope 3 emissions in order to develop science-based goals to reduce this footprint.

The Do What Matters plan in 2021

The Do What Matters plan has been embedded rapidly in TSB. 79% of employees say they understand their role in taking forward the plan, enabling good progress on our actions in 2020. Building on this momentum, we are well positioned to commit to a refreshed set of actions for 2021.

Visit www.tsb.co.uk/do-what-matters to read our Do What Matters progress report and understand more about our goals for 2021. We will publish our first Do What Matters plan annual report in mid-2021.

Financial performance in 2020

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

Profitability (statutory basis)

	Analysis	2020 £ million	2019 £ million	Change %
Net interest income	Page 18	**786.4**	841.1	(6.5)
Other income	Page 18	**142.4**	146.7	(2.9)
Total income	Page 18	**928.8**	987.8	(6.0)
Operating expenses	Page 19	**(969.4)**	(881.3)	10.0
Impairment	Page 19	**(164.0)**	(60.5)	171.1
Statutory (loss)/profit before taxation		**(204.6)**	46.0	(544.8)

TSB incurred a statutory loss before tax for 2020 of £204.6 million (2019: £46.0 million profit) with financial performance significantly affected by the COVID-19 pandemic. The four key factors driving the loss before taxation were:

- a reduction in total income of 6.0% to £928.8 million (2019: £987.8 million), primarily reflecting lower income from overdraft pricing changes, the waiving of certain interest charges resulting from government and regulatory measures in response to COVID-19 and lower interest rates and consumer spending. This was partially offset by strong mortgage trading performance in the second half of the year. The prior year also benefitted from the recognition of fees in respect of changes to card servicing arrangements;

- an increase in credit impairment charges to £164.0 million (2019: £60.5 million), resulting from the expected deterioration in the economic outlook, including a forecast decline in house prices and rise in unemployment;

- restructuring charges of £90.6 million (2019: £43.7 million) which included the costs of the 164 branch closures announced in September 2020 following the acceleration in TSB's transformation as a consequence of changes in customer behaviour induced by the COVID-19 pandemic. Restructuring costs also included severance costs from transformation activity in both the branch network and head office functions; and

- a provision of £55.0 million for estimated charges relating to the treatment of some customers in arrears while being supported by TSB's collection and recoveries function.

Profitability (management basis)

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

	2020 £ million	2019 £ million	Change %
Management (loss)/profit before taxation	**(96.9)**	76.8	(226.2)
Restructuring costs and other one off items	**(90.6)**	(43.7)	107.3
Collection and recovery conduct charges	**(55.0)**	–	–
Net effect of migration related items	**34.1**	4.0	752.5
Banking volatility	**3.8**	8.9	(57.3)
Statutory (loss)/profit before taxation	**(204.6)**	46.0	(544.8)

TSB incurred a management basis loss before tax in 2020 of £96.9 million (2019: £76.8 million profit) as a result of the reduction in total income and the increase in impairment charges referred to above. The management basis loss before tax excludes:

- the costs of restructuring the Bank including in relation to the branch closures that are planned for 2021 and changes in certain head office support functions;

- the previously mentioned estimated charges of £55.0 million relating to the treatment of some customers in arrears;

- the net effect of items relating to the IT systems migration in 2018, including related income from Lloyds Banking Group of £17.6 million and insurance receipts of £17.5 million less additional post migration costs of £1.0 million; and

- banking volatility which reflects losses on derivatives not in hedge accounting relationships and volatility associated with share schemes.

Further information on the drivers of TSB's Income Statement performance is set out on pages 18 to 19.

Financial performance in 2020 (continued)

Sources of funding and capital

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

	Further information	2020 £ million	2019 £ million	Change %
Customer deposits	Note 1 on page 63	**34,375.3**	30,182.4	13.9
Non-customer funding:				
Borrowings from the Bank of England		**3,065.8**	4,483.5	(31.6)
Debt securities in issue	Note 2 on page 63	**1,699.2**	1,676.3	1.4
Subordinated liabilities	Note 3 on page 65	**391.3**	395.9	(1.2)
Total non-customer funding		**5,156.3**	6,555.7	(21.3)
Funding resources		**39,531.6**	36,738.1	7.6
Shareholder's equity	Note 23 on page 99	**1,706.6**	1,886.0	(9.5)
Total sources of funding		**41,238.2**	38,624.1	6.8

Sources of funding

Customer deposits
Customer deposits increased by £4.2 billion, or 13.9% to £34.4 billion, reflecting lower levels of customer spending and increased savings as a result of lockdown restrictions and government initiatives in response to COVID-19.

Retail customer deposits grew by £3.2 billion to £31.9 billion with strong growth in both savings and current account balances. Business banking customer deposit balances also saw strong growth of £1.0 billion, or 71.9%, to £2.5 billion as a result of the flow of customers from the Incentivised Switching Scheme and business customers maintaining higher levels of liquidity in 2020, supported by funds received through the Bounce Back Loan Scheme.

Non-customer funding
Non-customer funding decreased by £1.4 billion to £5.2 billion, largely due to a cumulative repayment of £1.4 billion of borrowings under the Bank of England's Term Funding Scheme. In 2021, TSB expects to utilise the Bank of England's Term Funding Scheme with additional incentives for SMEs, introduced in March 2020. Debt securities in issue were broadly unchanged reflecting the maturity of all remaining notes issued under TSB's securitisation programmes offset by the issuance, to Sabadell, in December 2020 of £450 million of senior unsecured debt securities to meet Minimum Requirements for Eligible Liabilities (MREL) requirements.

Capital resources

TSB's capital position has remained above regulatory minimum requirements and internal risk appetite thresholds, with a Common Equity Tier 1 (CET1) capital ratio of 14.8% (2019: 20.6%) and a leverage ratio of 3.7% (2019: 4.6%) on a CRD IV fully loaded basis. In 2020, the CET1 capital ratio decreased by 5.8 percentage points reflecting the statutory loss for the year, lending growth and the effect of the introduction of new capital regulations in 2020 which resulted in an increase in risk weighted assets following a change to the definition of default.

	At 31 Dec 2020 £ million	At 31 Dec 2019 £ million
Shareholder's equity per balance sheet	**1,706.6**	1,886.0
Deferred tax assets arising from carry forward losses	**(102.7)**	(46.0)
Cash flow reserve regulatory adjustment	**18.4**	4.4
Prudent valuation prudential filter adjustment	**(2.3)**	(0.7)
Intangible assets	**(38.6)**	(20.3)
Common Equity Tier 1/Total Tier 1 capital (fully loaded)	**1,581.4**	1,823.4
Tier 2 capital (fully loaded)	**432.8**	393.5
Total capital resources (fully loaded)	**2,014.2**	2,216.9
Risk-weighted assets (RWA)	**10,685.1**	8,853.2
Common Equity Tier 1/Total Tier 1 capital ratio (fully loaded)	**14.8%**	20.6%
Total Capital ratio (fully loaded)	**18.9%**	25.0%

Financial performance in 2020 (continued)

Sources of funding and capital (continued)

The movements in capital in the year, as measured on a fully loaded basis, are shown below:

	CET1/ Total Tier 1 £ million	Tier 2 £ million	Total capital resources £ million
At 31 December 2019	**1,823.4**	**393.5**	**2,216.9**
Loss attributable to the shareholder	**(159.7)**	**–**	**(159.7)**
Change in excess of provision over expected losses	**–**	**39.0**	**39.0**
Movement in other comprehensive income	**(19.7)**	**–**	**(19.7)**
Change in intangible assets	**(18.3)**	**–**	**(18.3)**
Movement in Tier 2 subordinated liabilities	**–**	**0.3**	**0.3**
Movement in deferred tax assets on carried forward tax losses	**(56.7)**	**–**	**(56.7)**
Cash flow hedging reserve regulatory adjustment movement	**14.0**	**–**	**14.0**
Prudent valuation prudential filter adjustment change	**(1.6)**	**–**	**(1.6)**
At 31 December 2020	**1,581.4**	**432.8**	**2,014.2**

Risk-weighted assets (CRD IV)

RWAs at 31 December 2020 increased by £1,831.9 million (20.7%), primarily reflecting an increase in credit risk-weighted assets from growth in secured retail balances and the deployment of new IRB models in compliance with new capital regulations.

	At 31 Dec 2020 £ million	At 31 Dec 2019 £ million
Risk type analysis of risk-weighted assets:		
Standardised approach	**1,284.6**	1,487.8
Internal Ratings Based (IRB) approach	**7,982.7**	5,833.3
Total credit risk	**9,267.3**	7,321.1
Operational risk	**1,400.4**	1,484.4
Counterparty risk	**17.4**	47.7
Total risk-weighted assets	**10,685.1**	8,853.2

Leverage ratio

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

	At 31 Dec 2020 £ million	At 31 Dec 2019 £ million
Total Tier 1 Capital for leverage ratio (fully loaded)	**1,581.4**	1,823.4
Exposures for leverage ratio		
Total statutory balance sheet assets	**42,406.7**	39,520.9
Less accounting value for derivatives	**(338.2)**	(205.4)
Less reverse repurchase agreements	**–**	(201.1)
Exposure value for derivatives and securities financing transactions	**(103.2)**	90.8
Lending commitments	**978.7**	771.1
Regulatory adjustments to Tier 1	**(125.2)**	(62.6)
Other regulatory adjustments	**115.2**	(23.0)
Total exposures	**42,934.0**	39,890.7
Leverage ratio	**3.7%**	4.6%

The leverage ratio of 3.7% exceeds the Basel Committee's proposed minimum of 3.0%. Following the introduction of IFRS 9, TSB and other UK banks are supervised under transitional rules which follow European Banking Authority guidelines. Based on these guidelines TSB's CET1 ratio is 15.3% (2019: 20.8%), total capital ratio is 18.9% (2019: 25.1%) and leverage ratio is 3.8% (2019: 4.6%). The effect of the transitional adjustment to own funds, capital requirement and leverage will be disclosed within 'Key Metrics' and 'IFRS 9 Comparison' tables in TSB's Pillar III Significant Subsidiary Disclosures.

Financial performance in 2020 (continued)

Loans and liquid assets

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

	2020 £ million	2019 £ million	Change %
Secured (retail) (1)	**30,787.7**	29,192.6	5.5
Unsecured	**1,821.8**	1,754.2	3.9
Business banking	**708.4**	129.0	449.1
Total loans and advances to customers	**33,317.9**	31,075.8	7.2
Balances at central banks (2)	**4,910.1**	4,427.3	10.9
Debt securities (3)	**2,620.6**	2,136.0	22.7
Reverse repurchase agreements	–	201.1	(100.0)
Total liquid asset portfolio	**7,530.7**	6,764.4	11.3

(1) Includes Whistletree secured loans of £1,209.6 million (2019: £1,392.2 million).
(2) Combined with cash balances and demand deposits of £146.4 million (2019: £167.9 million) when shown on TSB's consolidated balance sheet.
(3) Of which £1,496.9 million (2019: £1,587.4 million) accounted for at fair value through other comprehensive income and £1,123.7 million (2019: £548.6 million) accounted for at amortised cost.

Loans and advances to customers

Loans to customers increased by £2.2 billion, or 7.2% to £33.3 billion. Secured retail lending growth of £1.6 billion to £30.8 billion primarily reflects strong trading performance in a buoyant market in the second half of 2020, following lower levels of activity in the first half due to the initial COVID-19 lockdown restrictions. Higher mortgage origination activity was driven by competitive pricing, improved customer retention and TSB's operational readiness during periods of increased demand, offset by the expected reduction in the closed Whistletree portfolio. Business banking loan balances increased by £579.4 million to £708.4 million, primarily due to lending through the Bounce Back Loan Scheme. Unsecured growth was more muted, reflecting lower demand as consumers reduced their spending and increased levels of saving.

Liquid asset portfolio

TSB's liquidity portfolio comprises highly liquid assets, primarily cash reserves at the Bank of England (BoE), UK gilts, supranational bonds, development bank bonds, and covered bonds, which are available and accessible to meet potential cash outflows. The increase in the liquidity portfolio during 2020 largely reflects customer deposit growth exceeding customer lending growth, partially offset by the partial repayment of borrowings under the BoE's Term Funding Scheme.

A key regulatory measure of liquidity adequacy is the Liquidity Coverage Ratio (LCR). This is designed to promote the short-term resilience of TSB's liquidity risk profile and is regularly monitored and forecast alongside other cash flow and liquidity ratios. At December 2020, the LCR was 201.0% (2019: 230.9%) against a PRA minimum regulatory requirement of 100%, with the reduction in 2020 reflecting the partial repayment of borrowings under the Term Funding Scheme and higher expected outflows as a result of the growth in lending commitments.

Encumbered assets

At 31 December 2020, £2,404.9 million (2019: £2,943.8 million) of assets were encumbered with counterparties other than central banks, primarily as collateral to support the issuance of debt securities (note 2 on page 63). A further £16,490.2 million of assets were positioned at central banks as collateral in support of drawings under the Bank of England's Term Funding Scheme and for normal liquidity management purposes, including held as cash.

			Assets not positioned at central banks			
	Assets encumbered with counterparties other than central banks £ million	Assets positioned at central banks (pre-positioned plus encumbered) £ million	Readily available for encumbrance £ million	Capable of being encumbered £ million	Unencumbered - cannot be used £ million	Total assets £million
Cash balances and other demand deposits	**–**	**4,910.1**	**–**	**–**	**146.5**	**5,056.6**
Financial assets at fair value through other comp. income	**391.7**(1)	**–**	**1,105.2**		**–**	**1,496.9**
Financial assets at amortised cost:						
Debt securities	**24.2**(1)	**–**	**1,099.5**	**–**	**–**	**1,123.7**
Loans to central banks and credit institutions	**43.3**(2)	**120.9**	**–**	**–**	**–**	**164.2**
Loans and advances to customers	**1,750.0**(3)	**11,459.2**	**–**	**20,108.7**	**–**	**33,317.9**
Other advances	**195.7**(1)	**–**	**–**	**–**	**24.5**	**220.2**
Remainder of assets	**–**	**–**	**–**	**–**	**1,027.2**	**1,027.2**
Total – December 2020	**2,404.9**	**16,490.2**	**2,204.7**	**20.108.7**	**1,198.2**	**42,406.7**
Total – December 2019	2,943.8	18,029.0	2,481.9	14,914.0	1,152.2	39,520.9

(1) Collateral placed with counterparties in respect of derivative financial liabilities and repurchase agreements.
(2) Cash held on deposit by the covered bond entity.
(3) Mortgage loans encumbered in support of external covered bond issuance.

Financial performance in 2020 (continued)

Income

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

Net interest income

	2020 £ million	2019 £ million	Change %
Net interest income (management and statutory basis)	**786.4**	841.1	(6.5)
Net interest margin (statutory basis)	**2.47%**	2.75%	(28)bps

Net interest income decreased by 6.5% to £786.4 million. This was primarily due to lower income from overdrafts reflecting regulatory driven pricing changes. The reduction was also due to the waiving of interest from customers who required the Bank's support in the light of the COVID-19 pandemic and from lower overdraft balances as customer spending activity reduced during the COVID-19 lockdowns.

Interest rates earned on loans

In 2020, the average rate earned on TSB's loans reduced to 2.76% (2019: 3.03%) reflecting continued competitive trends in the mortgage market and a lower mix of higher margin unsecured balances. The average rate earned on mortgages reduced to 2.29% (2019: 2.53%). This was driven by lower rates on the fixed rate portion of the portfolio, reflecting increased competition in the market and lower market rates, and from the expected ongoing run off of the higher rate back book. Yields on unsecured lending remained relatively stable at 10.0% (2019: 10.3%).

Cost of funding resources

The cost of customer deposits decreased to 0.23% in 2020 (2019: 0.41%), reflecting the partial pass-through of the decrease in the Bank of England base rate to 0.10% from 0.75% in March 2020. This resulted in lower savings deposit interest costs of 0.30% (2019: 0.48%) and lower bank account interest costs of 0.14% (2019: 0.31%). Business Banking interest costs remained broadly stable at 0.21% in 2020 (2019: 0.20%).

Other income

	2020 £ million	2019 £ million	Change %
Management basis other income	**108.4**	143.8	(24.6)
Migration related items	**35.1**	–	100.0
One off items	**(1.5)**	(3.5)	(57.1)
Banking volatility	**0.4**	6.4	(93.8)
Statutory other income	**142.4**	146.7	(2.9)

On a management basis, other income decreased by 24.6% to £108.4 million, primarily driven by lower levels of consumer spending as a result of the COVID-19 pandemic, which resulted in lower interchange income, international payments, foreign exchange and ATM reciprocity. The prior year also benefitted from the recognition of fees in respect of changes to card servicing arrangements.

On a statutory basis, other income also comprised banking volatility which reflects gains on derivatives not in hedge accounting relationships and volatility associated with share schemes and items relating to the IT systems migration in 2018 which included additional expected receipts from the migration dowry provided by Lloyds Banking Group of £17.6 million and insurance receipts of £17.5 million.

Financial performance in 2020 (continued)

Charges

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

Operating expenses

	2020 £ million	2019 £ million	Change %
TSB employee related costs	**324.7**	368.1	(11.8)
IT servicing and license costs	**189.7**	193.4	(1.9)
Property costs	**95.6**	94.7	1.0
Operational contracts	**44.5**	52.7	(15.6)
Marketing costs	**42.0**	39.9	5.3
Regulatory and professional costs	**29.4**	21.4	37.4
Investment costs	**57.5**	37.6	52.9
Other	**44.3**	39.8	11.3
Management basis operating expenses	**827.7**	847.6	(2.3)
Costs of restructuring the Bank	**89.1**	40.2	121.6
Collection and recovery conduct charges	**55.0**	–	–
Migration related items	**1.0**	(4.0)	125.0
Banking volatility	**(3.4)**	(2.5)	36.0
Statutory basis operating expenses	**969.4**	881.3	10.0

Management basis operating expenses decreased by 2.3% to £827.7 million, primarily reflecting ongoing progress on efficiency, including organisational design, branch transformation and IT costs. This reduction was achieved after taking account of an increased level of investment in the business in 2020, particularly in enhancing TSB's digital capability in response to changing customer behaviours.

On a statutory basis, operating expenses increased by 10.0%, with the above cost savings more than offset by the costs of restructuring the Bank, primarily representing the costs of branch closures announced in September 2020 and costs of reorganising certain head office functions. The increase was also due to a provision of £55.0 million for estimated charges relating to the treatment of some customers in arrears.

Impairment charge

	2020 £ million	2019 £ million	Change %
Secured (retail)	**10.5**	(1.2)	975.0
Unsecured	**147.8**	60.2	145.5
Business banking	**5.7**	1.5	280.0
Total impairment charge	**164.0**	60.5	171.1
Asset quality ratio	**0.51%**	0.20%	31bps

The impairment charge increased by 171.1% to £164.0 million, which is linked to the forecast decline in house prices and rise in unemployment under a deteriorating economic outlook. A summary of the economic scenarios used for assessing expected credit losses and related scenario weightings is provided in note 9 on page 74.

Taxation

The tax credit of £44.9 million (2019: tax charge of £19.7 million) reflects an effective tax rate of 21.9% (2019:42.8%) which is lower than the applied UK corporation tax rate in 2020 of 27% (which includes the Bank surcharge of 8% applicable to taxable profits of banks in excess of £25 million). This is primarily due to the net tax effect of non-deductible expenses. A reconciliation of the tax credit to that which would have resulted from using the UK corporation tax rate is set out in note 17 to the consolidated financial statements on page 84.

Risk management in TSB

Approach to risk

TSB seeks to remain liquid, solvent, operationally stable, trusted, and compliant at all times. The objective of TSB risk management is to support and enable these outcomes. The processes to identify, measure and control the risks inherent in its business model are embedded in TSB's risk management framework. Risks faced by TSB in delivering its business strategy are managed in the context of the wider communities in which TSB operates and the Do What Matters plan. TSB's approach to managing these risks is described below. TSB's principal risks and uncertainties are described starting on page 22.

Risk management framework

The risk management framework creates coherent standards and practices for all risk management activities and processes in TSB. The framework is designed around a simple model for categorising risk, so that all the components of our risk management such as risk appetite, governance, policies, reporting, assurance and organisational design are aligned to the same hierarchy of risks. The five principal risk categories are shown in the table below.

Financial risk	The risk of TSB having inadequate earnings, cash flow or capital to meet current or future requirements and expectations.
Credit risk	The risk that a borrower or counterparty fails to pay the interest or to repay the principal on a loan or other financial instrument as it falls due.
Operational risk	The risk of loss, damage or disruption arising from inadequate or failed processes, people and systems.
Conduct risk	The risk to the delivery of fair customer outcomes and market integrity.
Financial Crime risk	The risk that systems and controls are not adequate to manage financial crime within TSB's risk appetite and regulatory framework.

Accountability

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

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

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

Risk culture

TSB culture is monitored by the Executive Committee and Board, and the importance of individual accountability for managing risk is reinforced by the approach to performance management and remuneration for all employees. Our aim is for both our employees and our customers to experience the benefits of a high performing culture, supported by a clear customer focus where employees feel confident that customers receive fair outcomes that meet a genuine need.

The Board measures culture through the Culture Dashboard, which provides insight into TSB's culture against nine traits so that actions can be identified to enhance a high performing culture. The latest dashboard reflects strengthening in two traits; accountability and speak up which are now in line with the financial services industry. TSB will continue to embed a culture which in 2021 includes a new employee engagement roadmap to help engagement with strategy and purpose, and delivery against our Do What Matters plan commitments to improve team diversity and diversity of thinking. TSB sets a consistent tone from the top, with senior leaders role modelling the TSB culture with actions that match their words and everyone feeling safe to share ideas and speak up.

Risk management in TSB (continued)

Risk appetite

TSB defines risk appetite as the amount and type of risk that it is willing to take in the pursuit of its objectives. Risk appetite is approved by the Board and is aligned to, and approved by, Sabadell. Through regular meetings and reporting, the Board monitors performance against appetite and, if necessary, has appropriate plans to address any appetite breaches.

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

Risk governance

Risk ownership and accountability sits with individuals, supported by governance and reporting via TSB's risk committees. These are aligned to the five principal types of risk as described in the table below. Each committee is responsible for monitoring TSB's risk profile and challenging risk exposures across the relevant risk type in line with the risk appetite set by the Board.

This committee structure enables efficient decision making, providing clear escalation and reporting of risk to senior management and the Board which is responsible for providing oversight of the effectiveness of the risk management framework. A Risk Committee is aligned to each of our Level 1 risk categories to provide a dedicated focus on managing those risks.

Financial Risk (Asset & Liability Committee)
Chaired by the Chief Financial Officer, the committee is responsible for the strategic management of TSB's balance sheet, the profit and loss implications of balance sheet management actions and the risk management framework for market risk, liquidity risk, capital risk, earnings volatility and economic value.
Credit Risk Committee
Chaired by the Chief Risk Officer, the committee is responsible for the coordination and aggregation of all credit risk management activity, management of TSB's credit risk profile, including credit risk appetite metrics and credit strategies, and TSB's compliance with all relevant credit regulation and legislation.
Operational Risk Committee
Chaired by the Chief Operating Officer, the committee is responsible for the aggregation and coordination of operational risk management across the Bank, monitoring and challenging the operational risk profile, including key operational risks and controls, and for ensuring appropriate escalation and visibility of relevant breaches, losses and events.
Conduct Risk Committee
Chaired by the Customer Banking Director, the committee is responsible for the aggregation and coordination of conduct risk management across the Bank including delivery of substantially fair customer outcomes, compliance with relevant conduct regulation and legislation, monitoring and challenging the conduct risk profile, including key conduct risks and controls, and for appropriate escalation and visibility of relevant weaknesses, breaches, losses and events.
Financial Crime Risk Committee
Chaired by the Chief Risk Officer, the committee is responsible for assessing whether the risk of criminal conduct relating to money or financial services or markets is appropriately managed across TSB. The committee monitors and challenges the financial crime risk profile including key financial crime risks and controls, appropriate upward escalation and visibility of relevant breaches, losses and events relating to the financial crime risk categories.

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

Risk management in TSB (continued)

Principal risks and uncertainties faced by TSB

The Board closely monitors risks that have the potential to materially impact execution of strategy. Notwithstanding the improvement in IT stability, the significant impact of the COVID-19 crisis has shifted the focus of our principal risks in 2020.

The Bank's response to COVID-19 has resulted in enhancements and adjustments to the control environment across the Bank to better support our customers. This included facilitating working from home for most employees, adjusting the working environment for those employees that continued to work on-site, providing support to customers in financial difficulties, policy adjustments, supporting vulnerable customers, accelerating on-line forms for customers, and enhanced monitoring to enable TSB to respond quickly and effectively in supporting customers and employees.

- **Credit**: TSB has a proactive approach to managing credit exposure with close monitoring and review of new lending, adjusting underwriting criteria where appropriate. The Board has closely monitored adjustments to credit strategies and customer journeys to support customers who require support from our Financial Support Services team. In response to COVID-19, TSB has been assisting customers through relief measures such as payment holidays and the Bounce Back Loan Scheme, whilst actively monitoring and managing the credit and financial risks arising from these financial support measures. The modelling of customer behaviour is supporting an effective operational response and tailored customer treatments when repayment holidays come to an end.

- **Operational**: TSB's operational response to COVID-19 has enabled the Bank to continue to operate effectively whilst keeping customers and employees safe. Customers' needs have been successfully met where fast-paced changes were required, enabling large numbers of employees to work remotely and manage increased operational volumes, requests for payment holidays and new types of business lending. Control has been exercised from the outset through TSB's incident management framework.

- **Conduct:** The response to COVID-19, including the assistance provided to customers as they exit COVID-19 related support strategies, has been subject to regular review by the Executive and Board. Areas of significant focus, with Executive and Board oversight, have been the identification and support of customers in financial difficulty, vulnerable customers, rectifications, bereavements and complaints.

- **Financial Crime**: TSB continues to enhance its fraud control environment and detection capabilities. During 2020, significant IT investment included upgrades to core detection systems for transactional fraud.

- **Financial**: A range of high level potential mitigations for financial risks including pricing actions to manage margins given lower interest rates; possible credit policy actions, particularly if there is a sustained downturn; and potential cost reduction actions involving more discretionary elements of the cost base.

The consequences of Brexit are considered to present potential financial and credit risks to the Bank. No operational continuity risks materialised for TSB as the UK exited the EU but should any other risks materialise, these would be managed through TSB's risk management framework to maintain operational continuity.

Our financial stability, operational resilience and customer outcomes are also key themes in the risks considered by the Board throughout 2020 and are detailed below***.***

Risk management in TSB (continued)

Principal risks and uncertainties faced by TSB (continued)

Description	Mitigation
Risk of a systemic crisis	
The current COVID-19 crisis continues to evolve while the risk of a new systemic crisis emerging remains. The primary risks to TSB include increased pressure on capital resources, safeguarding and supporting the well-being of customers and employees, and operational resilience. As the crisis continues, more customers will require support through financial difficulty or vulnerability, and our credit and customer strategies and processes will require continued close review.	TSB remains well capitalised. The key risks to capital have been captured in the Bank's financial forecast, including the implementation of the new mortgages IRB models, and are being closely monitored. TSB continues to focus on identifying and delivering capital optimisation opportunities, as well as being prepared to issue Additional Tier 1 (AT1) instruments if required. TSB has taken a proactive approach to risk management during COVID-19, responding swiftly to customer needs and regulatory guidelines. This has included waiving fees and interest charges, implementation and monitoring of repayment holidays, accelerating the use of on-line forms for customer services, proactive contact for vulnerable customers and implementation and monitoring of other financial support measures such as the Bounce Back Loan Scheme. Customer behaviour modelling has been used to establish an effective operational response and tailored customer treatments when repayment holidays come to an end. While fraud levels increased across the industry, TSB has continued to support customers through the industry's first ever Fraud Refund Guarantee. TSB used its established incident management framework to respond effectively and efficiently to the pandemic and the associated operational risks. Our response remains flexible to the constantly evolving situation to continue to provide an acceptable level of customer service and operational stability.
Threats to profit resilience	
Lower for longer rates, continued market competition and increasing regulatory requirements have reduced profitability across the sector. The emergence of COVID-19 during 2020 has put further pressure on profitability, both in the short term due to increased impairments and the impact of customer treatments on income, and in the medium term if there is an extended period of low or negative interest rates. Should the credit shock from COVID-19 deteriorate significantly, there is risk of a more rapid short-term impact on profit and capital from the associated risks.	Various aspects of TSB's strategy have been accelerated to mitigate the impact of these risks, such as the digital transformation programme which responds to customer need, reduces costs, and improves efficiency. A robust discipline is maintained so that risk adjusted returns on new business are sufficient and credit adjustments have been made where appropriate so that customers continue to borrow well in the current economic environment. Investment has been made in our Financial Support Services capabilities ahead of an expected increase in volumes of customers requiring support once government support schemes are withdrawn.
Management of customer harm	
There are increasing societal and regulatory expectations for higher standards of diligent and proactive management of potential customer harm. Customer harm will have occurred if a customer has experienced material distress and/or inconvenience, obvious detriment or in some instances an unfair outcome. In the main this is likely to occur due to failures in systems, policy, process or controls.	The embedding of our risk management framework and maturing conduct risk management helps both identify where customer harm may occur and has occurred, so proactively managing potential impact on customers. The Executive Committee and Board receive regular management information on potential and actual customer harm, together with actions taken to prevent harm and address any weaknesses. Management is improving practices relating to the treatment of some customers in collections and recoveries.

Risk management in TSB (continued)

Principal risks and uncertainties faced by TSB (continued)

Description	Mitigation
Data management and security	
Without strong data governance practices, data could be mis-used, mis-interpreted, incorrect, or not available. This could result in issues under GDPR and BCBS 239 where data should be accurate, available on demand by customers, used for the purpose collected, and be aggregated and reported accurately – potentially leading to customer detriment, poor decision making, incorrect reporting, regulatory censure and fines. As more services and customer interactions become digital the potential impact of a successful cyber-attack grows. Each year there is an increase in the complexity and sophistication of attacks around the globe and while all industries are targeted, the banking industry remains high on the criminal hacking agenda. Without effective mitigating controls there is a significant risk that an attack could lead to service downtime and customer disruption, material data loss, financial loss, remediation cost, and reputational damage.	TSB has continued to focus on improving the monitoring and quality of customer data, and the delivery of Big Data and Operational Data Store projects will enable effective use of quality data. Focus is on maintaining a fully effective security control environment, building further capability to prevent and detect the evolving types of attack with the right tools and technology.
Risk of negative interest rates	
The Bank of England published a review of negative interest rates in its August 2020 Monetary Policy Report. The Governor of the Bank of England confirmed that the introduction of negative interest rates is one of many tools under consideration to steer the economy towards its 2% inflation rate target. The Bank of England has subsequently issued a survey across the banking industry to assess operational readiness. TSB's capital position could come under pressure due to margin compression and potential reduction in structural hedge income.	TSB is planning for the prospect of negative interest rates. The initial priority is for TSB to be operationally ready. An assessment is being made of the potential financial impact alongside the potential changes to product design, pricing, and hedging and investment strategies to offset reduced income. Management of the financial impact will be influenced by how the government chooses to implement negative rates, market-wide changes in pricing and products (particularly from price-makers), and any additional regulatory guidance that emerges.
Maintaining technical and operational resilience	
Disruption to business activities across TSB, and the banking industry, remains a material inherent risk and an area of high importance to our customers and regulators. With the reducing reliance on cash by our customers, the ability to maintain digital services to our customers and back office processing grows ever more important to prevent customer detriment, losses through rectifications, remediation costs, and to avoid reputational damage.	TSB has taken direct control of its technology estate, transitioned services to new third parties, and built further capability in the technology function. Technology is always evolving and with increased transparency following the technology estate transition, ongoing focus is on an effective and embedded technology control environment, building further resilience into our existing technology estate, and any new technology. Increased regulatory scrutiny is expected in 2021 following the new Operational Resilience regulation, covering process, technology, people, premises, and third parties. The necessary steps are being taken to comply and to demonstrate the resilience and interchangeability of key business services.
Increased competition with failed differentiation	
Fintech and other technological advances create alternatives to the traditional value chain and ways in which banks currently operate and service customers.	A core component of TSB's strategy is leveraging the technology to improve digital services. TSB has identified its core customer base and development of new products, services, and experiences are aimed specifically at meeting those customers' needs. Examples include the launch of the Spend and Save current account, new mortgage products and features including digital product transfers, and new partnerships with ApTap and Wealthify help our customers make more of their money. TSB also differentiates itself through the award-winning Fraud Refund Guarantee scheme.

Risk management in TSB (continued)

Emerging risks

The key emerging risks in TSB's operating environment are described below. TSB regularly considers the likelihood of the relevant risk materialising and the potential impact on its business strategy, customers, employees and shareholder. These risks are considered as part of the business planning cycle.

COVID-19 related horizon risks

COVID-19 has generated significant instability and the full impact of the consequential effects is not yet known. The longer-term effect on market forces and customer behaviours could significantly impact strategy and TSB's business model. TSB has a strong liquidity and capital position and ensures this includes sufficient MREL resources, with a buffer to cover any disruption. The approach to setting TSB's strategy considers a range of responsive and flexible strategic initiatives that can be deployed and adjusted as the landscape evolves.

Challenge to attract and retain talent in a competitive market

Demand for highly skilled and experienced employees has resulted in a competitive jobs market. This, together with added uncertainty over TSB's future ownership model, could have a negative impact on leadership and attrition, resulting in challenges with attracting and retaining talent. A number of projects have been established to deliver people, property and technical solutions and inclusion initiatives and the Board monitors and assesses culture bi-annually.

Climate change risk

Climate change presents several physical and transitional risks that need to be effectively identified and managed to prevent customer harm and adverse financial impacts. In line with PRA and Climate Financial Risk Forum (CFRF) guidance, climate change is positioned as a cross-cutting TSB risk, impacting a range of risk categories to varying degrees. TSB has conducted a high-level assessment of the extent to which risk categories are impacted by climate change. The risk categories expected to be most impacted correlate with the key areas detailed in the CFRF guidance, predominately credit, financial, market, physical, property, supplier, and disclosure risks.

A full assessment of the impact of climate change risks will be undertaken in early 2021 to support the embedding of effective risk management actions, ahead of the 2021 PRA deadline to fully embed the approach to managing climate-related financial risks.

TSB's Chief Risk Officer has accountability for ensuring financial risks of climate-related change are understood and discussed at Board level, embedded in risk management, and considered in TSB's strategy. Responsibility for leading TSB's consideration of the financial risks arising from climate change and its readiness has been assigned to a dedicated steering group. The activity plan has been structured around the key CFRF themes:

- Risk management – embedding climate change risk into TSB's governance framework, developing policies for managing exposure to climate-related financial risks and embedding climate change risk management within the risk management framework.

- Scenario analysis – use of scenario analysis to inform strategic planning and determine the impact of climate change financial risks on TSB's overall risk profile and business strategy.

- Disclosures – development of robust, decision-useful climate change disclosures.

- Innovation – the Climate Related Business Strategy group established under the Do What Matters plan pillar led by the Chief Operating Officer has responsibility for considering our operational approach to climate change. This includes understanding our environmental footprint as an organisation, both today and in the future, offering 'green' products designed to have a positive impact on the environment, considering how we can encourage employees to be more environmentally conscious, and assessing our suppliers' environmental footprint.

During October 2020, the Chief Risk Officer provided the Board Risk Committee with an update on the progress of TSB's response to the PRA's supervisory statement on enhancing banks' and insurers' approaches to managing the financial risks from climate change (SS3/19), detailing how planning has evolved following updated guidance from the PRA and the CFRF. A Board workshop is planned for March 2021 to assess progress against developments in industry practice.

Risk management in TSB (continued)

Emerging risks (continued)

The principal climate change risks to TSB relates to property collateral for secured lending. These are both physical risks (such as flooding), and transitional risks (such as affordability impacts on customers from increased energy efficiency investment requirements). The core mortgage book is the most at risk due to property value, albeit initial assessment has deemed the current impact as low.

The near-term risks are transitional, relating to energy efficiency, with the possibility of stronger energy performance regulation over time. As well as an assessment of the existing mortgage book, we have a new valuation tool that assesses climate change risk at origination and every new property during 2021 will be assessed. We have enhanced our monitoring with two new risk appetite metrics related to flooding and energy performance of our mortgage book. The steering group will drive action to mitigate any financial impact.

Strategic report on pages 2 to 26 approved, by order of the Board.

Keith Hawkins
Company Secretary,
2 February 2021

Corporate governance statement

How the business is managed

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

- Board authorities being delegated from the Boards of the Company and the Bank (together the TSB Boards) to Board committees and to the Chief Executive; and
- Delegated executive authorities through which the Chief Executive delegates aspects of her own authority to other senior executives and sets out the support provided to her by the executive committees.

TSB's corporate governance structure is supported by the internal control and governance framework as outlined on page 34. An important principle, applied throughout the corporate governance framework, is that the delegation of executive authority is to the individual office holders (who may in turn delegate aspects of their authority to others). Executive committees may be established to support the individuals in exercising their delegated authorities, but the committees do not separately hold any delegated authority in their own right. This approach to individual accountability is aligned to the principles of the Senior Managers & Certification Regime.

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

To assist with this, Sabadell operates an information sharing and co-ordination committee, the UK Steering & Coordination Committee (UKSCC) which seeks to provide Sabadell with a regular overview of the performance of TSB and to ensure that TSB policies and processes are aligned to those of the Sabadell Group where it is appropriate to do so. Certain members of the Bank's Executive Committee are appointed as members of the UKSCC.

Although the Company does not have shares with a premium listing on the London Stock Exchange, and does not need to comply with the UK Corporate Governance Code (Code), the Board has chosen to voluntarily adopt those principles of the Code that are considered appropriate for TSB as a wholly owned subsidiary of Sabadell and to report against the Code in the annual report. A copy of the Code is available at www.frc.org.uk. The following aspects of the Code are not considered appropriate for TSB:

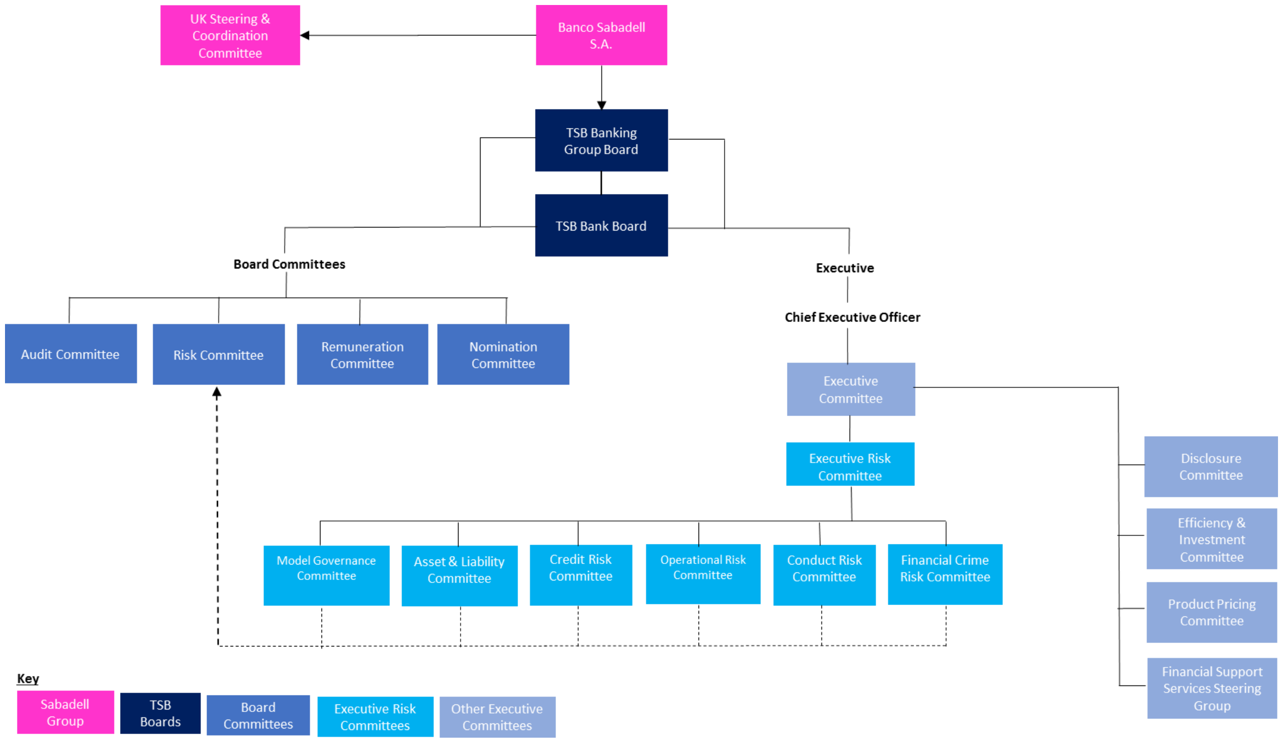
- All Directors should be subject to annual re-election by shareholders (Provision 18);
- Provisions relating to the proportion of Independent Non-executive Directors who are members of the Audit and Remuneration Committees (Provisions 24 and 32); and
- Provisions relating to dialogue with shareholders (Provisions 3 and 4).

In addition, the Remuneration Committee has not created a policy for post-employment shareholding requirements (Provision 36). TSB Executive Directors are already subject to long deferral periods (seven years with a further one year holding period) for Sabadell shares awarded as part of TSB variable remuneration. Therefore, the current view is that no specific post-cessation shareholding requirement be introduced for TSB Executive Directors at the present time. The Remuneration Committee continues to keep this under review as part of a regular Committee agenda item to consider market developments.

With regard to the requirement to align pension contribution rates for TSB Executive Directors with those available to the wider TSB workforce (Provision 38), the Remuneration Committee has considered and agreed to implement an approach to align the contribution rates by 31 December 2022.

How the business is managed (continued)

The corporate governance framework is reviewed at least annually by the Board to confirm that governance arrangements remain effective. The diagram below sets out the framework of Board and executive committees.



The role and responsibilities of the Board

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

(i) Strategy

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

(ii) Risk

- Reviewing the effectiveness of the Company's and Bank's risk management and internal control systems; and
- Approval of the Bank's Risk Appetite, Internal Capital Adequacy Assessment Process (ICAAP), Internal Liquidity Adequacy Assessment Process (ILAAP), Reverse Stress Test and Recovery Plan.

(iii) Shareholder communications

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

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

How the business is managed (continued)

Role of Directors

There is a clear division of responsibility between the Chairman and Chief Executive. This has been approved by the Board and is available to view at www.tsb.co.uk/investors/people/.

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

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

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

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

Board membership and composition

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

Chairman:	Richard Meddings (independent on appointment)
Executive Directors:	
Chief Executive	Debbie Crosbie
Chief Financial Officer	Ralph Coates
Independent Non-executive Directors:	Paulina Beato
	Libby Chambers
	Lynne Peacock (Senior Independent Director)
	Mark Rennison
	Andy Simmonds
	Polly Williams
Non-executive Directors:	César González-Bueno
	Tomás Varela
	David Vegara

Full biographical details of the Chairman and Executive Directors are included on page 54. Details of the Non-executive Directors, including their skills and experience, can be found at www.tsb.co.uk/investors/people/.

A record of the Directors who have served during the year is shown in the Directors' report on page 43. The letters of appointment for Non-executive Directors are available at the Company's registered office and at the Annual General Meeting.

How the business is managed (continued)

Board Committees

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

- The Risk Committee (chaired by Andy Simmonds) oversees the management of the risks TSB faces;
- The Audit Committee (chaired by Polly Williams) oversees financial reporting and internal control;
- The Nomination Committee (chaired by Richard Meddings) leads the process for appointments to the TSB Boards and succession planning for the TSB Boards and Executive Committee; and
- The Remuneration Committee (chaired by Lynne Peacock) formulates TSB remuneration policy and supports the ongoing delivery of sustainable performance.

The Audit and Nomination Committees have each prepared a report which includes a description of their role and composition. Each of the Board Committees' terms of reference are available at www.tsb.co.uk/investors/people/.

Meeting attendance

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

Name of Director (ix)	Board meetings attended	Audit Committee meetings attended	Risk Committee meetings attended	Nomination Committee meetings attended	Remuneration Committee meetings attended
Debbie Crosbie	7 out of 7	–	–	–	–
Ralph Coates	7 out of 7	–	–	–	–
Paulina Beato	7 out of 7	–	6 out of 6	–	6 out of 6
Libby Chambers (i)	2 out of 2	2 out of 2	–	–	2 out of 2
Dame Sandra Dawson (ii)	7 out of 7	–	–	4 out of 4	6 out of 6
César González-Bueno (iii)	6 out of 6	–	–	2 out of 2	4 out of 4
Graeme Hardie (iv)	2 out of 2	2 out of 2	2 out of 3	–	–
Richard Meddings	7 out of 7	–	–	4 out of 4	–
Stephen Page (v)	6 out of 6	–	5 out of 5	–	–
Lynne Peacock (vi)	5 out of 5	–	4 out of 4	2 out of 2	4 out of 4
Mark Rennison (vii)	2 out of 3	2 out of 2	2 out of 2	–	–
Andy Simmonds	7 out of 7	5 out of 5	6 out of 6	–	–
Polly Williams	7 out of 7	5 out of 5	6 out of 6	4 out of 4	6 out of 6
Tomás Varela	5 out of 7	3 out of 5	4 out of 6	–	–
David Vegara (viii)	6 out of 7	–	6 out of 6	–	–

(i) Appointed to the Board on 1 October 2020.
(ii) Resigned from the Board on 31 December 2020.
(iii) Appointed to the Board on 23 March 2020.
(iv) Resigned from the Board on 16 May 2020.
(v) Resigned from the Board on 31 October 2020.
(vi) Appointed to the Board on 22 April 2020.
(vii) Appointed to the Board on 1 August 2020.
(viii) Appointed to the Board on 22 January 2020.
(ix) Directors not able to attend meetings due to longstanding prior commitments, illness or unavoidable circumstances, provided comments to the chair concerned on matters to be discussed at the relevant meeting.

Board development

During the year, David Vegara, César González-Bueno, Lynne Peacock, Mark Rennison and Libby Chambers completed a comprehensive induction programme following their appointment to the Board as Non-executive Directors. David Vegara, who was appointed to the Board on 22 January 2020, replaced Miquel Montes (who resigned from the Board on 14 November 2019) as a Director appointed at the nomination of Sabadell, whilst César González-Bueno was appointed to the Board on 23 March 2020 as an additional Sabadell nominated Director. Details of other Non-executive Director appointments during 2020 are contained within the Nomination Committee report on page 35. Directors are given the opportunity to undertake further training in order that they are fully comfortable with their role within the Board and to enable them to contribute to the operation of the Board and the long-term success of the Company in the fullest manner possible.

Board 'education' sessions are also regularly held to allow Non-executive Directors to explore key strategic and risk issues outside of the time constraints of a formal Board meeting. The number of sessions run in 2020 was lower than had been the case in previous years due to management and Board focus on the Bank's response to COVID-19. Sessions were, however, run on diversity and inclusion and conflict management in ring-fenced bodies, whilst the Audit Committee held a 'deep dive' session on IFRS 9. The intention is for a fuller schedule of education sessions to resume in 2021.

How the business is managed (continued)

Board effectiveness

The review of Board effectiveness for 2020 was run internally by way of a self-assessment questionnaire. It was led by the then Senior Independent Director, Dame Sandra Dawson (who retired from the Board on 31 December 2020), and managed by the Company Secretariat. The questionnaire was circulated to each member of the Board, together with the Chief Risk Officer and General Counsel. The questions for the 2020 review built on the themes arising from the 2019 Board effectiveness exercise, with the addition of some specific questions relating to TSB's response to COVID-19. The Company Secretary collated and analysed the anonymised responses and summarised these for consideration by the Senior Independent Director and, ultimately, the Board. The review revealed a strengthening in all of the areas that had emerged as themes of the 2019 review. These included the pace and depth of strategic discussions, Board MI, and the composition, skills and experience of the Board. Each of these areas have continued on a trajectory of improvement during 2020. The report also revealed a consensus view that there had been comprehensive coverage of TSB's COVID-19 response across Board and Board Committees, with the frequency of meetings increased where necessary and discussions and engagement kept at the right level. Additional matters that the Board would like to focus on in 2021 were identified and, to this end, 'deep dive' sessions on the following topics will be scheduled: the Bank's longer-term business model, social media, and oversight of key suppliers.

The Board's Audit, Risk, Remuneration and Nomination Committees also conducted reviews of their own effectiveness during 2020. The Audit, Risk and Remuneration Committees agreed a questionnaire which was circulated to committee members and other members of the executive team who regularly attend committee meetings. The results of these effectiveness assessments were analysed by the chairs of the relevant Board committees, in consultation with the Company Secretariat, presented to the relevant Board committee and actions agreed for the coming year. Separately, the Nomination Committee reviewed and made changes to its annual cycle of meetings to enhance its effectiveness.

Independence

The Board has considered whether there are any relationships or circumstances which could appear to affect the Independent Non-executive Directors' judgement. No Independent Non-executive Director, or member of their immediate family, has ever had a material relationship with TSB nor receives additional remuneration apart from Director fees. The Independent Non-executive Directors do not participate in TSB's pension or share schemes. No Independent Non-executive Directors serve as Directors of any companies or affiliates in which any other Director is also a Director.

Tomás Varela is Sabadell's Chief Financial Officer and a member of Sabadell's Management Committee (Comité de Dirección), and David Vegara is Sabadell's Chief Risk Officer and a member of both Sabadell's Management Committee and the Sabadell Board, and for that reason are not considered to be independent. They do not receive any fees from TSB. César González-Bueno was appointed as Sabadell's new Chief Executive on 16 December 2020, subject to regulatory approval. On 22 December 2020, he entered into an agreement pursuant to which he receives fees from Sabadell. Since his appointment to the TSB Boards on 23 March 2020, César has not been considered to be independent, as he was appointed at the nomination of Sabadell. César was paid TSB Director fees in line with those paid to the Independent Non-executive Directors. The last such payment was made on 18 December 2020.

Management of conflicts of interest

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

Save as described as follows in relation to Tomás Varela, David Vegara, and César González-Bueno, there are no conflicts of interest between any duties owed by the Directors to the Company and their private interests or other duties. As Executive officers/Directors of Sabadell, Tomás Varela and David Vegara will have a conflict of interest in circumstances where the interests of TSB and the wider Sabadell Group are not, or may not be, aligned. This conflict has been authorised by the Board. Similarly, this conflict will also apply to César González-Bueno on his appointment as Sabadell Chief Executive becoming effective (on receipt of regulatory approval), and has been pre-authorised by the Board.

How the business is managed (continued)

Whistleblowing arrangements

TSB has a robust whistleblowing process in place which is available to all employees and contractors. The Board oversees the adequacy of TSB's whistleblowing arrangements, ensuring that they are proportionate and enable employees and contractors to raise concerns, in confidence, about possible wrongdoing in financial reporting or other matters. During 2020, in her role as TSB's Whistleblowing Champion, Polly Williams (Chair of the Audit Committee) received regular reports from management which provided details of whistleblowing matters. The Board receives an annual report from management providing an overview of whistleblowing procedures and outcomes, and challenges management on TSB's plans to ensure whistleblowing policies and processes are aligned with external best practice. As part of its annual review of whistleblowing matters, the Board was satisfied that there were no material concerns raised relating to TSB's whistleblowing processes or outcomes in 2020.

Reappointment of Directors

The Board considers that all Directors continue to be effective, committed to their roles and have sufficient time available to perform their duties. All Non-executive Directors, with the exception of David Vegara, Tomás Varela and César González-Bueno (being the Directors appointed at the nomination of Sabadell), have been appointed for an initial three year term and their continued appointment thereafter is considered by the Board at the end of the initial period of office. During 2020, the tenure as Independent Non-executive Directors of Paulina Beato, Dame Sandra Dawson, Stephen Page and Andy Simmonds were extended, together with the tenure of Richard Meddings as Board Chairman. The supporting rationale for these extensions is explained in the Nomination Committee report on page 35. As the Company is a wholly owned subsidiary of Sabadell it is not considered necessary for Directors to seek annual re-election or for the Directors appointed at the nomination of Sabadell to be appointed for a specified term.

In accordance with Provision 15 of the Code, Directors are required to seek prior approval from the Board before taking up additional external appointments. Two significant additional appointments were taken up by Directors during the financial year following pre-approval by the Board: i) Richard Meddings was appointed to the Board of Credit Suisse and as chairman of its Audit Committee (also serving on the Risk, Governance & Nominations, and Conduct & Financial Crime Control Committees). This reflected a re-balancing of his non-executive portfolio following stepping down from a number of positions in 2019 and 2020; and ii) Mark Rennison was appointed to the Board of Royal London (where he also serves on the Audit, Risk & Capital, and Nomination Committees). Whilst adding to Mark's portfolio, as part of a planned build of a small number of non-executive positions following his retirement from executive roles, the appointment will not impact Mark's time commitment for TSB.

Company Secretary and independent professional advice

Keith Hawkins has served as the Company Secretary throughout the year ended 31 December 2020. The Company Secretary is responsible to the Board for ensuring compliance with corporate governance requirements. The Board has access to the Company Secretary individually and collectively. As well as the support of the Company Secretary, any Director may take independent professional advice at the Company's expense in the furtherance of their duties, where considered necessary.

Evaluation of internal controls procedures

The Board has carried out an assessment of the effectiveness of the Company's risk management and internal control systems. The Audit Committee report explains the process in more detail on page 41.

External auditors

Following the conclusion of a tender process undertaken in 2018, KPMG were appointed, at the 2020 Annual General Meeting, to undertake the audit of the financial statements for the year ending 31 December 2020. Resolutions proposing the re-appointment of KPMG for the 2021 audit, and to authorise the Directors to determine their remuneration, will be proposed at the 2021 Annual General Meeting, as recommended by the Audit Committee and approved by the Board.

Principal accountant fees and services

An analysis of fees for professional services provided by KPMG, the Company's external auditors for the year ended 31 December 2020, is set out in note 14 to TSB's consolidated financial statements on page 82.

How the business is managed (continued)

Internal control and governance framework
An explanation of TSB's Executive Committee and its sub-committees is set out below.

(i) Executive Committee
Chaired by the Chief Executive, TSB's Executive Committee is TSB's principal executive committee and collectively supports the Chief Executive in developing and implementing TSB's strategy, monitoring business performance and agreeing any actions that are required to manage issues that affect TSB. Consideration is given to the interests of all stakeholders.

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

(ii) Executive Risk Committees
The role of the Executive Risk Committee, which is chaired by the Chief Executive, is to ensure an enterprise wide perspective of TSB's risks and determine strategic actions to address them.

The six further committees in the executive layer of risk governance (Asset & Liability Committee, Credit Risk Committee, Operational Risk Committee, Conduct Risk Committee, Financial Crime Risk Committee and Model Governance Committee), which each report into the Executive Risk Committee (and indirectly to the Board Risk Committee), monitor and challenge risk exposures against approved risk appetite and are structured to align with the risk management framework described on page 20. Each risk committee within the governance structure is responsible for ensuring the risk and control environment is established within its area of authority. This enables day-to-day decisions to be made, with clear reporting lines established through the Executive Risk Committee, Executive Committee and Board Risk Committee, and ultimately to the Board. Each of the six executive risk committees is chaired by an Executive Committee member. Further detail on the responsibilities of each of the executive risk committees is shown in the Risk governance section on page 21.

(iii) Other Executive Committee Sub-Committees
The following other executive committees report into the Executive Committee:

- The Product Pricing Committee which is responsible for reviewing and approving pricing strategy and any decisions in relation to the pricing of TSB's products;

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

- The Efficiency & Investment Committee which is responsible for managing cost in the business and monitoring delivery of operating expenses in the Medium Term Plan, for ensuring investment is aligned to strategic priorities and to track the progress of the investment portfolio, and to approve business cases for funding; and

- The Financial Support Services (FSS) Steering Group, which provides strategic oversight, advice and decisioning to support the Bank's on-going enhancement of its FSS function.

By order of the Board

Keith Hawkins
Company Secretary
2 February 2021

Nomination Committee report

Chairman's introduction

The Committee is authorised by the Board to keep the structure, size and composition of the TSB Boards under review and for making recommendations to the Board with regard to any changes required. It leads the process for appointments to the TSB Boards, Board committees and the chairmanship of those committees and also considers succession planning for the TSB Boards and Executive, taking into account the skills and expertise that will be needed in the future.

As at the date of this report, the members of the Nomination Committee are Richard Meddings (Chair), Polly Williams, Lynne Peacock and César González-Bueno. Lynne and César were appointed as members of the Committee on 22 and 30 April 2020, respectively. Dame Sandra Dawson served as a member of the Committee until she stepped down from the TSB Boards on 31 December 2020.

Appointment of directors and succession planning

The Committee met four times formally during 2020. The key matters discussed and agreed at these meetings were:

- Consideration of the extension of the term of office for Independent Non-executive Directors whose term expired in 2020, and to agree the search brief for individuals to replace those leaving the Board. Following the Committee's recommendation, the Board subsequently approved: i) the extension of the term of office of Paulina Beato, allowing the Board to continue to benefit from her broad experience and knowledge of TSB; ii) a short extension of the term of office of Stephen Page, enabling Stephen to complete his remit as a member of the Project Dawn Board sub-committee (being the project under which control of IT services was transitioned from Sabis to TSB); and iii) by written resolution of the Committee, the extension of the term of office of Dame Sandra Dawson, to facilitate a smooth handover to Lynne Peacock as TSB's Senior Independent Director at the end of 2020;

- Consideration, and recommendation to the Board, of the appointment as Independent Non-executive Directors of: i) Mark Rennison, as successor to Polly Williams as Chair of the Audit Committee. This followed an extensive search by Odgers Berndston (who have no other connection with TSB), which covered a broad range of candidates; ii) the appointment of Libby Chambers, following an extensive search by Odgers Berndston, whose brief had centred on identifying a proven Non-executive Director with strong customer/consumer experience; and iii) by written resolution of the Committee, the appointment of Adam Banks, following an extensive search by Egon Zehnder (who have no other connection with TSB) for a Non-executive Director with strong technology/digital experience to support the Bank's strategic ambitions in these areas. The Board subsequently approved these appointments, with Mark scheduled to take over from Polly as Audit Committee Chair in the first quarter of 2021, subject to regulatory approval, and Adam joining the Board on 8 February 2021; and

- Consideration, and recommendation to the Board, of the renewal of the initial three year terms of office of Richard Meddings (as Board Chairman) and Andy Simmonds (as Risk Committee Chairman) both of which expire in 2021, which reflected the Committee's assessment of Richard's and Andy's continuing strong performance in their respective roles. Following the Committee's recommendation, the Board subsequently approved these term renewals.

In addition to the appointment of the Directors recorded above, Lynne Peacock, David Vegara and César González-Bueno also joined the Board during the course of 2020. Lynne's appointment as the successor to Dame Sandra Dawson as Chair of the Remuneration Committee and Senior Independent Director was approved at Nomination Committee and Board meetings held in 2019, whilst David and César joined the Board at the nomination of Sabadell.

Executive Succession Planning

At its meeting held in November 2020, the Committee considered the Executive succession plan presented by TSB's HR Director, which covered the Executive Committee, together with the layer of senior management reporting into Executive Committee members. Earlier in the year, the Committee had agreed to enhance its effectiveness by including bi-annual formal consideration of Executive succession planning in the Committee meeting calendar.

Nomination Committee report (continued)

Diversity and inclusion

TSB is committed to fair and consistent treatment of all employees regardless of their personal characteristics, which include gender, ethnicity, religion, sexual orientation, transgender status, disability, nationality or age. The Board has adopted this approach to diversity and had regard to it during the recruitment process discussed above. The Directors' report, on page 45, provides further detail on TSB's approach to diversity and inclusion. A key aspect of this is TSB's Do What Matters plan, which was published in 2020 and includes a new framework to support TSB's existing ambition to create a truly inclusive workplace. The Board promotes and affirms TSB's aspiration to meet and exceed the target of 33% of Board positions being held by women, as set out in the Hampton-Alexander Review.

The Chairman's other significant commitments

My other significant commitments, in addition to the role of TSB Chairman, are as a Non-executive Director of Credit Suisse, where I chair the Audit Committee and am a member of the Risk, Governance & Nominations, and Conduct & Financial Crime Control Committees. I am also a Non-executive Director of HM Treasury, where I chair the Audit Committee. Details of my other external appointments are available at www.tsb.co.uk/investors/people/.

Richard Meddings
Chair, Nomination Committee
2 February 2021

Audit Committee report

Chair's introduction

Our established practice of including a report on the Audit Committee's activities in the Annual Report, on a voluntary basis, is a reflection of the importance of the Committee and the transparent and straightforward manner in which the Committee conducts its activities. This transparency is a key element in holding the Committee and me to account.

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

I have been chair of the Committee throughout 2020 and have been ably supported by my fellow Non-executive Directors, Andy Simmonds and Tomás Varela who have served as members of the Committee throughout the year. I thank Graeme Hardie, who left the Committee on his resignation from the Board in May 2020, for his wise counsel and the experience he brought to the Committee. I welcome Mark Rennison and Libby Chambers who joined the Committee in August and October 2020, respectively, bringing strong and relevant industry experience. Biographies of the members of the Committee can be found at www.tsb.co.uk/investors/people/. All Non-executive Directors, including the Chairman, of TSB have a standing invitation to attend any or all meetings of the Committee.

In my equivalent report of last year, I predicted that the Committee's attention would be targeted at understanding and challenging management's plans to maintain the effectiveness of TSB's risk management and internal control systems while improving their efficiency. This work included the Committee's challenge of the actions taken by management to embed the risk management framework and the outcomes of a programme of work to improve the automation and efficiency of controls across the business. The Committee has also reviewed and challenged management's plans to improve the IT control environment following the transition of control of IT services from Sabis to TSB.

I also noted that the Committee would continue to challenge management's key accounting judgements, particularly the use of multiple economic scenarios in evaluating expected credit losses as the political landscape unfolded and in respect of the accounting for the costs of restructuring the Bank. While this has been the case, these judgements have been made more complex as a result of the uncertainties introduced by the COVID-19 pandemic. The Committee received quarterly reports from management as the suite of economic scenarios evolved during the year. In particular, the Committee requested a 'deep-dive' review of proposed and reasonable alternative scenarios, probability weights and forecast credit impairment provisions in June, so that the Committee had the opportunity to challenge management's judgements in a timely basis and ahead of the half year reporting cycle. The Committee used its December meeting to provide similar challenge ahead of the year end financial reporting cycle. The Committee also maintained a deep interest in the industry wide response to the COVID-19 pandemic in its approach to the implementation of IFRS 9. In addition, the Committee has reviewed and challenged management's provisions and related disclosures in respect of estimated charges relating to the treatment of some customers in arrears while being supported by TSB's collection and recoveries function.

The report also explains the Committee's work in assessing the priorities of and the work undertaken by the Internal Audit function.

An effective external audit remains central to the Bank's financial reporting process. The Committee continues to review and challenge the approach to the external audit. The Committee monitored the transition of external audit services to KPMG in 2020 and challenged KPMG's plans and capacity to execute their incoming audit on a largely remote basis. In addition, in light of continued improvements in the control environment, the Committee challenged KPMG to deploy an audit strategy that increased the reliance on business controls.

In 2021, Mark will assume the chair of the Committee (subject to regulatory approval) when I step down from the Board. He and I expect the Committee's attention will be targeted towards challenging management's judgements in respect of the broader COVID-19 impacts (including on impairment, performance of the Bounce Back Loan Scheme offering, that was rapidly established in 2020, and from potential consequential product developments) and the transition costs arising from the evolution to a leaner business model. I also expect the Committee to increase its challenge over the controls over the data and models used in calculating capital requirements following the implementation of a new Internal Ratings Based suite of models. Finally, we expect the Committee to continue to closely monitor the control environment as the Bank's business model evolves.

Polly Williams
Chair, Audit Committee
2 February 2021

Audit Committee report (continued)

Membership and operation of the Committee

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

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

The Chair reports to the Board after each Committee meeting on the main matters discussed so that all Directors are informed on the activity of the Committee. The Chair is available to all Directors for discussion of any matters in more detail and maintains regular dialogue outside Committee meetings with members of the Executive Committee, particularly the Chief Executive, Chief Financial Officer, Chief Risk Officer and Chief Audit Officer, and also with the lead partner of the external auditor.

The Committee met five times during 2020.

Audit Committee responsibilities and activity in 2020

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

- Financial statements and related financial reporting;
- Risk management and internal control systems;
- Performance and effectiveness of the Internal Audit function; and
- Effectiveness of the relationship with the external auditor.

Financial statements and related financial reporting

The Committee is responsible for the review and challenge of TSB's half year and annual financial statements, including the significant financial reporting estimates and judgements which they contain. During 2020, the Committee has considered the following matters:

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

The Committee has considered and accepted management's review of TSB's accounting policies. These have been updated in 2020 to reflect the early adoption of the IASB's 'Interest Rate Benchmark Reform – Phase 2 Amendment', as described on page 94.

(ii) The methods used to account for significant transactions

The Committee has reviewed and supported proposals from management on the accounting for:

- The costs of restructuring the Bank;
- The estimated costs arising from the treatment of some customers in arears; and
- The replacement of relevant LIBOR based derivative financial instruments and the recouponing of the TSB covered bond programme as part of IBOR reform.

(iii) Viability and going concern assessments in uncertain macroeconomic circumstances

The Committee has considered management's approach to, and the conclusions of, the assessment of TSB's ability to remain a going concern, taking into account the Bank's capital and liquidity position. The Committee considered and, after taking the Bank's strategy and external market developments into account, supported management's conclusion that it remained appropriate to adopt the going concern basis in preparing the consolidated financial statements. The Committee also considered management's approach to, and the conclusions of, the assessment of TSB's viability. The Committee challenged management's viability assessment period, noting it was over the three years to December 2023. After consideration, the Committee supported the approach adopted by management as described on page 48.

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

The Committee considered management's approach to, and governance arrangements over, the preparation of this annual report and recommended to the Board that, taken as a whole, it was considered to be fair, balanced and understandable. The approach and results of the assessment are set out in the Directors' report on page 49.

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

The Committee has assessed the basis for and appropriateness of estimates and judgements proposed by management in the financial statements as presented below. After challenge, the Committee supported management's proposals.

<table>
<tr><th>Accounting estimate / judgement</th><th>Audit Committee considerations</th><th>Reference</th></tr>
<tr><td>Allowance for credit impairment losses</td><td>
At December 2020, expected credit losses were reflected in an allowance for credit impairment losses of £239.0 million (2019: £163.0 million) and a provision for off balance sheet commitments of £19.2 million (2019: £2.6 million).
During 2020, the Committee reviewed regular reports from management which assessed the adequacy of the allowance. As part of this process, the Committee requested early briefings from management in advance of the half year and full year close processes so that sufficient time was made available to the Committee to fully consider and challenge the impact of the heightened economic uncertainty from the COVID-19 pandemic on the adequacy of the allowance. These reports assessed the adequacy of historic provisions against subsequent recoveries, reviewed management's governance arrangements and, in particular, the governance over impairment models. They also benchmarked TSB's metrics against other banks and took account of guidance issued by respective regulators.
Economic scenarios and associated weightings at December 2020
The Committee received a report from management that assessed the appropriateness of the scenarios and probability weightings in light of the current environment. The Committee challenged management over their scenarios and probability weightings, noting that management were proposing four forecast scenarios.

Management's base case scenario, with a 50% weighting, forecasts a cautious recovery in 2021 as lockdown restrictions started to ease, with the economy returning to pre-pandemic levels in 2022;
The downside scenario, which was judged to have a 35% weighting, reflects a recovery in 2021, but at a slower rate as restrictions remain in place longer than in the base case;
A severe stress downside scenario, with a 5% weighting, was considered reflective of economic metrics that might occur in a scenario where the COVID-19 pandemic cannot be controlled. The low probability weighting reflected that, in management's view, the emergence of various vaccines and ongoing preparations have limited the probability of such a scenario; and
The potential for accelerated healthcare and technology developments that eradicate the virus more quickly than in the base scenario and supportive government policies were reflected in a low probability upside scenario with a 10% weighting.

Management presented analysis of the sensitivity of the allowance for credit impairment losses to alternative scenario weightings. In light of the current highly uncertain economic circumstances, management presented proposals for enhanced disclosure of those sensitivities, including the impact on the level of the allowance applying a 100% weighting to each of the scenarios, as set out on page 76. After substantial debate and challenge, the Committee supported management's proposals.
Post model adjustments
At 31 December 2020, the impairment provisions included £41.2 million (2019: £57.6 million) of management's adjustments to modelled outcomes. This included an adjustment to reduce the allowance by £33.2 million to take account of the government guarantee on Bounce Back loans. A key focus of the Committee during the year was an assessment of the level and rationale for such adjustments in light of the degree to which models were able to fully take account of the rapidly evolving economic conditions, customer support measures, and respective regulatory guidance. The Committee challenged reports prepared by management to support these adjustments, and management's plans to amend, where appropriate, the relevant models to minimise future adjustments.
The Committee concluded that a robust governance framework existed to monitor provisioning adequacy and that the assumptions and judgements applied by management were appropriate. The Committee was satisfied that the allowance and related disclosures in the financial statements, which had been enhanced in 2020 to provide greater insight as to the composition and nature of the adjustments, were appropriate.
</td><td>Note 9 'Allowance for credit impairment losses' Page 72</td></tr>
</table>

Audit Committee report (continued)

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

Accounting estimate / judgement	Audit Committee considerations	Reference
Recoverability of deferred tax assets	At 31 December 2020, deferred tax assets of £145.2 million (2019: £96.1 million) reflected carried forward losses and unutilised temporary differences, primarily arising from the transfer in 2013 of customer balances to TSB from LBG entities. Continued recognition of this asset requires judgement in assessing the availability of future taxable profits to absorb these carried forward losses and temporary differences. The Committee considered reports from management, including sensitivity analysis, which concluded that on the basis of forecast profits, the asset was recoverable over a period of seven years. A number of sensitivities were considered, including alternative forecast assumptions and execution risks associated with the Bank's strategy, which could result in a potential two year extension to the estimated recovery period. The Committee agreed with management's judgement that, based on TSB's forecast taxable profits and the associated sensitivity analysis, that the deferred tax asset should continue to be recognised in full.	Note 18 *Deferred tax assets* Page 85
Restructuring provisions	At 31 December 2020, TSB carried provisions of £67.8 million (2019: £28.5 million) in respect of estimated costs to restructure the bank as part of TSB's strategy. This included the estimated costs of the closure of 164 branches that were announced in September 2020, residual costs in respect of an earlier phase of branch closures announced in 2019 and the estimated severance costs arising from organisational change across a number of head office functions. The Committee reviewed reports from management setting out the approach undertaken and the assumptions used which were grounded in experience gained from previous branch closures and supporting evidence from property advisors. The Committee challenged management over the adequacy of the provisions and was satisfied that the provisions and related disclosures in the financial statements were appropriate in the light of recent experience.	Note 30 *'Provisions'* Page 103
Customer remediation provisions	At 31 December 2020, TSB carried a provision of £66.1 million (2019: £19.6 million) for estimated costs of alleged misconduct to its customers. This was primarily in respect of estimated charges relating to the treatment of some customers in arrears and who were being serviced by TSB's collections and recoveries department, for which a provision of £55.0 million was recognised during 2020. The residual provision reflects the remaining estimated costs of remediating customers for alleged mis-selling of added value current accounts and alleged breaches of the Consumer Credit Act. The Committee reviewed reports from management setting out the approach undertaken to assess any liability for alleged conduct issues. This included assessing themes and volumes of customer complaints received by TSB. With respect to the collections and recoveries provision, the Committee challenged management on the methodology used given customer treatment strategies were yet to be concluded and detailed customer analysis was ongoing. The Committee noted that management had segmented customers between those that may have suffered financial loss and those who, while not suffering financial loss, may have suffered potential service issues. For the former, the Committee assessed management's customer segmentation by type of customer service treatment which provided additional granular support for management's estimation of potential losses suffered and compensatory interest payable. In respect of the latter, the Committee assessed the range of potential redress payments, recognising that a final agreed customer treatment strategy had not yet been finalised by management or the regulator. The Committee noted that management's broad range for the total estimated cost of remedying this matter of between £53.1 million and £57.4 million relied on significant judgement, given the early stage of analysis. This analysis is most dependent on assumed rates of redress and the range of remediation strategies that may be deployed. The Committee was satisfied that the provisions and related disclosures in the financial statements were appropriate.	Note 30 *'Provisions'* Page 103
Recovery of post migration charges	The Migration Services Agreement (MSA) and the Outsourced Services Agreement (OSA) provide TSB with the contractual right to seek recovery of losses from Sabis for breach of contract up to the level of liability caps in each agreement. The parties have previously reached provisional agreement, subject to mutual reservation of rights while negotiations are concluded, where TSB will recover an aggregate of £192.6 million under the respective contracts. This represents 100% of the liability cap in the respective agreements. Settlement is pending the conclusion of discussions with insurers. The Committee agreed with management's conclusion that, it remains appropriate to recognise the aggregate recovery under the respective agreements.	Note 31 *'Other liabilities'* Page 104

Audit Committee report (continued)

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

Accounting estimate / judgement	Audit Committee considerations	Reference
Assessment of exposure to regulatory investigations	The FCA and PRA's formal joint investigation in connection with the handling of the IT migration, which commenced in 2018, and was in connection with the handling of the migration of data and IT systems, is ongoing. Further, during 2020, the FCA is investigating conduct related matters in TSB's collections and recoveries function. As these investigations are ongoing, it is not yet possible to determine their outcomes. The Committee was satisfied with management's assessment, which included the consideration of industry wide practice in similar circumstances, and the disclosure as a contingent liability included in the financial statements.	Note 24 *'Contingent liabilities'* Page 100
Impairment assessment of the Company's investment in TSB Bank plc	At December 2020, the Company carried an investment in TSB Bank plc of £1,589.4 million. The Committee considered reports from management which concluded that the recoverable amount of the investment, based on value in use, exceeded the carrying value of the investment. This assessed the sensitivity of the valuation to alternative forecast profits and discount rates. The Committee agreed with management's judgement that, based on TSB Bank's forecast profits and the associated sensitivity analysis, no impairment was required.	Note 4(ii) '*Investment in subsidiaries*' Page 109

Risk management and internal control systems

The Committee is responsible for reviewing the adequacy and effectiveness of TSB's risk management and internal control systems and reporting on that review. During 2020, the Committee took account of the following inputs into its review:

- Regular reports from management on steps taken to embed the risk management framework and the outcomes of a programme of work to improve the automation and efficiency of controls across the business;
- Management's plans to transition IT controls from Sabis as TSB took control of its IT services and the associated improvement programme;
- Ongoing monitoring reports on the effectiveness of TSB's risk management and internal control systems;
- Quarterly reports from management which concluded that TSB's internal financial control framework has adequate coverage and is operating effectively;
- An unqualified ISAE 3402 controls report in respect of outsourced credit and debit card operations; and
- Regular management information on the activities of Internal Audit and its annual report on internal controls, including the findings from audit reports over the IT control framework operated by Sabis.

On the basis of this work, the Committee was satisfied that while the operation of TSB's risk management and internal control systems was broadly adequate in 2020, it noted that certain aspects of the internal control systems should be improved and function more efficiently. While reflecting continued improvement since 2019, continued progress is required in embedding the IT control framework, digital service stability, processes for screening customers' transactions and embedding of enhancements to support customers in financial difficulty.

The key elements of the management of risk within the business and the effective system for internal controls are set out within the corporate governance statement (see page 34).

Performance and effectiveness of the Internal Audit function

The Committee is responsible for monitoring the performance and effectiveness of Internal Audit. During 2020, the Committee carried out this responsibility by:

- Approving the appointment of the Chief Audit Officer;
- Approving the Internal Audit Plan, taking into account the Chartered Institute of Internal Auditors' Guidance on Effective Internal Audit in the Financial Services Sector;
- Monitoring the execution and continuing appropriateness of the 2020 Internal Audit plan, to reflect strategy, and management's response to COVID-19 and the impact on core business processes, material risks and key controls;
- Approving the Internal Audit budget and confirming it is satisfied that Internal Audit has the appropriate resources, including use of subject matter experts where appropriate, to deliver the audit plan;
- Receiving regular reports from the Chief Audit Officer on Internal Audit activities undertaken in 2020 and monitoring activities resulting from Internal Audit reports;
- Reviewing the Internal Audit annual effectiveness self-assessment against industry standards;
- Reviewing the interaction and alignment between Internal Audit and the Risk function and between Internal Audit and the external auditor; and
- Confirming that Internal Audit maintains its independence and remains fully informed of management's and the Risk function's reporting and views on risks and the internal control environment.

Audit Committee report (continued)

Effectiveness of the relationship with the external auditors

The Committee is responsible for the effectiveness of TSB's relationship with its external auditor and for assessing their independence and objectivity. During 2020 the Committee discharged this responsibility by:

- Agreeing the terms of the audit engagement letter and reviewing and approving the audit fee proposal. Fees paid to the external auditor are set out in note 14 to the consolidated financial statements on page 82;

- Reviewing and challenging, throughout the year, the external auditor's audit strategy and consideration of significant risks and other areas of audit focus to ensure TSB's circumstances are appropriately reflected. The Committee also challenged KPMG to consider adopting an audit approach with an increased reliance on business and automated controls given their increasing maturity. The Committee also monitored and challenged KPMG's capacity to complete their first year audit on a largely remote basis;

- Receiving reports from the external auditor covering management's estimates and judgements;

- Reviewing the outcomes of the Financial Reporting Council's Audit Quality Review inspection reports as they relate to KPMG and potential considerations for TSB's audit;

- Considering the approach to obtaining independent assurance over outsourced controls;

- Performing ongoing review of the audit service through discussions between the Chair of the Audit Committee, Chief Financial Officer and Chief Risk Officer and KPMG's audit engagement personnel;

- Ensuring compliance with policy governing the use of the external auditor for non-audit services to safeguard their objectivity and independence (see note 14 on page 82 for fees paid to the external auditor); and

- Reviewing and challenging reports from the external auditor on maintaining their independence including reference to compliance with UK and EU regulation and ethical standards, KPMG firm wide processes and controls and the potential for threats to independence at a firm and personal level arising from a range of sources, for example, dependence on non-audit services, other business or personal relationships, familiarity or undue influence by TSB management.

Following the tender process conducted in 2018, the audit of the 2020 financial statements is the first to have been undertaken by KPMG. Pamela McIntyre was the senior statutory auditor for the audit of the 2020 financial statements.

A resolution to re-appoint KPMG for the audit of the financial statements for the year ending 31 December 2021 will be proposed at the 2021 Annual General Meeting.

Directors' report

Introduction
The Directors of TSB Banking Group plc (the Company) present their report and audited consolidated financial statements for the year ended 31 December 2020, in accordance with section 415 of the Companies Act 2006.

The following information is incorporated into this Directors' report:
- The information in the section 172 statement (pages 9 to 11) on employee engagement and fostering of business relationships with customers, suppliers and others;
- The 'how the business is managed' section of the corporate governance statement (pages 28 to 34); and
- The diversity and inclusion section of the Nomination Committee report (page 36).

Results and dividends
The consolidated balance sheet can be found on page 60 and the consolidated statement of comprehensive income is on page 61. The Directors do not currently propose to pay a dividend.

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

Richard Meddings	
Debbie Crosbie	
Ralph Coates	
Paulina Beato	
Libby Chambers	(appointed 1 October 2020)
Dame Sandra Dawson	(resigned 31 December 2020)
César González-Bueno	(appointed 23 March 2020)
Graeme Hardie	(resigned 16 May 2020)
Stephen Page	(resigned 31 October 2020)
Lynne Peacock	(appointed 22 April 2020)
Mark Rennison	(appointed 1 August 2020)
Andy Simmonds	
Tomás Varela	
David Vegara	(appointed 22 January 2020)
Polly Williams	

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

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

Directors' indemnities
Each of the Directors has the benefit of a deed of indemnity which constitutes a 'qualifying third party indemnity provision'. This indemnification for Directors provided by the Company has been arranged in accordance with the Articles and the Companies Act 2006. With the exception of the Non-executive Directors appointed during 2020, the indemnities were in place throughout 2020. The indemnity for David Vegara was executed on 28 January 2020, for César González-Bueno on 2 April 2020, for Lynne Peacock on 28 April 2020, for Mark Rennison on 1 August 2020, and for Libby Chambers on 1 October 2020. Each of the indemnities remain in force at the date of signing these financial statements and are available for inspection at the Company's registered office.

Directors' emoluments waiver
Tomás Varela, David Vegara, and (following the final payment made on 18 December 2020) César González-Bueno do not receive a fee as Non-executive Directors of the Company. None of the other Directors, save for the Chairman who waived his entitlement to the fee for membership of the Nomination Committee, have waived their emoluments during the period under review, nor have they agreed to waive future emoluments.

Governance arrangements
The Board has chosen to voluntarily adopt those principles of the UK Corporate Governance Code (Code) that are considered appropriate for TSB as a wholly owned subsidiary of Sabadell. Details of the aspects of the Code not considered appropriate for TSB, together with areas where TSB has deviated from the recommendations of the Code and the rationale for this, are set out on page 28.

Directors' report (continued)

Employee information

Employee voice and a speak up culture
TSB behaviours provide a framework to enable all TSB employees to feel what customers feel, look for better, say it straight and do what matters. Collaboration and open, honest, two-way communication is therefore encouraged at all levels. As employees have adjusted to different ways of working in 2020, TSB has focused on maintaining these channels of communication to support a speak up culture and maintain connection between individuals and teams, supported by TSB's digital workplace. There are regular all employee events hosted by the Chief Executive and other members of the Executive Committee, and each Executive Committee member also holds conversations within their business areas. TSB's employee forum, The Link, has met seven times in 2020, providing a direct connection between employees and executive leadership. The Link also reports annually to the Board.

We also continue to work closely with our recognised unions, Accord and Unite, to build strong relationships and, during 2020, conversations occurred weekly in relation to the health, safety and wellbeing of all employees regarding TSB's response to the COVID-19 pandemic. Our annual employee experience survey, 'Your Say Matters', provides all employees the opportunity to feedback on working at TSB, and additional 'pulse' surveys have provided timely feedback and insight into the employee experience in relation to COVID-19 and new ways of working. In 2020, each Executive Committee member has also begun a reverse mentoring relationship with an employee from a different background to their own, providing a different perspective and direct connection with individual experiences across TSB.

Training and development
We have continued to build a strong development culture at TSB focused across three strategic pillars of Digital, Money Confidence and Leadership. We launched our investing in people programme in April 2020 and committed, by the end of 2022, to invest more than 100,000 hours of additional formal training on delivering this strategy and an additional 100,000 hours focused on ongoing training including new to bank induction/training, regulatory and compliance training. So far we have delivered over 50,000 hours towards the strategic target and a further 60,000 hours in additional training.

We have built a robust Money Confidence programme for which we are in the process of obtaining accreditation by the Chartered Banker Institute. This programme focuses on what is expected of our branch employees and how to have a highly engaging customer conversation.

Our apprenticeship offering has been amended to reflect our blueprint to become a more data and digitally led bank. Investment in these programmes has increased by 70% to drive and deliver our primary corporate objectives. TSB's apprenticeship levy was used in full in 2020 which is upper quartile within the financial services sector.

The focus on our new performance management approach, as detailed in the Remuneration review starting on page 50, has been supported by our new Talking Performance module which brings to life what a performance mindset means at TSB and how it can help us achieve our goals and make the most of our new performance framework. Managers are integral to the performance management process and a series of new signature actions have been established to embed the basics of leadership and develop excellence through coaching with our TSB Manager and Leader as Coach programmes. To support this further, all employees are encouraged to have a personal development plan.

Recognition and reward
Not only do we give a voice to our employees, but we also encourage the recognition and celebration of their contribution and behaviours. This is demonstrated by the introduction of our new recognition programme, Spotlight, in partnership with Achievers. This gives employees the opportunity to recognise exceptional contributions of fellow employees who demonstrate appropriate TSB behaviours. In the period since Spotlight went live, in July 2020, over 64,000 recognitions have been received by employees.

As described in more detail in the Remuneration review, TSB's approach to reward is driven by its core strategy and supports its employees. The approach is considered to be fair, transparent and consistent for everyone. It includes competitive salary, allowances and benefits plus a single variable pay award that allows our employees to share consistently in the success of the organisation. This enables all employees to be rewarded for the important role they play in the success of our business.

Directors' report (continued)

Employee information (continued)

Diversity and inclusion
In 2020 TSB published the Do What Matters plan, providing a new framework to support TSB's existing ambition to create a truly inclusive workplace. TSB's commitments are:

1. *Creating a TSB for everyone through our behaviours and ways of working.* TSB is developing an inclusive leadership approach beginning with bias and mental health awareness training for all TSB line managers to be completed by the end 2021.

2. *Building a diverse and balanced workforce that reflects the customers we serve.* TSB maintains a strong commitment to achieving gender balance. At the time of this report, 40% of senior leaders are female, 42% of Directors are female, well ahead of the Hampton Alexander Review target of 33%, and 30% of the Executive Committee are female. Building genuinely diverse teams is critical to the success of our business. In 2020, TSB has also focused on improving the quality of the diversity data held, enabling a full workforce analysis of disability, ethnicity, sexual orientation, and social mobility as well as better targeting support for those with caring responsibilities. A set of targets for 2025 has been established which seeks to ensure the diversity of TSB's workforce is aligned with that of the UK working age population. This will allow a more holistic approach to the recruitment, development and engagement of talent and to build diverse teams. For TSB's Black, Asian and Minority Ethnic groups this will mean a representation of 14% and Black ethnic representation of 3% to meet the UK working age population. For disability and LGBT+ initial data indicates that TSB's workforce already reflects the wider population. We will seek to maintain this going forward by continuing to focus on an inclusive culture and monitoring the workforce, including how our hiring and development practices support social mobility. We will also seek to improve the diversity of our senior leadership population, maintaining at least 40% of roles held by women, and improving Black, Asian and Minority Ethnic representation to at least 10%.

3. *Putting accessibility at the heart of our approach to inclusion and building confidence to have conversations on mental health internally and with customers.* Employees with disabilities are treated fairly and can compete on equal terms for career progression. TSB is a Level 2 Disability Confident Employer with a clear action plan to progress to Level 3 Disability Leader status. TSB commits 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. New training in the accessibility features of TSB's digital workplace is evidencing that a more digital workplace can be more accessible. We've also listened to employees with disabilities and long term health conditions on the benefits and challenges of remote working to help design TSB's future ways of working. A new Workplace Adjustment passport is supporting improved conversations around adjustments required by employees (including in relation to training and career development). In 2020, TSB launched a new digital tool to support all TSB employees to take proactive care of their mental wellbeing, with one in three employees signed up to use the platform. To support our leaders to be confident to have conversations about wellbeing there is a mental health module included in the TSB Manager Programme.

4. *Supporting social mobility in local communities.* TSB has participated in the Social Mobility Foundation's Employer Index for the first time in 2020, placing in the top 100 employers. This has allowed a full gap analysis and clear roadmap for 2021 to support social mobility in local communities, including working with the Government's Kickstart scheme providing new job placements to young people who are at risk of long-term unemployment in 2021.

TSB also has an active, employee led, intersectional Inclusion Network with executive level sponsors for Disability, Ethnicity, Gender Balance and LGBT+. In 2020, the Inclusion Network ran an extensive programme of events, including LGBT History Month, International Women's Day, Autism awareness, Mental Health awareness, Ramadan, Virtual Pride, Black History Month and Purple Light Up to further the conversation across TSB to create a truly inclusive workplace.

Supporting our employees during the COVID-19 pandemic
The health and safety of our employees was, and still is, a priority during the COVID-19 pandemic. From March 2020, steps to provide clear guidance and support to all employees were taken. All non-essential travel was stopped and TSB adopted Government advice for citizens in a transparent manner. We ensured no financial impact for permanent employees who needed to self-isolate and allowed employees to take essential (mobile) equipment home in order to maximise productivity, engagement and the continuation of service to our customers. Our Digital Workplace meant that home working was enabled quickly and improvements have continued to be made during 2020. 4,500 employees were enabled to work from home with a peak of 3,500 working fully from home.

For essential workers who continued to travel to TSB locations to maintain essential customer services, precautionary measures were taken through the provision of personal protective equipment, security guards, increased hygiene protocols and screens. The pressure of work was alleviated on those in the front line through the redeployment of employees to support high impact areas (Customer Operations and Business Banking). To say thank you to all those who ensured TSB was able to serve customers through the initial peak of the pandemic, a £500 award was made to front line employees.

Directors' report (continued)

Employee information (continued)

Supporting our employees during the COVID-19 pandemic (continued)
Access to mental health support was integral to our approach. Research by the mental health charity Mind reports that one in five adults experienced a decline to their mental health during the pandemic. In March 2020, the digital mental wellbeing platform, UnMind, was launched for all employees to provide easy access to a wide range of scientifically backed tools to proactively support mental wellbeing. So far, one in three employees have registered and we have recently enabled sharing of the tool with employees' family members and friends.

We also worked to optimise two-way communication, asking all managers to use their one-to-one conversations with each employee to discuss specific requirements or tailored support. These were supplemented by weekly branch communications and regular 'all employee' calls with members of the Executive Committee. Listening remained as important as ever. A 'pulse' survey in April 2020 asked specific questions about how employees were feeling, and their reaction to TSB's initial response. This feedback provided immediate input to decisions around the ongoing response to the pandemic and input into our future ways of working strategy.

Our response to the pandemic is ongoing as we adapt our approach in reaction to Government advice. We continue to track and understand employee feelings through our annual engagement survey and work closely with managers and leaders to ensure adequate support is provided to all employees.

Share capital
At 2 February 2021, the total issued share capital with voting rights consisted of 500,000,000 ordinary shares of £0.01 each. The total issued share capital is held by Banco de Sabadell, S.A.

Future developments
The development of TSB is set out in the Chief Executive's statement on pages 5 to 7.

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

Financial risk management and hedging policies
Details of the use of financial instruments, together with risk management disclosures can be found in the Managing financial risk section of the financial statements on pages 86 to 97 and the Risk management section in the Strategic report on pages 20 to 26.

Post balance sheet events
There are no significant events affecting TSB that have arisen between 31 December 2020 and the date of this report that require disclosure.

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

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

Corporate headquarters and registered office
The corporate headquarters and registered office address for TSB Banking Group plc is 20 Gresham Street, London, EC2V 7JE. Website: www.tsb.co.uk.

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

Directors' report (continued)

Environmental information

TSB is committed to being a responsible user of resources and continues to consider ways it can reduce its environmental impact. Total emissions have reduced by 20% compared to 2019 (Scope 1, 2 & 3 in the table below). However, since October 2019, TSB has purchased all power from renewable sources, resulting in a 66% reduction in operational (Scope 1 and 2) market-based carbon emissions. Scope 1 and 2 emissions are those that come directly from the activities of TSB e.g. heating and fleet vehicles (scope 1) and from electricity used by TSB (scope 2). Scope 3 emissions relate to TSB's business travel.

TSB seeks to mitigate the environmental impact of its property, and where improvements are required, energy efficient equipment is chosen. In 2020, TSB completed the refurbishment of its main corporate site in Edinburgh, Henry Duncan House, investing almost £2 million to reduce energy use by installing new LED lighting and replacing the building's air conditioning system. Reduced business travel and use of paper and plastic in TSB's workplaces has also contributed to lower carbon emissions.

The table below shows TSB's greenhouse gas emissions as required by the UK Streamlined Energy and Carbon Reporting (SECR) Regulations. TSB reports the mandatory emissions as a 'large organisation' and has used the data collated to set a strategy towards a net-zero carbon future, including a decarbonisation plan, travel plan and engagement campaign.

The data has been compiled in accordance with the GHG Protocol Corporate Accounting and Reporting Standard, and independently audited by Concept Energy Solutions Limited. Further information on TSB's methodology can be found at https://www.tsb.co.uk/data-and-methodology-report-2020.pdf.

Summary of Streamlined Energy and Carbon Reporting	**2020**	2019
Emissions – Location-based[1] in gross tonnes of carbon dioxide equivalent (tCO_2e[2]):		
Scope 1 emissions:		
Combustion of gas[3]	**2,601**	2,645
Fuel for transport purposes	**33**	164
Heating oil	**61**	54
Scope 2 emissions - purchased electricity[3][4]	**5,561**	7,139
Total scope 1 and 2 emissions	**8,256**	10,002
Scope 3 emissions - business travel[5]	**221**	647
Total emissions	**8,477**	10,649
Intensity ratio[6]	**1.29**	1.50
Energy consumption KWH (million)	**38.601**	43.720

(1) Location-based emissions are those measured using the UK national grid electricity conversion factors, updated annually.
(2) tCO_2e – carbon dioxide equivalent is the measure of greenhouse gas emissions.
(3) Estimated consumption rates, based on consumption rates for previous years, have been used to compile data for a small number of properties where meter readings were unavailable.
(4) Scope 2 emissions (for SECR) include only direct commercial electricity supplies and are location-based. The small amount of domestic or cross charged consumption from landlords is not included, but TSB are working on improvements for the next reporting period.
(5) Emissions from rental cars and employee owned vehicles where TSB is responsible for purchasing the fuel.
(6) Calculated as the sum of (SECR) emissions divided by the average number of full time employees of 6,563 (2019: 7,114).

TSB has a Renewable Energy Guarantees Origin (REGO) electricity purchase agreement that started in October 2019 which has supported the reduction of greenhouse gas emissions as is shown in the table below. TSB are committed to continuing this source of electricity supply.

TSB greenhouse gas emissions data	**2020**	2019
Measured using market-based[1] emission factors in gross tCO_2e[2]:		
Total Scope 1 & 2 emissions tCO_2e (market-based)[1][3]	**2,761**	8,283
Scope 2 emissions – purchased electricity tCO_2e (market-based)[1]	**–**	5,274

(1) Market based emissions are those associated with renewable energy supplies which carry a zero-rated emission.
(2) tCO_2e – carbon dioxide equivalent is the measure of greenhouse gas emissions.
(3) Includes additional fugitive emissions (refrigerant gas emissions from air conditioning systems) of 66 tCO2e (2019: 146 tCO2e) not required for SECR, in Scope 1.

Directors' report (continued)

Going concern

The Directors recognise their responsibility to make an assessment of TSB's ability to continue as a going concern, for a period of at least 12 months from the date the financial statements are approved. The Directors' assessment of going concern is integrated with that of the assessment of the viability of TSB. The Directors, having taken into account the matters noted in the 'Basis of preparation' on page 58, are satisfied that adequate funding, liquidity and capital resources will be in place to allow the financial statements to continue being prepared on a going concern basis and are not aware of any material uncertainties that may cast significant doubt upon TSB's ability to continue as a going concern.

Viability statement

As more fully explained in the corporate governance statement on page 28, TSB has committed to voluntarily adopt provisions of the Code appropriate for a wholly owned subsidiary, which includes provisions that require the Directors to confirm that TSB will be able to continue in operation and to meet its financial liabilities as they fall due over a specified period determined by the Directors taking account of the current position and principal risks of TSB.

The Directors have assessed TSB's viability to December 2023. The assessment has been made over this period as it is within the six year period from 2021 to 2026 over which TSB's medium term strategic and financial plan is prepared, key capital and leverage ratios are forecast and regulatory and internal stress testing of the profit, capital and funding forecasts are carried out. In doing so, they took into account the increasing uncertainty of forecasts in the outer years of the planning period from developments in the economic environment, and competition and regulatory developments.

The Directors confirm that they have carried out a robust assessment of the emerging and principal risks facing TSB, the procedures in place to identify emerging risks, and how such risks are being managed or mitigated, and, in light of TSB's capital and funding resources, they have a reasonable expectation that TSB will be able to continue in operation and meet its liabilities as they fall due in the period to December 2023.

In making this assessment, the Directors have considered a wide range of information. Central to this assessment is the 2020 medium term plan. This includes assessment of future projections of profitability, capital requirements, capability, resources and funding. In addition, the Directors have assessed the key strategic risks that could threaten TSB's prospects and business model more broadly and the monitoring and mitigation activities around them.

Statement of directors' responsibilities in respect of the financial statements

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

Company law requires the Directors to prepare consolidated and Company financial statements for each financial year. Under that law they are required to prepare the consolidated financial statements in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006 and applicable law and have elected to prepare the Company financial statements on the same basis.

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 consolidated group and of the Company and of the consolidated group's profit or loss for that period. In preparing each of the consolidated group and Company financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable, relevant and reliable;
- state whether they have been prepared in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006;
- assess the consolidated group and Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and
- use the going concern basis of accounting unless they either intend to liquidate the consolidated group or the Company or to cease operations, or have no realistic alternative but to do so.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that its financial statements comply with the Companies Act 2006. They are 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, and have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the consolidated group and to prevent and detect fraud and other irregularities.

Under applicable law and regulations, the Directors are also responsible for preparing a Strategic report and a Directors' report that complies with that law and those regulations.

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

Directors' report (continued)

Fair, balanced and understandable

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

- The annual report is drafted and comprehensively reviewed by appropriate senior management with overall co-ordination by the Financial Controller;
- A verification process is undertaken to ensure factual accuracy, with additional review of compliance with content and disclosure requirements by TSB's legal team; and
- The annual report is reviewed by TSB employees from a range of functions, TSB's Executive Committee and the Audit Committee prior to approval by the Board.

By order of the Board
Keith Hawkins
Company Secretary
2 February 2021
Registered in England and Wales, Company Number 08871766

Remuneration review 2020

Ever since TSB was launched onto high streets across Great Britain, the remuneration approach has remained consistent. It is designed to be simple and fair. This underlying principle remains integral to our reward philosophy.

Overview of TSB's remuneration policy for 2020
The aim of TSB's remuneration policy is to provide competitive remuneration aligned to the delivery of the strategic goals (as explained in the Chief Executive's statement on page 5). It is designed to attract and retain talented individuals and to generate sustainable business performance, while taking into account effective risk management and acceptable conduct. In addition, TSB aims to align the remuneration approach with that of its parent, Sabadell.

The key elements of the reward framework are as follows:

- Salary - provides core remuneration taking into account relevant market benchmarks, complexity of the role and the individual's experience and performance.

- Variable pay is comprised of the Variable Pay Award which was introduced in 2020 to replace the TSB Award and the one-off transitional 2019 New Award. It is based on in-year performance measured against the primary corporate objectives or PCOs (a balanced scorecard with a combination of business measures relating to financial resilience, risk, the customer and employees which focuses on operational excellence, sustainable returns, the customer and making TSB simpler and more efficient). This award will be granted to all employees if affordability thresholds are met, along with appropriate profit and risk management gateways.

  From the start of 2020, TSB no longer uses individual performance ratings and instead has developed and enhanced the performance management process. The focus is on improving performance rather than measuring it, and encouraging coaching and development through regular conversations between employees and line managers. Employees who achieve their personal objectives, demonstrate the core behaviours, regularly meet or go beyond the expectations of their role and whose performance is not classified as 'needs improvement', will be eligible for a Variable Pay Award.

  The individual performance rating process for the most senior levels has been replaced with a structured, cascaded individual balanced scorecard. The financial and non-financial metrics in the individual scorecards are taken from the wider set of TSB's primary corporate objectives and balanced scorecard, as well as Sabadell Group metrics.

- Market appropriate benefits - principally pension contributions to a defined contribution scheme or where appropriate, an equivalent cash payment; 4% of salary available to use in our flexible benefits offering; and an employer provided car or alternative cash allowance at certain grades.

- In respect of 2020 performance, TSB will not exceed an annual cap on total variable remuneration of one times salary, calculated in accordance with the PRA's remuneration regulations. Most of TSB's banking competitors operate with an annual cap of two times salary.

Consideration for all TSB employees
The Remuneration Committee's remit extends beyond executive pay. The Committee has determined that the simplest and fairest approach to the annual pay review for Grades B to F, based on the 2020 performance year (effective from 1 April 2021), is to set a salary increase budget of 0.75% based on affordability within which awards to employees will not be differentiated.

TSB continues to be committed to paying the Living Wage after it became an accredited Living Wage employer in August 2016.

The Remuneration Committee is provided with regular reports on the broader workforce so its members are able to understand all employee trends and other data when considering executive pay.

Diversity and inclusion
In 2020 TSB published the Do What Matters plan, providing a new framework to support TSB's existing ambition to create a truly inclusive workplace. TSB's commitments in this regard are set out in the Directors' report on page 45.

Remuneration review 2020 (continued)

Outlining TSB's Obligations
TSB's remuneration policy continues to comply with the PRA and the FCA Remuneration Codes, which have been in effect since June 2015, and the PRA's required approach to buyouts for Material Risk Takers (MRTs), which came into effect from January 2017. In addition, the policy complies with the European Banking Authority Guidelines on remuneration and is aligned with the Sabadell remuneration policy.

In respect of variable pay plans, 60% of grants under the Senior Managers & Certification Regime will be deferred over seven years with pro-rata release between the third and seventh year based on release underpins. Any shares issued will be subject to a 12 month retention period after the point of release. For MRTs, other than Senior Managers, 40% of grants will be deferred over three or five years, depending on the regulatory status of the employee, with a retention period on the shares of 12 months after the point of release (six months for Risk Managers in accordance with the Remuneration Codes). TSB's approach to deferral of total variable remuneration for senior employees ensures that awards are delivered as required by regulations.

The Bank continues to review the changes required to comply with the Capital Requirements Directive V (CRD V) which came into force on 28 December 2020 and is relevant for the 2021 performance year.

With regard to the requirements of the UK Corporate Governance Code, the Board has committed to voluntarily adopt those principles of the Code that are considered appropriate for TSB as a wholly owned subsidiary, operating in the UK market. This includes the alignment of pension contribution rates for TSB Executive Directors with those available to the wider TSB workforce (Provision 38). To this end, the Remuneration Committee has considered and agreed to implement an approach to align the contribution rates by the Investment Association's 31 December 2022 deadline.

In addition, the Remuneration Committee has not created a policy for post-employment shareholding requirements (Provision 36). TSB Executive Directors are already subject to long deferral periods (seven years with a further one year holding period) for Sabadell shares awarded as part of TSB variable remuneration. Therefore, the current view is that no specific post-cessation shareholding requirement be introduced for TSB Executive Directors at the present time. The Remuneration Committee continues to keep this under review as part of a regular Committee agenda item to consider market developments.

Reward Outcomes in 2020
2020 has been a challenging year for TSB resulting in a financial performance that was adverse to plan, primarily due to the consequences of the COVID-19 pandemic and the provision for estimated charges relating to the treatment of some customers in arrears. TSB's statutory loss before tax for 2020 was £204.6 million compared to a profit before tax of £46.0 million in 2019.

The Remuneration Committee has reviewed the business performance in 2020 and taken into account risk events in conjunction with the Board Risk Committee, the affordability of paying variable pay, and the associated risk of low variable pay. After the assessment of performance, the Committee has determined that an ex ante risk adjustment of 5% (£1.1 million) of the pool is made in relation to the conduct related matter in TSB's collections and recoveries function for which a provision covering the estimated redress costs was recognised. In addition, the Committee has determined that a further adjustment to the pool is made of 40% (£8.1 million) on the basis of affordability. The final pool approved to distribute is £10.5 million. This means that all TSB Partners who are not deemed to be 'needs improvement' will receive 39% of their on target award.

The Committee has confirmed the approach announced in April 2020 whereby the two Executive Directors as well as the rest of the Executive Committee have voluntarily waived all variable pay for the 2020 performance year as a result of the then developing COVID-19 pandemic and implications for the bank. This approach was agreed shortly after the PRA requested the boards of the UK's largest banks to cancel payments of 2019 restricted cash bonuses to senior staff. This decision was confirmed by the Committee despite the PRA stating in December 2020 that it expects firms to exercise a high degree of caution and prudence in determining the size of any cash bonuses granted to senior staff given the uncertain outlook and the need for banks to deploy capital to support the wider economy.

Unvested prior year SPA awards that were due to vest in March 2021 will not vest, consistent with SPA awards which were due to vest in March 2020, as performance against the predetermined financial target (cumulative return on equity) was not achieved.

In 2018, the Committee took the decision to delay the payment of the vested but as yet unpaid tranches of the Sabadell Integration Awards (SIA) and other awards due to vest in March 2021, subject to the outcome of both internal and external regulatory investigations in to the post migration issues and subsequent consideration by the Committee in light of any findings. This decision continues to subsist.

Remuneration review 2020 (continued)

Consideration of Conduct and Risk

The Remuneration Committee takes risk and conduct issues very seriously. Risk profile and behaviours are a key gateway that must be satisfied for any incentive awards to pay out. Risk adjustment is a result of several factors:

1. A balance of measures included in individual objectives and business scorecards acts as a framework for adjusting the bonus pool for both performance and risk inherent in TSB's activities;
2. The use of a framework to quantify the risk adjustment of the variable remuneration pool in 2020; and
3. The appropriate governance to make informed and robust decisions, including the Remuneration Governance Group (which makes recommendations to the Remuneration Committee on matters as required to ensure that the appropriate standards of risk management and corporate governance are applied), Remuneration Committee oversight and independent access to the Chief Risk Officer and Chief Financial Officer.

Incentive pools and awards may be adjusted, including to zero, in the event of material breaches. All elements of variable remuneration for MRTs are subject to malus and clawback provisions in line with regulatory requirements.

Highest paid Director – 2020 remuneration disclosure(*)

The table below sets out the total remuneration paid to Debbie Crosbie, TSB's highest paid Director, for qualifying services as a Director in the period from 1 January to 31 December 2020. In addition, the buy out relating to the 2020 instalments of Debbie Crosbie's unvested variable remuneration forfeited when she left employment with her previous firm is set out below.

	2020	2019
Basic salary(1)	**£950,000**	£633,333
Benefits(2)	**£48,110**	£31,667
Pension(3)	**£168,217**	£112,115
Fixed Pay	**£1,166,327**	£777,115
Variable Remuneration(4)	**–**	£184,925
Joining awards vesting during the year(5)	**–**	£480,620
Total Remuneration (audited)	**£1,166,327**	£1,442,660

Notes

(1) Salary from 1 January to 31 December 2020. For 2019, salary was for the period 1 May to 31 December 2019 to reflect her start date.
(2) Benefits include the taxable value of all benefits received, which included a car allowance and a flexible benefits allowance set at 4% of basic salary.
(3) The value of the pension allowance provided which has been paid at a percentage of 17.7%.
(4) 2020 variable remuneration voluntarily waived.
(5) There were no 2020 cash instalments paid to Debbie Crosbie in relation to the buy out of unvested variable remuneration forfeited when she left employment with her previous firm, Virgin Money UK PLC (formerly CYBG PLC). 289,492 Sabadell shares of the total that were awarded to Debbie Crosbie in 2019 in respect of the buy out, vested to her in 2020. 203,100 of these vested shares were released to her in 2020; the balance will be released in 2021.
(*) The aggregate remuneration for all Directors is set out in note 15 to the financial statements on page 83.

Consideration by the Directors of matters relating to Directors' remuneration

The Remuneration Committee is authorised by the Board to consider and recommend to the Board the remuneration policy. The policy is considered regularly by the Remuneration Committee, taking account of changes in regulation and the wider market. In formulating and reviewing policy, independent advice is sought and considered. In particular, the sustainability of the policy and its risk impact are carefully reviewed. The remuneration policy is formally reviewed at least annually and, once approved by the Remuneration Committee, is reviewed and approved by the Board. The Remuneration Committee's terms of reference are kept under regular review and can be found at http://www.tsb.co.uk/investors/people/.

The Remuneration Committee is chaired by Lynne Peacock and the other committee members in 2020 were Dame Sandra Dawson (who was chair until May 2020 and stepped down from the Board on 31 December), Polly Williams, who chairs the Audit Committee, Paulina Beato, César González-Bueno (from 30 April 2020) and Libby Chambers (from 1 October 2020). Andy Simmonds, Chair of the Risk Committee, attends meetings of the Remuneration Committee from time to time to ensure alignment between the work of the Remuneration Committee and the Risk Committee. Remuneration Committee meetings are also attended by the Chairman together with the Chief Executive Officer, HR Director and Director of Reward and Performance and from time to time the Chief Financial Officer and the Chief Risk Officer attend to provide input on their specialist areas. The Company Secretary, or an appropriate delegate, acts as the secretary to the Remuneration Committee. None of these additional attendees participates in the discussion of issues directly affecting their own remuneration.

Remuneration review 2020 (continued)

Consideration by the Directors of matters relating to Directors' remuneration (continued)

The Remuneration Committee appointed Deloitte LLP (Deloitte) to provide independent advice on remuneration matters following a presentation to the Remuneration Committee members in 2014. The Remuneration Committee reviewed Deloitte's work during 2020 and decided to continue with Deloitte's appointment until 31 March 2021, with a widespread review of potential new advisers to be undertaken with a view to their appointment being effective from 1 April 2021. Deloitte is a member of the Remuneration Consultants Group and, as such, voluntarily operates under the code of conduct in relation to executive remuneration consulting in the UK. Deloitte has provided independent advice on matters under consideration by the Remuneration Committee including compliance with regulations, advice on market trends and data, remuneration policy and implementation of remuneration arrangements, including support in remuneration arrangements for departing Executives. The Remuneration Committee is satisfied that the advice it has received has been objective and independent.

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

Herbert Smith Freehills attend Remuneration Committee meetings and provide advice in relation to legal questions when required.

Leadership team biographies

Chairman and Executive Directors:

Richard Meddings – Chairman
Richard was appointed to the TSB Board in 2017 and became Chairman in February 2018. He became Executive Chairman, on an interim basis, between 4 September 2018 and 30 April 2019, acting as both Chief Executive and Chairman.

Richard has more than 30 years of executive experience in the financial sector in both retail, business and investment banking. A Chartered Accountant, he has worked in various positions in Finance, Risk, Governance and Corporate Finance at Hill Samuel, Barclays and Credit Suisse and was Finance Director of Woolwich plc. He was an Executive main Board Director of Standard Chartered from 2002 to 2014 and served as Group Finance Director between 2006 and 2014.

Richard is a non-executive director at Credit Suisse, where he chairs the Audit Committee and is also a member of the Risk, Governance & Nominations, and Conduct & Financial Crime Control Committees. Richard's other current non-executive Board positions are at Teach First and HM Treasury. He also currently chairs the Hastings Educational Opportunity Area.

Richard has in the past served as a Non-executive Director of 3i Group plc, Legal & General Group plc, Deutsche Bank AG and Jardine Lloyd Thompson Group plc, and as a member of the governing body of the International Chamber of Commerce UK.

Debbie Crosbie – Chief Executive
Debbie became TSB's Chief Executive Officer on 1 May 2019, joining from CYBG.

Debbie led the development and launch of TSB's three year growth strategy in her first year as CEO. She has accelerated digitalisation at TSB, improved efficiency, increased the focus on customer experience and oversaw the successful relaunch of the TSB brand.

She has over 25 years of experience in financial service leadership with extensive experience of leading turnaround strategies and, while Acting CEO of Clydesdale Bank, led preparations for its successful demerger and subsequent IPO. Debbie is a Fellow of the Chartered Bankers Institute, sits on the CBI President's Committee and is a member of both the Glasgow Economic Leadership Board and the Strathclyde University Business School Advisory Board. In 2015, Debbie became the first female executive to sign Scottish banknotes and in 2016 she was the University of Strathclyde's Alumna of the Year.

Ralph Coates – Chief Financial Officer
Ralph was appointed TSB Chief Financial Officer, and joined the Board, in 2016.

Ralph is responsible for TSB's financial stewardship and economic contribution, including the funding, investment, planning and reporting that are core to TSB's growth strategy.

Prior to joining TSB, Ralph was the Finance Director of the Bank of England, supporting its strategic transformation and the delivery of its policy agenda. Ralph is a Chartered Accountant and began his career with PricewaterhouseCoopers in his native South Africa, before moving to London where he specialised in Transaction Services, focusing on M&A in the retail sector. Ralph spent nine years at Barclays Bank in a number of leadership roles, including Finance Director for the UK Retail & Business Bank.

The biographies of TSB's Non-executive Directors can be found at [www.tsb.co.uk/investors/people/.](http://www.tsb.co.uk/investors/people/)

Leadership team biographies(continued)

TSB Executive Committee members:
In addition to Debbie Crosbie (Chief Executive) and Ralph Coates (Chief Financial Officer), the following individuals comprise the membership of the Executive Committee.

Marc Armengol – Corporate Strategy Director
Marc was appointed TSB Corporate Strategy Director in 2018.

Instrumental in the development of TSB's growth strategy, Marc oversees its delivery. He is also the Executive sponsor of TSB's programmes to support small businesses (customers and suppliers).

Marc has broad experience of leading large, multi-national transformational projects. He joined Sabadell in 2002, where as Head of Organisation, he spearheaded the transformation of the operating model, leading projects across the bank, and co-ordinating the integration of multiple acquisitions in Spain. In 2014, he moved to the USA as Chief Operating Officer for Sabadell (Americas), and subsequently led corporate strategy for Iberia Bank which acquired Sabadell's business in the Americas in 2017.

Liz Ashford – HR Director
Liz was appointed as TSB HR Director in 2019.

Leading all people aspects of TSB's growth strategy, Liz has driven employee engagement, with a strong focus on creating an inclusive workplace. She works closely with the TSB Board's Remuneration Committee and is Executive sponsor of TSB's disability network.

Liz brings significant experience leading change and business transformation gained from a career that has spanned financial services, as well as retail and utilities sectors. This includes investment banking at both HSBC and ABN AMRO, the private bank Kleinwort Benson, the energy company Essent (part of RWE), Harrods and most recently at Aviva where she was the Global People Director, Aviva Investors.

Robin Bulloch – Customer Banking Director
Robin was appointed TSB Customer Banking Director in 2019.

Robin is at the heart of transforming the TSB customer experience through delivering the right products, in the right way and in the right location, for both retail and business customers. In 2020, he led the TSB brand relaunch and is the Executive sponsor of programmes that deliver Money Confidence to customers.

Robin has a strong reputation for leading large customer-facing operations and delivering business and cultural transformation. Prior to TSB, he spent 8 years at Lloyds Banking Group where he was Managing Director for Community Banking and also led its general insurance division. Before that, in two spells at RBS, he held a number of senior executive roles including Managing Director at RBS and NatWest Branch Banking, and Chief Executive of Tesco Personal Finance. He was also Operations Director at GE Capital. Robin is a Fellow of the Chartered Bankers Institute and also sits on their board.

Guy Dunlop – General Counsel
Guy was appointed TSB General Counsel in 2019.

He leads the Legal and Company Secretariat teams that provide a broad range of legal and regulatory advice, legal risk management, strategic counsel, company secretarial services and governance advice and support to all areas of the Bank.

He is Executive sponsor of the LGBTQ+ network which was awarded a top 10 place in the Global Diversity List 2020. Prior to joining TSB, Guy was the General Counsel for The Prudential (UK and European business unit). Before this he held senior roles with Freshfields Bruckhaus Deringer, Clifford Chance and Genworth Financial Mortgage Insurance. Guy is qualified as a solicitor in England and Wales and in his native South Africa.

Leadership team biographies(continued)

George Gordon – Communications and Corporate Affairs Director
George was appointed TSB Communications and Corporate Affairs Director in 2018.

He leads media relations, employee communications, government affairs and corporate responsibility programmes, with a remit focused on enhancing TSB's reputation. He is Executive sponsor of TSB's Community programmes.

George brings over 20 years of leadership experience from roles in retail, consumer goods, government and financial services. Prior to TSB, George worked for Tesco for 8 years, where he played a key part in the recovery of the business, serving as UK & Ireland Communications Director and as Head of Communications at Tesco Bank. Prior to that he worked for Unilever for 14 years, including a two year secondment to the UK Government (Cabinet Office) advising ministers and policymakers on better regulation.

Carlos Paz – Chief Risk Officer (CRO)
Carlos was appointed TSB Chief Risk Officer in January 2020.

Carlos oversees TSB's risk management approach, working closely with the Board Risk Committee, and manages the bank's relationships with regulators.

Carlos originally joined TSB as Chief Audit Officer in 2016 from Sabadell where, as Chief Risk Control Officer, he led the design, development and oversight of the Group's risk appetite framework. Prior to this he was the Chief Financial Officer of Catalunya Bank for three years, where, during the global financial crisis, he was appointed to work closely with the Spanish regulator and the European Commission to develop and implement the resolution plan for the bank.

Vanessa Swanton – Chief Audit Officer
Vanessa was appointed TSB Chief Audit Officer in May 2020.

Vanessa leads the internal scrutiny of the work to deliver TSB's growth strategy, working closely with the Board Audit Committee. She is also the Executive sponsor of TSB's gender balance network.

Vanessa joined TSB from insurance company LV (Liverpool Victoria) where she was Chief Internal Auditor for two years. Prior to that, Vanessa was a Director at the management consultants, Ernst & Young. She began her career at Lloyds Banking Group where she spent 16 years working across all areas of the group and three lines of defence.

Suresh Viswanathan – Chief Operating Officer
Suresh was appointed as TSB Chief Operating Officer in 2019.

Suresh has overseen the digital transformation at TSB, a cornerstone of the growth strategy, including bringing direct control of technology in-house. He is also Executive sponsor of both the BAME network and TSB's programmes to reduce environmental impact.

He has over 30 years of experience in technology and financial services, specialising in setting up complex global technology operations and integrations. Suresh began his career at Citi Group, where he set up their branch-banking platform and led acquisition and integrations across Central and Eastern Europe, Middle East and Africa. He joined Barclays in 2008 as Chief Information Officer for Barclays Corporate Bank and then went on to lead Operations and Technology for Barclays UK, where he helped set up their ring-fenced bank. In 2020, he became an advisory board member of Rackspace Technology.

Financial statements

Alignment with TSB's business model

The presentation of TSB's consolidated financial statements aligns with the execution of its strategy, its business model and the management of the financial risk to which it is exposed. As such, the consolidated financial statements are structured around the key elements of TSB's business model as explained on page 8.

Basis of preparation

These consolidated financial statements of TSB Banking Group plc (TSB) comprise the results of TSB Banking Group plc (the Company) consolidated with those of its subsidiaries, including TSB Bank plc. Details of subsidiary undertakings are provided in note 4 to the Company financial statements on page 109. These consolidated financial statements have been prepared in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006.

The consolidated financial statements have been prepared under the historical cost convention as modified by the recognition of certain financial assets and financial liabilities, including derivative contracts, at fair value through profit or loss, and financial assets at fair value through other comprehensive income.

Going concern

The going concern basis is dependent on maintaining enough capital and funding of the balance sheet. The directors considered a number of factors including the projections for TSB and its capital and liquidity position. TSB's business activities and objectives, together with the factors likely to affect its future development, performance and position are set out in the Strategic report. A loss before tax for the year of £204.6 million (2019: £46.0 million profit) has been reported. Despite this loss, TSB continues to be in compliance with, and exceeds, its regulatory capital and liquidity requirements. The Directors have also prepared detailed forecasts which show that a surplus over total capital requirements is forecast to be maintained, as is compliance with minimum liquidity ratios.

As part of those forecasts, the Directors have modelled the impact of a severe but plausible downside stress in line with the 'low rate' severe downside scenario described in note 9, updated to take into account the Bank of England stress scenario published in January 2021. Based on the forecasts and stresses performed, the Directors are satisfied that TSB will have sufficient regulatory capital and liquidity for a period of at least 12 months from the date of approval of these financial statements. Accordingly, they continue to adopt the going concern basis in preparing the financial statements.

Accounting policies

The significant accounting policies used in the preparation of the consolidated financial statements are consistent with those applied in 2019 with the exception of the early adoption of '*Interest Rate Benchmark Reform – Phase 2*' (the Phase 2 Amendment) as described under '*IBOR reform'* in note 22. The accounting policies are presented in a manner consistent with TSB's business model and are included in the relevant sections of the consolidated financial statements. In addition, the following accounting policies relate to the consolidated financial statements as a whole.

Consolidation - Subsidiaries are all entities (including special purpose entities) over which TSB has control. TSB controls an entity when it is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. Subsidiaries are fully consolidated from the date on which control is transferred to TSB and are deconsolidated from the date that control ceases. Inter-company transactions, balances and unrealised gains and losses on transactions between group entities 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 in the income statement.

Significant accounting estimates and judgements

The preparation of financial statements in accordance with IFRS requires management to make judgements, estimates and assumptions in applying the accounting policies that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. The significant judgements made by management in applying accounting policies and the key sources of estimation uncertainty in these consolidated financial statements, which together are deemed critical to the results and financial position, are presented within the relevant note disclosures. These areas are discussed in the Audit Committee report as set out in the corporate governance statement on pages 39 to 41.

Index to the consolidated financial statements

TSB's primary consolidated financial statements are presented on pages 60 to 62. The notes to these consolidated financial statements are structured to follow TSB's business model as set out on page 8 and are listed below.

Consolidated balance sheet

as at 31 December 2020

	Note	2020 £ million	2019 £ million	Reference to business model
Assets				
Financial assets at amortised cost				
Cash, cash balances at central banks and other demand deposits		**5,056.6**	4,595.2	*Loans and liquid assets (page 67)*
Reverse repurchase agreements		**–**	201.1	
Debt securities	5	**1,123.7**	548.6	
Loans and advances to customers	7	**33,317.9**	31,075.8	
Loans to credit institutions	6	**43.3**	373.2	
Loans to central banks		**120.9**	96.1	
Other advances	8	**220.2**	279.6	
Financial assets at fair value through other comprehensive income				
Debt securities	5	**1,496.9**	1,587.4	
Financial assets at fair value through profit or loss				
Derivative financial assets not in hedge accounting relationships	22	**198.3**	112.0	*Managing risk (page 86)*
Hedging derivative financial assets	22	**139.9**	93.4	
Fair value adjustments for portfolio hedged risk	22	**80.2**	20.5	
Property and equipment	26	**258.9**	293.2	
Intangible assets	28	**49.5**	20.3	
Deferred tax assets	18	**145.2**	96.1	
Other assets	29	**155.2**	128.4	
Total assets		**42,406.7**	39,520.9	
Liabilities				
Financial liabilities at amortised cost:				
Customer deposits	1	**34,375.3**	30,182.4	*Sources of funding (page 63)*
Borrowings from central banks		**3,065.8**	4,483.5	
Debt securities in issue	2	**1,699.2**	1,676.3	
Subordinated liabilities	3	**391.3**	395.9	
Lease liabilities	27	**123.3**	141.8	
Other financial liabilities		**51.6**	81.3	
Financial liabilities at fair value through profit or loss				
Derivative financial liabilities not in hedge accounting relationships	22	**302.3**	127.9	*Managing risk (page 86)*
Hedging derivative financial liabilities	22	**225.2**	288.5	
Fair value adjustments for portfolio hedged risk	22	**117.0**	52.2	
Provisions	30	**153.1**	51.8	
Other liabilities	31	**196.0**	153.3	
Total liabilities		**40,700.1**	37,634.9	
Equity				
Share capital	23	**5.0**	5.0	
Share premium	23	**965.1**	965.1	
Other reserves	23	**(285.1)**	(285.1)	
Retained profits brought forward	23	**1,189.9**	1,163.6	
(Loss)/profit attributable to the shareholder for the current year	23	**(159.7)**	26.3	
Fair value reserve	23	**11.6**	13.6	
Cash flow hedging reserve	23	**(20.2)**	(2.5)	
Shareholder's equity		**1,706.6**	1,886.0	
Total equity and liabilities		**42,406.7**	39,520.9	

The accompanying notes are an integral part of the consolidated financial statements. The consolidated financial statements on pages 58 to 105 were approved by the Board of Directors on 2 February 2021 and signed on its behalf by:

Debbie Crosbie
Chief Executive

Ralph Coates
Chief Financial Officer

Consolidated statement of comprehensive income

for the year ended 31 December 2020

Income statement:	**Note**	**2020 £ million**	**2019 £ million**
Interest and similar income:			
Interest income calculated using the effective interest method	11	**922.0**	1,050.6
Other interest income	11	**(41.0)**	(5.8)
Total interest and similar income		**881.0**	1,044.8
Interest and similar expense	11	**(94.6)**	(203.7)
Net interest income	11	**786.4**	841.1
Fee and commission income	12	**122.4**	159.8
Fee and commission expense	12	**(36.5)**	(41.5)
Net fee and commission income	12	**85.9**	118.3
Net gains/(losses) on financial assets and liabilities:			
Gains on derecognition of financial assets measured at fair value through other comprehensive income		**21.8**	24.6
Losses on equity instruments at fair value through profit or loss		**(0.4)**	(0.1)
Losses on derivative financial assets at fair value through profit or loss		**(5.0)**	(14.6)
Gains from hedge accounting	22	**5.8**	20.8
Losses on derecognition of non-financial assets		**(3.5)**	(3.5)
Other operating income	13	**37.8**	1.2
Other income		**142.4**	146.7
Total income		**928.8**	987.8
Total operating expenses	14	**(969.4)**	(881.3)
Operating (loss)/profit before impairment losses and taxation		**(40.6)**	106.5
Impairment losses on financial assets at amortised cost	9	**(162.7)**	(60.9)
Impairment (losses)/credit on loan commitments	30	**(1.3)**	0.4
Total impairment losses		**(164.0)**	(60.5)
(Loss)/profit before taxation		**(204.6)**	46.0
Taxation	17	**44.9**	(19.7)
(Loss)/profit for the year	23	**(159.7)**	26.3
Other comprehensive (loss)/profit:			
Items that may be subsequently reclassified to profit or loss:			
Change in fair value reserve:			
Change in fair value		**14.8**	17.3
Transfers to the income statement		**(17.0)**	(24.6)
Taxation thereon	18	**0.2**	2.3
	23	**(2.0)**	(5.0)
Change in cash flow hedging reserve:			
Change in the fair value of derivatives in cash flow hedges		**(21.5)**	(24.4)
Transfers to the income statement		**(2.9)**	24.4
Taxation thereon	18	**6.7**	0.7
	23	**(17.7)**	0.7
Other comprehensive loss for the year, net of taxation		**(19.7)**	(4.3)
Total comprehensive (loss)/income for the year		**(179.4)**	22.0

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

Consolidated statement of changes in equity

for the year ended 31 December 2020

	Share capital £ million	Share premium £ million	Other reserves: Merger reserve £ million	Other reserves: Capital reorg-anisation reserve £ million	Other reserves: Capital reserve £ million	Fair value reserve £ million	Cash flow hedging reserve £ million	Retained profit £ million	Share-holder's equity £ million
Balance at 1 January 2019	5.0	965.1	616.5	(1,311.6)	410.0	18.6	(3.2)	1,163.6	1,864.0
Comprehensive income/(loss):									
Profit for the year	–	–	–	–	–	–	–	26.3	26.3
Other comprehensive (loss)/income	–	–	–	–	–	(5.0)	0.7	–	(4.3)
Total comprehensive (loss)/income	–	–	–	–	–	(5.0)	0.7	26.3	22.0
Balance at 31 December 2019	5.0	965.1	616.5	(1,311.6)	410.0	13.6	(2.5)	1,189.9	1,886.0
Comprehensive loss:									
Loss for the year	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**(159.7)**	**(159.7)**
Other comprehensive loss	**–**	**–**	**–**	**–**	**–**	**(2.0)**	**(17.7)**	**–**	**(19.7)**
Total comprehensive loss	**–**	**–**	**–**	**–**	**–**	**(2.0)**	**(17.7)**	**(159.7)**	**(179.4)**
Balance at 31 December 2020	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**11.6**	**(20.2)**	**1,030.2**	**1,706.6**

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

Consolidated cash flow statement

for the year ended 31 December 2020

	Note	2020 £ million	2019* £ million
Cash flows from operating activities			
(Loss)/profit before taxation		**(204.6)**	46.0
Adjustments for:			
Change in operating assets and liabilities	32	**2,253.9**	(593.9)
Non-cash and other items	32	**268.3**	128.6
Taxation received		**–**	20.5
Net cash provided by/(used) in operating activities		**2,317.6**	(398.8)
Cash flows from investing activities			
Purchase of property and equipment		**(30.2)**	(18.0)
Purchase and development of intangible assets		**(35.9)**	(7.6)
Purchase of debt securities		**(1,341.3)**	(994.9)
Sale of debt securities		**977.8**	1,424.3
Net cash (used in)/provided by in investing activities		**(429.6)**	403.8
Cash flows from financing activities			
Repayments of borrowing from central banks		**(1,410.0)**	(1,995.0)
Issue of debt securities in issue		**450.0**	750.0
Repayment of debt securities in issue		**(440.2)**	(177.5)
Repayments of repurchase agreements		**–**	(1,084.5)
Lease payments		**(26.4)**	(38.8)
Net cash used in financing activities		**(1,426.6)**	(2,545.8)
Change in cash and cash equivalents		**461.4**	(2,540.8)
Cash and cash equivalents at 1 January	32	**4,595.2**	7,136.0
Cash and cash equivalents at 31 December	32	**5,056.6**	4,595.2

* Comparative information for 2019 has been reclassified to align with the current year presentation. This has resulted in interest received on debt securities of £53.2 million and interest paid on borrowings from central banks, debt securities in issue and subordinated liabilities of £(94.0) million being reclassified from investing activities and financing activities, respectively, and presented in net cash used in operating activities.

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

Notes to the consolidated financial statements

Sources of funding

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

Accounting policies relevant to sources of funding

(a) Financial liabilities

Financial liabilities include 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 the date that TSB becomes a party to the contractual provisions of the instrument. A financial liability is derecognised from the balance sheet when TSB has discharged its obligations, the contract is cancelled or the contract expires, or where the terms of the debt instrument have been significantly modified.

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

	2020 £ million	2019 £ million
Bank accounts	**13,235.6**	10,860.9
Instant access saving deposits	**16,209.8**	14,952.8
Deposits with agreed maturity	**2,454.5**	2,934.5
Business banking deposits	**2,475.4**	1,434.2
Total customer deposits	**34,375.3**	30,182.4

2. Debt securities in issue

2020	Balance at 1 Jan 2020 £ million	(Repayments)/ Issues £ million	Exchange rate and other adjustments £ million	Balance at 31 Dec 2020 £ million
Securitisation programmes:				
Duncan Funding 2015-1 plc	**355.7**	**(369.0)**	**13.3**	**–**
Duncan Funding 2016-1 plc	**70.8**	**(71.2)**	**0.4**	**–**
	426.5	**(440.2)**	**13.7**	**–**
Covered bond programme:				
Series 2017-1 Covered Bonds	**498.9**	**–**	**0.1**	**499.0**
Series 2019-1 Covered Bonds	**750.9**	**–**	**(0.8)**	**750.1**
	1,249.8	**–**	**(0.7)**	**1,249.1**
Senior unsecured debt securities	**–**	**450.0**	**0.1**	**450.1**
Total debt securities in issue	**1,676.3**	**9.8**	**13.1**	**1,699.2**

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

Notes to the consolidated financial statements

Sources of funding (continued)

2. Debt securities in issue (continued)

Issuing entity	Date of issue	31 Dec 2020 £ million	31 Dec 2019 £ million	Interest rate at 31 Dec 2020	Maturity date	Issue currency
Duncan Funding 2015-1 plc	11/2015	**–**	101.5	n/a	09/2020	GBR
Duncan Funding 2015-1 plc	11/2015	**–**	254.2	n/a	09/2020	EUR
Duncan Funding 2016-1 plc	05/2016	**–**	15.8	n/a	07/2020	EUR
Duncan Funding 2016-1 plc	05/2016	**–**	55.0	n/a	07/2020	GBR
TSB Bank plc – covered bonds	12/2017	**499.0**	498.9	0.42%	12/2022	GBR
TSB Bank plc – covered bonds	02/2019	**750.1**	750.9	0.92%	02/2024	GBR
TSB Bank plc – senior unsecured debt securities	12/2020	**450.1**	–	2.15%	06/2023	GBR
Total debt securities in issue		**1,699.2**	1,676.3			

Securitisation programmes

During 2020, all securitisation notes issued under TSB's securitisation programmes matured. At 31 December 2019, loans and advances to customers included loans securitised under these securitisation programmes, the majority of which had been sold to bankruptcy remote structured entities. As the structured entities were funded by the issue of debt on terms whereby the majority of the risks and rewards of the portfolio were retained by TSB, the structured entities were consolidated fully and all of these loans were retained on TSB's balance sheet, with the externally issued notes in issue included within debt securities in issue. The balances of the advances subject to these arrangements and the carrying value of the notes in issue at 31 December 2019 are listed below.

	31 December 2019	
	Loans and advances securitised [(1)] £ million	Liability £ million
Duncan Funding 2015-1 plc	1,191.7	1,293.5
Duncan Funding 2016-1 plc	2,086.6	2,241.7
	3,278.3	3,535.2
Less retained notes held by TSB		(3,108.7)
Total securitisation notes		426.5

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

Cash deposits of £342.5 million (note 6) held by TSB at 31 December 2019 were restricted in use to repayment of the debt securities issued by the structured entities and other legal obligations. TSB recognised the full liabilities associated with its securitisation programmes within debt securities in issue, although the obligations of TSB are limited to the cash flows generated from the underlying assets.

Covered bond programmes

Loans and advances to customers of £1,815.0 million (2019: £1,802.2 million) have been assigned to a limited liability partnership to provide security for the issuance of covered bonds of £1,249.1 million (2019: £1,249.8 million). TSB retains all of the risks and rewards associated with these loans and the partnership is consolidated fully with the loans retained on TSB's balance sheet, and the related covered bonds in issue included within debt securities in issue.

Cash deposits of £43.3 million (2019: £30.7 million) held by TSB are restricted in use to repayment of the term advances related to covered bonds and other legal obligations (note 6). At 31 December 2020, TSB had over-collateralised the covered bond programmes in order to meet the programme terms, secure the rating of the covered bonds, and to provide operational flexibility. The obligations of TSB to provide collateral may increase due to the formal requirements of the programmes. TSB may also voluntarily contribute collateral to support the ratings of the covered bonds but did not do so during 2020 or 2019. During 2020 and 2019, there were no defaults on any principal or interest or any other breaches with respect to borrowings under the covered bond programmes.

IBOR reform

In July 2020, the terms of £500.0 million of covered bonds, where interest was calculated based on LIBOR, were modified to use SONIA from the September 2020 interest reset date and thereafter. This was undertaken on an economically equivalent basis as at the date of the modification and the covered bonds continue to be recognised on the balance sheet with no modification gain or loss being recognised. At 31 December 2020, all covered bonds issued by TSB reference SONIA to determine the rate of interest payable on notes issued.

Notes to the consolidated financial statements

Sources of funding (continued)

2. Debt securities in issue (continued)

Senior unsecured debt securities in issue

In December 2020, the Company issued £450.0 million floating rate notes due to mature in June 2023 to its parent company, Banco de Sabadell, S.A. to satisfy MREL requirements. These were issued at a price of 100% of the principal amount. The notes pay interest at SONIA plus 2.1% payable quarterly in arears. The Company has the option to redeem these notes in June 2022 and quarterly thereafter, subject to approval of the PRA.

3. Subordinated liabilities

	2020 £ million	2019 £ million
Fixed/floating rate reset callable subordinated Tier 2 notes due May 2026	**385.0**	385.0
Unamortised discount	**(0.1)**	(0.4)
Accrued interest	**3.4**	3.4
Fair value hedge accounting adjustment (note 22)	**3.0**	7.9
Total subordinated liabilities	**391.3**	395.9

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

4. Fair value of financial liabilities

The following table summarises the carrying values, fair values, and valuation hierarchy, of financial liabilities. 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.

	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2020					
Customer deposits	**–**	**34,405.2**	**–**	**34,405.2**	**34,375.3**
Debt securities in issue	**1,267.1**	**450.1**	**–**	**1,717.2**	**1,699.2**
Subordinated liabilities	**–**	**394.0**	**–**	**394.0**	**391.3**
Derivative liabilities at fair value through profit or loss	**–**	**302.3**	**–**	**302.3**	**302.3**
Hedging derivative liabilities	**–**	**225.2**	**–**	**225.2**	**225.2**
At 31 December 2019					
Customer deposits	–	30,214.6	–	30,214.6	30,182.4
Debt securities in issue	1,684.4	–	–	1,684.4	1,676.3
Subordinated liabilities	–	398.3	–	398.3	395.9
Derivative liabilities at fair value through profit or loss	–	127.9	–	127.9	127.9
Hedging derivative liabilities	–	288.5	–	288.5	288.5

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When available, TSB measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions on an arm's length basis. If a market for a financial instrument is not active, the TSB establishes fair value using a valuation technique. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same for which market observable prices exist, net present value and discounted cash flow analysis.

Notes to the consolidated financial statements

Sources of funding (continued)

4. Fair value of financial liabilities (continued)

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

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

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. There were no transfers between levels in 2020 or 2019.

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

Loans and liquid assets

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

Accounting policies effective for the year ended December 2020

(b) Classification and measurement of financial assets

Financial assets is the term used to describe TSB's loans to customers and other institutions. It includes loans and advances to customers, credit institutions, and central banks, financial assets at fair value through other comprehensive income, cash and balances with central banks and other demand deposits, derivative financial assets (see accounting policy (j) under Managing financial risk), and other advances. A financial asset is recognised on the balance sheet when the cash is advanced to the borrower, or in the case of purchases of debt securities, on the settlement date.

Classification and measurement

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

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

Financial assets that are debt instruments 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. Amortised cost is the amount at which a financial asset is initially recognised, minus principal repayments, plus or minus the unamortised amount of any difference between the initial amount recognised and the maturity amount, calculated using the effective interest rate method. The carrying amount of these assets is adjusted by an expected credit loss allowance.

Financial assets that are debt instruments 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 other income. Derivative financial assets are measured at FVPL (see accounting policy (j) under Managing financial risk). All equity instruments are measured at FVPL with dividends continuing to be recognised in other income in the income statement.

Notes to the consolidated financial statements

Loans and liquid assets (continued)

Accounting policies effective for the year ended December 2020 (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 since initial recognition. For financial assets in stage 2, recognition of a lifetime ECL impairment allowance is required. Interest income on stage 2 financial assets is calculated on the gross carrying amount of the financial asset; and
- Stage 3 - Financial assets which have experienced one or more events that have had a detrimental impact on the estimated future cash flows and are considered to be credit impaired. Like stage 2, recognition of a lifetime expected ECL impairment allowance is required. However, interest income on stage 3 loans is calculated on the financial asset balance net of the impairment allowance.

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

Definition of default for IFRS 9

Loans and advances that are more than 90 days past due, or considered by management as unlikely to pay their obligations, are considered to be in default and credit impaired (stage 3) for IFRS 9. Examples of loans considered unlikely to pay include customers in bankruptcy or subject to an individual voluntary arrangement, customers undergoing repossession, and customers who have received a forbearance treatment, generally within the previous two years, and have either now returned to early arrears or have received an additional forbearance measure. Customers who have cured but who were 90 days past due, or considered unlikely to pay, in the previous six months are also considered to remain in default and classified as credit impaired. TSB policy is not to rebut the presumption in IFRS 9 that loans which are more than 90 days past due are in default.

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

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

Significant increase in credit risk

Financial assets are considered to be in stage 2 when their credit risk has increased significantly since initial recognition. The main factor that is considered by TSB is an increase in the residual lifetime Probability of Default (PD) since initial recognition. A loan will be considered to have experienced a significant increase in credit risk, and be transferred from stage 1 to stage 2 if the residual lifetime PD has increased by a factor of 2 times the origination PD and the increase is between 10bps and 410bps (for different cohorts of secured retail), between 250bps and 770bps for unsecured products, and more than 50bps for business banking assets. As a secondary qualitative assessment criterion, financial assets that are in forbearance but not credit impaired are considered to have experienced significant increase in credit risk and will be in stage 2. As a backstop, TSB does not rebut the presumption in IFRS 9 that all financial assets that are more than 30 days past due have experienced a significant increase in credit risk. Consequently, in respect of loans and advances to customers, TSB does not use the practical expedient 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').

However, in respect of all other categories of financial assets at amortised cost and financial assets to fair value through other comprehensive income, TSB uses 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 which is consistent with the definition of default for IFRS 9 as described above.

Notes to the consolidated financial statements

Loans and liquid assets (continued)

Accounting policies effective for the year ended December 2020 (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. For such assets, lifetime ECL are incorporated into the calculation of the effective interest rate on initial recognition. Consequently, POCI assets do not carry an impairment allowance on initial recognition. The amount recognised as a loss subsequent to initial recognition is equal to the change in lifetime ECL since initial recognition of the asset. 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. Financial assets that are written off could still be subject to enforcement activities in order to comply with TSB's procedures for recovery of amounts due. In the event of significant improvements in expected recoveries on stage 3 assets, impairment reversals are recognised as a credit to impairment losses in the income statement.

Modified financial assets and derecognition
A financial asset that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement made on substantially different terms. Where the contractual cash flows of a financial asset have been 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 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.

Methodology for measuring expected credit losses
The allowance for ECLs is calculated using three main components: a probability of default (PD), a loss given default (LGD); and the exposure at default (EAD). For accounting purposes, the 12 month and lifetime PDs represent the probability of a default occurring over the next 12 months or the lifetime of the financial instruments, respectively, based on conditions existing at the balance sheet date and expected future economic conditions that affect credit risk.

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

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

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

Where TSB enters into securitisation transactions to finance certain loans and advances to customers using a structured entity funded by the issue of debt, these loans and advances continue to be recognised, as TSB has not transferred substantially all the risks and rewards. A corresponding liability for the funding is also recognised.

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

Notes to the consolidated financial statements

Loans and liquid assets (continued)

5. Debt securities

Fair value through other comprehensive income (FVOCI)	2020 £ million	2019 £ million
UK Gilts	**1,405.4**	1,171.4
Supranational and development bank bonds	**91.5**	416.0
Total debt securities at FVOCI	**1,496.9**	1,587.4

Amortised cost	2020 £ million	2019 £ million
UK Gilts	**555.3**	102.9
Supranational and development bank bonds	**356.9**	279.4
Covered bonds	**211.5**	166.3
Total debt securities at amortised cost	**1,123.7**	548.6

Debt securities of £1,496.9 million (2019: £1,587.4 million) are held as part of the liquid asset portfolio, where the business model is to hold the assets to collect the contractual cash flows and to generate cash flows from selling the assets. These assets are carried at FVOCI.

Debt securities of £1,123.7 million (2019: £548.6 million) are held as part of a second, separate liquid asset portfolio, where the business model is solely to hold the assets to collect the contractual cash flows. These assets are carried at amortised cost.

At 31 December 2020, UK gilts at FVOCI with a carrying value of £225.8 million (2019: £nil) were subject to repurchase agreements. A further £190.1 million had been pledged as collateral (2019: £131.7 million).

6. Loans to credit institutions

	2020 £ million	2019 £ million
Cash deposits held	**43.3**	373.2
Total loans to credit institutions	**43.3**	373.2

At 31 December 2020, restricted cash deposits were held in respect of TSB's covered bond programme. At 31 December 2019, cash deposits were held for both TSB securitisation programmes (£342.5 million) and covered bond programmes (£30.7 million). As described in note 2, during 2020, TSB's securitisation programmes matured and the associated deposit balances were no longer required.

Notes to the consolidated financial statements

Loans and liquid assets (continued)

7. Loans and advances to customers

	2020 £ million	2019 £ million
Secured (retail)	**30,790.4**	29,189.2
Unsecured portfolios	**1,992.7**	1,855.1
Business banking	**715.3**	131.1
	33,498.4	31,175.4
Valuation adjustments(1)	**58.5**	63.4
Gross loans and advances to customers	**33,556.9**	31,238.8
Allowance for credit impairment losses(2) (note 9)	**(239.0)**	(163.0)
Loans and advances to customers	**33,317.9**	31,075.8

(1) Comprises accrued interest of £19.1 million (2019: £14.2 million) and effective interest rate adjustments of £39.4 million (2019: £49.2 million).
(2) Comprises allowance for credit impairment losses on secured lending of £43.4 million (2019: £34.7 million), unsecured lending of £187.6 million (2019: £125.1 million) and business banking lending of £8.0million (2019: £3.2 million).

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

	2020 £ million	2019 £ million
Credit cards	**2,956.9**	2,697.5
Mortgage offers made	**2,164.1**	1,164.5
Current accounts and other lending	**1,130.5**	1,091.6
Total commitments	**6,251.5**	4,953.6

The credit impairment provision in respect of total loan commitments is shown in note 30.

8. Other advances

	2020 £ million	2019 £ million
Items in the course of collection from credit institutions	**21.7**	16.6
Items in the course of collection from non-credit institutions	**2.8**	0.4
Collateral placed at central clearing houses	**190.8**	257.3
Collateral placed with credit institutions	**4.9**	5.3
Total other advances	**220.2**	279.6

Notes to the consolidated financial statements

Loans and liquid assets (continued)

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

The following tables detail changes in the gross carrying value of loans and advances to customers and the allowance for credit impairment losses. In addition, the movement in expected credit loss provisions in respect of off balance sheet exposures is shown in note 30. For all other classes of financial assets to which TSB is exposed to credit risk (as listed in note 19(i) on page 87), expected credit losses have been assessed as immaterial.

	Stage 1		Stage 2		Stage 3		POCI [(1)]		Total	
TSB	Gross Loans £ million	Allow. for credit impair-ment losses £ million	Gross Loans £ million	Allow. for credit impair-ment losses £ million	Gross Loans £ million	Allow. for credit impair-ment losses £ million	Gross Loans £ million	Allow. for credit impair-ment losses £ million	Gross Loans £ million	Allow. for credit impair-ment losses £ million
At 1 January 2019	26,678.8	(50.8)	2,877.9	(69.7)	398.3	(71.0)	190.0	(7.2)	30,145.0	(198.7)
Changes reflected in impairment losses:										
Increases due to originations	6,206.7	(23.3)	34.8	–	11.2	–	5.7	–	6,258.4	(23.3)
Decreases due to repayments	(4,400.8)	10.5	(612.7)	3.4	(72.4)	2.2	(34.4)	0.1	(5,120.3)	16.2
Changes in credit risk [(2)]	–	75.1	–	(82.5)	–	(23.7)	–	4.9	–	(26.2)
Amounts written off	(0.1)	–	(0.8)	0.7	(106.8)	68.3	–	–	(107.7)	69.0
Transfers between stages	(302.9)	(63.8)	150.7	87.3	152.2	(23.5)	–	–	–	–
To stage 1	3,433.0	(80.6)	(3,413.5)	77.4	(19.5)	3.2	–	–	–	–
To stage 2	(3,710.8)	16.2	3,784.3	(22.2)	(73.5)	6.0	–	–	–	–
To stage 3	(25.1)	0.6	(220.1)	32.1	245.2	(32.7)	–	–	–	–
At 31 December 2019	28,181.7	(52.3)	2,449.9	(60.8)	382.5	(47.7)	161.3	(2.2)	31,175.4	(163.0)
Transfers to credit impairment provisions (note 30)	**–**	**8.6**	**–**	**6.5**	**–**	**0.2**	**–**	**–**	**–**	**15.3**
Changes reflected in impairment losses:										
Increases due to originations	**7,594.3**	**(48.1)**	**80.0**	**(0.3)**	**15.5**	**–**	**6.3**	**–**	**7,696.1**	**(48.4)**
Decreases due to repayments	**(4,725.5)**	**16.9**	**(480.2)**	**4.0**	**(76.8)**	**2.5**	**(23.6)**	**–**	**(5,306.1)**	**23.4**
Changes in credit risk [(2)]	**–**	**30.1**	**–**	**(116.6)**	**–**	**(22.6)**	**–**	**(0.6)**	**-**	**(109.7)**
Amounts written off	**–**	**–**	**–**	**–**	**(67.0)**	**43.4**	**–**	**–**	**(67.0)**	**43.4**
Transfers between stages:	**(1,297.0)**	**(22.1)**	**1,151.7**	**48.0**	**145.3**	**(25.9)**	**–**	**–**	**–**	**–**
To stage 1	**3,469.8**	**(107.9)**	**(3,454.0)**	**104.9**	**(15.8)**	**3.0**	**–**	**–**	**–**	**–**
To stage 2	**(4,746.3)**	**85.2**	**4,824.3**	**(90.7)**	**(78.0)**	**5.5**	**–**	**–**	**–**	**–**
To stage 3	**(20.5)**	**0.6**	**(218.6)**	**33.8**	**239.1**	**(34.4)**	**–**	**–**	**–**	**–**
At 31 December 2020	**29,753.5**	**(66.9)**	**3,201.4**	**(119.2)**	**399.5**	**(50.1)**	**144.0**	**(2.8)**	**33,498.4**	**(239.0)**

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

Impairment losses recognised in the income statement of £162.7 million comprise of changes in the impairment allowance reflected in the lines under the heading ‘changes reflected in impairment losses’ together with the net amounts written off as reflected in the table above. In addition, impairment losses includes the subsequent recovery of amounts previously written off and other amounts charged directly to the income statement.

Gross loans balances increased by £2,323.0 million to £33,498.4 million. This was driven by secured (retail) lending which increased by £1,601.2 million reflecting strong trading performance, particularly in the second half of 2020 following lower levels of activity in the first half due to the initial COVID-19 lockdown restrictions. In addition, business banking increased by £584.1 million, primarily due to lending through the Bounce Back Loan Scheme. Growth in unsecured balances was more muted, increasing £137.7 million, reflecting lower demand as consumers reduced spending during 2020.

Stage 1 gross loans increased by £1,571.8 million reflecting the increase described above partially offset by a net transfer of £1,297.0 million to stages 2 and 3. This reflected the deterioration in the economic outlook from COVID-19. Gross transfers from stage 1 to stage 2 of £4,746.3 million reflect the initial impact of COVID-19. This was partially offset by balances transferring back from stage 2 to stage 1 in the second half of the year as customer behaviour and economic forecasts settled and the effect of the change to the thresholds for assessing significant increase in credit risk, as described on page 77. Determining the threshold between stage 1 and 2 requires judgment in assessing significant increase in credit risk as also described on page 77.

Stage 2 balances increased by £751.5 million reflecting the net transfers in from stage 1, partially offset by ongoing customer repayments of balances. Stage 3 balances increased by £17.0 million reflecting the deteriorating economic environment in 2020 but this was largely offset by loan balances written off and customer repayments.

Gross loans written off during 2020 of £67.0 million (2019: £107.7 million) continue to be subject to the right to undertake enforcement activities, despite there being no realistic prospect of recovery.

Notes to the consolidated financial statements

Loans and liquid assets (continued)

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

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

	Stage 1		Stage 2		Stage 3		POCI		Total	
Secured (retail)	Gross Loans £ million	Allow. for credit 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 2019	25,202.3	(17.6)	2,250.9	(4.4)	287.3	(7.5)	189.8	(7.0)	27,930.3	(36.5)
Changes reflected in impairment losses:										
Increases due to originations	5,823.1	(18.3)	6.3	–	3.0	–	3.4	–	5,835.8	(18.3)
Decreases due to repayments	(4,054.6)	9.7	(425.6)	0.8	(62.8)	1.0	(32.0)	–	(4,575.0)	11.5
Changes in credit risk	–	12.8	–	(7.7)	–	(1.4)	–	4.9	–	8.6
Amounts written off	–	–	–	–	(1.9)	–	–	–	(1.9)	–
Transfers between stages	(223.4)	(2.9)	145.3	3.8	78.1	(0.9)	–	–	–	–
To stage 1	2,776.5	(5.6)	(2,762.9)	5.5	(13.6)	0.1	–	–	–	–
To stage 2	(2,990.1)	2.7	3,055.7	(3.9)	(65.6)	1.2	–	–	–	–
To stage 3	(9.8)		(147.5)	2.2	157.3	(2.2)	–	–	–	–
At 31 December 2019	26,747.4	(16.3)	1,976.9	(7.5)	303.7	(8.8)	161.2	(2.1)	29,189.2	(34.7)
Transfers to credit impairment provisions (note 30)	**–**	**–**	**–**	**–**	**–**	**0.1**	**–**	**–**	**–**	**0.1**
Changes reflected in impairment losses:										
Increases due to originations	**6,164.0**	**(32.4)**	**13.1**	**(0.3)**	**6.0**	**–**	**4.5**	**–**	**6,187.6**	**(32.7)**
Decreases due to repayments	**(4,193.9)**	**15.9**	**(317.1)**	**1.3**	**(53.0)**	**2.3**	**(21.9)**	**–**	**(4,585.9)**	**19.5**
Changes in credit risk	**–**	**10.3**	**–**	**(5.3)**	**–**	**0.1**	**–**	**(0.7)**	**–**	**4.4**
Amounts written off	**–**	**–**	**–**	**–**	**(0.5)**	**–**	**–**	**–**	**(0.5)**	**–**
Transfers between stages:	**(943.7)**	**11.9**	**867.3**	**(8.0)**	**76.4**	**(3.9)**	**–**	**–**	**–**	**–**
To stage 1	**2,667.8**	**(7.8)**	**(2,656.9)**	**7.5**	**(10.9)**	**0.3**	**–**	**–**	**–**	**–**
To stage 2	**(3,607.4)**	**19.6**	**3,679.7**	**(21.3)**	**(72.3)**	**1.7**	**–**	**–**	**–**	**–**
To stage 3	**(4.1)**	**0.1**	**(155.5)**	**5.8**	**159.6**	**(5.9)**	**–**	**–**	**–**	**–**
At 31 December 2020	**27,773.8**	**(10.6)**	**2,540.2**	**(19.8)**	**332.6**	**(10.2)**	**143.8**	**(2.8)**	**30,790.4**	**(43.4)**

Unsecured and business banking	£ million	£ million	£ million	£ million	£ million	£ million	£ million	£ million	£ million	£ million
At 1 January 2019	1476.5	(33.2)	627.0	(65.3)	111.0	(63.5)	0.2	(0.2)	2,214.7	(162.2)
Changes reflected in impairment losses:										
Increases due to originations	383.6	(5.0)	28.5	–	8.2	–	2.3	–	422.6	(5.0)
Decreases due to repayments	(346.2)	0.8	(187.1)	2.6	(9.6)	1.2	(2.4)	0.1	(545.3)	4.7
Changes in credit risk	–	62.3	–	(74.8)	–	(22.3)	–	–	–	(34.8)
Amounts written off	(0.1)	–	(0.8)	0.7	(104.9)	68.3	–	–	(105.8)	69.0
Transfers between stages:	(79.5)	(60.9)	5.4	83.5	74.1	(22.6)	–	–	–	–
To stage 1	656.5	(75.0)	(650.6)	71.9	(5.9)	3.1	–	–	–	–
To stage 2	(720.7)	13.5	728.6	(18.3)	(7.9)	4.8	–	–	–	–
To stage 3	(15.3)	0.6	(72.6)	29.9	87.9	(30.5)	–	–	–	–
At 31 December 2019	1,434.3	(36.0)	473.0	(53.3)	78.8	(38.9)	0.1	(0.1)	1,986.2	(128.3)
Business banking portfolio(1)	**(118.1)**	**1.7**	**(9.6)**	**0.7**	**(3.5)**	**0.8**	**-**	**-**	**(131.2)**	**3.2**
Unsecured - at 1 January 2020	**1,316.2**	**(34.3)**	**463.4**	**(52.6)**	**75.3**	**(38.1)**	**0.1**	**(0.1)**	**1,855.0**	**(125.1)**
Transfers to credit impairment provisions	**–**	**8.3**	**–**	**6.4**	**–**	**0.1**	**–**	**–**	**–**	**14.8**
Changes reflected in impairment losses:										
Increases due to originations	**708.0**	**(13.1)**	**10.8**	**–**	**7.0**	**–**	**1.8**	**–**	**727.6**	**(13.1)**
Decreases due to repayments	**(357.3)**	**1.0**	**(143.8)**	**2.6**	**(20.9)**	**0.1**	**(1.7)**	**–**	**(523.7)**	**3.7**
Changes in credit risk	**–**	**8.2**	**–**	**(96.9)**	**-**	**(22.7)**	**–**	**0.1**	**–**	**(111.3)**
Amounts written off	**–**	**–**	**–**	**–**	**(66.2)**	**43.4**	**–**	**–**	**(66.2)**	**43.4**
Transfers between stages:	**(271.2)**	**(21.2)**	**204.4**	**42.7**	**66.8**	**(21.5)**	**–**	**–**	**–**	**–**
To stage 1	**676.5**	**(81.8)**	**(672.1)**	**79.5**	**(4.4)**	**2.3**	**–**	**–**	**–**	**–**
To stage 2	**(931.5)**	**60.1**	**936.6**	**(63.7)**	**(5.1)**	**3.6**	**–**	**–**	**–**	**–**
To stage 3	**(16.2)**	**0.5**	**(60.1)**	**26.9**	**76.3**	**(27.4)**	**–**	**–**	**–**	**–**
Unsecured - At 31 December 2020	**1,395.7**	**(51.1)**	**534.8**	**(97.8)**	**62.0**	**(38.7)**	**0.2**	**–**	**1,992.7**	**(187.6)**

(1) Business banking is presented as a separate class of financial instrument in 2020.

Notes to the consolidated financial statements

Loans and liquid assets (continued)

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

During 2020, the business banking portfolio increased significantly as a result of lending under the Bounce Back Loan Scheme. Given the different risk characteristics in this portfolio relative to the unsecured portfolios, business banking is considered to be a separate asset class of financial instrument and movements during 2020 in gross loans and allowances have been presented separately.

	Stage 1		Stage 2		Stage 3		POCI		Total	
Business banking	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 2019	118.1	(1.7)	9.6	(0.7)	3.5	(0.8)	–	–	131.2	(3.2)
Transfers to credit impairment provisions	–	0.3	–	0.1	–		–	–	–	0.4
Changes reflected in impairment losses:										
Increases due to originations	722.3	(2.6)	56.1	–	2.5	-	–	–	780.9	(2.6)
Decreases due to repayments	(174.3)	–	(19.3)	0.1	(2.9)	0.1	–	–	(196.5)	0.2
Changes in credit risk	–	11.6	-	(14.4)	–	–	–	–	–	(2.8)
Amounts written off	–	–	–	–	(0.3)	–	–	–	(0.3)	–
Transfers between stages:	(82.1)	(12.8)	80.0	13.3	2.1	(0.5)	–	–	–	–
To stage 1	125.5	(18.3)	(125.0)	17.9	(0.5)	0.4	–	–	–	–
To stage 2	(207.4)	5.5	208.0	(5.7)	(0.6)	0.2	–	–	–	–
To stage 3	(0.2)	–	(3.0)	1.1	3.2	(1.1)	–	–	–	–
At 31 December 2020	584.0	(5.2)	126.4	(1.6)	4.9	(1.2)	–	–	715.3	(8.0)

As described on page 77, a post model adjustment (PMA) of £2.3 million was recognised in the impairment allowance in relation to Bounce Back Loan Scheme loans underwritten in the year where it has been assessed that there is a possibility TSB will not be able to call on the government guarantee. This reflects a risk that there may be additional Bounce Back Loan exposures where TSB might not be able to call on the government guarantee. TSB has sought to mitigate this risk through a number of internal actions which include scheme eligibility assessments for individual loans and proactive discussions with the British Business Bank.

Significant estimates - measurement uncertainty and sensitivity analysis of expected credit losses
The measurement of the allowance for credit impairment losses is complex and involves the use of significant judgement and estimation uncertainty as follows:

- Estimation uncertainty from the use of multiple forward-looking economic scenarios and associated weightings;
- Judgements required to adjust modelled outcomes to reflect where they are not considered to fully capture expected credit losses (referred to as PMAs); and
- Judgements required to assess when a financial asset has experienced a significant increase in credit risk.

Forecast economic scenarios
TSB currently uses four economic scenarios, representative of management's view of forecast economic conditions. Key scenario assumptions are set internally for GDP, house prices, unemployment and interest rates. The forecast for GDP is compared with data published by the Bank of England and other external sources to ensure the scenarios are free from bias and reflect independent external information.

Severe downside scenarios, when considered appropriate, are typically aligned with those used for ICAAP purposes and are considered to be tail risk scenarios, used to capture non-linearity in expected credit losses. This is where the relationship of credit losses to the relevant economic variables which influence credit losses (e.g. house prices or unemployment) is such that each unit of change in an economic variable does not lead to a uniform change in expected credit losses. For example, credit losses in secured portfolios may remain subdued in an environment where house prices exhibit only a small decrease. However, after a certain level of house price fall credit losses would be forecast to increase more meaningfully where collateral values fall below the level of the customer loan.

Scenarios and associated weightings are reviewed monthly by an internal forum and updated, as necessary, to enable significant developments to be taken into account in measuring credit impairment provisions. The scenarios and weightings are presented quarterly for review and approval for use by the Audit Committee.

Notes to the consolidated financial statements

Loans and liquid assets (continued)

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

Forecast economic scenarios (continued)
The four scenarios, together with the weightings applied at December 2020, are described below. By necessity, these scenarios have been updated significantly from the scenarios used in 2019 to reflect the impact in 2020 of COVID-19. At the date of this report, GDP was expected to have decreased by 11.5% in 2020 while house prices remained buoyant and unemployment stable, reflecting support from the government through measures such as the various job protection schemes and relaxations to stamp duty on house purchases. Throughout 2020, the potential outcomes from the UK:EU trade agreement negotiations were monitored and reflected in the suite of economic scenarios used throughout the year. Subsequent to the agreement reached in December, scenarios that considered the specific risks of 'no deal' Brexit were removed.

Base case scenario: Cautious recovery following the COVID-19 economic 'shock' in 2020
- Following a significant fall in 2020, a recovery in GDP commences from early 2021 with a return to pre-pandemic levels in the first half of 2022. Employment levels continue to be maintained by government support schemes, with unemployment forecast to peak in the second quarter of 2021 at 7.3%. Forecast house prices are expected to suffer a peak to trough fall of 12% by the second half of 2021 reflecting the anticipated increase in unemployment and the end of the current temporary concession in stamp duty.

Downside scenario: Recovery stalls in the first half of 2021
- GDP begins to recover in H1 2021, but at a slower rate than the base case scenario, as restrictions remain in place. Certain sectors, such as hospitality and leisure, are particularly damaged. Unemployment rises sharply, peaking at 8.7% in the second quarter of 2021 due to weak recovery and the ending of the Government's support schemes. Unemployment eventually begins to fall but remains higher than the base case due to long-term scarring effects. In response, the BoE cuts Bank Rate to zero. House prices suffer a peak to trough fall of 15% in this scenario.

Severe downside (low interest rate) scenario: Uncontrolled pandemic
- Designed to capture the risks of a high impact, low probability scenario where the COVID-19 pandemic cannot be controlled. Confidence collapses and there is a significant flight from higher risk assets. GDP stagnates in 2021 after another decrease in Q1 2021. Unemployment rises to a peak of 10.8% in Q2 2021 and drives a house price fall of 23%, despite Bank Rate being cut to zero.

Upside: Rapid Recovery
- Developments in health/technology eradicate the COVID-19 virus more quickly than in the base case scenario and the economy is boosted by supportive fiscal and monetary policies. Unemployment rises less sharply in H1 2021 than in the base case and reverses more quickly due to the stronger recovery. The BoE leaves Bank Rate on hold until Q4 2022. By this time, GDP has comfortably surpassed its Q4 2019 level, and unemployment is below 4%. House prices fall in 2021 but recover more rapidly than the base case in 2022 and beyond.

The table below shows the weightings applied to each of the economic scenarios applied in measuring the allowance for credit impairment losses, together with ranges of the most sensitive inputs of unemployment, house prices, and interest rates:

						At 31 December 2020
		Base case	**Upside**		**Downside**	**Severe Downside**
Scenario weighting		**50 %**	**10 %**		**35 %**	**5 %**
Unemployment	Peak rate	**7.3 %**	**6.1 %**		**8.7 %**	**10.8 %**
House prices	Peak-to-trough fall	**(11.8)%**	**(6.9)%**		**(15.2)%**	**(22.5)%**
Interest rates	Most extreme rate(1)	**0.25 %**	**1.25 %**		**0.0 %**	**0.0 %**
						At 31 December 2019
		Base case	Upside	Mild Down	Downside	Severe Down %
Scenario weighting		40%	10%	20%	25%	5%
Unemployment	Peak rate	3.8%	3.8%	5.1%	6.3%	9.2%
House prices	Peak-to-trough fall	+ve	+ve	(14.0)%	(20.5)%	(34.5)%
Interest rates	Most extreme rate(1)	0.75%	2.0%	0.25%	0.0%	4.0%

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

Notes to the consolidated financial statements

Loans and liquid assets (continued)

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

The table below sets out the key economic variables used in the scenarios, together with their weighted averages.

Scenario	Weighting	Economic measure[1]	2021	2022	2023	2024	2025
Upside	10%	GDP	**9.3%**	**6.7%**	**1.7%**	**1.6%**	**1.6%**
		Unemployment	**4.3%**	**3.4%**	**3.3%**	**3.3%**	**3.3%**
		House prices	**(5.8)%**	**4.4%**	**4.8%**	**5.0%**	**3.6%**
		Interest rates	**0.1%**	**0.25%**	**0.75%**	**1.25%**	**1.25%**
Base	50%	GDP	**6.1%**	**5.8%**	**1.5%**	**1.4%**	**1.4%**
		Unemployment	**6.8%**	**5.0%**	**4.5%**	**4.2%**	**4.0%**
		House prices	**(11.8)%**	**7.3%**	**5.6%**	**5.0%**	**3.6%**
		Interest rates	**0.1%**	**0.1%**	**0.1%**	**0.1%**	**0.25%**
Downside	35%	GDP	**3.5%**	**4.9%**	**1.3%**	**1.4%**	**1.4%**
		Unemployment	**8.0%**	**6.4%**	**5.6%**	**5.0%**	**5.0%**
		House prices	**(13.5)%**	**3.1%**	**5.6%**	**5.0%**	**3.6%**
		Interest rates	**0%**	**0%**	**0%**	**0%**	**0%**
Severe Down	5%	GDP	**0.8%**	**3.6%**	**1.2%**	**1.4%**	**1.4%**
		Unemployment	**9.3%**	**7.1%**	**6.5%**	**6.1%**	**5.6%**
		House prices	**(13.5)%**	**(10.3)%**	**0%**	**0%**	**3.4%**
		Interest rates	**0%**	**0%**	**0%**	**0%**	**0%**
Weighted average	n/a	GDP	**5.2%**	**5.5%**	**1.4%**	**1.4%**	**1.4%**
		Unemployment	**7.0%**	**5.4%**	**4.9%**	**4.5%**	**4.4%**
		House prices	**(11.9)%**	**4.7%**	**5.2%**	**4.8%**	**3.6%**
		Interest rates	**0.1%**	**0.1%**	**0.1%**	**0.2%**	**0.25%**

(1) GDP is presented as the annual change in forecast quarterly average GDP for each year. Unemployment and interest rates are presented as the Q4 forecast for each year. House price changes are presented as the year-on-year change in Q4 forecast house prices in each year.

Key variables in each of the scenarios, as set out above, are assumed to revert to a long term constant rate over a period of up to two years after the end of the initial forecast period. The long term reversionary rates used are forecast as follows: GDP 1.5% (2019: 1.5%), unemployment 4.0% (2019: 3.6%); interest rates 1.0% (2019: 1.25%); and house price growth of 3.75% (2019: 3.75%) per annum.

Sensitivity to alternative weightings

The calculation of the allowance for credit impairment losses is sensitive to changes in the chosen weightings. The table below summarises the impact on the allowance for credit impairment losses from the use of alternative scenario weightings. The probability-weighted allowance for credit impairment losses was 10% higher (2019: 21% higher) than if it had been measured using only the base case scenario assumptions.

	2020 £ million	2019 £ million
Allowance for credit losses	**239.0**	163.0
Provision for off balance sheet exposures (note 30)	**19.2**	2.6
Combined on and off balance sheet - using weighted forecast	**258.2**	165.6
Increase/(decrease) if a 100% weighting was applied to each scenario:		
Upside	**(50.0)**	(34.0)
Base case	**(23.0)**	(29.0)
Downside	**33.0**	20.0
Severe down – low rate	**177.0**	208.0

Notes to the consolidated financial statements

Loans and liquid assets (continued)

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

Judgements required in assessing post model adjustments
At 31 December 2020, the allowance of £239.0 million (2019: £163.0 million) included PMAs of £41.2 million (2019: £57.6 million) as shown in the table below:

	2020 £ million	2019 £ million
COVID-19 related (consumer behaviour)	**38.0**	–
Impairment default triggers	**14.7**	17.4
Model performance	**19.9**	16.8
Operational matters	**13.0**	23.4
Economic scenarios	**(11.2)**	–
Bounce Back Loan Scheme	**(33.2)**	–
Total	**41.2**	57.6

The suite of methodologies used to calculate PMAs are grounded in similar principles to those adopted for the core impairment models, with the inputs and PMA methodologies subject to regular oversight and PMA outputs reviewed in a consistent manner to the output from the core impairment models. The key categories of PMAs are as follows:

- COVID-19 related PMAs capture the increased risk of credit losses in all portfolios arising from changes in consumer behaviour which have not been considered in conditioning the impairment models. For example, circumstances, such as customer repayment holidays, static bureau data reporting, and associated exclusion from forbearance classifications, together with changes in customer spending patterns are changing the indicators of underlying credit risk but are not being captured by the impairment models.

- Impairment default trigger PMAs primarily reflect management's judgement that impairment models do not fully capture the risks of credit losses arising from interest only mortgage redemptions and certain mortgage customer's current affordability benefitting from low interest rates.

- Model performance PMAs capture adjustments for known weaknesses in the impairment models for secured (retail) and unsecured portfolios. These have been temporarily remediated through PMAs until a rebuild of the model or model component can be completed and implemented within the core ECL model framework.

- PMAs to address operational matters have reduced significantly in 2020 reflecting the clearance of historical, migration related delays to unsecured loan charge offs and the adoption, during 2020, of updated house price indexation data.

- The economic scenarios PMA was required to reflect late changes in economic scenarios that took account of Brexit negotiations and COVID-19 developments in the finalisation of the approved economic scenarios and associated weightings, as described starting on page 74.

- A PMA to reduce the modelled allowance for credit impairment losses by £35.5 million in respect of Bounce Back loans was required as the government guarantee is not a feature of the associated business banking loss given default model. This was partially offset by a £2.3 million PMA that increased the impairment allowance to reflect the risk of reduced recovery under the government guarantee arising from potential deficiencies in operational processes.

Judgements required in assessing significant increase in credit risk
TSB's policy for determining when a financial asset has experienced a significant increase in credit risk is explained on page 68. In applying this policy, the key judgement is the level of increase in the residual lifetime probability of default (PD) as compared to the equivalent position at the origination of the financial asset. At 31 December 2020, secured (retail) loans were considered to have experienced a significant increase in credit risk (and be in stage 2) when the residual lifetime PD had increased by a factor of 2 times the origination PD and the increase was between 10bps and 410bps (2019: 10bps). In addition, the threshold was 2 times the origination PD and the increase was between 250bps and 770bps (2019: 30bps-100bps) for unsecured and more than 50bps for business banking. In assessing the appropriateness of this judgement, management applied a framework that considers a number of quantitative factors, including the accuracy of the thresholds and their predictive ability. In the light of analysis undertaken during 2020, changes in thresholds resulted in £578.6 million of gross loans being transferred from stage 2 to stage 1, together with the associated impairment allowance of £0.1 million.

Consistent with the COVID-19 related PMA described above, a PMA was applied to the modelled stage allocation of gross loans to capture the increased risk of credit losses arising from changes in consumer behaviour which have not been considered in conditioning the impairment models. This resulted in the transfer of £1,193.1 million of gross balances from stage 1 to stage 2 and £24.3 million from stage 2 to stage 3.

Notes to the consolidated financial statements

Loans and liquid assets (continued)

10. Fair value of financial assets

The following table summarises the carrying values, fair values, and valuation hierarchy of financial assets presented on TSB's consolidated balance sheet. 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.

	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2020					
Debt securities at amortised cost	**1,127.9**	**–**	**–**	**1,127.9**	**1,123.7**
Loans and advances to customers	**–**	**–**	**33,315.0**	**33,315.0**	**33,317.9**
Financial assets at fair value through other comprehensive income	**1,496.9**	**–**	**–**	**1,496.9**	**1,496.9**
Derivative assets at fair value through profit or loss	**–**	**198.3**	**–**	**198.3**	**198.3**
Hedging derivative assets	**–**	**139.9**	**–**	**139.9**	**139.9**
At 31 December 2019					
Debt securities at amortised cost	549.9	–	–	549.9	548.6
Loans and advances to customers	–	–	31,040.7	31,040.7	31,075.8
Financial assets at fair value through other comprehensive income	1,587.4	–	–	1,587.4	1,587.4
Derivative assets at fair value through profit or loss	–	112.0	–	112.0	112.0
Hedging derivative assets	–	93.4	–	93.4	93.4

A description of the fair value levels is included in note 4. Financial assets at fair value through other comprehensive income are valued using quoted market prices and are therefore classified as Level 1 assets. Derivative financial assets are primarily collateralised 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 LIBOR and SONIA rates. As such, derivative financial instruments are classified as Level 2 assets.

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

Cash, cash balances at central banks and other demand deposits; loans and advances to central banks; loans and advances to credit institutions and other advances are generally short term in nature and to counterparties with a high credit quality and the carrying amount is a reasonable approximation of fair value.

Notes to the consolidated financial statements

Income

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

Accounting policies relevant to recognising income

(e) Interest income and expense

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

The effective interest rate is calculated on initial recognition of the financial asset or liability, estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts paid or received by TSB that are an integral part of the overall return, direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument and all other premiums or discounts. Reversionary interest is not included in the assessment of the effective interest rate on secured products. 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; and

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

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

(f) Other operating income
Other operating income, including fees and commissions, which are not an integral part of the EIR are generally recognised over time as the service is provided and TSB satisfies its performance obligations.

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

Notes to the consolidated financial statements

Income (continued)

11. Net interest income

Interest and similar income	2020 £ million	2019 £ million
Interest income calculated using the effective interest method:		
Cash, cash balances at central banks and other demand deposits	**9.8**	47.0
Financial assets at fair value through other comprehensive income	**15.1**	24.5
Debt securities at amortised cost	**7.6**	4.3
Loans to credit institutions	**0.5**	2.1
Loans and advances to customers	**889.0**	972.7
	922.0	1,050.6
Derivative financial instruments	**(41.0)**	(5.8)
Total interest and similar income	**881.0**	1,044.8

Interest and similar expense		
Interest expense calculated using the effective interest method:		
Borrowings from central banks	**(9.5)**	(46.0)
Deposits from credit institutions	**(0.1)**	(0.2)
Customer deposits	**(74.7)**	(116.4)
Repurchase agreements	**–**	(1.8)
Debt securities in issue	**(13.8)**	(21.8)
Subordinated liabilities	**(22.4)**	(22.4)
Lease liabilities	**(1.3)**	(1.6)
	(121.8)	(210.2)
Derivative financial instruments	**27.2**	6.5
Total interest and similar expense	**(94.6)**	(203.7)
Net interest income	**786.4**	841.1

Included within interest and similar income is £15.9 million (2019: £18.7 million) in respect of impaired financial assets.

12. Net fee and commission income

	2020 £ million	2019 £ million
Fee and commission income		
Bank accounts	**43.8**	47.8
Credit and debit card fee income	**55.4**	85.7
Insurance commission income	**9.2**	11.0
Other	**14.0**	15.3
	122.4	159.8
Fee and commission expense		
Bank accounts	**(19.5)**	(28.2)
Credit and debit card fee expense	**(1.4)**	(0.2)
Other	**(15.6)**	(13.1)
	(36.5)	(41.5)
Net fee and commission income	**85.9**	118.3

The decrease in fee and commission income in 2020 was primarily driven by lower levels of consumer spending resulting from COVID-19, which crystallised in the form of lower interchange income, international payments, foreign exchange and ATM reciprocity. The prior year also benefitted from a non-recurring £22.0 million in respect of changes made to card servicing arrangements. Fees and commissions which are an integral part of the EIR are recognised in net interest income.

13. Other operating income

	2020 £ million	2019 £ million
Migration related income (1)	**35.1**	–
Rental income	**0.6**	0.8
Other income	**2.1**	0.4
Total other operating income	**37.8**	1.2

(1) Migration related income from Lloyds Banking Group of £17.6 million and insurance recoveries of post migration losses of £17.5 million.

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 employees, running our branches, investing in our business, paying for advertising and marketing. Occasionally, our customers' circumstances change and they are expected to be unable to repay the money they borrow from us causing us to incur impairment losses. Finally, TSB complies with its tax obligations to HMRC.

Accounting policies relevant to recognising charges

(g) Pensions and other post-retirement benefits

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

(h) Share based compensation

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

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

(i) Taxation

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

14. Operating expenses

	2020 £ million	2019 £ million
Staff costs		
Wages and salaries	**239.8**	260.0
Social security costs	**25.7**	26.6
Other pension costs	**32.1**	34.4
Severance costs	**45.1**	34.3
Other staff costs	**6.3**	13.0
Total staff costs	**349.0**	368.3
Premises expenses		
Rent	**7.3**	5.4
Rates, maintenance and other premises expenses	**63.4**	48.3
Total premises expenses	**70.7**	53.7
Other expenses		
IT servicing and license costs	**231.7**	194.1
Regulatory, legal and consultancy costs	**58.9**	72.7
Collection and recovery conduct charges (note 30)	**55.0**	–
Marketing	**42.3**	40.3
Other expenses [1]	**87.5**	131.6
Recovery of additional post migration charges	**–**	(39.6)
Total other expenses	**475.4**	399.1
Depreciation of property and equipment	**41.8**	26.3
Depreciation of right of use asset	**25.8**	28.2
Amortisation of intangible assets	**6.7**	5.7
Total operating expenses	**969.4**	881.3

(1) Other expenses primarily comprise of the costs of various operational contracts, costs of non-staff contractors, fraud and operational losses.

The monthly average number of employees on a headcount basis during the year was 7,068 (2019: 8,198), all of whom were employed in the UK. Included in employee costs is remuneration paid to key management personnel as set out in note 25(i).

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

	2020 £ million	2019 £ million
Fees payable to the Company's auditor for the audit of the Company's annual accounts	**0.2**	0.1
Fees payable to the Company's auditor and its associates for other services:		
Audit of the accounts of subsidiaries	**3.1**	4.1
Audit related assurance services	**1.4**	0.2
Total fees payable to TSB's auditors	**4.7**	4.4

Audit related assurance services in 2020 reflect fees payable to the Company's auditor for the audit the half year accounts, as required by TSB's parent, Sabadell. In 2019, such fees were disclosed within amounts for the audit of the accounts of subsidiaries.

Notes to the consolidated financial statements

Charges (continued)

15. Directors' emoluments

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

	2020 £ 000	2019 £ 000
Remuneration paid to Directors in respect of qualifying services	**2,699**	2,660
Employer contributions to pension schemes (including cash paid in lieu)	**287**	232
Cash received under long-term incentive arrangements	**–**	481
Total	**2,986**	3,373

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

	2020 Number	2019 Number
Exercised share options	**–**	–
Received shares under long term incentive schemes	**–**	1
Accrued pension benefits under defined contribution pension schemes	**2**	2

16. Share based payments

During 2020, expenses of £2.7 million (2019: £1.3 million) were recognised in respect of share based compensation arrangements. Such arrangements are limited to the operation of a Share Incentive Plan (SIP) which provide employees with the opportunity to own shares in Sabadell and the granting, where relevant, of shares to certain senior employees as part of their recruitment arrangements.

As all share based compensation arrangements involve an award of Sabadell shares, these arrangements are accounted for as cash settled share based payment arrangements resulting in the recognition of a liability. This liability is remeasured monthly, with changes recognised in operating expenses, to reflect the latest Sabadell share price and the estimated number of shares expected to vest. At 31 December 2020, £4.1 million (2019: £5.4 million) was recognised in respect of share based payment liabilities. An explanation of the instruments transacted to economically hedge TSB's exposure to share based payment liabilities is set out in note 25(ii).

TSB also operated a Sharesave scheme where eligible employees had the opportunity to enter into a contract to save up to £500 per month and, at the maturity date, three years from the start of the savings contract, had the option to use these savings to acquire shares in Sabadell. The options under the scheme vested on 1 October 2019 and employees had until 31 March 2020 to exercise their options after which time all remaining unvested options lapsed. Any participants who had taken a payment holiday had a later maturity date. At 31 December 2020 no options remained outstanding. At 31 December 2019, the fair value of the options, determined using a Black Scholes option pricing model, was 8.0 pence and a liability of £2.3 million was recognised on the consolidated balance sheet.

	2020		2019	
	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	**7,955**	**77.68**	11,990	77.68
Granted	**–**	**–**	–	–
Exercised	**(1,204)**	**77.68**	(2,619)	77.68
Forfeited	**(6,751)**	**77.68**	(780)	77.68
Cancelled	**–**	**–**	(636)	77.68
Outstanding at 31 December	**–**	**–**	7,955	77.68
Exercisable at 31 December	**–**	**–**	7,955	77.68

Notes to the consolidated financial statements

Charges (continued)

17. Taxation

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

	2020 £ million	2019 £ million
UK corporation tax		
Current tax charge on (loss)/profit for the year	**–**	(0.1)
Adjustments in respect of prior years	**–**	0.3
Current tax credit	**–**	0.2
Deferred tax (note 18)		
Origination and reversal of temporary differences:		
Deferred tax charge on business transfers	**(20.5)**	(20.9)
Change in UK corporation tax rate	**7.7**	–
Accelerated capital allowances	**0.7**	0.5
Adjustments in respect of prior years	**1.7**	(0.7)
Deferred tax credit in relation to trading losses	**58.0**	3.8
Other	**(2.7)**	(2.6)
Deferred tax credit/(charge)	**44.9**	(19.9)
Taxation credit/(charge)	**44.9**	(19.7)

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

	2020 £ million	2019 £ million
(Loss)/profit before taxation	**(204.6)**	46.0
Taxation credit/(charge) at applied UK corporation tax rate of 27.0% (2019: 27.0%)	**55.2**	(12.4)
Factors affecting charge:		
Disallowed costs	**(19.7)**	(6.1)
Changes to UK corporation tax rates	**7.7**	(0.8)
Adjustments in respect of prior years	**1.7**	(0.4)
Taxation credit/(charge)	**44.9**	(19.7)

The applied UK corporation tax rate of 27% includes the 8% bank surcharge on profits in excess of £25 million together with the UK corporation tax rate of 19%. Disallowed costs primarily reflect estimated customer redress costs and certain other costs associated with restructuring the Bank. Disallowed costs in 2019 primarily reflect restructuring costs.

During 2020, the UK corporation tax was substantively enacted at 19% for 2020 and for subsequent years. Prior to this, the rate had been scheduled to reduce from 19% to 17% with effect from 1 April 2020. The effect of this was to increase the value of the carried forward tax losses and temporary differences that will now be utilised when the rate is higher than previous expected which increased the deferred tax asset by £7.7 million.

Notes to the consolidated financial statements

Charges (continued)

18. Deferred tax assets

The movement in deferred tax assets is as follows:

	2020 £ million	2019 £ million
At 1 January	**96.1**	113.0
Income statement credit/(charge) (note 17)	**44.9**	(19.9)
Group relief	**(2.7)**	–
Amounts charged to equity:		
Movements in fair value reserve	**0.2**	2.3
Movements in cash flow hedge reserve	**6.7**	0.7
At 31 December	**145.2**	96.1

Deferred tax assets are comprised as follows:

	2020 £ million	2019 £ million
Deferred tax arising on carried forward trading losses	**102.7**	46.0
Deferred tax arising on business transfers	**20.5**	38.0
Deferred tax in respect of the transition to IFRS 9	**18.2**	19.3
Deferred tax arising on cash flow hedge reserve	**7.4**	0.7
Revaluations of financial assets at fair value through other comprehensive income	**(4.4)**	(4.6)
Other temporary differences	**0.8**	(3.3)
Total deferred tax assets	**145.2**	96.1

Significant judgement
The valuation and assessment of recovery of deferred tax assets requires an estimate of the amount and timing of future taxable profits. The level of estimated future taxable profits takes into account the Board approved medium term plan and associated risk factors which estimated that the asset was recoverable within seven years. A number of sensitivities were considered, including alternative forecast assumptions and execution risks associated with the Bank's strategy, which could result in a potential two year extension to the estimated recovery period. Based on this, management concluded it remains appropriate to recognise the deferred tax asset in full.

Notes to the consolidated financial statements

Managing financial risk

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

Accounting policies relevant to managing financial risk

(j) Derivative financial instruments and hedge accounting

All derivative financial instruments are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow as appropriate. Fair value is the exit price from the perspective of market participants who hold the asset or owe the liability at the measurement date. 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 derivatives are recognised immediately in the income statement, with the exception of derivatives designated in a cash flow hedge. For derivatives in cash flow hedges, the effective portion of the change in fair value is recognised in other comprehensive income until the point at which the hedged item affects profit or loss.

Hedge accounting

TSB 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 an interest rate 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 cash flows.

In its application of the hedge accounting policy, TSB follows the requirements of the EU endorsed version of IAS 39 'Financial Instruments: Recognition and Measurement' which are not available in the version issued by the IASB specifically relating to hedging core deposits, and the relaxation of effectiveness testing, such that a layer approach can be used in a macro fair value hedge. 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. For micro fair value hedges, this is applied using a straight line method over the period to maturity, and for macro fair value hedges, the cumulative adjustment is amortised over the period to expiry of the relevant repricing period.

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.

Hedge accounting – IBOR reform

TSB's accounting policy in respect of hedge accounting relationships directly affected by IBOR reform is on page 94 under the heading IBOR reform.

Notes to the consolidated financial statements

Managing financial risk (continued)

19. Credit risk

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

(i) Maximum credit exposure

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

	2020 Exposure £ million	2020 Credit Quality	2019 Exposure £ million	2019 Credit Quality
Financial assets at amortised cost:				
Cash, cash balances at central banks and other demand deposits:				
Cash	**143.6**	**Not rated**	160.1	Not rated
Balances with central banks	**4,910.1**	**AA-**	4,427.3	AA-
On demand deposits	**2.9**	**At least BBB**	7.8	At least BBB
Reverse repurchase agreements	**–**	**–**	201.1	AA-
Debt securities at amortised cost(1)	**1,123.7**	**At least AA-**	548.6	At least A
Loans and advances to customers	**33,317.9**	**Note 19(ii)**	31,075.8	Note 19(ii)
Loans to credit institutions	**43.3**	**A+**	373.2	At least A+
Loans to central banks	**120.9**	**AA-**	96.1	AA-
Other advances	**220.2**	**At least BBB**	279.6	At least BBB
Financial assets at fair value through other comprehensive income(2)	**1,496.9**	**At least AA-**	1,587.4	At least AA-
Financial assets subject to expected credit loss requirements	**41,379.5**		38,757.0	
Derivative financial assets(3)	**338.2**		205.4	
Total on-balance sheet financial assets	**41,717.7**		38,962.4	
Lending commitments	**6,251.5**	**Note 19(ii)**	4,953.6	Note 19(ii)
Maximum credit risk exposure	**43,969.2**		43,916.0	

(1) Includes £482.7 million (2019: £362.3 million) rated AAA.
(2) Includes £317.2 million (2019: £416.1 million) rated AAA.
(3) At 31 December 2020, the net uncollateralised balance of derivative financial instruments was nil (2019: £43.4 million, as set out in note 22, with counterparties rated A+).

(ii) Credit quality of loans and advances to customers and lending commitments

In assessing the credit quality of loans and advances to customers and lending commitments, TSB uses an internal rating scale which assigns a grade based on a customer's 12 month expected probability of default (PD). The PDs used to assign a risk grade, as shown in the table below, are point in time PDs. This is different to the IFRS 9 PDs used to assess IFRS 9 staging and expected credit loss measurement which are adjusted to reflect the effect of forward looking economic scenarios.

	PD range Lower	PD range Upper	Internal grading
Excellent quality	0%	1.200%	1-4
Good quality	1.201%	4.500%	5-6
Satisfactory quality	4.501%	14.000%	7-9
Lower quality	14.001%	20.000%	10
Below standard (including in default)	20.001%	100%	11-13

Notes to the consolidated financial statements

Managing financial risk (continued)

19. Credit risk (continued)

(ii) Credit quality of loans and advances to customers and lending commitments (continued)
The table below sets out the credit quality, by stage, of gross loan and advances to customers.

					2020					2019
Secured (retail)	**Stage 1 £ million**	**Stage 2 £ million**	**Stage 3 £ million**	**POCI £ million**	**Total £ million**	**Stage 1 £ million**	**Stage 2 £ million**	**Stage 3 £ million**	**POCI* £ million**	**Total £ million**
Excellent quality	**27,000.4**	**119.6**	**–**	**1.9**	**27,121.9**	26,712.4	1,725.7	–	1.2	28,439.3
Good quality	**451.9**	**382.5**	**–**	**69.5**	**903.9**	29.2	102.2	–	65.9	197.3
Satisfactory quality	**317.7**	**1,466.3**	**–**	**5.5**	**1,789.5**	2.2	108.8	–	7.8	118.8
Lower quality	**2.7**	**65.1**	**–**	**0.6**	**68.4**	–	15.0	–	1.1	16.1
Below standard (including in default)	**1.1**	**506.7**	**332.6**	**66.3**	**906.7**	3.7	25.2	303.6	85.2	417.7
Gross carrying amount	**27,773.8**	**2,540.2**	**332.6**	**143.8**	**30,790.4**	26,747.5	1,976.9	303.6	161.2	29,189.2
Unsecured										
Excellent quality	**1,138.7**	**165.2**	**3.4**	**–**	**1,307.3**	455.7	56.6	0.8	–	513.1
Good quality	**219.2**	**257.9**	**4.2**	**–**	**481.3**	734.3	241.0	2.4	–	977.7
Satisfactory quality	**33.6**	**80.2**	**4.5**	**–**	**118.3**	111.8	113.8	3.3	–	228.9
Lower quality	**3.1**	**11.9**	**1.6**	**–**	**16.6**	9.5	22.1	1.8	–	33.4
Below standard (including in default)	**1.1**	**19.6**	**48.3**	**0.2**	**69.2**	5.1	29.7	67.1	0.1	102.0
Gross carrying amount	**1,395.7**	**534.8**	**62.0**	**0.2**	**1,992.7**	1,316.4	463.2	75.4	0.1	1,855.1
Business banking										
Excellent quality	**198.1**	**–**	**–**	**–**	**198.1**	68.9	3.3	–	–	72.2
Good quality	**123.3**	**0.9**	**0.1**	**–**	**124.3**	37.7	0.9	–	–	38.6
Satisfactory quality	**232.5**	**15.1**	**–**	**–**	**247.6**	11.4	5.4	–	–	16.8
Lower quality	**29.9**	**29.9**	**–**	**–**	**59.8**	–	–	–	–	–
Below standard (including in default)	**0.2**	**80.5**	**4.8**	**–**	**85.5**	–	–	3.5	–	3.5
Gross carrying amount	**584.0**	**126.4**	**4.9**	**–**	**715.3**	118.0	9.6	3.5	–	131.1

The table below sets out the credit quality, by stage, of lending commitments.

					2020					2019
Commitments	**Stage 1 £ million**	**Stage 2 £ million**	**Stage 3 £ million**	**POCI £ million**	**Total £ million**	Stage 1 £ million	Stage 2 £ million	Stage 3 £ million	POCI £ million	Total £ million
Excellent quality	**5,512.5**	**142.0**	**5.0**	**0.3**	**5,659.8**	4,037.5	461.1	2.1	0.5	4,501.2
Good quality	**294.6**	**173.4**	**1.9**	**18.0**	**487.9**	220.0	76.7	1.5	16.4	314.6
Satisfactory quality	**47.6**	**24.8**	**1.2**	**0.6**	**74.2**	51.4	29.3	1.0	0.5	82.2
Lower quality	**1.3**	**3.5**	**0.2**	**–**	**5.0**	1.2	11.2	0.4	0.1	12.9
Below standard (including in default)	**–**	**2.2**	**21.0**	**1.4**	**24.6**	0.5	3.3	36.7	2.2	42.7
Total	**5,856.0**	**345.9**	**29.3**	**20.3**	**6,251.5**	4,310.6	581.6	41.7	19.7	4,953.6

(iii) Collateral held as security for financial assets

Financial assets subject to expected credit loss requirements
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.

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

					2020					2019
LTV of Secured (retail	**Stage 1 £ million**	**Stage 2 £ million**	**Stage 3 £ million**	**POCI £ million**	**Total £ million**	Stage 1 £ million	Stage 2 £ million	Stage 3 £ million	POCI £ million	Total £ million
Less than 70%	**19,364.2**	**2,270.2**	**250.2**	**112.1**	**21,996.7**	18,880.4	1,593.0	211.8	114.0	20,799.2
70% to 80%	**5,539.9**	**189.4**	**40.9**	**20.7**	**5,790.9**	4,476.4	212.4	48.3	25.2	4,762.3
80% to 90%	**2,778.5**	**70.2**	**20.6**	**6.7**	**2,876.0**	2,839.2	125.2	24.4	14.5	3,003.3
90% to 100%	**79.1**	**5.5**	**14.1**	**3.7**	**102.4**	537.6	35.2	9.7	5.4	587.9
Greater than 100%	**12.1**	**4.9**	**6.8**	**0.6**	**24.4**	13.8	11.1	9.5	2.1	36.5
Secured (retail)	**27,773.8**	**2,540.2**	**332.6**	**143.8**	**30,790.4**	26,747.4	1,976.9	303.7	161.2	29,189.2

Notes to the consolidated financial statements

Managing financial risk (continued)

19. Credit risk (continued)

(iii) Collateral held as security for financial assets (continued)
TSB does not take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations. 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. In respect of the £576.8 million of Bounce Back loans, TSB benefits from a 100% guarantee from the British Business Bank.

Financial assets at fair value through profit or loss (not subject to expected credit loss requirements)
Derivative financial assets of £338.2 million (2019: £205.4 million) are largely cash collateralised interest rate swaps transacted through central clearing houses. The effect of the collateralisation is shown in note 22 under the heading 'Offsetting financial assets and financial liabilities'.

(iv) Forbearance and loan modifications
TSB operates a number of schemes to assist borrowers who are experiencing financial difficulties. Forbearance solutions may offer relief in the form of reductions to contractual payments including freezes to interest payments, and for customers who have longer term financial difficulties, term extensions and capitalisation of arrears. TSB applies the European Banking Authority definition of forbearance and at 31 December 2020, forborne loans were £301.3 million (2019: £301.8 million), of which £170.6 million (2019: £163.4 million) were credit impaired. At 31 December 2020, the allowance for loan losses held in respect of forborne loans was £26.3 million (2019: £20.2 million).

During 2020 gross balances of £14.7 million (2019: £12.9 million) in respect of unsecured loans were subject to modification of the original terms through the temporary freezing of customer interest obligations. At the time, the loans were categorised as either stage 2 or 3 and the allowance for expected credit losses was measured at lifetime expected credit loss. These resulted in modification losses of £0.8 million (2019: £0.7 million).

(v) COVID-19
In response to the COVID-19 pandemic, TSB introduced repayment holidays to enable customers to take a temporary break from making loan repayments where they are experiencing, or are reasonably expected to experience, payment difficulties caused by COVID-19. During the period of the repayment holiday, no further arrears are reported on customers' records although interest on the deferred payments continues to accrue.

At 31 December 2020, loans and advances to customers include £5,140.4 million (secured retail: £4,922.7 million, unsecured: £204.4 million and business banking: £13.3 million) where a repayment holiday had been granted in 2020 in response to the COVID-19 pandemic. Of this total £3,015.4 million were stage 1, £1,898.2 million were stage 2, and £226.8 million were stage 3.

At 31 December 2020, £411.5 million (secured retail: £371.8 million, unsecured: £26.4 million, and business banking: £13.3 million) relates to loans where the payment holidays remained in effect at the year end.

As repayment holidays are available to all customers impacted by COVID-19, and are not tailored to individual borrower circumstances, they are not included in the forbearance totals above.

As described on page 77, PMAs were applied to both the gross loan stage and the allowance for loan losses to reflect the increased risk of credit losses due to payment holidays.

Notes to the consolidated financial statements

Managing financial risk (continued)

20. Liquidity risk

Definition and exposure

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

Sources of funding

TSB's funding 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. Further information regarding sources of funding is available on pages 15 to 16.

Risk appetite

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

Measurement and monitoring

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

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

At 31 December 2020	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total Carrying Value £ million
Financial liabilities measured at amortised cost:						
Customer deposits	32,041.5	342.4	875.2	1,116.2	–	34,375.3
Borrowings from central banks	0.8	900.0	1,315.0	850.0	–	3,065.8
Debt securities in issue	–	0.4	–	1,698.8	–	1,699.2
Subordinated liabilities	–	–	3.4	387.9	–	391.3
Lease liabilities	–	–	2.6	34.3	86.4	123.3
Other financial liabilities	51.6	–	–	–	–	51.6
Derivative liabilities at fair value through profit or loss	2.4	0.3	12.4	157.0	130.2	302.3
Hedging derivative liabilities	–	3.2	4.9	71.9	145.2	225.2
Other liabilities(1)	196.0	–	87.0	66.1	117.0	466.1
Total liabilities	**32,292.3**	**1,246.3**	**2,300.5**	**4,382.2**	**478.8**	**40,700.1**
Financial assets at amortised cost:						
Cash, cash balances at central banks and demand deposits	5,056.6	–	–	–	–	5,056.6
Debt securities	3.1	0.6	1.5	379.7	738.8	1,123.7
Loans and advances to customers	877.1	288.6	1,354.6	6,676.4	24,121.2	33,317.9
Loans to credit institutions	41.8	–	–	1.5	–	43.3
Loans to central banks	120.9	–	–	–	–	120.9
Other advances	220.2	–	–	–	–	220.2
Financial assets at fair value through other comprehensive income	0.3	2.7	7.4	–	1,486.5	1,496.9
Derivative assets at fair value through profit or loss	0.8	0.6	5.8	180.7	10.4	198.3
Hedging derivative assets	–	–	4.4	70.6	64.9	139.9
Other assets (2)	157.1	3.8	21.2	167.8	339.1	689.0
Total assets	**6,477.9**	**296.3**	**1,394.9**	**7,476.7**	**26,760.9**	**42,406.7**

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

(2) Other assets comprise 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)

20. Liquidity risk (continued)

At 31 December 2019	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total Carrying Value £ million
Financial liabilities measured at amortised cost:						
Customer deposits	27,325.5	220.3	1,094.9	1,541.7	–	30,182.4
Repurchase agreements	–	–	–	–	–	–
Borrowings from central banks	8.5	–	10.0	4,465.0	–	4,483.5
Debt securities in issue	–	44.5	383.3	1,248.5	–	1,676.3
Subordinated liabilities	–	–	3.4	392.5	–	395.9
Lease liabilities	2.1	4.3	17.8	55.0	62.6	141.8
Other financial liabilities	81.3	–	–	–	–	81.3
Derivative liabilities at fair value through profit or loss	0.1	0.4	3.3	65.6	58.5	127.9
Hedging derivative liabilities	–	–	6.0	15.9	266.6	288.5
Other liabilities	205.1	–	–	–	52.2	257.3
Total liabilities	27,622.6	269.5	1,518.7	7,784.2	439.9	37,634.9
Financial assets at amortised cost:						
Cash, cash balances at central banks and demand deposits	4,595.2	–	–	–	–	4,595.2
Reverse Repurchase agreements		201.1	–	–	–	201.1
Debt securities	1.1	0.2	1.1	119.4	426.8	548.6
Loans and advances to customers	903.6	289.7	1,242.2	5,608.3	23,032.0	31,075.8
Loans to credit institutions	–	247.8	64.6	60.8	–	373.2
Loans to central banks	96.1	–	–	–	–	96.1
Other advances	279.6	–	–	–	–	279.6
Financial assets at fair value through other comp. income	0.3	1.9	8.4	–	1,576.8	1,587.4
Derivative assets at fair value through profit or loss	0.2	1.2	3.1	72.6	34.9	112.0
Hedging derivative assets	–	–	46.5	26.2	20.7	93.4
Other assets	129.4	2.4	10.9	81.8	334.0	558.5
Total assets	6,005.5	744.3	1,376.8	5,969.1	25,425.2	39,520.9

Expected cash flows on customer deposits and loans and advances to customers vary significantly from the contractual cash flows shown in the table above. Customer deposits are largely repayable on demand but have proven to be a stable source of funding. Loans and advances to customers comprise of a large proportion of mortgages which mature earlier than the contractual maturity as customers take advantage of early redemption options.

Notes to the consolidated financial statements

Managing financial risk (continued)

20. Liquidity risk (continued)

Contractual maturities for financial liabilities form an important source of information for the management of liquidity risk. The table below analyses financial liabilities and commitments by relevant contractual maturity grouping on an undiscounted future cash flow basis, which includes estimated interest payments.

At 31 December 2020	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:						
Customer deposits	**32,043.7**	**343.5**	**900.7**	**1,127.1**	**–**	**34,415.0**
Borrowings from central banks	**0.8**	**900.2**	**1,316.6**	**850.3**	**–**	**3,067.9**
Debt securities in issue	**–**	**7.6**	**23.0**	**1,750.1**	**–**	**1,780.7**
Subordinated liabilities	**–**	**–**	**396.1**	**–**	**–**	**396.1**
Lease liabilities	**0.2**	**6.4**	**17.3**	**75.5**	**29.4**	**128.8**
Other financial liabilities	**51.6**	**–**	**–**	**–**	**–**	**51.6**
Loan commitments	**3,847.4**	**172.0**	**1,972.4**	**25.7**	**234.0**	**6,251.5**
	35,943.7	**1,429.7**	**4,626.1**	**3,828.7**	**263.4**	**46,091.6**
Derivative financial instruments - outflows	**15.3**	**97.6**	**100.4**	**282.4**	**205.4**	**701.1**
Derivative financial instruments - inflows	**(1.2)**	**(1.9)**	**(4.4)**	**(45.0)**	**(121.0)**	**(173.5)**
Total financial liabilities	**35,957.8**	**1,525.4**	**4,722.1**	**4,066.1**	**347.8**	**46,619.2**

At 31 December 2019	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Liabilities						
Financial liabilities measured at amortised cost:						
Customer deposits	27,348.6	224.7	1,110.9	1,561.3	–	30,245.5
Borrowings from central banks	8.5	–	10.0	4,465.0	–	4,483.5
Debt securities in issue	30.4	15.8	354.9	1,298.9	–	1,700.0
Subordinated liabilities	–	–	22.1	396.1	–	418.2
Lease liabilities	2.6	5.1	21.1	61.0	68.0	157.8
Other financial liabilities	81.3	–	–	–	–	81.3
Loan commitments	3,523.4	162.8	1,012.9	30.8	223.7	4,953.6
	30,994.8	408.4	2,531.9	7,813.1	291.7	42,039.9
Derivative financial instruments - outflows	20.5	63.8	154.6	422.1	370.7	1,031.7
Derivative financial instruments - inflows	(15.7)	(23.0)	(97.5)	(261.6)	(201.8)	(599.6)
Total financial liabilities	30,999.6	449.2	2,589.0	7,973.6	460.6	42,472.0

The amounts shown are the net amounts for those derivatives that are net settled, which comprises the majority of TSB's derivative financial instruments. Gross nominal inflows and outflows are presented for derivatives that have simultaneous gross settlement such as cross currency swaps.

21. Capital resources

TSB maintains capital resources which exceed regulatory requirements and which seek to support the strategic growth of the business, and ensure that TSB is able to absorb losses under stressed conditions. Capital risk is managed under a framework where risk appetite is set and approved annually by the Board. A series of metrics are used to monitor capital against early warning indicators with regular reporting in place to update and inform senior management. Further information on capital resources is shown on pages 15 and 16 in the Financial performance in 2020 section of the Strategic report. The table below presents TSB's regulatory capital resources.

	2020 £ million	2019 £ million
Shareholder's equity	**1,706.6**	1,886.0
Regulatory deductions	**(125.2)**	(62.6)
Common Equity Tier 1/Total Tier 1 capital	**1,581.4**	1,823.4
Tier 2 capital	**432.8**	393.5
Total capital resources	**2,014.2**	2,216.9

Notes to the consolidated financial statements

Managing financial risk (continued)

22. Market risk

Definition and exposure

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

Management and measurement

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

A 12 month view of the sensitivity of net interest income is calculated on the basis of TSB's current consolidated balance sheet with re-pricing dates adjusted according to behavioural assumptions. At 31 December 2020, 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 £18.4 million (2019: £12.8 million) from a 25bps increase in rates, and a decrease of £18.6 million (2019: £13.1 million) from a 25bps decrease. The measure assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount and does not take into account potential management actions.

Derivative financial instruments

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

Derivative financial instruments at fair value through profit or loss	2020 Contract/ notional amount £ million	2020 Assets fair value £ million	2020 Liabilities fair value £ million	2020 Gain/(loss) recognised in profit or loss £ million	2019 Contract/ notional amount £ million	2019 Assets fair value £ million	2019 Liabilities fair value £ million	2019 Gain(loss) recognised in profit or loss £ million
Interest rate swaps	**20,790.4**	**198.3**	**(299.6)**	**(0.5)**	22,917.2	110.7	(127.9)	(14.7)
Foreign exchange forwards	**–**	**–**	**–**	**–**	–	–	–	0.4
Equity forwards and options	**5.7**	**–**	**(2.7)**	**(4.5)**	11.7	1.3	–	(0.3)
Total	**20,796.1**	**198.3**	**(302.3)**	**(5.0)**	22,928.9	112.0	(127.9)	(14.6)

Hedging derivative financial instruments	2020 Contract/ notional amount £ million	2020 Assets fair value £ million	2020 Liabilities fair value £ million	2020 Change in fair value used for calculating hedge ineffectiveness £ million	2019 Contract/ notional amount £ million	2019 Assets fair value £ million	2019 Liabilities fair value £ million	2019 Change in fair value used for calculating hedge ineffectiveness £ million
(Fair value hedges)								
Interest rate risk								
Interest rate swaps	**18,658.5**	**139.9**	**(216.7)**	**(116.8)**	14,292.8	44.6	(281.1)	(82.0)
(Cash flow hedges)								
Interest rate and credit risk								
Forward settlement contracts	**140.9**	**–**	**(2.2)**	**(12.9)**	190.0	2.9	–	1.8
Interest rate risk								
Interest rate swaps	**185.0**	**–**	**(6.3)**	**(21.4)**	404.9	2.3	(7.4)	(6.1)
Foreign exchange risk								
Cross currency rate swaps	**–**	**–**	**–**	**–**	270.1	43.6	–	(20.0)
Total	**18,984.4**	**139.9**	**(225.2)**	**(151.1)**	15,157.8	93.4	(288.5)	(106.3)

Managing financial risk (continued)

22. Market risk (continued)

Risk management

Where all relevant criteria are met, hedge accounting is applied to remove the accounting mismatch between the hedging instrument and the hedged item. Where derivatives do not meet the hedge accounting criteria they are classified as 'fair value through profit or loss'.

TSB transacts derivatives largely to economically hedge interest rate risk. TSB hedges LIBOR and SONIA benchmark interest rate risk using both fair value hedges and cash flow hedges. As a result of TSB's dynamic hedging strategies described below, the loss on derivatives at fair value through profit or loss in respect of interest rate risk of £0.5 million (2019: £14.7 million) should be considered in conjunction with the gain of £7.7 million (2019: £18.2 million) from the amortisation of accumulated adjustments on the hedged items for which hedge accounting no longer applies.

IBOR reform

Background

IBOR reform refers to the global reform and replacement of interbank offered rates (IBOR) with alternative interest rate benchmark reference rates. In order to manage TSB's response, in 2019, a cross-functional Reference Rate Replacement Steering Committee was established, reporting to the Asset & Liability Committee. The committee has primarily focused on evaluating TSB's exposure to financial instruments and other contracts that are impacted by IBOR reform and to oversee their amendment or replacement. In addition the committee has considered the impact of IBOR reform on its interest rate risk management to enable TSB to take the necessary actions in response ahead of the transition deadline.

The committee concluded that financial instruments impacted by IBOR reform were limited to two classes of financial instruments, being a portfolio of interest rate swaps and the £500 million covered bond issued by TSB in December 2017. These referenced LIBOR which is being replaced by the end of 2021.

In respect of the interest rate swaps that reference LIBOR, during 2020, swaps with a notional amount of £1,517.5 million were replaced with economically equivalent swaps that reference SONIA. At 31 December 2020, the residual portfolio had a notional amount of £17,144.2 million. Of these, £16,206.7 million mature within the next five years, £598.9 million mature after five years but before ten years, and £338.6 million mature after ten years. Plans have been established to replace the remaining swaps during 2021. As explained in note 2, during 2020 the terms of the covered bond were modified and since September 2020 have referenced SONIA.

Hedge accounting policy

At 31 December 2020, interest rate swaps that reference LIBOR with a notional amount of £8,187.7 million (2019: £11,771.3 million) were designated as fair value hedges of fixed rate exposures. The LIBOR linked covered bond was previously in a cash flow hedge relationship that hedged the LIBOR based expected future cash flows. This hedge relationship was dedesignated during 2020 when the covered bond was modified to SONIA. TSB considers these hedge accounting relationships to be directly affected by IBOR reform as the interest rate risk designated in the fair value hedging relationship is based on LIBOR, and the timing and amount of covered bond LIBOR cash flows are uncertain.

TSB applies the reliefs permitted by 'Interest Rate Benchmark Reform – Amendments to IFRS 9, IAS 39 and IFRS 9' (the Phase 1 Amendment). As such, in assessing whether fair value hedge relationships are expected to be highly effective (applying a prospective effectiveness assessment), it is assumed that the benchmark interest rate is not altered as a result of IBOR reform. For a cash flow hedge of a forecast transaction, it is assumed that the benchmark interest rate will not be altered as a result of IBOR reform for the purpose of asserting that the forecast transaction is highly probable. In determining whether a previously designated forecast transaction is no longer expected to occur, TSB assumes that the hedged interest rate benchmark cash flows will not be altered as a result of IBOR reform.

In 2020, the IASB issued 'Interest Rate Benchmark Reform – Phase 2' (the Phase 2 Amendment) which is effective from 1 January 2021, with early adoption permitted. This permits TSB's fair value hedge relationships to persist where the LIBOR swap was replaced with a SONIA equivalent, as the replacement is considered to be undertaken solely due to IBOR reform and the replacement SONIA swap is economically equivalent to the original LIBOR swap. In addition, TSB has applied the relief which permits amendment of the hedging documentation to reference SONIA and to revise the description of the hedged item. TSB has also applied the relief which permits the amount in the cash flow hedge reserve relating to a dedesignated hedge to be deemed to be based on the alternative benchmark rate, on which the future cash flows will be based. TSB has elected to early adopt the Phase 2 Amendment, applying it retrospectively to its hedge accounting relationships.

Notes to the consolidated financial statements

Managing financial risk (continued)

22. Market risk (continued)

Hedge accounting overview

The profile of interest risk being managed is dynamic, changing in response to business activity and is economically hedged with derivatives. Where natural offsets occur, these derivatives are not designated in hedge accounting relationships. The remaining derivatives may be designated in a hedge accounting relationship to minimise profit volatility. Hedge relationships are considered effective where changes in the hedged item offset changes in the hedging instrument to within an 80% to 125% ratio. Effectiveness tests are performed at inception and on a monthly basis using either dollar offset, linear regression or critical terms match, depending on the nature of the hedged items. Ineffectiveness arising on hedge relationships can arise due to a number of factors which include basis mismatch, maturity mismatch, credit valuation adjustments and cash flow timing mismatch between the hedged item and hedging instrument.

Macro fair value hedge accounting – fixed rate mortgages and demand deposits

Pay fixed, receive floating interest rate swaps are typically designated as a portfolio fair value hedge of fixed rate mortgage assets and 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, TSB's approach is to dedesignate these hedge relationships and redesignate new relationships on a monthly basis. 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.

Micro fair value hedge accounting –subordinated debt and debt securities

TSB has issued fixed rate subordinated debt and purchased fixed rate debt securities as part of its Treasury management strategy, and these are hedged with interest rate swaps and designated in a fair value hedge.

Cash flow hedge accounting – forward bond sales

TSB seeks to minimise interest rate and credit risk arising on purchased hold to collect and sell debt securities, using forward settlement contracts. The sales proceeds represent a forecast transaction which is hedged by the forward contract. At 31 December 2020, forward settlement agreements with a notional amount of £140.9 million (2019: £190.0 million) were expected to mature within one year (2019: within one year) at a price of 160% of the notional amount (2019: 123%).

Cash flow hedge accounting – covered bonds

Interest rate risk on issued floating rate covered bonds is hedged using interest rate swaps that exchange floating rate cash flows for fixed rate cash flows. At 31 December 2020, hedged forecast covered bond cash flows were expected to mature after five years.

Cash flow hedge accounting – foreign currency debt securities in issue

TSB previously issued Euro denominated floating rate securitisation notes and as a result was exposed to foreign currency risk as TSB's functional currency is pounds sterling. TSB hedged the foreign currency exposure via cross currency interest rate swaps that exchanged floating rate euro cash flows and principal for floating rate sterling cash flows and principal. At 31 December 2020, these issuances had matured, however in 2019, cross currency swaps with a notional amount of: £270.1 million were expected to mature within year. The average exchange rate applicable to these cross currency swaps in 2019 was £1/€1.14.

Exposures covered by hedging accounting strategies

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

2020	Carrying amount of hedged item assets/(liability) £ million	Accumulated fair value hedge adj. on hedged item £ million	Balance sheet line item that includes the hedged item	Change in fair value for calculating hedge ineffectiveness £ million	Cash flow hedge reserve continuing hedges £ million
Interest rate risk (Fair value hedges)					
Portfolio hedged risk:					
Demand deposits	**(6,123.5)**	**(117.0)**	**Customer deposits**	**(69.9)**	**n/a**
Fixed rate mortgages	**10,545.4**	**80.2**	**Loans & adv to customers**	**58.4**	**n/a**
Individual hedged risk:					
Fixed rate subordinated liabilities	**(391.3)**	**(3.0)**	**Subordinated liabilities**	**4.9**	**n/a**
Debt securities	**1,271.0**	**–**	**Financial assets at FVOCI**	**102.3**	**n/a**
Debt securities	**898.0**	**31.2**	**Financial assets at amortised cost**	**19.8**	**n/a**
				115.5	**n/a**
Interest rate / credit risk (Cash flow hedges)					
Debt securities	**225.8**	**n/a**	**Financial assets at FVOCI**	**12.9**	**(2.2)**
Interest rate (Cash flow hedges)					
Covered bonds issued	**185.0**	**n/a**	**Debt securities in issue**	**21.1**	**(25.3)**

Notes to the consolidated financial statements

Managing financial risk (continued)

22. Market risk (continued)

Exposures covered by hedging accounting strategies (continued)

2019	£ million	£ million	Balance sheet line item that includes the hedged item	£ million	£ million
Interest rate risk (Fair value hedges)					
Portfolio hedged risk:					
Demand deposits	(6,335.9)	(52.2)	Customer deposits	(53.6)	n/a
Fixed rate mortgages	6,309.2	20.5	Loans & adv to customers	48.0	n/a
Individual hedged risk:					
Fixed rate subordinated liabilities	(395.9)	(7.9)	Subordinated liabilities	2.5	n/a
Debt securities	1,354.7	–	Financial assets at FVOCI	78.6	n/a
Debt securities	317.3	11.4	Financial assets at amortised cost	9.1	n/a
	1,249.4	(28.2)		84.6	n/a
Interest rate / credit risk (Cash flow hedges)					
Debt securities	232.8	n/a	Financial assets at FVOCI	(6.2)	(2.9)
Interest rate (Cash flow hedges)					
Covered bonds issued	404.9	n/a	Debt securities in issue	2.9	5.8
Foreign exchange risk (Cash flow hedges)					
Securitisation notes issued	270.1	n/a	Debt securities in issue	20.0	(0.2)

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 £116.0 million (2019: £108.8 million).

Hedge accounting ineffectiveness

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

				Amounts reclassified from reserves to P&L as:	
2020	**Hedge ineffectiveness recognised in P&L £ million**	**Gain/(loss) recognised in OCI £ million**	**P&L line item that includes hedge ineffectiveness**	**Hedged item affected P&L £ million**	**P&L line item that includes reclassified amount £ million**
Interest rate risk (Fair value hedges)	**(1.3)**	**–**	**Gains from hedge accounting**	**n/a**	**n/a**
Interest rate / credit risk (Cash flow hedges)	**–**	**(12.9)**	**n/a**	**7.7**	**Other income**
Interest rate (Cash flow hedges)	**(0.3)**	**(21.1)**	**Gains from hedge accounting**	**1.7**	**Other income**
Foreign exchange risk (Cash flow hedges)	**–**	**12.5**	**n/a**	**(12.3)**	**Other income**
	(1.6)	**(21.5)**		**(2.9)**	
2019					
Interest rate risk (Fair value hedges)	2.6	–	Gains from hedge accounting	n/a	n/a
Interest rate / credit risk (Cash flow hedges)	–	1.8	n/a	3.6	Other income
Interest rate risk (Cash flow hedges)	–	(6.2)	n/a	0.3	Other income
Foreign exchange risk (Cash flow hedges)	–	(20.0)	n/a	20.5	Other income
	2.6	(24.4)		24.4	

Gains from hedge accounting in the income statement of £5.8 million (2019: £20.8 million) comprise hedge ineffectiveness of £(1.6) million (2019: £2.6 million) and £7.4 million (2019: £18.2 million) of amortisation of de-designated cash flow hedges and fair value hedge adjustments on hedged items for which hedge accounting had previously been discontinued.

Notes to the consolidated financial statements

Managing financial risk (continued)

22. Market risk (continued)

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

	2020 Fair value reserve £ million	2020 Cash flow hedge reserve £ million	2019 Fair value reserve £ million	2019 Cash flow hedge reserve £ million
Balance as at 1 January	**13.6**	**(2.5)**	18.6	(3.2)
Amounts recognised in other comprehensive income:				
Interest rate risk (fair value hedge)				
Changes in fair value of purchased debt securities	**117.0**	**n/a**	95.9	n/a
Accumulated fair value hedge adjustment	**(102.2)**	**n/a**	(78.6)	n/a
Net amounts reclassified to profit or loss	**(17.0)**	**n/a**	(24.6)	n/a
Taxation	**0.2**	**n/a**	2.3	n/a
Interest rate and credit risk (cash flow hedges)				
Effective portion of changes in fair value of forward contracts	**n/a**	**(12.9)**	n/a	1.8
Amounts reclassified from reserves to profit or loss	**n/a**	**7.7**	n/a	3.6
Taxation	**n/a**	**1.4**	n/a	(0.7)
Interest rate (cash flow hedges)				
Effective portion of changes in fair value of interest rate swaps	**n/a**	**(21.1)**	n/a	(6.2)
Amounts reclassified from reserves to profit or loss	**n/a**	**1.7**	n/a	0.3
Taxation	**n/a**	**5.3**	n/a	1.4
Foreign exchange risk (cash flow hedges)				
Effective portion of changes in fair value of cross currency swaps	**n/a**	**12.5**	n/a	(20.0)
Amounts reclassified from reserves to profit or loss	**n/a**	**(12.3)**	n/a	20.5
Balance as at 31 December	**11.6**	**(20.2)**	13.6	(2.5)

Offsetting financial assets and financial liabilities

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

				Related amounts where set off in the balance sheet is not permitted		
At 31 December 2020	Gross amounts £ million	Amounts offset £ million	Net amounts reported on the balance sheet £ million	Related financial instrument amounts not offset £ million	Cash collateral (received)/ pledged[1] £ million	Net amount £ million
Derivative financial assets	**338.2**	**–**	**338.2**	**(338.2)**	**–**	**–**
Reverse repurchase agreements	**225.8**	**(225.8)**	**–**	**–**	**–**	**–**
Other assets	**347.8**	**(192.6)**	**155.2**	**–**	**–**	**155.2**
Derivative financial liabilities	**(527.5)**	**–**	**(527.5)**	**338.2**	**189.3**	**–**
Repurchase agreements	**(225.8)**	**225.8**	**–**	**–**	**–**	**–**
Other liabilities (note 31)	**(388.6)**	**192.6**	**(196.0)**	**–**	**–**	**(196.0)**
At 31 December 2019						
Derivative financial assets	205.4	–	205.4	(157.9)	(4.1)	43.4
Reverse repurchase agreements	201.1	–	201.1	(190.7)	(0.4)	10.0
Other assets	321.0	(192.6)	128.4	–	–	128.4
Derivative financial liabilities	(416.4)	–	(416.4)	157.9	258.5	–
Other liabilities (note 31)	(345.9)	192.6	(153.3)	–	–	(153.3)

(1) Collateral amounts (cash and non-cash financial collateral) are reflected at their fair value and this amount is limited to the net balance sheet exposure in order to exclude any over collateralisation. The collateral amount presented includes non-cash collateral of £8.4 million.

Notes to the consolidated financial statements

Other important disclosures

Accounting policies relevant to this section

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

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

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

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

(m) Premises and equipment
Property, plant and equipment are recognised at cost less accumulated depreciation. Cost includes the original purchase price of the assets and the costs attributable to bringing the asset into working condition for its intended use. Subsequent expenditure is capitalised only if it is probable that future economic benefits associated with the expenditure will flow to TSB. The value of land (included in premises) is not depreciated. Depreciation on other premises and equipment is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows:

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

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date. Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset’s carrying amount is determined to be greater than its recoverable amount it is written down immediately. The recoverable amount is the higher of the asset’s fair value less costs to sell and its value in use.

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

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

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

The right-of-use asset is subsequently depreciated using the straight-line method from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. The estimated useful lives of right-of-use assets are determined on the same basis as those of property and equipment. The right-of-use asset is written down by any impairment losses, for example where a leased property will be closed before the end of the lease term, and is adjusted for certain remeasurements of the lease liability. No lease liability or related right of use asset is recognised in respect of short term leases, of less than one year, or leases of low value assets. As permitted by accounting standards, the cost of such leases are expensed as incurred.

Notes to the consolidated financial statements

Other important disclosures (continued)

Accounting policies relevant to this section (continued)

(n) Leases (continued)

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

(o) Intangible assets

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

Computer software intangible assets are amortised using the straight line method over their estimated useful lives of between 3 and 5 years. Amortisation commences when the assets are ready for their intended use. Estimated useful lives are reviewed annually and adjusted, if appropriate, in the light of technological developments, usage and other relevant factors. Computer software is reviewed for indicators of impairment at each reporting date and whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Where the carrying amount is not recoverable the asset is written down immediately to the estimated recoverable amount.

23. Shareholder's equity

	Share capital £ million	Share premium £ million	Merger reserve £ million	Capital reorg-anisation reserve £ million	Capital reserve £ million	Fair value reserve £ million	Cash flow hedging reserve £ million	Retained profits £ million
Balance at 1 January 2019	5.0	965.1	616.5	(1,311.6)	410.0	18.6	(3.2)	1,163.6
Net change in fair value reserve	–	–	–	–	–	(5.0)	–	–
Net change in cash flow hedging reserve	–	–	–	–	–	–	0.7	–
Profit for the year	–	–	–	–	–	–	–	26.3
At 31 December 2019	5.0	965.1	616.5	(1,311.6)	410.0	13.6	(2.5)	1,189.9
Net change in fair value reserve	**–**	**–**	**–**	**–**	**–**	**(2.0)**	**–**	**–**
Net change in cash flow hedging reserve	**–**	**–**	**–**	**–**	**–**	**–**	**(17.7)**	**–**
Loss for the year	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**(159.7)**
At 31 December 2020	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**11.6**	**(20.2)**	**1,030.2**

At 31 December 2020, TSB Banking Group plc had in issue 500.0 million (2019: 500.0 million) one pence ordinary shares authorised, allotted and fully paid up.

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

The capital reserve represents a capital contribution received in 2013 from a, then, parent company. The fair value reserve represents the unrealised change in the value of financial assets at fair value through other comprehensive income since the instrument's initial recognition. The cash flow hedging reserve represents the cumulative gains and losses on effective cash flow hedging instruments that will be recycled to the income statement when the hedged transactions affect profit or loss.

Notes to the consolidated financial statements

Other important disclosures (continued)

24. Contingent liabilities

Significant judgement

Regulatory and conduct matters
During 2018, the FCA and PRA commenced a formal joint investigation in connection with the handling of the migration of data and IT systems. This investigation is ongoing and it is not yet possible to determine its outcome.

Further, as explained in note 30, management and the FCA are investigating conduct related matters in TSB's collection and recoveries function for which a provision covering the estimated redress costs has been recognised. It is not, however, currently possible to conclude if any regulatory penalty will be levied and therefore no costs for an estimated penalty have been recognised in these financial statements.

25. Related party transactions

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

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

	2020 £ 000	2019 £ 000
Short term employee benefits	**5,597**	7,448
Post-employment benefits	**730**	808
Other long term benefits	**–**	765
Share based payments	**–**	1,084
Payments for loss of office	**459**	1,170
Total	**6,786**	11,275

The decrease in compensation payable to key management personal in 2020 largely reflects the absence of variable reward costs.

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.

	2020 £ 000	2019 £ 000
Loans		
At 1 January	**11**	5
Advances (includes key management personnel appointed during the year)	**216**	87
Interest charged during the year	**–**	–
Repayments made during the year (including key management personnel resigned during the year)	**(194)**	(81)
At 31 December	**33**	11

The loans attracted interest at customer rates and were made in the ordinary course of business. Expected credit losses are assessed to be immaterial.

Notes to the consolidated financial statements

Other important disclosures (continued)

25. Related party transactions (continued)

	2020 £ 000	2019 £ 000
Deposits		
At 1 January	**1,796**	1,377
Deposits made during the year (includes key management personnel appointed during the year)	**4,471**	5,900
Interest expense on deposits	**7**	6
Withdrawals made during the year (including key management personnel resigned during the year)	**(4,361)**	(5,486)
At 31 December	**1,913**	1,797

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

(ii) Transactions and balances with Sabadell Group companies

Operational IT costs

Operating expenses of £124.8 million (2019: £167.0 million) were incurred in respect of services provided by Sabis, TSB's parent company's IT supplier, under the OSA for running and developing the banking platform. The decrease during 2020 reflects that in December 2019, as part of the strategy to take direct management of suppliers of IT services, TSB entered into an agreement with IBM to provide IT services to TSB. The contract became effective from 1 January 2020 and these services became operational on a phased basis throughout 2020. These services were previously provided by Sabis under the OSA which has been amended to remove the relevant services with effect from the date that IBM's service became operational.

Residual IT Migration related balances

In connection with the IT migration in 2018, the MSA and OSA contracts provide TSB with the right to seek recovery of eligible losses for breach of contract up to the level of liability caps in each agreement. The respective parties have reached provisional agreement, subject to mutual reservations of rights while negotiations are concluded, to recognise an aggregate estimated recovery under the agreements of £192.6 million (2019: £192.6 million), reflecting the maximum recovery amount under the contracts. TSB intends to settle on a net basis and consequently, the residual MSA liability of £100.0 million (2019: £100.0 million) has been presented on the statement of financial position net of the recovery of £100.0 million (2019: £100.0 million). The amount payable to Sabis in respect of the OSA and other change services of £113.9 million (2019: £95.2 million) is presented net of recovery of £92.6 million (2019: £92.6 million). Taken together, the aggregate liability to Sabis recognised on the consolidated balance sheet is £21.3 million (2019: £2.6 million) (note 31).

Issuance of senior unsecured debt securities

In December 2020, TSB issued £450.0 million of floating rate notes June 2023 to its parent company Sabadell, at an issue price of 100% of the principal amount. The notes pay interest at SONIA plus 2.1%. Interest expense of £0.1 million was recognised in 2020 and was payable at 31 December 2020.

Economic hedging of share based compensation liability

TSB holds forward purchase agreements with Sabadell to acquire 10.5 million (2019: 6.6 million) Sabadell shares to satisfy estimated requirements under various share based compensation arrangements. This forward agreement had a liability fair value of £2.7 million (2019: asset fair value of £0.5 million) and TSB had placed cash collateral with Sabadell of £2.7 million (2019: Sabadell had placed cash collateral with TSB of £0.6 million).

At 31 December 2019, TSB held options from Sabadell to acquire 8.3 million Sabadell shares at an exercise price of 77.68p in order to hedge the risk associated with the TSB Sharesave scheme. These options had a fair value of £0.8 million at 31 December 2019 and Sabadell had placed cash collateral of £1.4 million. At 31 December 2020, no options remained outstanding under the TSB Sharesave scheme (note 16).

Other transactions and balances

Sabadell acts as an intermediary for TSB in respect of international payments and TSB has nostro accounts as a result of this arrangement which had a net balance due from Sabadell of £1.9 million (2019: £4.9 million).

Notes to the consolidated financial statements

Other important disclosures (continued)

26. Property and equipment

	Property £ million	Equipment £ million	Property Right of use leasing asset £ million	Total £ million
Cost				
At 1 January 2019	231.7	111.7	163.0	506.4
Additions	17.1	4.7	13.7	35.5
Disposals	(3.0)	(5.0)	–	(8.0)
Lease term remeasurement	–	–	(6.6)	(6.6)
Write-offs	–	–	(2.8)	(2.8)
At 31 December 2019	245.8	111.4	167.3	524.5
Additions	**10.5**	**23.8**	**5.1**	**39.4**
Disposals	**(22.3)**	**(12.4)**	**(5.2)**	**(39.9)**
Lease term remeasurement	–	–	**1.5**	**1.5**
At 31 December 2020	**234.0**	**122.8**	**168.7**	**525.5**
Accumulated depreciation				
At 1 January 2019	108.1	72.2	–	180.3
Depreciation charge for property and equipment (note 14)	19.1	7.2	–	26.3
Depreciation charge for right of use asset (note 14)	–	–	28.2	28.2
Write-offs	(1.4)	(1.6)	(0.5)	(3.5)
At 31 December 2019	125.8	77.8	27.7	231.3
Depreciation charge for property and equipment (note 14)	**27.8**	**14.0**	–	**41.8**
Depreciation charge for right of use asset (note 14)	–	–	**25.8**	**25.8**
Disposals	**(19.3)**	**(12.3)**	**(0.7)**	**(32.3)**
At 31 December 2020	**134.3**	**79.5**	**52.8**	**266.6**
Carrying amount				
At 31 December 2019	120.0	33.6	139.6	293.2
At 31 December 2020	**99.7**	**43.3**	**115.9**	**258.9**

27. Lease liabilities

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

Lease liability	Property 2020 £ million	Property 2019 £ million
Balance at 1 January	**141.8**	171.9
Additions	**5.1**	13.7
Lease term remeasurement	**1.5**	(6.6)
Interest expense for the year	**1.3**	1.6
Lease payments made in the year	**(26.4)**	(38.8)
Carrying amount at 31 December	**123.3**	141.8

Notes to the consolidated financial statements

Other important disclosures (continued)

28. Intangible assets

	2020 £ million	2019 £ million
Cost		
At 1 January	**30.5**	22.9
Additions	**35.9**	7.6
At 31 December	**66.4**	30.5
Accumulated amortisation		
At 1 January	**10.2**	4.5
Amortisation charge for the year (note 14)	**6.7**	5.7
At 31 December	**16.9**	10.2
Carrying amount	**49.5**	20.3

29. Other assets

	2020 £ million	2019 £ million
Other assets and prepayments	**144.3**	114.0
Amounts recoverable under customer remediation indemnity (note 30)	**10.9**	14.4
Total other assets	**155.2**	128.4

30. Provisions

	Restructuring provision(2) £ million	Customer redress provisions £ million	Operational losses provision £ million	Credit impairment provisions £ million	Total £ million
At 1 January 2020	28.5	19.6	1.1	2.6	51.8
Transfers(1)	**–**	**–**	**–**	**15.3**	**15.3**
Charge to the income statement	**64.0**	**56.2**	**–**	**1.3**	**121.5**
Reversals to the income statement	**(2.3)**	**(2.9)**	**–**	**–**	**(5.2)**
Utilisation	**(22.4)**	**(6.8)**	**(1.1)**	**–**	**(30.3)**
At 31 December 2020	**67.8**	**66.1**	**–**	**19.2**	**153.1**

(1) During 2020, the methodology for allocating expected credit losses on revolving facilities was changed such that ECL in excess of a customer's drawn balance is now presented in the credit impairment provision. This change resulted in the transfer of £15.3 million from the allowance for credit impairment losses to the credit impairment provision.

(2) Included in the net charge to the income statement of £61.7 million, is £39.7 million reported in severance costs and £22.0 million reported in rates, maintenance and other premises expenses in note 14.

Significant estimates

Customer redress provisions

During 2020, management and the FCA commenced a review of support treatments offered to some customers who are, or were, in arrears and being serviced by TSB's collections and recoveries department. While not yet complete, this has identified an indicative early view of potentially impacted customers over a period from 2013 to 2020 who may have suffered either financial loss or distress and inconvenience. The assessment of the potential cost of customer redress, including compensatory interest, and related operational costs are estimated to lie within a range of £53.1 million to £57.4 million and are dependent on the assumed rates of redress and range of remediation strategies deployed. A provision of £55.0 million has been recognised and is expected to be utilised over the next two to three years. As the assessment of the potential costs of redress continues to take place, estimating the amount of the provision requires judgement, particularly with respect to the number of customers who may have been affected, the estimated financial loss suffered by customers and the estimated rates of redress.

In respect of other customer redress matters, TSB is largely protected from losses arising from historic misconduct under an indemnity provided by Lloyds Bank plc. However, TSB retains the primary liability for the alleged misconduct to its customers and a provision for customer remediation of £11.1 million (2019: £19.6 million) is carried. A recoverable of £10.9 million (2019: £14.4 million) has been recognised under the indemnity provided by Lloyds Bank plc (note 29). 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)

30. Provisions

Significant estimates

Restructuring provision
At 31 December 2020, TSB carried provisions of £67.8 million (2019: £28.5 million) in respect of estimated costs to restructure the Bank as part of TSB's strategy. This included estimated costs in respect of the closure of 164 branches that were announced in September 2020, residual costs in respect of an earlier phase of branches closures announced in 2019 and the estimated severance costs arising from organisational change across a number of head office functions. The amounts are expected to be settled in 2021.

Estimating the amount of the provision requires judgement, particularly with respect to the estimated costs of branch decommissioning costs and dilapidation costs in respect of leasehold properties. In estimating the provision, experience gained from recent branch closures was used, together with supporting evidence from property advisors. An increase/decrease of 10% to the average branch decommissioning costs and to the dilapidation rate per leasehold branch would have increased/decreased the provision balance at 31 December 2020 by £2.4 million.

31. Other liabilities

	2020 £ million	2019 £ million
Amounts payable to Sabadell Group companies (note 25)	**21.3**	2.6
Accruals and deferred income	**87.6**	70.1
Share based payment liability	**4.1**	5.4
Other creditors	**83.0**	75.2
Total other liabilities	**196.0**	153.3

Significant judgement – MSA and OSA contract liabilities

The MSA and OSA contracts provide TSB with the right to seek recovery of eligible losses for breach of contract up to the level of liability caps in each agreement. The parties have reached provisional agreement, subject to mutual reservation of rights while negotiations are concluded, where TSB will recover an aggregate of £192.6 million (2019: £192.6 million) under the respective contracts.

As the parties have the legal right and intend to settle these amounts net, the amounts payable to Sabis under the MSA and OSA contracts are presented on the statement of financial position net of the estimated recovery of £192.6 million (2019: £192.6 million).

32. Notes to the consolidated cash flow statement

The table below presents the change in liabilities arising from financing activities.

	Borrowings from central banks £ million	Debt securities in issue £ million	Subordinated liabilities £ million	Repurchase agreements £ million	Total non customer funding £ million
At 1 January 2019	6,482.2	1,122.6	398.2	1,084.8	9,087.8
Repayment of borrowings from central banks (net)	(1,995.0)	–	–	–	(1,995.0)
Repayment of securitisation funding(1)	–	(177.5)	–	–	(177.5)
Issuance of covered bonds	–	750.0	–	–	750.0
Repayments of repurchase agreements (net)	–	–	–	(1,084.8)	(1,084.8)
Exchange differences(1)		(20.5)			(20.5)
Non-cash movements	(3.7)	1.7	(2.3)	–	(4.3)
At 31 December 2019	4,483.5	1,676.3	395.9	–	6,555.7
Repayment of borrowings from central banks (net)	**(1,410.0)**	**–**	**–**	**–**	**(1,410.0)**
Repayment of securitisation funding	**–**	**(440.2)**	**–**	**–**	**(440.2)**
Issuance of senior unsecured debt securities	**–**	**450.0**	**–**	**–**	**450.0**
Exchange differences	**–**	**13.7**	**–**	**–**	**13.7**
Non-cash movements	**(7.7)**	**(0.6)**	**(4.6)**	**–**	**(12.9)**
At 31 December 2020	**3,065.8**	**1,699.2**	**391.3**	**–**	**5,156.3**

(1) In order to align with the current year presentation, exchange differences in 2019 have been presented separately.

Notes to the consolidated financial statements

Other important disclosures (continued)

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

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

	2020 £ million	2019) £ million
Increase in loans to central banks	**(24.8)**	(8.3)
Decrease/(increase) in loans to credit institutions	**329.9**	(2.6)
Increase in loans and advances to customers	**(2,402.4)**	(1,132.8)
Decrease/(increase) in reverse purchase agreements	**201.1**	(201.1)
Decrease in other advances	**59.4**	102.5
Net change in derivative financial instruments and fair value adjustment for portfolio hedged risk	**(216.6)**	(162.4)
(Increase)/decrease in other assets	**(23.9)**	54.8
Increase/(decrease) in deposits from credit institutions	**4.2**	(2.7)
Increase in customer deposits	**4,217.0**	1,089.9
(Decrease)/increase in other financial liabilities	**(33.9)**	14.2
Increase/(decrease) in provisions	**101.3**	(11.8)
Increase/(decrease) in other liabilities	**42.6**	(333.6)
Change in operating assets and liabilities	**2,253.9**	(593.9)
Depreciation and amortisation	**74.3**	60.2
Impairment losses on loans and advances to customers	**162.7**	60.9
Exchange differences(1)	**13.7**	(20.5)
Other non-cash items(1) (2)	**17.6**	28.0
Non-cash and other items	**268.3**	128.6
Analysis of cash and cash equivalents as shown in the balance sheet		
Cash	**143.6**	160.1
Balances with central banks	**4,910.1**	4,427.3
On demand deposits	**2.9**	7.8
Total cash and cash equivalents	**5,056.6**	4,595.2

(1) In order to align with the current year presentation, exchange differences in 2019, previously included in other non-cash items, have been presented separately.
(2) Interest received on debt securities of £53.2 million in 2019 and interest paid on borrowings from central banks, debt securities in issue and subordinated liabilities of £(94.0) million have been reclassified from investing activities and financing activities, respectively, and presented in other non-cash items.

33. Approval of the consolidated financial statements

These consolidated financial statements were approved by the Board of Directors on 2 February 2021. The Company's ultimate parent company and ultimate controlling party is Banco de Sabadell, S.A. (incorporated in Spain), which is also the parent undertaking of the largest group of undertakings for which consolidated financial statements are drawn up and of which the Company is a member. Banco de Sabadell S.A. is the parent undertaking of the smallest such group of undertakings for which consolidated financial statements are drawn up and of which the Company is a member. Copies of the consolidated annual report and accounts of Banco de Sabadell S.A. are expected to be available in due course from www.grupbancsabadell.com/en/.

Company balance sheet

As at 31 December 2020

Company Number: 08871766

	Note	2020 £ million	2019 £ million
Assets			
Non-current assets:			
Investments in subsidiaries	4	**1,589.4**	1,589.4
Loans to subsidiaries	4	**838.4**	388.0
		2,427.8	1,977.4
Current assets:			
Derivative financial assets	5	**–**	0.5
Amounts due from subsidiaries	4	**0.4**	0.7
Other advances		**2.7**	–
Current tax asset		**0.4**	0.4
Deferred tax asset		**0.7**	–
Total assets		**2,432.0**	1,979.0
Liabilities			
Non-current liabilities:			
Senior unsecured debt securities	2	**450.1**	–
Subordinated liabilities	2	**388.3**	388.0
Current liabilities:			
Derivative financial liabilities	5	**2.7**	–
Amounts due to subsidiaries	4	**18.5**	14.9
Other financial liabilities		**–**	0.7
Total liabilities		**859.6**	403.6
Equity			
Share capital	3	**5.0**	5.0
Share premium	3	**965.1**	965.1
Merger reserve	3	**616.5**	616.5
(Loss)/profit for the year		**(3.0)**	0.3
Accumulated losses brought forward		**(11.2)**	(11.5)
Shareholder's equity		**1,572.4**	1,575.4
Total equity and liabilities		**2,432.0**	1,979.0

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

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

The Company financial statements on pages 106 to 111 were approved by the Board of Directors on 2 February 2021 and signed on its behalf by:

Debbie Crosbie
Chief Executive

Ralph Coates
Chief Financial Officer

Company statement of changes in equity

for the year ended 31 December 2020

	Share capital £ million	Share premium £ million	Merger reserve £ million	Accumulated losses £ million	Shareholder's equity £ million
Balance at 1 January 2019	5.0	965.1	616.5	(11.5)	1,575.1
Comprehensive loss					
Total comprehensive income for the year	–	–	–	0.3	0.3
Balance at 31 December 2019	5.0	965.1	616.5	(11.2)	1,575.4
Comprehensive income					
Total comprehensive loss for the year	**–**	**–**	**–**	**(3.0)**	**(3.0)**
Balance at 31 December 2020	**5.0**	**965.1**	**616.5**	**(14.2)**	**1,572.4**

Company cash flow statement

for the year ended 31 December 2020

	2020 £ million	2019 £ million
Cash flows from operating activities		
(Loss)/profit before taxation	**(3.0)**	0.6
Adjustments for:		
Change in current liabilities	**5.6**	(0.2)
Change in current assets	**(2.6)**	(0.4)
Net cash provided by operating activities	**–**	–
Cash flows from investing activities		
Increase in loans to subsidiaries	**(450.0)**	–
Net cash used in investing activities	**(450.0)**	–
Cash flows from financing activities		
Issue of senior unsecured debt securities	**450.0**	
Net cash provided by financing activities	**450.0**	–
Change in cash and cash equivalents	**–**	–
Cash and cash equivalents at 1 January	**–**	–
Cash and cash equivalents at 31 December	**–**	–

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

Notes to the Company financial statements

1. Basis of preparation

The financial statements of TSB Banking Group plc (the Company), a public limited company, limited by shares, with registered office 20 Gresham Street, London, EC2V 7JE, have been prepared in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006. The Company financial statements have been prepared under the historical cost convention as modified by the recognition of derivative financial instruments at fair value through profit or loss.

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

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

2. Non-current liabilities

Debt securities in issue – senior unsecured debt securities

In December 2020, the Company issued £450.0 million floating rate notes due June 2023 to its parent company, Banco de Sabadell, S.A. at an issue price of 100% of the principal amount. The notes pay interest at SONIA plus 2.1% payable quarterly in arears. The Company has the option to redeem these notes in June 2022 and quarterly thereafter, subject to approval of the Prudential Regulatory Authority.

Subordinated liabilities

	2020 £ million	2019 £ million
Fixed/floating rate reset callable subordinated Tier 2 notes due May 2026	**385.0**	385.0
Unamortised discount	**(0.1)**	(0.4)
Accrued interest	**3.4**	3.4
Total subordinated liabilities	**388.3**	388.0

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

3. Share capital, share premium and merger reserve

Details of the Company's share capital, share premium and merger reserve are set out in note 23 to the consolidated financial statements.

4. Related party transactions

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

(i) Key management personnel
The key management personnel of TSB and the Company are the same. The relevant disclosures are set out in note 25 to the consolidated financial statements.

Notes to the Company financial statements

4. Related party transactions (continued)

(ii) Investment in subsidiaries

The Company's only legal subsidiary undertaking is TSB Bank plc, a banking business incorporated and registered in Scotland whose registered office is Henry Duncan House, 120 George Street, Edinburgh, EH2 4LH.

The Company holds 100% of the ordinary share capital and voting rights of TSB Bank plc and carried this investment at its cost of £1,589.4 million (2019: £1,589.4 million).

Significant estimate – impairment assessment

In the light of COVID-19 pandemic and the related significantly reduced profitability of TSB in 2020 it was concluded that an impairment assessment should be undertaken. This concluded that no impairment was required as the recoverable amount of the Company's investment exceeded its £1,589.4 million carrying amount.

In estimating the recoverable amount of the Company's investment, TSB Bank plc's value in use was calculated using a discounted cash flow approach. This method consisted of estimating the theoretical dividends that could be distributed in the future after equity requirements were met.

Significant judgement was required in estimating the key inputs to the valuation model, which comprised the forecast post tax profits of TSB Bank plc and the discount rate to be applied. Forecast profits were based on the Board's approved medium term plan, covering the six years to 2026. Profits in the subsequent period were estimated to increase at nominal rate of 1.7%. A post tax rate of 9.1% was used to discount the estimated future cash flows.

The value in use is sensitive to alternative inputs. A 1% increase in the discount rate to 10.1% would decrease the value in use by £214 million. A decrease in the long term forecast profit growth rate from 1.7% to zero would decrease the value in use by £104 million. Individually, under each of these alternative inputs, the value in use would continue to exceed the carrying value and, as such, it was concluded that that no impairment was required.

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

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

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

(iii) Loans to subsidiaries

	2020 £ million	2019 £ million
Loans to subsidiaries	**835.0**	385.0
Unamortised discount	**(0.1)**	(0.4)
Accrued interest	**3.5**	3.4
Total loans to subsidiaries	**838.4**	388.0

In May 2014, the Company subscribed for £385 million of fixed/floating rate reset callable subordinated Tier 2 notes due May 2026 issued by its principal subsidiary, TSB Bank plc. In December 2020, the Company subscribed for £450 million of floating rate notes due June 2023 issued by TSB Bank plc. The allowance for credit impairment losses on these 'stage 1' loans was nil (2019: nil).

Notes to the Company financial statements

4. Related party transactions (continued)

(iv) Other related party transactions

At 31 December 2020, amounts due by the Company to subsidiary companies were £18.5 million (2019: £14.9 million). Amounts due from subsidiary companies were £0.4 million (2019: £0.7 million).

The Company holds forward purchase agreements with Sabadell to acquire 10.5 million (2019: 6.6 million) Sabadell shares to satisfy estimated requirements under various share based compensation arrangements. This forward agreement had a liability fair value of £2.7 million (2019: asset fair value of £0.5 million) and TSB had placed cash collateral with Sabadell of £2.7 million (2019: Sabadell had placed cash collateral with TSB of £0.6 million).

5. Financial instruments

(i) Measurement basis of financial instruments

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

At 31 December 2020	At fair value through profit or loss £ million	Financial assets at amortised cost £ million	Held at amortised cost £ million	Total £ million
Financial assets				
Loans to subsidiaries	**–**	**838.4**	**–**	**838.4**
Total financial assets	**–**	**838.4**	**–**	**838.4**
Financial liabilities				
Derivative financial liabilities	**(2.7)**	**–**	**–**	**(2.7)**
Debt securities in issue	**(450.1)**	**–**	**–**	**(450.1)**
Subordinated liabilities	**–**	**–**	**(388.3)**	**(388.3)**
Total financial liabilities	**(452.8)**	**–**	**(388.3)**	**(841.1)**
At 31 December 2019				
Financial assets				
Loans to subsidiaries	–	388.0	–	388.0
Derivative financial assets	0.5	–	–	0.5
Total financial assets	0.5	388.0	–	388.5
Financial liabilities				
Subordinated liabilities	–	–	(388.0)	(388.0)
Total financial liabilities	–	–	(388.0)	(388.0)

(ii) Fair value of financial instruments

The table below analyses the fair values, and valuation hierarchy, of the financial assets and liabilities of the Company. The valuation techniques for the Company's financial assets and liabilities are set out in notes 4 and 10 to the consolidated financial statements.

At 31 December 2020	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
Financial assets					
Loans to subsidiaries	**–**	**844.1**	**–**	**844.1**	**838.4**
Financial liabilities					
Derivative financial liabilities	**–**	**(2.7)**	**–**	**(2.7)**	**(2.7)**
Debt securities in issue	**–**	**(450.1)**		**(450.1)**	**(450.1)**
Subordinated liabilities	**–**	**(390.4)**	**–**	**(390.4)**	**(388.3)**
At 31 December 2019					
Financial assets					
Loans to subsidiaries	–	398.3	–	398.3	388.0
Derivative financial assets	–	0.5	–	0.5	0.5
Financial liabilities					
Subordinated liabilities	–	(398.3)	–	(398.3)	(388.0)

Notes to the Company financial statements

5. Financial instruments (continued)

(iv) Credit risk

The Company's credit risk arises solely from amounts due from its wholly owned subsidiary, TSB Bank plc. At 31 December 2020, no ECL has been recognised on the Company financial assets (2019: £nil).

(v) Liquidity risk

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

At 31 December 2020	Up to 1 month £ million	1-3 months £ million	3-12 months £ million	1-5 years £ million	Over 5 years £ million	Total £ million
Debt securities in issue	**–**	**–**	**–**	**504.0**	**–**	**504.0**
Subordinated liabilities	**–**	**–**	**396.1**	**–**	**–**	**396.1**
Total non-derivative financial liabilities	**–**	**–**	**396.1**	**504.0**	**–**	**900.1**
Derivative liabilities – outflows	**–**	**–**	**2.7**	**–**	**–**	**2.7**
Total	**–**	**–**	**398.8**	**504.0**	**–**	**902.8**
At 31 December 2019						
Subordinated liabilities	–	–	22.1	418.2	–	440.3
Total non-derivative financial liabilities	–	–	22.1	418.2	–	440.3

Independent auditor's report to the members of TSB Banking Group plc

1. Our opinion is unmodified

We have audited the financial statements of TSB Banking Group plc ('the Parent Company') for the year ended 31 December 2020 which comprise the consolidated balance sheet, consolidated statement of comprehensive income, consolidated statement of changes in equity, consolidated cash flow statement, Parent Company balance sheet, Parent Company statement of changes in equity, Parent Company cash flow statement, and the related notes, including the accounting policies.

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the Parent Company's affairs as at 31 December 2020 and of the Group's loss for the year then ended;
- the Group financial statements have been properly prepared in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006;
- the Parent Company financial statements have been properly prepared in accordance with international accounting standards in conformity with the requirements of, and as applied in accordance with the provisions of, the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation to the extent applicable.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ('ISAs (UK)') and applicable law. Our responsibilities are described below. We believe that the audit evidence we have obtained is a sufficient and appropriate basis for our opinion. Our audit opinion is consistent with our report to the Audit Committee.

We were first appointed as auditor by the shareholders on 5 May 2020. The period of total uninterrupted engagement is one year for the financial year ended 31 December 2020. We have fulfilled our ethical responsibilities under, and we remain independent of the Group in accordance with, UK ethical requirements including the FRC Ethical Standard as applied to public interest entities. No non-audit services prohibited by that standard were provided.

2. Key audit matters: our assessment of risks of material misstatement

Key audit matters are those matters that, in our professional judgement, were of most significance in the audit of the financial statements and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by us, 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. We summarise below the key audit matters, in decreasing order of audit significance, in arriving at our audit opinion above, together with our key audit procedures to address those matters and, as required for public interest entities, our results from those procedures. These matters were addressed, and our results are based on procedures undertaken, in the context of, and solely for the purpose of, our audit of the financial statements as a whole, and in forming our opinion thereon, and consequently are incidental to that opinion, and we do not provide a separate opinion on these matters.

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

2. Key audit matters: our assessment of risks of material misstatement (continued)

	The risk	Our response
Loan loss provisioning ***31 December 2020: £239.0 million*** ***Refer to page 39 (Audit Committee report) and note 9 (accounting policy and financial disclosures)***	***Subjective estimate*** The measurement of expected credit losses ('ECL') involves significant judgements and estimates. There is increased risk of material misstatement of ECL in the current year due to the increased judgement and estimation uncertainty as a result of COVID-19. The key areas where we identified greater levels of judgement and therefore increased levels of audit focus in the Group's estimation of ECL are: - **Economic scenarios** – IFRS 9 requires the Group to measure ECL on a forward-looking basis reflecting a range of future economic conditions. Significant judgement is applied to determining the economic scenarios used, particularly in the context of COVID-19, and the probability weightings assigned to each economic scenario. - **Qualitative adjustments** – Adjustments to the model-driven ECL results are raised by the Group to address issues relating to model limitations, model responsiveness or emerging trends relating to COVID-19. They represent approximately 28.0% of the total ECL. Certain adjustments are inherently uncertain and significant judgement is involved in estimating these amounts. - **Significant Increase in Credit Risk ('SICR')** – The criteria selected to identify a significant increase in credit risk is a key area of judgement within the Group's ECL calculation as these criteria determine whether a 12 month or lifetime provision is recorded. Increased judgement exists in the current year relating to the treatment of those customers who were granted one or more COVID-19 payment reliefs. - **Model estimations** – Inherently judgmental modelling is used to estimate ECLs which involves determining Probabilities of Default ('PD'), Loss Given Default ('LGD'), and Exposures at Default ('EAD'). The LGD model used in the secured portfolio and the PD models used in the unsecured portfolios are the key drivers of the Group's ECL results and are therefore the most significant judgmental aspect of the Group's ECL modelling approach. The effect of these matters is that, as part of our risk assessment, we determined that the impairment of loans to customers has a high degree of estimation uncertainty, with a potential range of reasonable outcomes greater than our materiality for the financial statements as a whole, and possibly many times that amount. The financial statements disclose the sensitivities estimated by the Group (note 9). **Disclosure quality** The disclosures regarding the Group's application of IFRS 9 are key to explaining the key judgements and material inputs to the IFRS 9 ECL results.	Our audit procedures included: **Recalculations:** We recalculated the ECL measured on each of TSB's loan portfolios. We performed sample testing over key inputs, data and assumptions impacting ECL calculations to assess the reasonableness of economic forecasts, weights, and model assumptions applied. **Our economic scenario expertise:** We involved our own economic specialists to assist us in assessing the appropriateness of the Group's methodology for determining the economic scenarios used and the probability weightings applied to them. We assessed the overall reasonableness of the economic forecasts by comparing the Group's forecasts to our own modelled forecasts. As part of this work we challenged the reasonableness of the Group's considerations of the economic uncertainty relating to COVID-19. **Qualitative adjustments:** For each of the significant adjustments to the model-driven ECL results we assessed the reasonableness of the adjustments by evaluating the key assumptions, inspecting the calculation methodology and tracing a sample of data used back to source data. **SICR**: We assessed the ongoing effectiveness of the SICR criteria and independently calculated the loans' stage for TSB's loans and advances. In addition, we assessed the reasonableness of the Group's treatment of COVID-19 payment relief customers from a SICR perspective. **Our financial risk modelling expertise:** We involved our own financial risk modelling specialists in evaluating the Group's IFRS 9 models. We used our knowledge of the Group and our experience of the industry that the Group operates in to independently challenge the appropriateness of the Group's IFRS 9 models. **Assessing transparency:** We evaluated whether the disclosures appropriately reflect and address the uncertainty which exists when determining the Group's overall ECL. As a part of this, we assessed the sensitivity analysis that is disclosed. In addition, we challenged whether the disclosure of the key judgments and assumptions made, including in respect of COVID-19, was sufficiently clear. **Our results** The results of our testing were satisfactory, and we considered the ECL charge and provision recognised and the related disclosures to be acceptable.

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

2. Key audit matters: our assessment of risks of material misstatement (continued)

	The risk	Our response
IT access, change management and operations ***Refer to page 41 (Audit Committee report)***	***Data capture and integrity*** The Group has self-acknowledged historical issues with the design and implementation of controls within the Group's IT control environment, specifically in relation to user access and change management. During 2020 the Group has continued to work on improving the IT control environment through their IT remediation and stabilisation programmes. The GITCs are a subset of IT controls within the wider IT control environment. The Group's accounting and reporting processes are dependent on automated controls (such as data feeds or automated calculations) enabled by IT systems. There is a risk that if the general IT controls ("GITCs") are not sufficient then inappropriate access could be gained to IT applications and inappropriate changes made to the application itself or to the integrity of related automated controls. In addition, GITCs which are not sufficient could also affect the integrity of data stored on the IT systems and the effectiveness of automated and manual controls which use this data. As part of our audit we have performed a risk assessment of the GITC environment throughout 2020. Based on our risk assessment we identified that remediation and embedding of the GITCs was well progressed but not yet complete and therefore concluded that we would not seek to test the design or operating effectiveness of the GITCs in 2020. As a consequence and based on this risk assessment procedure, we have instead focused on testing the operation of certain automated controls and the accuracy of the relevant data elements.	Our audit procedures included: **Risk assessment:** We performed a risk assessment of the GITC environment to assess whether it was sufficient to support an approach whereby we would test and place reliance on certain automated controls. As part of this risk assessment we inspected reports provided by the Group of testing performed over the design, implementation and operating effectiveness of GITCs prepared by parties including external consultants. ***Controls testing:*** Key aspects of our testing involved: - We performed walkthroughs to understand the key financial reporting processes and the related controls; and - We evaluated and placed reliance on selected automated controls - including those which support the calculation of fees and interest. As we did not place reliance on GITCs we increased the frequency with which we tested the operation of these automated controls during the period subject to audit. ***Tests of detail:*** We used sample testing to agree relevant data elements used in the financial reporting process (including customer and transactional data) to appropriate supporting evidence. As we did not place reliance on the GITC environment we increased our sample sizes for this testing; and - Where we performed substantive testing over areas such as certain data feeds and data calculations, we increased our sample sizes because we did not place reliance on relevant GITCs. **Our results** We concluded from our risk assessment that although the remediation and embedding programme is not yet complete, the GITC control framework was sufficient to allow us to test and place reliance on certain automated controls. As we have not evaluated the design and operating effectiveness of the GITCs, we have increased the frequency with which we have tested the automated controls throughout the period subject to audit and, where appropriate, we have increased the sample sizes we used to perform substantive testing. We did not identify any significant deficiencies in the automated controls or any material errors in the relevant data elements which we tested.

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

2. Key audit matters: our assessment of risks of material misstatement (continued)

	The risk	Our response
Macro-economic uncertainty ***Refer to page 38 (Audit Committee report) and page 58 (Basis of preparation)***	***Disclosure quality*** Macro-economic events such as COVID-19 and Brexit have had a significant economic impact on the UK economy. In response, the UK government, and the Bank of England, have announced measures such as lowering the base rate and countercyclical regulatory capital buffer. The eventual impact of COVID-19, Brexit and the success of these measures remains uncertain. This has given rise to a challenge across the industry as banks have sought to factor the impact of this macro-economic uncertainty into their forecasting and key accounting judgements. Through our risk assessment, we have focused our audit on considering this uncertainty in the areas of ECL provisions, forecasting and the Directors' assessment of the appropriateness of the going concern basis of preparation which takes account of capital and liquidity. The financial statements explain how the Directors have incorporated the impact of macro-economic uncertainty in their determination of ECL provisions and the carrying value of the Parent Company's investment in subsidiary. Our response to both these matters is set out in more detail in the relevant Key Audit Matter. The financial statements also explain how the Directors have formed a judgement that it is appropriate to adopt the going concern basis of preparation for the Group and Parent Company, with no material uncertainty disclosed. This judgement takes into account all relevant aspects including the impact of the macro-economic environment. The judgement is based on an evaluation of the inherent risks to the Group's and Parent Company's business model and how those risks might affect the Group's and Parent Company's financial resources or ability to continue operations over a period of at least a year from the date of approval of the financial statements. The risk most likely to affect the Group's and Parent Company's available financial resources over the period is the ongoing economic uncertainty. This impact could lead to reduced regulatory capital levels over the course of the next 12 months. In addition to the impacts on our ECL and investment in subsidiary Key Audit Matters, the risk for our audit is whether or not a material uncertainty exists that may cast significant doubt on the ability of the Group and Parent Company to continue as a going concern. Had there been such an uncertainty, then that fact would need to be disclosed.	We considered whether the risks posed by macro-economic uncertainty could plausibly affect the liquidity and capital in the going concern period by assessing the directors' sensitivities over the level of available financial resources indicated by the Group's financial forecasts taking account of severe, but plausible, adverse effects that could arise from these risks individually and collectively. Our audit procedures included: **Our sector experience**: We considered the directors' assessment of sources of risk for the Group's and Parent Company's business and financial resources compared with our own understanding of the risks. We considered the directors' plans to take action to mitigate the risks. **Challenge of assumptions**: We inspected the Group's and Parent Company's forecasting, capital and liquidity plans to identify the key assumptions within these. We challenged the reasonableness of assumptions underpinning the Group's and Parent Company's forecasts. **Sensitivity analysis**: We challenged the severity of the stressed scenarios used by the Group and Parent Company in their capital and liquidity assessments and the viability of possible management actions that might be required in the event of such stresses materialising. **Assessing transparency**: We critically assessed the completeness and accuracy of the matters covered in the going concern disclosure within the financial statements using our knowledge of the relevant facts and circumstances developed during our audit work, considering the economic outlook, key areas of estimation uncertainty, and mitigating actions available to the Group and Parent Company to respond to these risks. **Our results** We found the going concern disclosure without any material uncertainty to be acceptable.

2. Key audit matters: our assessment of risks of material misstatement (continued)

	The risk	Our response
Recoverability of investment in subsidiary (Parent Company only) ***31 December 2020: £1,589 million*** ***Refer to page 41 (Audit Committee Report) and note 4(ii) on page 109 (accounting policy and financial disclosures).***	***Recoverability of investment*** The carrying amount of the Parent Company's investment in subsidiary is significant and at risk of recoverability as the subsidiary is loss making. The estimated recoverable amount of this balance is subjective due to the inherent uncertainty in forecasting future trading conditions and cashflows. The effect of these matters is that, as part of our risk assessment, we determined that the recoverable amount of the cost of investment in subsidiary has a high degree of estimation uncertainty. The financial statements (note 4(ii) on page 109) disclose the sensitivity estimated by the Parent Company.	Our procedures included: ***Methodology assessment:*** We assessed whether the value in use methodology was an appropriate valuation methodology and in line with the requirements of IAS36. ***Benchmarking assumptions***: We compared the growth rate assumption and discount rate applied to externally derived data for these key inputs. ***Our expertise***: We assessed the appropriateness of the discount rate. We independently calculated discount rate ranges using external data sources and peer bank data for local risk-free rates, betas and market/entity risk premiums. ***Sensitivity analysis*****:** We performed breakeven analysis on the discount rate and terminal growth rate. ***Reliability of forecasts:*** We challenged the reasonableness of key judgements and assumptions in estimating the forecasts. ***Historical comparison:*** We assessed the Directors' ability to accurately prepare forecasts by comparing historical forecasts to actual results. ***Comparing valuations:***: We assessed the consistency of projected cash flows per the impairment assessment to the Board approved forecasts. ***Assessing transparency***: We assessed whether the Parent Company's disclosures about the sensitivity of the outcome of the impairment assessment to changes in key assumptions reflected the risks inherent in the valuation of the investment in subsidiary. **Our results:** We found the Parent Company's conclusion that there is no impairment of its investment in subsidiaries to be acceptable.

3. Our application of materiality and an overview of the scope of our audit

Materiality for the financial statements as a whole was set at £7.5 million, determined with reference to a benchmark of total revenue, of which it represents 0.81%. We consider total revenue to be the most appropriate benchmark as it provides a more stable measure year on year than group loss before tax.

Materiality for the Parent Company financial statements as a whole was set at £7.5 million, determined with reference to a benchmark of Parent Company total assets, of which it represents 0.3%.

In line with our audit methodology, our procedures on individual account balances and disclosures were performed to a lower threshold, performance materiality, so as to reduce to an acceptable level the risk that individually immaterial misstatements in individual account balances add up to a material amount across the financial statements as a whole .

Performance materiality for the Group and Parent Company was set at 65% of materiality for the financial statements as a whole, which equates to £4.88 million. We applied this percentage in our determination of performance materiality reflecting that this is our first year as auditors of the Group and Parent Company and we have not tested general IT controls.

We agreed to report to the Audit Committee any corrected or uncorrected identified misstatements exceeding £0.375 million, in addition to other identified misstatements that warranted reporting on qualitative grounds.

The Group team performed the audit of the Group as if it was a single aggregated set of financial information. The audit was performed using the materiality and performance materiality levels set out above.

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

4. Going concern

The directors have prepared the financial statements on the going concern basis as they do not intend to liquidate the Group or the Parent Company or to cease their operations, and as they have concluded that the Group's and the Parent Company's financial position means that this is realistic. They have also concluded that there are no material uncertainties that could have cast significant doubt over their ability to continue as a going concern for at least a year from the date of approval of the financial statements ('the going concern period').

An explanation of how we evaluated management's assessment of going concern is set out in the key audit matter in relation to macro-economic uncertainty in section 2 of this report.

Our conclusions based on this work:

- we consider that the directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate;
- we have not identified, and concur with the directors' assessment that there is not, a material uncertainty related to events or conditions that, individually or collectively, may cast significant doubt on the Group's or Parent Company's ability to continue as a going concern for the going concern period; and
- we found the going concern disclosure on page 58 (Basis of preparation) to be acceptable.

However, as we cannot predict all future events or conditions and as subsequent events may result in outcomes that are inconsistent with judgements that were reasonable at the time they were made, the above conclusions are not a guarantee that the Group or the Parent Company will continue in operation.

5. Fraud and breaches of laws and regulations – ability to detect

Identifying and responding to risks of material misstatement due to fraud

To identify risks of material misstatement due to fraud ('fraud risks') we assessed events or conditions that could indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. Our risk assessment procedures included:

- Enquiring of directors, Internal Audit and inspection of policy documentation as to the Group and Parent Company's high-level policies and procedures to prevent and detect fraud, including the Internal Audit function, and the Group and Parent Company's channel for 'whistleblowing', as well as whether they have knowledge of any actual, suspected or alleged fraud.
- Reading Board, Board Audit Committee and Risk Committee minutes.
- Considering remuneration incentive schemes and performance targets for management and directors.
- Using analytical procedures to identify any unusual or unexpected relationships.
- Using our own forensic specialists to assist us in identifying fraud risks based on discussions of the circumstances of the Group and Parent Company.

We communicated identified fraud risks throughout the audit team and remained alert to any indications of fraud throughout the audit.

As required by auditing standards, and taking into account possible pressures to meet profit targets and our overall knowledge of the control environment, we perform procedures to address the risk of management override of controls, in particular the risk that Group management may be in a position to make inappropriate accounting entries and the risk of bias in accounting estimates and judgements such as loan loss provisioning. On this audit we do not believe there is a fraud risk related to revenue recognition because there is limited complexity in the calculation and recognition of revenue.

We also identified a fraud risk related to estimation of loan loss provisioning, specifically relating to economic scenarios and qualitative adjustments in response to significant estimation that involves subjective judgments or uncertainties that are difficult to corroborate. Further detail in respect of loan loss provisioning is set out in the key audit matter disclosures in section 2 of this report.

We also performed procedures including:

- Identifying journal entries to test based on risk criteria and comparing the identified entries to supporting documentation. These included those posted by senior finance management and those posted and approved by the same user.
- Assessing significant accounting estimates for bias.

We discussed with the Audit Committee matters related to actual or suspected fraud, for which disclosure is not necessary, and considered any implications for our audit.

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

5. Fraud and breaches of laws and regulations – ability to detect (continued)

Identifying and responding to risks of material misstatement due to non-compliance with laws and regulations
We identified areas of laws and regulations that could reasonably be expected to have a material effect on the financial statements from our general commercial and sector experience, through discussion with the directors and other management (as required by auditing standards), and from inspection of the Group's regulatory and legal correspondence and discussed with the directors and other management the policies and procedures regarding compliance with laws and regulations.

As the Group is regulated, our assessment of risks involved gaining an understanding of the control environment including the entity's procedures for complying with regulatory requirements.

We communicated identified laws and regulations throughout our team and remained alert to any indications of non-compliance throughout the audit.

The potential effect of these laws and regulations on the financial statements varies considerably.

Firstly, the Group is subject to laws and regulations that directly affect the financial statements including financial reporting legislation (including related companies legislation), distributable profits legislation and taxation legislation and we assessed the extent of compliance with these laws and regulations as part of our procedures on the related financial statement items.

Secondly, the Group is subject to many other laws and regulations where the consequences of non-compliance could have a material effect on amounts or disclosures in the financial statements, for instance through the imposition of fines or litigation or the loss of the Group's and Parent Company's licence to operate. We identified the following areas as those most likely to have such an effect: specific areas of regulatory capital and liquidity, conduct, money laundering and financial crime and certain aspects of company legislation recognising the financial and regulated nature of the Group's and Parent Company's activities. Auditing standards limit the required audit procedures to identify non-compliance with these laws and regulations to enquiry of the directors and other management and inspection of regulatory and legal correspondence, if any. Therefore if a breach of operational regulations is not disclosed to us or evident from relevant correspondence, an audit will not detect that breach.

For the customer redress matter discussed in note 30, our procedures included inquiries of internal counsel and inspection of correspondence with the regulator.

For the joint regulatory investigation matter discussed in note 24, our procedures included inquiries with internal and external legal counsel as to the status of the investigation.

Within note 9, management has disclosed the potential future risks relating to the applicability of the government guarantee over losses arising on the government bounce back loan scheme. We have compared the disclosure against our own understanding of the nature and rules of the scheme and have concluded it is appropriate

We discussed with the Directors matters related to actual or suspected breaches of laws or regulations, for which disclosure is not necessary, and considered any implications for our audit.

Context of the ability of the audit to detect fraud or breaches of law or regulation
Owing to the inherent limitations of an audit, there is an unavoidable risk that we may not have detected some material misstatements in the financial statements, even though we have properly planned and performed our audit in accordance with auditing standards. For example, the further removed non-compliance with laws and regulations is from the events and transactions reflected in the financial statements, the less likely the inherently limited procedures required by auditing standards would identify it.

In addition, as with any audit, there remained a higher risk of non-detection of fraud, as these may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal controls. Our audit procedures are designed to detect material misstatement. We are not responsible for preventing non-compliance or fraud and cannot be expected to detect non-compliance with all laws and regulations.

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

6. We have nothing to report on the strategic report and the directors' report

The directors are responsible for the strategic report and the directors' report. Our opinion on the financial statements does not cover those reports and we do not express an audit opinion thereon.

Our responsibility is to read the strategic report and the directors' report and, in doing so, consider whether, based on our financial statements audit work, the information therein is materially misstated or inconsistent with the financial statements or our audit knowledge. Based solely on that work:

- we have not identified material misstatements in those reports;
- in our opinion the information given in the strategic report and the directors' report for the financial year is consistent with the financial statements; and
- in our opinion those reports have been prepared in accordance with the Companies Act 2006.

7. We have nothing to report on the other matters on which we are required to report by exception

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

- adequate accounting records have not been kept by the Parent Company, or returns adequate for our audit have not been received from branches not visited by us; or
- the Parent Company financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

We have nothing to report in these respects.

8. Respective responsibilities

Directors' responsibilities

As explained more fully in their statement set out on page 48, the directors are responsible for: the preparation of the financial statements including being satisfied that they give a true and fair view; 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; assessing the Group and Parent 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 they either intend to liquidate the Group or the Parent Company or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities

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 our opinion in an auditor's report. Reasonable assurance is a high level of assurance, but does not 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 aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

A fuller description of our responsibilities is provided on the FRC's website at www.frc.org.uk/auditorsresponsibilities.

9. The purpose of our audit work and to whom we owe our responsibilities

This report is made solely to the Parent Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Parent Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Parent Company and the Parent Company's members, as a body, for our audit work, for this report, or for the opinions we have formed.

Pamela McIntyre (Senior Statutory Auditor)
for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants
15 Canada Square
London
E14 5GL
2 February 2021

Glossary

Allowance for credit impairment losses	Provisions held on the balance sheet as a result of raising a charge against profit for expected credit losses in the loan book. The allowance may be either individual or collective.
Arrears	A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan is unpaid or overdue. Such a customer is also said to be in a state of delinquency and the entire outstanding balance is delinquent.
Basel III	The capital reforms and introduction of a global liquidity standard proposed by the Basel Committee on Banking Supervision in 2010 and due to be phased in, through CRD IV, from 1 January 2015 onward. This was further enhanced in December 2017 to refine the capital framework and introduce new elements including the output capital floor. These revisions will come into force between 1 January 2022 and 1 January 2027.
Basis point (bps)	One hundredth of a per cent (0.01 per cent). 100 basis points is 1 per cent. Used in quoting movements in interest rates.
BCBS 239	The Basel Committees standard entitled ‘Principles for effective risk data aggregation and risk reporting’.
Common Equity Tier 1 (CET1) capital	The highest quality form of regulatory capital under CRD IV that comprises common shares issued and related share premium, retained earnings and other reserves less specified regulatory adjustments.
Common Equity Tier 1 capital ratio	Common Equity Tier 1 capital as a percentage of risk-weighted assets.
Contractual maturities	Contractual maturity refers to the final payment date of a loan or other financial instrument, at which point all the remaining outstanding principal will be repaid and interest is due to be paid.
Coverage ratio	Impairment allowance as a percentage of impaired loans.
Customer deposits	Money deposited by account holders. Such funds are recorded as liabilities of TSB.
Encumbrance	The use of assets to secure liabilities, such as by way of a lien or charge.
Exposure at default	Exposure at default (EAD) represents the estimated exposure to a customer in the event of default. In determining EAD amounts, consideration is made of the extent to which undrawn commitments may be drawn down at the point of default and the application of credit risk mitigation (i.e. eligible financial collateral).
Forbearance	Forbearance takes place when a concession is made on the contractual terms of a loan in response to an obligor’s financial difficulties.
Internal Capital Adequacy Assessment Process (ICAAP)	TSB’s own assessment of the amount and type of capital it considers adequate to cover the level and nature of the risks to which it is or might be exposed.
Internal Liquidity Adequacy Assessment Process (ILAAP)	TSB’s own assessment of the adequacy of its liquidity and funding resources to cover the level and nature of risks to which it is or might be exposed.
Internal Ratings-Based approach (IRB)	A methodology of estimating the credit risk within a portfolio by utilising internal risk parameters to calculate credit risk regulatory capital requirements. There are two approaches to IRB: Foundation IRB and Advanced IRB.
Leverage ratio	Tier 1 capital divided by the exposure measure. Basel III reforms introduced a leverage ratio framework designed to reinforce risk based capital requirements with a simple, transparent, non-risk based ‘backstop’ measure.
Liquidity Coverage Ratio (LCR)	Measures the percentage of high quality liquid assets relative to expected net cash outflows over a 30 day period. High quality liquid assets should be unencumbered, liquid in markets during a time of stress and, ideally, be central bank eligible.
Loan to deposit ratio	The ratio of loans and advances to customers net of allowance for impairment losses divided by customer deposits.

Glossary (continued)

Loans past due	Loans are past due when a counterparty has failed to make a payment when contractually due.
Loan-to-value ratio (LTV)	The LTV ratio is a mathematical calculation which expresses the amount of a mortgage balance outstanding as a percentage of the total appraised value of the property. A high LTV indicates that there is less value to protect the lender against house price falls or increases in the loan if repayments are not made and interest is added to the outstanding balance of the loan.
Loss given default	Loss given default (LGD) represents the estimated proportion of an EAD amount that will be lost in the event of default. It is calculated after taking account of credit risk mitigation and includes the cost of recovery.
Master netting agreement	An agreement between two counterparties that have multiple derivative contracts with each other that provides for the net settlement of all contracts through a single payment, in a single currency, in the event of default on, or termination of, any one contract.
Net interest income	The difference between revenues earned by interest-earning assets and the cost of interest-bearing liabilities.
Net interest margin	Net interest margin is net interest income as a percentage of average interest-earning assets.
Net Promoter Score (NPS)	NPS is based on the question "On a scale of 0-10, where 0 is not at all likely and 10 is extremely likely, how likely is it that you would recommend TSB to a friend or colleague?" NPS is the percentage of TSB customers who score 9-10 after subtracting the percentage who score 0-6.
Pillar 3	The third pillar of the Basel III framework aims to encourage market discipline by setting out disclosure requirements for banks on their capital, risk exposures and risk assessment processes. These disclosures are aimed at improving the information made available to the market.
Probability of default	Probability of default (PD) represents an estimate of the likelihood that a customer will default on their obligation within a 12 month time horizon.
Repurchase agreements	Short-term funding agreements which allow a borrower to sell a financial asset as collateral for cash. As part of the agreement the borrower agrees to repurchase the security at some later date, usually less than 30 days, repaying the proceeds of the loan.
Risk-weighted assets	A measure of a bank's assets adjusted for their associated risks. Risk weightings are established in accordance with the Basel Capital Accord as implemented by the PRA.
Sabadell	Banco de Sabadell, S.A. This is TSB Banking Group plc's parent company.
Securitisation	Securitisation is a process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities.
Standardised approach	The Standardised approach to calculating credit risk capital requirements requires the use of a standard set of risk weights prescribed by the regulator. Use may be made of external credit ratings supplied by external credit assessment institutions to assign risk weights to exposures. Standardised approaches, following prescribed methodologies, also exist for calculating market risk and operational risk capital requirements.
Subordinated liabilities	Liabilities which, in the event of insolvency or liquidation of the issuer, are subordinated to the claims of depositors and other creditors of the issuer.
Tier 1 capital	A measure of a bank's financial strength defined by CRD IV. It captures Common Equity Tier 1 capital plus other Tier 1 securities in issue, subject to deductions.
Tier 1 capital ratio	Tier 1 capital as a percentage of risk-weighted assets.
Tier 2 capital	A component of regulatory capital defined by CRD IV, mainly comprising qualifying subordinated loan capital and eligible collective impairment allowances.

Abbreviations

BPS	Basis points
CET1	Common Equity Tier 1
CRD IV	Capital Requirements Directive IV
EDTF	Enhanced Disclosure Task Force
ECL	Expected credit loss
EIR	Effective interest rate
FCA	Financial Conduct Authority
GDPR	General Data Protection Regulation
HMRC	Her Majesty's Revenue and Customs
IAS	International Accounting Standards
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IRB	Internal ratings based approach
LBG	Lloyds Banking Group
LCR	Liquidity coverage ratio
LTV	Loan to value
MREL	Minimum Requirement for Eligible Liabilities
MSA	Migration Services Agreement
NPS	Net promoter score
OSA	Outsourced Services Agreement
PCA	Personal current account
POCI	Purchased or originated credit impaired
PRA	Prudential Regulatory Authority

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