Shawbrook Bank Limited
(Company No: 00388466)

Annual Report and Accounts
For the year ended 31 December 2018

PROUDLY DIFFERENT.

View our Annual Report & Accounts and Pillar 3 Report online:
A full version of our Annual Report & Accounts and Pillar 3 Report are available online at www.shawbrook.co.uk

Contents

Company information

Non-Executive Directors
John Callender
Robin Ashton
Cédric Dubourdieu
Roger Lovering
Lindsey McMurray
Paul Lawrence
Andrew Didham

Executive Directors
Ian Cowie
Dylan Minto

Company Secretary
Daniel Rushbrook

Registered office
Lutea House, Warley Hill Business Park,
Brentwood, Essex, CM13 3BE

Independent auditor
KPMG LLP
15 Canada Square,
London, E14 5GL

Bankers
Royal Bank of Scotland plc
Bishopsgate,
London, EC2M 4RB

Solicitors
Slaughter and May
One Bunhill Row,
London, EC1Y 8YY

Company number: 00388466

Chairman's statement

A year of progress
As my first year as Chairman, I am delighted to introduce this year's Annual Report and Accounts, reflecting on the year's events and our many successes. The Group has continued to generate sustainable returns, achieving an underlying return on tangible equity of 16.3%, and an underlying profit before taxation of £110.3 million. These results mark another year of great progress for the Group, achieving continued profitability despite the heightened economic and political uncertainties.

In 2018, I was pleased to appoint Ian Cowie as Group Chief Executive Officer, following the departure of Steve Pateman from the business in July. I would like to thank Steve for the important role he played over the last three years and for his commended service to the Group. I would also like to extend my gratitude to my predecessor, Iain Cornish, for his positive contributions to the Group.

Building capacity and capability
2018 has been a year of investment, as we continued to support business growth by making significant investments in our operations, IT and risk infrastructure. In November, we welcomed Russ Thornton as our inaugural Chief Technology Officer. Russ will lead our drive to deliver operational efficiencies and improved customer experience through the intelligent application of technology.

Unlocking future potential, our strong income growth has enabled us to invest in the recruitment of new talent to support business development. True to our ongoing commitment to staff training, we have maintained a core focus on developing our people and encouraged lateral movement across the organisation with the introduction of 'My Shawbrook Pathway'. This has been achieved through a wide range of personal development programmes and a new structured leadership programme, with an overarching aim to encourage and incentivise our high-performance culture.

Strong governance
We are committed to maintaining the highest standards of corporate governance throughout the Group. Effective Board oversight is vital to the successful delivery of the Group's strategy and key in embedding a cohesive and high performing culture across the business. In support of this continuing commitment to good corporate governance, an independent Board Effectiveness review was carried out in Q3 2018.

As a Board, we aim to promote an engaging culture that supports our values and strategy in business. Shawbrook is very much a relationship business serving customers in a way which requires experience, knowledge, judgement and integrity. We actively recruit and develop our people to ensure we have a workforce that possesses these qualities in abundance, and who are passionate about what they do.

Securing healthy foundations
During the year, we continued to balance risk management with reward, encouraging a culture of thoughtful judgement and decision making to build out our business model and secure healthy foundations for the future. In 2018, the composition of our funding shifted slightly, following the final drawdown from the Bank of England Term Funding Scheme (TFS). In 2019, we will look to diversify our wholesale funding sources to optimise the Group's liability mix. The asset side of our balance sheet also remains a model of resilience and flexibility as we close the year with a robust, diversified loan portfolio (63% Property Finance, 24% Business Finance, 13% Consumer Finance). I believe these key drivers position us well for the year ahead, safeguarding the Group against the uncertain economic backdrop.

Strategic opportunities
During my first year as Chairman, I have found Shawbrook to be a unique business built on the core values of serving customers, collaboration and entrepreneurism.

Having met many of the Group's stakeholders, I am encouraged by the relentlessness and ambition that I have seen across the Group and I look forward to watching the business grow from strength to strength.

Throughout 2019 we will continue to revolve our strategy ensuring we identify opportunities for growth and that resource is deployed in areas the add the most value for both customers and the Group.

Chairman's statement (continued)

Outlook

Entering 2019, I am excited to be working with an enthusiastic Management team who will continue to deliver sustainable growth through the deployment of good sense specialist banking products in markets that remain poorly served by the mainstream banks.

Over the past year, the UK banking sector has continued to evolve, driven by increased regulatory oversight, the transformation of financial technology and the ongoing macroeconomic uncertainty resulting from Brexit negotiations. We are mindful of the associated challenges that lie ahead, but I am confident we have a secure model that can capitalise on the opportunities that this climate will present, as we continue to develop a strong and healthy business for all stakeholders.

I would like to thank the Board, the Management team and colleagues across the business for their contribution to everything we have achieved together in 2018.

John Callender
Chairman

Chief Executive Officer's statement

Financial strength

In 2018, my first period as Chief Executive Officer, we achieved another year of increased profitability. The Group saw new lending improve during the period, resulting in a 20% increase in the customer loan book to £5.9 billion. The year's solid financial performance is attributable to the thoughtful and human approach taken to the way we do business.

Whilst maintaining a core focus on sustainable growth, in 2018 we continued to build our customer base and strengthen our balance sheet. Supporting our customers to achieve their financial goals where others could not or chose not to; we continued to leverage our specialist knowledge, innovative lending solutions and tailored decision making to deliver bespoke outcomes for each of our customers.

Customer led approach

At Shawbrook we are constantly striving to keep the customer at the forefront of everything we do, from our customer-centric solutions to regular broker feedback sessions; positive customer outcomes remain paramount. Our commitment to service did not go unrecognised in 2018, achieving an impressive customer satisfaction score of 87%[1]. I am mindful however, of the importance of keeping up with evolving customer expectations and as a result, in 2019 we will continue to develop our offering by utilising technology to create excellent customer outcomes.

Specialists in our space

Challenging the status quo, in 2018, we continued to build our presence in our specialist markets. Leveraging opportunities as they arose, we invested in and developed our customer propositions.

Our Property Finance business continued to experience sustained growth, increasing the loan book 16% in the year to £3.7 billion. Capitalising on the shift towards the professionalisation of the lettings market, and the solid relationships held across our dedicated broker network, our specialist Buy-to-Let proposition remained a key driver for business success.

In our Business Finance division, we have seen the business strengthen and momentum build month on month. The reach of our now established Regional Business Centre network, and the subsequent ability to serve the needs of local businesses has supported the expansion of our wider offering, supporting the aspirations of SMEs in this segment.

During the year, we also expanded our capability into several new adjacent markets, entering Sports Finance, Renewables and Growth Capital. Moving into 2019 with a strong business pipeline, improved processes and significant growth potential we will continue to identify and explore different opportunities to position ourselves as the specialist lender of choice.

The way we do business in our Consumer division continued to give us a leading edge in our specialist space. In January, we introduced our Transparency Charter, reinforcing our commitment to be honest, open and fair, paving the way for us to champion the customer. In July we integrated an advanced decisioning tool into the business, to further enhance our risk management controls.

Investing and innovating

In 2018, our strong income growth facilitated several thoughtful investments across the business with the aim of leveraging technology to create a streamlined experience for the customer – while preserving the understanding and expertise that help us support even the most complex of customer's. In Consumer Savings, we optimised our infrastructure and enhanced our e-savings portal creating a safer and seamless self-serve platform for our savings customers. In Property Finance, we made further improvements to our commercial mortgages platform to introduce greater automation in support of smarter customer outcomes.

As we invested for the future, our underlying cost to income ratio was impacted by these strategic decisions, increasing to 50.9% (2017: 45.7%). We also chose to take advantage of several inorganic investment opportunities which emerged during the period, acquiring three property portfolios worth c.£0.3 billion with a view to maintaining a diversified portfolio.

---

[1] Through an independent survey conducted by Charterhouse in 2018.

Chief Executive Officer statement (continued)

Delivering on our strategic objectives

Our markets continued to be challenging in 2018, as increased competition impacted pricing and wider macro-economic factors continued to shape the financial landscape. Despite these pressures, lending remained strong achieving yields of 6.7% across the portfolio. Our enduring commitment to thoughtful underwriting, conduct and risk management has enabled us to maintain a stable underlying cost of risk, achieving 68bps (43bps including the £13.0 million of insurance gains[1]) in 2018 (2017: 53bps). Further information on credit risk is included within the risk management report (pages 18 to 65).

Embedding a collaborative culture

Creating a diverse, inclusive and collaborative workplace is fundamental to business success and thus this remains a core strategic priority for me and my team. In the year, we took steps to strengthen Shawbrook's culture. Recognising the importance of cooperation across the business, we introduced several employee engagement initiatives to secure a shared purpose under one, connected bank.

Outlook

We enter 2019 with heightened ambitions, a healthy business pipeline and a renewed sense of vigour. Trading conditions in our core markets remain positive, and despite ongoing concerns associated with the uncertainty surrounding the impact of the UK leaving the European Union, I believe our agility and entrepreneurial spirit will enable us to capitalise on market movements. I feel very privileged to be at the helm of a business which is well positioned to support a range of customer needs and help them navigate through the economic conditions to realise their ambitions.

Ian Cowie
Chief Executive Officer

[1] During 2018, the Group received £13.0 million relating to the Group's insurance claim in respect of the controls breach identified in the Business Finance division in 2016. Cost of risk including this £13.0 million is 0.43%. Cost of risk adjusted to exclude this £13.0 million is 0.68%.

Strategic report

The Shawbrook Story

Since 2011, we've been quietly growing our business. Our approach to lending and savings is founded on the simple quality of good sense, adopting traditional values with a modern delivery. This is a big part of who we are.

Communication matters. We listen, we understand, and we talk to one another. We care about our customers and where they're going.

People are the life force of our business, so our approach is to blend human judgement with technological tools when it comes to decision-making.

That's why ensuring a deep understanding of our customers is our top priority.

Shawbrook – Proudly different.

How we've done

2018 key highlights

How we have delivered against our strategic pillars:	Achieve strong risk adjusted returns 6.7% Gross asset yield	Enhance customer focus 87% Customer satisfaction* *feedback from our 2018 Charterhouse survey
Progressively increase originations 20% increase in loan book to £5.9bn	Maintain excellent credit quality 68bps Cost of risk** **43bps including the £13.0 million of insurance proceeds received relating to the controls breach in Business Finance in 2016	Maintain conservative foundations 12.2% CET1 17.0% Total capital ratio

Our business

What we do
Shawbrook is a specialist UK lending and savings bank focused on Property Finance, Business Finance and Consumer Lending and Savings. We differentiate ourselves by concentrating on markets where our expert knowledge, judgement and personalised approach to underwriting offers us a competitive advantage. This approach supports attractive, stable returns and sustainable growth, benefiting businesses and individuals in parts of the market that continue to be poorly served by mainstream banks.

Our divisions

Property Finance

Property Finance is comprised of our Commercial Property and Residential Mortgages teams. Serving professional landlords and property traders in residential and commercial asset classes, and personal customers through second charge and specialist first charge mortgages.

£3.7 billion
Customer loans

Business Finance

The Business Finance division offers an extensive suite of services to address the needs of the UK SME market. Shawbrook International extends the Bank's lending proposition into the Channel Islands.

£1.4 billion
Customer loans

Consumer Lending and Savings

The Consumer division provides unsecured loans to personal customers for a variety of purposes including home improvement, holiday ownership and point of sale finance and personal loans.

£0.7 billion
Customer loans

Our savings sub-division provides a wide range of cash savings solutions, targeting UK customers.

£5.0 billion
Customer deposits

Strategic report (continued)

Our differentiated approach

The Shawbrook way, a customer led approach...

- Specialists
- Thoughtful decision making through judgement
- Driven by customer needs
- Innovative and tailored products
- Focus on quality

Our five strategic pillars

- Achieve strong risk adjusted returns
- Enhance customer focus
- Maintain excellent credit quality
- Progressively increase originations
- Maintain conservative foundations

Our values

- **We are expert:** We are quietly confident and enabling.
- **We are driven:** We are ambitious and passionate.
- **We are practical:** We are down to earth and pragmatic.
- **We act with integrity:** We are thoughtful and responsible.

Our people and community

731
Employees (period average)

49
Charities supported

58% M 42% F
Gender split

Business review

The statutory results have been prepared in accordance with International Financial Reporting Standards (IFRS). Where appropriate, certain aspects of the results are presented to reflect the Board's view of the Group's underlying performance without distortions caused by non-recurring items that are not reflective of the Group's ongoing business activities.

Underlying results should be considered in addition to, and not as a substitute for, the Group's statutory results, and the Group's presentation of underlying results should not be construed as an indication that future results will be unaffected by exceptional items. Underlying results have limitations as analytical tools and they should not be considered in isolation or as substitutes for analysis of the Group's results as reported on a statutory basis. Limitations may include, but are not limited to, the following:

- they may not reflect every cash expenditure, future requirements for capital expenditure or contractual commitments; and
- they may not reflect the impact of earnings or charges resulting from matters the Directors consider not to be indicative of ongoing operations.

Due to these limitations, underlying results are not intended as an alternative to the Group's statutory results or as an indicator of the Group's operating performance. The Group compensates for these limitations by using underlying results, along with other comparative tools, together with statutory results, to assist in the evaluation of operating performance.

In the year ended 31 December 2018, there are no underlying adjustments.

In the year ended 31 December 2017, the following items were excluded from the underlying results:

- Costs of £0.2 million relating to expenses incurred during the year in relation to the offer from Marlin Bidco for the entire share capital of Shawbrook Group plc.
- IFRS 2 charges amounting to £5.9 million recognised in 2017 in respect of share-based awards made to employees that vested on Marlin Bidco gaining control of Shawbrook Group plc.
- Corporate activity costs of £0.4 million in 2017 related to the cost of the incremental deposits raised to prefund the acquisition of a c.£190 million portfolio of property loans at the end of Q3 2017, which completed at the end of November 2017.

International Organisation of Securities Commissions regulation does not permit adjustment for items that are reasonably likely to occur in the foreseeable future, or activities that affected the entity's recent past, when considering underlying results as in their experience there are rarely circumstances where an explanation is sufficiently robust to result in restructuring costs or impairment losses being described as non-recurring. In addition, European Securities and Markets Authority regulation states that items which affected past periods and will affect future periods; such as restructuring costs or impairment losses, will rarely be considered as non-recurring, infrequent or unusual.

Business review (continued)

Profit and loss

To ensure equal prominence of the Group's statutory and underlying results, the following table provides a reconciliation of the statutory results to the underlying results:

	2018 £m	2017 £m
Statutory results		
Interest income, net income from operating leases, net fee and commission income, and net gains on financial instruments	**360.1**	314.0
Interest expense and similar charges	**(87.2)**	(75.9)
Net operating income	**272.9**	238.1
Administrative expenses	**(128.8)**	(113.2)
Impairment losses on financial assets[1 2]	**(23.2)**	(23.3)
Provisions for liabilities and charges	**(10.1)**	(2.1)
Total operating expenses	**(162.1)**	(138.6)
Share of results of associates	**(0.5)**	-
Statutory profit before taxation	**110.3**	99.5
Taxation	**(28.3)**	(25.3)
Statutory profit after taxation, attributable to owners	**82.0**	74.2
Reconciliation of statutory to underlying results		
Statutory profit before taxation	**110.3**	99.5
Underlying adjustments		
Project Marlin costs	-	0.2
IFRS 2 charges	-	5.9
Corporate activity costs	-	0.4
Total underlying adjustments	-	6.5
Profit before taxation on an underlying basis	**110.3**	106.0
Taxation on an underlying basis[3]	**(28.3)**	(26.8)
Profit after taxation on an underlying basis, attributable to owners	**82.0**	79.2

[1] Impairment losses on financial assets in the year ended 31 December 2018 reflect expected credit losses calculated in accordance with IFRS 9. Impairment losses on financial assets in the year ended 31 December 2017 reflect impairment losses calculated in accordance with IAS 39. As such, results are not directly comparable.

[2] 2018 includes a recovery of £13.0 million received by the Group in relation to the insurance claim in respect of the controls breach identified in the Business Finance division in 2016.

[3] The income tax charge on underlying adjustments has been calculated at the implied corporation tax rate. Income tax charge on certain underlying adjustments has been assumed as £nil on the basis of being disallowable for tax purposes.

Business review (continued)

Performance

The Group's underlying profit before taxation has improved from £106.0 million in 2017 to £110.3 million in 2018 due to the growth in the Group's asset base. This improvement is against the background of a competitive market where margins have seen some compression in some of the Group's divisions.

Key performance indicators
The below table sets out the Group's key performance indicators (KPIs). The Group's KPIs are defined on page 151.

	2018	2017
Assets		
Average principal employed (£m)	**5,351.8**	4,424.9
Loans and advances to customers (£m)	**5,880.0**	4,880.4
Profitability (on an underlying basis)		
Gross asset yield (%)	**6.7**	7.1
Liability yield (%)	**(1.6)**	(1.7)
Net interest margin (%)	**5.1**	5.4
Management expenses ratio (%)	**(2.6)**	(2.5)
Cost of risk (%)	**(0.43) / (0.68)**[1]	(0.53)
Return on lending assets before tax (%)	**2.1**	2.4
Return on lending assets after tax (%)	**1.5**	1.8
Return on tangible equity (%)	**16.3**	19.9
Cost to income ratio (%)	**50.9**	45.7
Asset quality		
Ratio of Stage 3 loans (%)	**2.0**	N/a
Ratio of past due over 90 days and impaired loans (%)	**N/a**	1.2
Liquidity		
Liquidity coverage ratio (%)	**244.9**	290.6
Capital and leverage		
Common Equity Tier 1 capital ratio (%)	**12.2**	12.8
Total Tier 1 capital ratio (%)	**15.2**	16.5
Total capital ratio (%)	**17.0**	19.1
Leverage ratio (%)	**9.1**	9.4
Risk-weighted assets (£m)	**4,206.8**	3,361.7

Underlying profit before taxation in 2018 increased to £110.3 million (2017: £106.0 million) and statutory profit before taxation increased to £110.3 million (2017: £99.5 million). This increased profitability has been driven by an increase in the loan book (including operating leases) to £5,880.0 million (2017: £4,880.4 million).

Net interest margin remained relatively stable at 5.1% (2017: 5.4%). Underlying return on tangible equity of 16.3% was achieved in 2018 (2017: 19.9%).

[1] During 2018, the Group received £13.0 million relating to the Group's insurance claim in respect of the controls breach identified in the Business Finance division in 2016. Cost of risk including this £13.0 million is 0.43%. Cost of risk adjusted to exclude this £13.0 million is 0.68%.

Business review (continued)

Capital decreased marginally resulting in a Common Equity Tier 1 capital ratio of 12.2% (2017: 12.8%). Total capital ratio also decreased from 19.1% in 2017 to 17.0% in 2018. Leverage ratio declined from 9.4% in 2017 to 9.1% in 2018.

Cost to income ratio increased from 45.7% in 2017 to 50.9% in 2018 as a result of the Group's continued strategic investment activity.

Divisional performance

The Group has four reportable operating segments. These are the Group's three lending divisions plus a central segment representing the savings business, central functions and shared central costs. Operating segments are reported in a manner consistent with the internal reporting provided to the Chief Executive Officer, who is considered to be the Chief Decision Making Officer.

Year ended 31 December 2018	Property Finance £m	Business Finance £m	Consumer Lending £m	Central £m	Total £m
Interest income, net income from operating leases, net fee and commission income, and net gains on financial instruments	192.2	98.1	65.3	4.5	360.1
Interest expense and similar charges	(50.5)	(15.8)	(10.0)	(10.9)	(87.2)
Net operating income / (expense)	**141.7**	**82.3**	**55.3**	**(6.4)**	**272.9**
Administrative expenses and provisions for liabilities and charges	(16.8)	(23.6)	(29.3)	(69.2)	(138.9)
Impairment losses on financial assets[1]	(5.6)	10.9	(28.5)	-	(23.2)
Total operating expenses	**(22.4)**	**(12.7)**	**(57.8)**	**(69.2)**	**(162.1)**
Share of results of associates	(0.5)	-	-	-	(0.5)
Profit / (loss) before taxation	**118.8**	**69.6**	**(2.5)**	**(75.6)**	**110.3**

Year ended 31 December 2017	Property Finance £m	Business Finance £m	Consumer Lending £m	Central £m	Total £m
Interest income, net income from operating leases, net fee and commission income, and net gains on financial instruments	175.6	88.7	44.5	5.2	314.0
Interest expense and similar charges	(41.1)	(13.2)	(8.2)	(13.4)	(75.9)
Net operating income / (expense)	134.5	75.5	36.3	(8.2)	238.1
Administrative expenses and provisions for liabilities and charges	(17.1)	(16.7)	(15.5)	(66.0)	(115.3)
Impairment losses on financial assets[1]	(2.4)	(8.5)	(12.4)	-	(23.3)
Total operating expenses	(19.5)	(25.2)	(27.9)	(66.0)	(138.6)
Profit / (loss) before taxation	115.0	50.3	8.4	(74.2)	99.5

The strategic report was approved by the Board of Directors on 18 April 2019 and was signed on its behalf by:

Ian Cowie
Chief Executive Officer

[1] Impairment losses on financial assets in the year ended 31 December 2018 reflect expected credit losses calculated in accordance with IFRS 9. Impairment losses on financial assets in the year ended 31 December 2017 reflect impairment losses calculated in accordance with IAS 39. As such, results are not directly comparable.

Directors' report

The Directors present their Annual Report and Accounts for the year ended 31 December 2018.

Principal activities
The Company and its subsidiaries comprise the 'Group'. The Company is a banking institution which is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

Results for the year
The Group made profit before taxation for the year of £110.3 million (2017: £99.5 million) and profit after taxation of £82.0 million (2017: £74.2 million).

The Company made profit before taxation for the year of £110.8 million (2017: £100.2 million) and profit after taxation of £82.6 million (2017: £74.9 million).

Dividends
The Directors are not recommending a final dividend (2017: nil) in respect of the year ended 31 December 2018.

Directors
The Directors who served during the year were:

- Robin Ashton
- John Callender (appointed on 8 March 2018)
- Iain Cornish (resigned on 8 March 2018)
- Ian Cowie (appointed on 27 July 2018)
- Andrew Didham
- Cédric Dubourdieu
- David Gagie (resigned on 31 January 2019)
- Sally-Ann Hibberd (resigned on 31 January 2019)
- Stephen Johnson (resigned 23 January 2019)
- Paul Lawrence
- Roger Lovering
- Lindsey McMurray
- Dylan Minto
- Steve Pateman (resigned on 27 July 2018)

The Company Secretary during the year was Daniel Rushbrook.

Directors' interest in the shares of the Company
The Directors of the Group have no interest in the share capital of the Company. The Company is a wholly owned subsidiary of Shawbrook Group plc.

Directors' and Officers' insurance
The Group has maintained appropriate Directors' and Officers' liability insurance throughout 2018.

Share capital
Shawbrook Bank Limited is a company limited by shares.

Details of the Group's issued share capital is shown in Note 28 of the financial statements.

Rights of the Shareholders of the Company
Holders of the shares of the Company are entitled to dividends as decided from time to time and are entitled to one vote per share at general meetings of the Company. There are no restrictions on the rights implicit to these shares.

Post balance sheet events
Details of any post balance sheet events can be found in Note 40 of the financial statements.

Branches, future developments and financial risk management objectives and policies
The Group operates in the United Kingdom and has a branch in Jersey. Information about future developments, internal control and financial risk management systems in relation to financial reporting and financial risk management objectives and policies in relation to the use of financial instruments can be found in the following sections of the Annual Report which are incorporated into this report by reference:

For further information on future developments of the Group please refer to the strategic report.

For further information on internal control and financial risk management systems in relation to financial reporting of the Group please refer to the risk management report.

For further information on financial risk management objectives and policies in relation to the use of financial instruments of the Group please refer to the risk management report.

Information presented in other sections of this document
The Directors elected to present the following information in other sections of this document. The likely future developments are discussed in the Group's Viability statement in Section 15 of the risk management report. Information on financial instruments are described in Note 31 of the financial statements. Financial risk management objectives and policies are described in the risk management report.

Research and development activities
During the ordinary course of business the Group develops new products and services within the business units.

Employees
The Group is committed to being an equal opportunities employer and opposes all forms of discrimination. Applications from people with disabilities will be considered fairly and if existing employees become disabled, every effort is made to retain them within the workforce wherever reasonable and practicable. The Group also endeavours to provide equal opportunities in the training, promotion and general career development of disabled employees.

The Group regularly provides employees with information of concern to them, which incorporates the Group's current performance and its future aims and strategies. During the year, employees were kept up to date with developments in strategy and changes to management through a number of channels. Specifically, the Chief Executive Officer has held all staff calls and introduced a platform to promote feedback to the Executive Management team. The Group conducts an Annual Employee Survey and uses the results of this survey to improve performance in areas that are important to staff. A monthly newsletter providing business updates and background information on the Group is circulated to all staff.

Employee share schemes
Full details of the Group's employee share schemes are set out in Note 10 of the financial statements. In 2018, no share-based payment schemes have been in operation.

Slavery and human trafficking
In 2018, the Group took appropriate steps to ensure slavery and human trafficking were absent from both the business and supply chain through the introduction of a database for the monitoring of Modern Slavery Act compliance. To further demonstrate the Group's commitment to the statement the following steps were taken to ensure it was engrained across the Group:

- **Identified and addressed risks:** The Group updated its policies and processes for reviewing and evaluating current and prospective suppliers to understand their self-assessment of slavery and human trafficking issues;
- **Developed policies:** The Group has continuously improved its policies throughout the year. During the year a Group-wide procurement and supplier performance management policy was introduced which enhances the onboarding process and reinforces the importance of due diligence and supplier governance in relation to slavery and human trafficking issues; and
- **Training:** Alongside the Group's employee-based training, the Group also extended training on modern slavery to suppliers and business owners in line with the new procurement and supplier performance management policy.

Directors' report (continued)

Political and charitable donations

The Group made charitable donations of £64k during the year (2017: £42k). The Group did not make any political donations during the year (2017: £nil).

Going concern

The financial statements are prepared on a going concern basis, as the Directors are satisfied that the Group has the resources to continue in business for the 12 months from the reporting date. In making this assessment, the Directors have considered a wide range of information relating to present and future conditions, including the current state of the balance sheet, future projections of profitability, cash flows and capital resources and the longer-term strategy of the business. The Group's capital and liquidity plans, including stress tests, have been reviewed by the Directors.

The Group's forecasts and projections show that it will be able to operate at adequate levels of both liquidity and capital for the 12 months from the reporting date, including a range of stressed scenarios, the availability of alternative sources of capital if required and appropriate management actions.

After making due enquiries, the Directors believe that the Group has sufficient resources to continue its activities for the 12 months from the reporting date and to continue its expansion, and the Group has sufficient capital to enable it to continue to meet its regulatory capital requirements as set out by the Prudential Regulation Authority.

Disclosure of information to the auditor

The Directors confirm that:

1. so far as each of the Directors is aware, there is no relevant audit information of which the auditor is unaware; and
2. the Directors have taken all the steps that they ought to have taken as Directors in order to make themselves aware of any relevant audit information and to establish that the auditor is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of the Companies Act 2006.

Auditor

Resolutions to reappoint KPMG LLP as the Group's auditor and to give the Directors the authority to determine the auditor's remuneration will be proposed at the Parent Company's Annual General Meeting.

By order of the Board

Ian Cowie
Chief Executive Officer
18 April 2018

Risk management report

1. The Group's approach to risk management

The Group seeks to manage the risks inherent in its business activities and operations through close and disciplined risk management which quantifies the risks taken, manages and mitigates them as far as possible and prices appropriately for the residual level of risk carried in order to produce an appropriate commercial return through the cycle.

The Group's approach to risk management continues to evolve and has benefited from further investment during 2018 in areas such as conduct, compliance, financial crime, technology and the embedding of credit grading within the overall implementation of IFRS 9. There has been further investment in the Group's key operating divisions including additional capacity, quality control and quality assurance and portfolio management to support the Group's lending objectives. The Group's Risk Management Framework was further enhanced in 2018, reflecting an increased focus on capacity and capability in the first line of defence in support of lending growth, technology risk to support the Group's digital strategy and the maturity of the Group's quality assurance and financial crime capabilities. The Group also appointed a Data Protection Officer in 2018 and implemented a new Privacy Working Group as a sub-group of the Enterprise Risk Management Committee to oversee the privacy framework.

This enterprise wide Risk Management Framework is underpinned by the following key elements:

Risk strategy
The risk strategy sets out the risk management objectives which support the achievement of the Group's commercial goals and the operation of business activities which seek to deliver those aims. The risk strategy sets out which risks are to be acquired or incurred and how they will be managed by the organisation.

The strategic risk management objectives are to:
- identify material risks arising in the day-to-day activities and operations of the Group;
- quantify the risks attached to the execution of the Group's business plans;
- set an appropriate risk appetite with calibrated measures and tolerance levels;
- optimise the risk/reward characteristics of business written;
- set minimum standards in relation to the acquisition, incurrence and management of risk;
- secure and organise the required level and capability of risk infrastructure and resources;
- undertake remedial action where any weaknesses are identified; and
- scan the external horizon for emerging risks.

Risk appetite
The level of risk that the Group is willing to tolerate in operating the various elements of its business are defined in a risk appetite statement, which is agreed by the Board and reviewed on a regular basis. This articulates qualitative and quantitative measures of risk which are cascaded across various areas of the Group's operations, calibrated by reference to the Group's absolute capacity for risk absorption, limit of appetite and target thresholds. During 2018, the Group completed a full review of the Group risk appetite framework incorporating greater alignment to the Group Risk Management Framework, enhancements in risk measurement and reflecting changes in the ownership of the Group. The review included a full annual review of the divisional and functional risk appetite statements.

Risk Management Framework
All of the Group's business and support service activities, including those outsourced to third party providers or originated via brokers and other business intermediaries, are executed within the parameters of a single comprehensive Risk Management Framework (RMF). This sets out minimum requirements and ensures consistent standards and processes are set across the organisation. Risks are identified, measured, managed, monitored, reported and controlled using the RMF. The design and effectiveness of the framework is overseen and reviewed by the Risk Committee. The key elements of the framework are set out later in this report.

1. The Group's approach to risk management (continued)

Governance

All the Group's risk activities are subject to detailed and comprehensive governance arrangements which set out how risk-based authority is delegated from the Board to Executive Management and the various risk management committees and individuals. These bodies and senior officers are accountable and responsible for ensuring that the day-to-day risks are appropriately managed within the agreed risk appetite and in accordance with the requirements of the RMF. Escalation and reporting requirements are set out in risk policies and by the risk appetite thresholds.

Culture

The Group is led by an experienced Executive Management team with a combination of significant underwriting expertise and institutional and regulatory banking experience at various major financial institutions and specialist lenders. This heritage provides the platform for a set of values and behaviour where the customer is at the heart of the decision-making process and business areas are held fully accountable for risk performance. At the individual level, this process begins with the induction programme and job descriptions, is carried into the setting of individual objectives and performance reviews and ultimately reflected in the compensation and reward structure.

Risk appetite statement

The risk appetite statement is a detailed and granular expression of the level of risk the Group is willing to accept in relation to the pursuit of its business strategy. The risk appetite statement is not static and will evolve to both reflect and support the Group's business objectives, the operating environment and risk outlook.

Whilst the risk appetite statement provides an aggregated measure of performance against risk appetite, it is not just a reporting tool. Just as importantly, it also provides a framework which is used dynamically to inform strategic and operational management decisions, as well as supporting the business planning process.

The risk appetite statement is reviewed periodically by the Risk Committee and agreed with the Board on an annual basis as a minimum. A dashboard with the status of each metric is monitored monthly. Executive Management and the Board exercise their judgement as to the appropriate action required in relation to any threshold trigger breach, dependent on the scenario at the time.

The risk appetite statement identifies six groups of risk appetite objectives which are further subdivided into 26 appetite dimensions as set out diagrammatically overleaf. A suite of qualitative statements and quantitative measures have been set for each dimension, with risk limits calibrated by reference to absolute capacity, maximum risk tolerance and a threshold trigger level.

1. The Group's approach to risk management (continued)

Risk appetite statement objectives and dimensions

Risk appetite objectives	Strategic risk	Liquidity and market risk	Creditworthiness and concentration risk	Operational risk	Conduct	Reputation
Risk appetite dimensions	Profit volatility	Funding and liquidity	Creditworthiness risk	Technology (including systems)	Product design	Regulatory perception
	Financial strength	Interest rate risk in the banking book	Concentration risk	Physical assets and security	Sales and distribution risk	Change perception
	Lending growth			Information risk	Postsales service	Media promoter
				Operations risk	Culture	Social advocacy
				Change risk		
				Third parties		
				People		
				Financial crime		
				New product approval		
				Financial reporting		
				Model risk		

Risk Management Framework

Responsibility for risk management sits at all levels across the Group from the Board and Executive Committee down through the Group's divisions, central functions, and in turn to each divisional head and their business managers and risk officers.

In 2018, the Group continued to invest in its risk management capability to position the Group to deliver its strategic and commercial objectives. This included improving the capacity and capability across the Group and specifically included the Executive Committee appointment of a Chief Technology Officer and the appointment of a new Chief Compliance Officer.

The Group's RMF describes the various activities, techniques and tools which are mandated to support the identification, measurement, control, management, monitoring, reporting and challenge of risk across the Group. It is designed to provide an integrated, comprehensive, consistent and scalable structure which is capable of being communicated to and clearly understood by all our employees and is described in the sections below.

The RMF also incorporates the organisational arrangements for managing risk with specific responsibilities distributed to certain functions. This ensures that there is clear accountability, responsibility and engagement at appropriate levels within the organisation which can provide robust review and challenge as well as be challenged. Operationally, the RMF is organised around the key risk categories (see Section 4).

2. Risk governance and oversight

Risk governance describes the architecture through which the Board allocates and delegates primary accountability, responsibility and authority for risk management across the organisation.

Responsibility for risk oversight is delegated from the Board to the Risk Committee and Audit Committee. The ultimate responsibility for risk remains with the Board.

Accountability, responsibility and authority for risk management is delegated to the Chief Executive Officer and Chief Risk Officer, who in turn allocate responsibility for oversight and certain approvals across a number of management committees.

Authority and responsibility for material operational risk management, decision-making and risk assurance is vested in the Chief Risk Officer and the Risk function. Lesser levels of authority are cascaded to the Senior Management within the support functions and business divisions.

Oversight of the key risk categories

<table>
<tr><th rowspan="2"></th><th colspan="4">Board</th></tr>
<tr><th colspan="3">Risk Committee</th><th>Audit Committee</th></tr>
<tr><th>Risk category</th><th>First line</th><th colspan="2">Second line</th><th>Third line</th></tr>
<tr><td>Creditworthiness risk</td><td>Credit management in business areas</td><td>Credit risk</td><td>Enterprise Risk Management Committee</td><td rowspan="6">Internal audit</td></tr>
<tr><td>Liquidity and market risk</td><td>Treasury</td><td>Market and liquidity risk</td><td>Asset and Liability Committee</td></tr>
<tr><td>Operational risk</td><td>All business divisions, functions and Chief Operating Office</td><td>Operational risk</td><td>Enterprise Risk Management Committee</td></tr>
<tr><td>Conduct, legal and compliance risk</td><td>All business divisions</td><td>Compliance</td><td>Enterprise Risk Management Committee</td></tr>
<tr><td>Strategic risk</td><td>Executive Directors and Senior Management</td><td>Finance</td><td>Executive Committee</td></tr>
<tr><td>Systems and change risk</td><td>Infrastructure and technology / Innovation and delivery</td><td>Operational risk</td><td>Enterprise Risk Management Committee</td></tr>
</table>

These bodies and senior officers are accountable and responsible for ensuring that the risks are appropriately managed within the agreed risk appetite and in accordance with the requirements of the RMF.

Individuals are encouraged to adopt an open and independent culture of challenge which is important in ensuring risk issues are fully surfaced and debated with views and decisions recorded. Risk governance and culture is reinforced by the provisions of the Senior Managers and Certification Regime.

Formal risk escalation and reporting requirements are set out in risk policies, individual committee terms of reference and the approved risk appetite thresholds and limits.

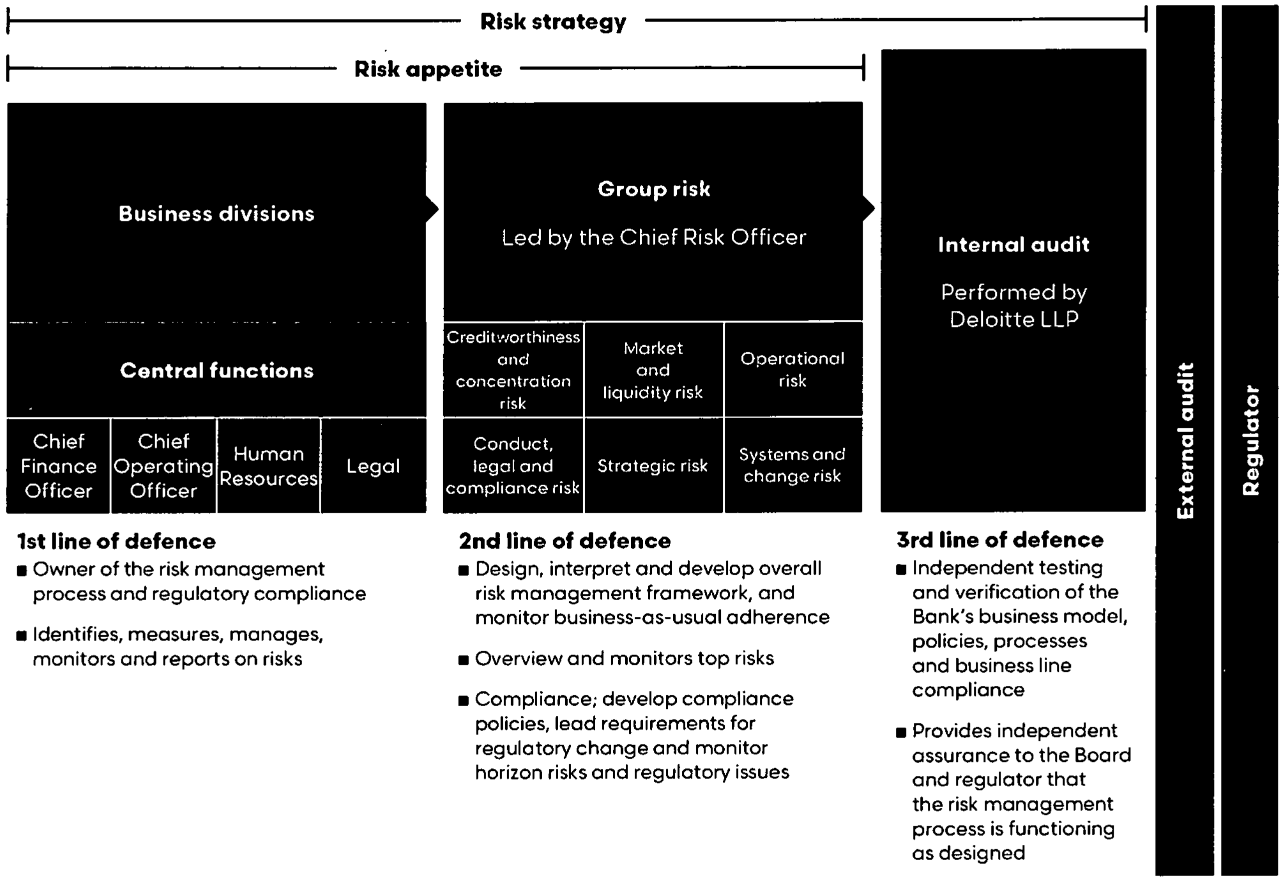
Committee structure and risk responsibilities
The monitoring and controlling of risk is a fundamental part of the management process within the Group. The Board oversees the management of the key risk categories across the organisation.

During 2018, the Group made a number of changes to enhance its risk governance. The Chief Risk Officer re-instated the Regulatory Change Working Group to oversee the early identification and implementation of changes in the regulatory landscape. The remit of the Policy Review Group was also widened to provide consistency in policy development, approval and the annual review cycle across the Group.

2. Risk governance and oversight (continued)

Three lines of defence model

The Group's RMF is underpinned by the 'three lines of defence' model which is summarised in the diagram below:



The Group implemented a change to its key risk categories in 2018 to reflect the Group's focus on assessing a customer's ability and willingness to pay as an integral part of its credit assessment.

First line of defence

Responsibility for risk management resides in the front-line business divisions and central functions, and line management is directly accountable for identifying and managing the risks that arise in their business or functional area. They are required to establish effective controls in line with Group risk policy and act within the risk appetite parameters set and approved by the Board. The first line of defence comprises each of the three lending divisions. The first line of defence also includes the Finance function led by the Chief Finance Officer, Operations led by the Chief Operating Officer, Human Resources led by the Group Human Resources Director and Legal led by General Counsel and Company Secretary. Whilst Human Resources and Legal are not customer facing themselves, they provide support and back-up to the customer facing divisions and have insight into many operational factors that could ultimately impact on Group's exposure to market, liquidity, credit, regulatory, legal, conduct, compliance and operational risk.

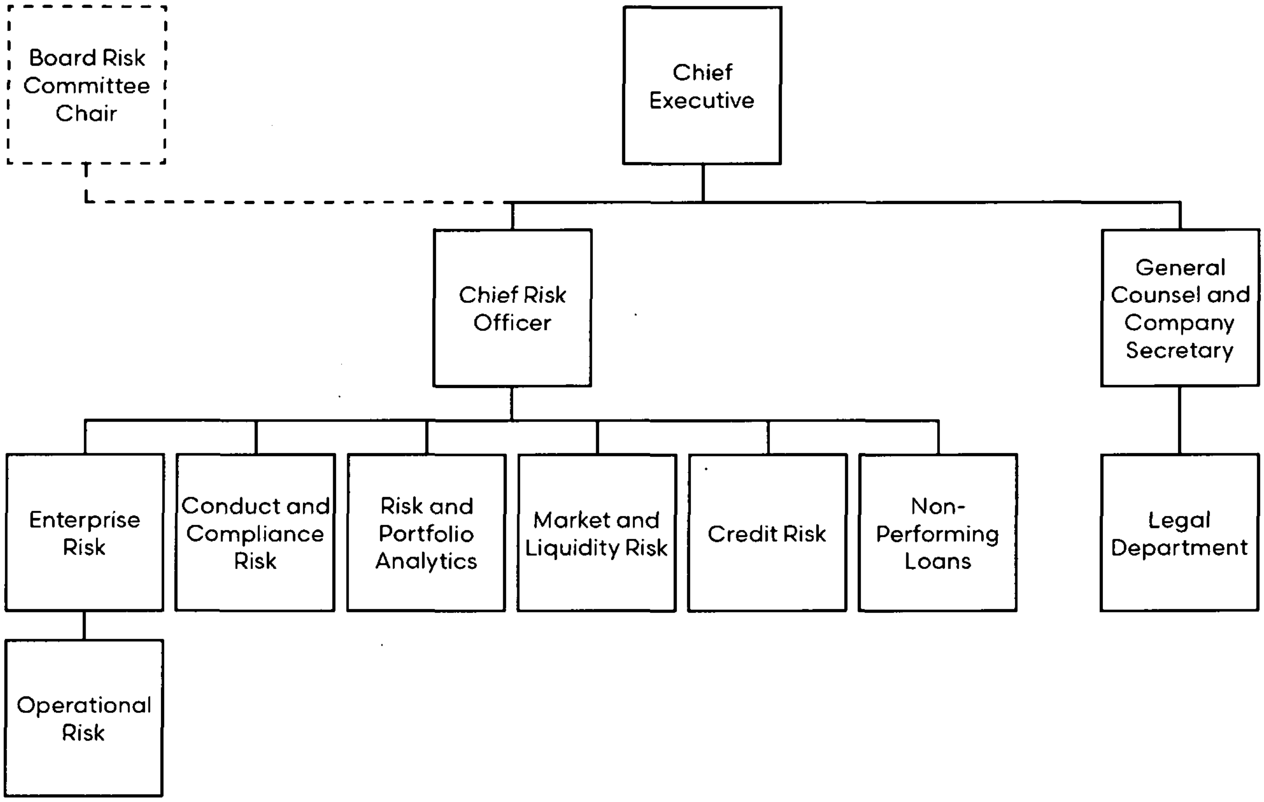
Each division and functional area operates to set risk policies to ensure that activities remain within the Board's stated risk appetite for that area of the Group. The risk policies are approved by the appropriate committee in accordance with their terms of reference and reviewed annually with any material changes requiring approval at committee level.

The first line of defence has its own operational process and procedures manuals to demonstrate and document how it conforms to the approved policies and controls. Likewise, it develops quality control programmes to monitor and measure adherence to and effectiveness of procedures. All employees within a customer facing unit are considered first line of defence. Each employee is aware of the risks to the Group of their particular activity and the divisional and function heads are responsible for ensuring there is a 'risk aware' culture within the first line of defence. For certain key policies, divisional staff complete regular on-line training programmes to ensure knowledge is refreshed and current.

2. **Risk governance and oversight** (continued)

Second line of defence
The second line of defence comprises the Group's central and independent risk management and compliance function led by the Chief Risk Officer, who reports to the Chairman of the Risk Committee and to the Chief Executive Officer. The Chief Risk Officer is also provided with unfettered access to the Chairman of the Board. The second line of defence also includes the General Counsel and Company Secretary who report to the Chief Executive Officer.

The high-level risk structure is shown below:



The second line of defence is necessarily and deliberately not customer facing and has no responsibility for any business targets or performance. It is primarily responsible for:

- the design and build of the various components of the Group's RMF and embedding these, together with the risk strategy and risk appetite across the organisation;
- independent monitoring of the Group's activities against the Board's risk appetite and limits, and provision of monthly analysis and reporting on the risk portfolio to the Executive Committee and the Board;
- issuing and maintaining the suite of Group risk policies;
- undertaking physical reviews of risk management, controls and capability in the first line units and providing risk assurance reports to the Executive Committee and the Board on all aspects of risk performance and compliance with the RMF;
- providing advice and support to the first line of defence in relation to risk management activities;
- credit approvals between divisional authority and the threshold for Credit Approval Committee; and
- undertaking stress testing exercises and working with Finance and Treasury on the production of the Internal Capital Adequacy Assessment Process (ICAAP), Internal Liquidity Adequacy Assessment Process (ILAAP) and the Recovery Plan and Resolution Pack (collectively the RRP).

2. Risk governance and oversight (continued)

Third line of defence
The third line of defence, Internal Audit (currently outsourced to Deloitte LLP), provides independent assurance on the activities of the Group, effectiveness of the Group's RMF and internal controls directly to the Board and Audit Committee. Internal Audit reports directly to the Chairman of the Audit Committee as well as the Chief Executive Officer and is independent of the first and second lines of defence.

The third line of defence has access to the activities and records of both the first and second lines of defence. It can inspect and review adherence to policy and controls in the first line, the monitoring of activity in the second line and the setting of policy and controls in the second line. The third line of defence does not independently establish policy or controls itself, outside of those necessary to implement its recommendations with respect to the other two lines of defence. The third line may in some cases use as a starting point the reports and reviews compiled by the second line but is not restricted to them or necessarily influenced by their findings.

The third line of defence's scope of work is agreed with the Audit Committee to provide an independent assessment of the governance, risk management and internal control frameworks operated by the Group and to note the extent to which the Group is operating within its risk appetite. It does this by reviewing aspects of the control environment, key processes and specific risks and includes review of the operation of the second line of defence.

The Group's engagement of Deloitte LLP to carry out the functions of the third line of defence provides the Group with access to specialist capabilities beyond its current scale and provides insight into best practice.

Risk policies and controls
The RMF is enacted through a comprehensive suite of control documents and risk policies, setting out the minimum requirements and standards in relation to the acquisition and management of risk assets as well as the control of risks embedded in the Group's operations, activities and markets.

The Group's high-level control documents and risk policies are owned and managed by the Group Risk function, headed by the Chief Risk Officer and approved by the Board or, where delegated, the appropriate Risk Committee. The suite of policies is grouped according to importance and key risk categories.

Group-level risk policies are supplemented as required by divisional risk processes and procedures, where more specific and tailored criteria are detailed. Divisional processes and procedures are required to be compliant with Group policy and dispensations or waivers are required where gaps are identified. These process and procedure manuals provide staff at all levels with day-to-day direction and guidance in the execution of their duties.

The effectiveness of and compliance with the risk policy framework is evaluated on a continuous basis through the monthly reporting requirements (including risk policy exceptions reporting). Additionally, a quarterly control self-certification process supplemented by a program of audits, thematic risk assurance reviews and quality control testing is undertaken by each of the three lines of defence.

Asset class policies
The Group's lending policies are contained in 15 asset class policies and a further 15 lending policies. These have been arranged to operate on a Group wide basis rather than based upon divisional products. This is considered to provide a more stable, consistent risk standard and control across the Group's portfolio of loan assets. Asset classes can also be aligned more readily with risk-weightings, probability of default (PD), loss given default (LGD) and expected credit loss (ECL) metrics which facilitates risk reporting, risk adjusted profitability analysis and modelling for stress testing and capital adequacy purposes.

Asset class policies are structured on the basis of policy rules which must be adhered to and guidelines where an element of controlled discretion is permitted. All planned exceptions to policy rules require approval at the Group risk level and both planned and unplanned exceptions to policy rules are reported monthly to the relevant risk management committee.

3. Top and emerging risks

The Group's top and emerging risks are identified through the process outlined in the 'Risk Management Framework' (Section 1) and are considered regularly by Management through the Enterprise Risk Management Committee and subsequently by the Risk Committee.

Top risks

The Group sees seven themes as its top risks:

- geopolitical risk;
- economic and competitive environment;
- pace of regulatory change;
- intermediary, outsourcing and operational resiliency;
- pace, scale of change and people risk;
- credit impairment; and
- information risk.

These themes, together with the Group's strategy to mitigate the risk and the direction of each theme are considered further in the following sections:

Top risk	Mitigation	Change
Geopolitical risk		**Risk increased**
The Group's financial position continues to improve with continued profitability and strong capital ratios. However, increasing geopolitical risk presents a risk to the business, its financials and earnings volatility following an unprecedented political event. The UK has experienced a number of political events during 2018. Although the European Union (EU) has agreed a withdrawal agreement with the UK there is no parliamentary majority of any option. The UK Prime Minister has successfully defended a no confidence vote amongst the Conservative members, but nothing has materially changed. Global populist trends, terrorist attacks and a continued weakening of sterling remain key features of the wider economy. These risks have the potential to have an impact on the Group and the impact could be wide reaching affecting other risks such as economic, regulatory, business change, outsourcing, people, credit risk impairment and conduct risk.	The Group monitors the environment and its chosen markets on a regular basis and continues to prioritise return on tangible equity over volume. The Group operates in specialist areas where Management and staff have significant expertise and a deep understanding of customer needs to drive a long-term relationship with its customers through the cycle. The Group undertakes a comprehensive assessment of its risk appetite and stress tests its lending and deposit portfolios to ensure that it can meet its objectives in severe but plausible economic conditions. The Group reviews its key outsource partners to establish early warning indicators and to formalise exit plans.	The UK economic outlook is expected to remain favourable in the short term but with increasing risks to the downside driven by weak productivity that may increase the potential for volatility for the Group and its customers. Developments regarding the UK's withdrawal from the EU, and in particular the reaction of households, businesses and asset prices to them, remain a significant influence on, and source of uncertainty about, the economic outlook.

3. Top and emerging risks (continued)

Top risk	Mitigation	Change
Economic and competitive environment A reversal in UK economic conditions, particularly in England where the majority of the Group's operations are based, could affect the Group's performance in a number of ways. These are set out below: • lower demand for the Group's products and services; • changes in funding costs resulting from ongoing political uncertainty accompanied by a loss of confidence in the market; • rising competition compressing Group margins below sustainable levels; and • higher impairments through increased defaults and/or reductions in collateral values.	The Group uses its expertise and deep understanding of its customers' needs to drive long-term relationships with its customers through the cycle. The Group monitors its chosen markets on a regular basis, reviews adjacent markets where it has expertise and considers opportunities for inorganic growth that are consistent with its strategy. The Group operates in specialist areas where Management and staff have expertise and a deep understanding of customer needs to deliver superior service. As a result, loans to Small and Medium Enterprises (SMEs) and consumers are subject to bespoke underwriting based on their ability to repay and sufficient security. The Group undertakes a comprehensive assessment of its risk appetite to ensure that it can meet its objectives in severe but plausible economic conditions. The Group completes comprehensive stress testing of its lending and deposit portfolios to test resilience to severe but plausible economic conditions. The Group also establishes a prudent balance sheet strategy with robust levels of capital and liquidity and a prudent funding structure.	**Risk increased** The UK economy has proven to be more resilient during 2018 than expected led by strong employment and conditions that continue to support affordability. However, the strong growth in Q3 has not continued into Q4 2018 and the Board expects there to be a continued period of uncertainty. As at 31 December 2018, the risk of a disorderly exit from the EU has increased with no majority in Parliament for any option.

3. Top and emerging risks (continued)

Top risk	Mitigation	Change
Pace of regulatory change		**Risk increased**
The prudential and conduct regulatory regimes are subject to change and could lead to increases in the level and quality of capital that the Group needs to hold to meet regulatory requirements. The countercyclical buffer increased to 1.0% at the end of November 2018 to add resiliency to the market prior to the UK's withdrawal from the EU. The Financial Policy Committee and the Prudential Regulation Committee (PRC) could use any reduction in Common Equity Tier 1 capital in the event of a disorderly exit from the EU to inform the setting of regulatory buffers. The PRC has indicated that it will set additional Prudential Regulation Authority (PRA) buffers in light of the 2018 stress test results to reflect the judgement that banks need to make substantial improvements to raise the management of model risk to a standard required for stress testing including whether judgements used are well supported through the use of appropriate empirical data or benchmarking analysis. The Financial Conduct Authority (FCA) has undertaken a number of thematic reviews during 2018 including the implementation of the Mortgage Credit Directive in second charge firms, a review of operational resiliency with the PRA and a review of credit worthiness and has set out its plans for 2019.	The regulatory environment continues to evolve and change. The Group actively engages with regulators, industry bodies and advisors to actively engage in consultation processes. The Group undertakes forward capital planning and sensitivity analysis using its ICAAP to ensure that the Group has sufficient time to respond to any changes in capital requirements.	UK financial services businesses remain subject to significant scrutiny and the current level of risk is elevated when compared to last year. The Group adopts the standardised approach to credit risk. The Basel Committee on Banking Supervision announced changes to the risk-weightings under the standardised approach in December 2017 that will lead to an increase in capital requirements over the period of the strategic plan. The Group implemented IFRS 9 from 1 January 2018 and achieved General Data Protection Regulation compliance by 25 May 2018. The Group attested to its compliance with the Mortgage Credit Directive for its residential second charge lending business on 1 May 2018, in line with the requirement of the Dear CEO letter to all second charge lenders from the FCA. The Group attested to the Risk Committee to its compliance with Policy Statement PS18/19 on assessing credit worthiness on 1 November 2018.

3. Top and emerging risks (continued)

Top risk	Mitigation	Change
Intermediary, outsourcing and operational resiliency The Group is a specialist lending and savings bank for SMEs and consumers. The specialist nature of some of its lending through intermediaries and brokers could mean that some customers find themselves with an increased risk of an unfavourable outcome. For the Group this could also lead to increased conduct related redress, additional fraud or credit risk impairments. The Group uses a number of third parties to support the delivery of its objectives. The availability and resiliency of its core customer facing systems play a key role in supporting the Group's reputation in its chosen markets.	The Group works with carefully selected intermediary and broker partners who take on the role of advising SMEs and consumers. The Group recognises that it is ultimately accountable for the lending it originates through its partners and continually undertakes reviews of their performance. The Group continually reviews its risk management approach to intermediaries, brokers and outsource partners to reflect the regulatory environment in which the Group operates.	**Risk increased** The Group has continued to invest in its oversight of intermediaries, brokers and outsource partners during 2018. The Group continued to invest in its relationship with Target Servicing Limited and expects to further improve the Group's outsourcing risk profile. This includes (but is not limited to) work on arrears management, forbearance and resiliency planning. The Group continues to explore other third-party relationships through which to deliver its objectives and improve operational resiliency.
Pace, scale of change and people risk The scale and pace of change could create delivery challenges and could lead to disruption of the Group's plans and in the delivery of its objectives. The Group is a diverse specialist lending and savings bank and has a need to add a significant number of colleagues over the plan to deliver its objectives. Failure to add the required capacity and capability may lead to a disruption in the delivery of its objectives.	The Group understands the need to manage change without disrupting the Group's operating environment and impacting customer service. The Group has implemented a new change prioritisation process in 2018 to prioritise change and provide effective oversight of the change portfolio to ensure that requirements are delivered within budget and on time. These operational risks are managed through a strong focus on change governance and programme management disciplines and are led by a dedicated executive member. The risks are further mitigated by the Group's strengthening of the Executive Management team.	**Risk increased** The Group continues to invest in its change management processes to increase the pace and scale of change without impacting on the Group's operations and customer service. The Group has appointed a Chief Technology Officer in 2018 to support the delivery of its technical transformation over the strategic plan. During 2018, the Group has continued to embed the new target operating model and the implementation of the Chief Operating Office. The Group has a strong appetite for change and the risk of an impact on its operations remains. The Group has invested in its leadership community through an 'Inspire' leadership programme and has focused on the actions arising from its people engagement surveys and regular reviews of the succession and talent management plans.

3. Top and emerging risks (continued)

Top risk	Mitigation	Change
Credit impairment As at 31 December 2018, the Group had customer loans (including operating leases and net of loss allowances) of £5.9 billion and is exposed to credit impairment if customers are unable to repay loans and any outstanding interest and fees. In addition, the Group has exposure to a small number of counterparties with whom it places surplus funding.	The Group recognises that it will experience credit impairment in connection with its lending activities, but manages its exposure by: • undertaking a prudent assessment of through-the-cycle losses in pricing, forecasting and stress testing; • maintaining consistent and conservative loan to value ratios and avoiding material weakening of credit quality to drive volumes; • lending predominantly on a secured basis against identifiable and accessible assets; • operating strong controls and governance with effective oversight by a centralised Group credit team; and • maintaining a prudent Treasury counterparty policy with surplus funding placed with the Bank of England and UK clearing banks.	**No change** Underlying Group credit impairment has remained low, reflecting favourable market conditions in the UK and the Group's approach to lending. The Group's counterparty exposure has remained broadly unchanged with the majority of surplus funding placed with the Bank of England and balances with UK clearing banks. The Group believes that the potential for additional credit impairment has increased with uncertainty over the outlook of the Brexit negotiations and the outlook for the UK economy given recent forecasts of productivity and increasing consumer debt. The Group has completed its implementation of IFRS 9 and will make use of the transition arrangements. The Group considers that its exposure to the retail sector and construction is manageable.
Information risk The pace of technological development is changing the way in which SMEs and consumers want to engage with the Group, leading to a number of risks. These are set out below: • increasing customer demand could exceed the Group's ability to provide highly reliable and widely available systems and services; • the evolving nature and scale of criminal activity could increase the likelihood and severity of attacks on the Group's systems; and • franchise value and customer trust could be significantly eroded by a sustained hack of the Group's systems leading to a diversion of funds or the theft of customer data.	The Group continually reviews its control environment for information security to reflect the evolving nature of the threats to which the Group is exposed. The Group's strategy for mitigating information security risk is comprehensive, including: a documented cyber strategy, ongoing threat assessments, regular penetration testing, the wide deployment of detective controls and a programme of education and training.	**No change** The Group continues to invest in its capabilities to reduce its exposure to a cyber-attack and has further refined its risk appetite and controls with respect to information security. However, the risk of information security breaches, threats from cyber-crime and the impact of new technology on the Group's businesses remain.

3. Top and emerging risks (continued)

Emerging risks
The Group has identified the following emerging risks:

Emerging risk	Mitigation
Brexit Parliament voted against the Government on the Withdrawal Agreement vote on 15 January 2019 and in the absence of any majority for any option the likelihood of a no-deal Brexit has increased. Given the Group does not have operations outside of the UK, the key risk for the Group is considered to be a general downturn in the UK economy. In the event of a no-deal exit, the availability of skilled workers or ability to export goods to the EU at competitive prices may impact some of the Group's customers.	As well as keeping abreast of the negotiations and the potential impact to the UK economy, the Group has considered a more severe alternative downside scenario based on a disorderly no-deal Brexit. The scenario is based on a significant reduction in investment which helps to move the UK into a recession, increasing unemployment. In the short-term, the consumer price index remains elevated before deflationary pressures on sterling and gross domestic product start to reduce the consumer price index, presenting an opportunity for the Monetary Policy Committee to reduce interest rates. The Group has considered the first order impacts on its strategy arising from a fall in investment that may lead to a reduction in demand for its lending products and that may impact the Group's ability to grow in its SME markets. It has also considered the impact of a fall in residential and commercial property prices within its Property division and the impact of an increase in default in its Consumer Lending division following an increase in unemployment. The Group has identified a series of early warning indicators that it has set out in each scenario so that it can react in a timely manner. The Group has also invested in its quality control and quality assurance capabilities and its non-performing loan management capabilities so that it is well prepared in case of any scenario emerging. The Group considers that the current alternatives fall within its current stress testing scenarios and has considered through its ICAAP the impact on its key suppliers.
Minimum requirements for own funds and eligible liabilities (MREL) funding requirements MREL is an EU regulation that supports orderly resolution and protects depositors and taxpayers in the event of bank failure. The Group is currently not considered in scope however, over time the Group may fall in scope for more complex resolution strategies and going concern requirements.	The Group actively monitors its position in relation to MREL and as part of its strategic decision making. The Group will engage with the PRA during its strategic planning process to understand the point that the Group may face additional MREL requirements to ensure that the Group has plenty of time to prepare.

3. Top and emerging risks (continued)

Emerging risk	Mitigation
Financial crime The risk of a downturn in the UK economy could result in an increased risk of financial crime activity.	 The Group is enhancing its expertise in the first line of defence to ensure a continued focus on strategy and regulatory compliance. In addition, the Chief Operating Office continues to build out their ability to manage financial crime risk as part of the ongoing servicing.
Climate change On 15 October 2018, the PRA published a consultation paper on 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change'. Following the consultation period, the PRA will be setting its expectations from banks on how they approach the management of the 'far-reaching and foreseeable' financial risks from climate change. For banks, climate-related risk factors will manifest as credit risk (e.g. increasing flood risk to mortgage portfolios, declining agricultural output increasing default rates, tightening energy efficiency standards impacting property exposures, disruptive technology leading to financial losses), market risks (commodity prices, corporate bonds, equities and certain derivatives contracts) and operational risks (severe weather events impacting business continuity).	 The Compliance team will monitor developments during the consultation period and the post-consultation rule-setting period and update the relevant governance forums.
General Data Protection Regulation (GDPR) Whilst the GDPR was implemented on 25 May 2018 and the Group's programme team worked with all the functions to ensure a compliant position was reached, the increased public awareness of data privacy has resulted in a risk of increased data subject rights requests. In addition, the Group must ensure ongoing compliance to the GDPR as well as effective management of privacy.	 The Group appointed a Data Protection Officer in May 2018 who supported the GDPR programme through to conclusion, ensuring that compliant record of processing activities had been completed with legitimate, privacy and data protection impact assessments also being completed where required. The existing privacy related policies have been updated and the Privacy Office will now focus on implementing an enhanced privacy program framework to ensure the Group's privacy management structure is enhanced.

4. Key risk categories

The key risk categories faced by the Group are as follows:

Risk category	Definition
Creditworthiness risk (including concentration and single name risk) **(Section 5)**	• The risk that a borrowing client or treasury counterparty fails to repay some or all of the capital or interest advanced to them due to lack of willingness to pay (credit risk) and/or lack of ability to pay (affordability). This category also includes credit concentration risk which is the risk of exposure to particular groups of customers or sectors or geographies that uncontrolled may lead to additional losses that the Shareholder or the market may not expect.
Liquidity and market risk **(Section 6 and 7 respectively)**	• Liquidity risk is the risk that the Group is unable to meet its current and future financial obligations as they fall due, or is only able to do so at excessive cost. • Market risk is the risk of financial loss through un-hedged or mismatched asset and liability positions that are sensitive to changes in interest rates or currencies.
Operational risk **(Section 8)**	• The risk of loss resulting from inadequate or failed internal processes, people and system failures, or from external events including strategy and reputational risks.
Conduct, legal and compliance risk **(Section 9)**	• Conduct risk is the risk that the Group's behaviour will result in poor customer outcomes and that our people fail to behave with integrity. • Legal and compliance risk is the risk of regulatory enforcement and sanction, material financial loss, or loss to reputation the Group may suffer as a result of its failure to identify and comply with applicable laws, regulations, codes of conduct and standards of good practice.
Strategic risk **(Section 10)**	• The risk that the Group is unable to meet its objectives through the inappropriate selection or implementation of strategic plans. This includes the ability to generate lending volumes inside risk appetite.
Systems and change risk **(Section 11)**	• Systems risk is the risk that new threats are introduced to our critical systems resulting in them becoming unavailable during core operational times. • Change risk is the risk that transition changes in the business will not be supported by appropriate change capability and be improperly implemented. It is also the risk that too many in-flight changes cause disruption to business operations.

A more detailed summary of each key risk is contained in the following sections.

5. Creditworthiness risk

Creditworthiness risk is the risk of suffering financial loss should borrowers or counterparties default on their contractual obligations to the Group due to lack of willingness to pay (credit risk) and/or lack of ability to pay (affordability). These risks are managed by the Board Risk Committee and the Asset and Liability Committee (ALCo). This risk has two main components:

- Customer credit risk (from core lending activity); and
- Treasury credit risk (from Treasury activity).

The Group's treasury credit risk exposure is limited to short-term deposits placed with leading UK banks.

5.1. Credit risk approval process

The Group operates a hierarchy of lending authorities based principally upon the size of the aggregated credit risk exposure to counterparties, group of connected counterparties or, where applicable, a portfolio of lending assets that are subject to a single transaction. In addition to maximum amounts of credit exposure, sole lending mandates may stipulate sub-limits and / or further conditions and criteria.

Each division has a maximum authority level allocated, with exposures above these levels requiring approval from an approver in the second line of defence or the Credit Approval Committee. In each lending division, at least one signatory to the loan must be a segregated first line of defence credit approver who has no responsibility for, or remuneration arrangements linked to, sales targets, on-going sales origination or relationship responsibility with the borrower.

The maximum divisional mandate for Business Finance and Commercial Property Finance is £1.25 million. The maximum divisional mandate for Residential Property Finance is £100,000 and for Consumer Lending is £75,000. Exposures beyond these limits up to £5 million may be approved by an approver in the second line of defence and exposures up to the Group single name concentration limit of £25 million must be approved by the Credit Approval Committee. The Group has a nominal appetite for wholesale exposures above £25 million within the lending authority of the Credit Approval Committee. In addition, where transactions involve financing portfolios of lending assets in excess of £15 million, or where an individual loan is required in excess of appetite, Board approval is also required.

Lending is advanced subject to the Group lending approval policy and specific credit criteria. When evaluating the credit quality and covenant of the borrower, significant emphasis is placed on the nature of the underlying collateral. This process also includes the review of the Board's appetite for concentration risk.

The Group is a responsible lender and consumer affordability has remained a key area of focus for the Group. The Group's approach to affordability is set out in a Board approved responsible lending policy that is embedded within each lending division's lending guides.

5.2. Credit monitoring

Approval and on-going monitoring control is exercised both within the divisions and through oversight by the Group's Credit Risk function. This applies to both individual transactions as well as at the portfolio level by way of monthly credit information reporting, measurement against risk appetite limits and testing via risk quality assurance reviews.

The divisions operate through the Chief Operating Office function's timely collections and arrears management processes. The Group further invested in 2018 in the development of its operational arrangements and capabilities for non-performing loan management to ensure that the Group is capable of operating in a more challenging environment where interest rates are rising and there is lower demand and liquidity in property markets.

5.3. Impairment under IFRS 9 (from 1 January 2018)

Audited: *The following section is covered by the independent auditor's report.*

From 1 January 2018, impairment of financial assets is calculated using a forward looking expected credit loss (ECL) model. The Group records an allowance for ECLs ('loss allowance') for all financial assets not held at fair value through profit or loss, together with an allowance for ECLs for financial guarantee contracts and loan commitments. The Group's accounting policy is detailed in Note 1.7(v) of the financial statements.

5. **Creditworthiness risk** (continued)

5.3. **Impairment under IFRS 9 (from 1 January 2018)** (continued)

Measurement of ECLs depends on the 'stage' of the financial asset, based on changes in credit risk occurring since initial recognition, as described below:

- **Stage 1:** when a financial asset is first recognised it is assigned to Stage 1. If there is no significant increase in credit risk from initial recognition the financial asset remains in Stage 1. Stage 1 also includes financial assets where the credit risk has improved and the financial asset has been reclassified back from Stage 2. For financial assets in Stage 1, a 12-month ECL is recognised.
- **Stage 2:** when a financial asset shows a significant increase in credit risk from initial recognition it is moved to Stage 2. Stage 2 also includes financial assets where the credit risk has improved and the financial asset has been reclassified back from Stage 3. For financial assets in Stage 2, a lifetime ECL is recognised.
- **Stage 3:** when there is objective evidence of impairment and the financial asset is considered to be in default, or otherwise credit-impaired, it is moved to Stage 3. For financial assets in Stage 3, a lifetime ECL is recognised.
- **Purchased or originated credit-impaired (POCI):** POCI assets are financial assets that are credit-impaired on initial recognition. On initial recognition they are recorded at fair value. ECLs are only recognised or released to the extent that there is a subsequent change in the ECLs. Their ECL is always measured on a lifetime basis.

In relation to the above:

- **Lifetime ECL** is defined as ECLs that result from all possible default events over the expected behavioural life of a financial instrument.
- **12-month ECL** is defined as the portion of lifetime ECL that will result if a default occurs in the 12 months after the reporting date, weighted by the probability of that default occurring.

For loan commitments, where the loan commitment relates to the undrawn component of a facility, it is assigned to the same stage as the drawn component of the facility. For pipeline loans, the loan commitment is assigned to Stage 1.

For financial guarantee contracts, the Group assigns a stage using the definitions described above.

Under the requirements of IFRS 9, the Group calculates a loss allowance for cash and balances at central banks, loans and advances to banks, loans and advances to customers and investment securities. A further loss allowance is calculated for financial guarantee contracts and loan commitments.

As at 31 December 2018, the loss allowances for cash and balances at central banks, loans and advances to banks, and investment securities are immaterial, totalling less than £0.1 million. The loss allowance for loans and advances to customers is £67.8 million.

5. Creditworthiness risk (continued)

5.3. Impairment under IFRS 9 (from 1 January 2018) (continued)

The following table provides an analysis of loans and advances to customers by reportable segment and the year-end stage classification:

As at 31 December 2018	Property Finance £m	Business Finance £m	Consumer Lending £m	Total £m
Stage 1	3,051.5	1,179.7	690.8	4,922.0
Stage 2	607.8	188.5	75.3	871.6
Stage 3	60.6	54.0	6.6	121.2
Gross loans and advances to customers	**3,719.9**	**1,422.2**	**772.7**	**5,914.8**
Stage 1	(2.0)	(5.9)	(15.6)	(23.5)
Stage 2	(5.5)	(4.0)	(11.2)	(20.7)
Stage 3	(6.2)	(13.0)	(4.4)	(23.6)
Loss allowance	**(13.7)**	**(22.9)**	**(31.2)**	**(67.8)**
Fair value adjustments for hedged risk	(0.6)	-	(0.5)	(1.1)
Total loans and advances to customers	**3,705.6**	**1,399.3**	**741.0**	**5,845.9**
Loss allowance coverage (%)	**0.4%**	**1.6%**	**4.0%**	**1.1%**

As at 31 December 2018, the loss allowance for financial guarantee contracts is £nil because the contract is fully collateralised through a first fixed charge over a blocked deposit account. As such, the amount the Group should have to pay should the guarantee be called upon is £nil.

As at 31 December 2018, the loss allowance for loan commitments is £1.0 million. The following table provides an analysis of loan commitments by reportable segment and the year-end stage classification:

As at 31 December 2018	Property Finance £m	Business Finance £m	Consumer Lending £m	Total £m
Stage 1	145.6	344.9	52.0	542.5
Stage 2	-	6.8	-	6.8
Gross loan commitments	**145.6**	**351.7**	**52.0**	**549.3**
Stage 1	-	(1.0)	-	(1.0)
Loss allowance	**-**	**(1.0)**	**-**	**(1.0)**
Total loan commitments	**145.6**	**350.7**	**52.0**	**548.3**
Loss allowance coverage (%)	**-**	**0.3%**	**-**	**0.2%**

Movement in the Group's loss allowance is presented in the financial statements as follows:

- **Loans and advances to customers:** presented as a deduction from the gross carrying amount. See Note 14 of the financial statements.
- **Loan commitments:** presented as a provision. See Note 25 and Note 38 of the financial statements.

5. Creditworthiness risk (continued)

5.3. Impairment under IFRS 9 (from 1 January 2018) (continued)

Calculation of expected credit losses
ECLs are the discounted product of the probability of default (PD), exposure at default (EAD) and loss given default (LGD), detailed below. ECLs are determined by projecting the PD, EAD and LGD for each future month for each exposure. The three components are multiplied together and adjusted to reflect forward looking information. This calculates an ECL for each future month, which is then discounted back to the reporting date and summed. The discount rate used in the ECL calculation is the original effective interest rate or an approximation thereof.

Probability of default
PD is an estimate of the likelihood of default over a given time horizon. A default may only happen at a certain time over the assessed period, if the facility has not been previously derecognised and is still in the portfolio.

The Group has developed a credit grading system for all its asset classes and has mapped these to a common master grading scale that has been aligned to the Standard and Poor's grading scale. The Group operates both a model-based PD for its high volume portfolios such as Consumer Lending and Residential Property Finance and has developed and implemented a Slotting approach for the low volume and high value obligors in Business Finance and large ticket commercial property cases. Both processes deliver a measure of a point-in-time measure of default.

For the model-based portfolios, the measure of PD is based on information available to the Group from credit reference agencies and internal product performance data. For the Slotted portfolios, the measure of PD relates to attributes relating to financial strength, political and legal environment, asset/transaction characteristics, strength of sponsor and security.

The current risk grading framework consists of 25 grades on a master grading scale reflecting varying degrees of risk and default. The responsibility for setting risk grades lies with the approval point for the risk or committee as appropriate. Risk grades are subject to regular reviews by Group Risk. The Group's grading scale is mapped to Standard and Poor's grading scale and aggregated for reporting purposes in the following way:

Grading	Master grading scale	PD range	Standard and Poor's grade
Low risk	1-10	<=0.38%	AAA to BBB-
Medium risk	11-15	>0.38% to <= 1.76%	BB+ to BB-
High risk	16-25	>1.76%	B+ to D

For each asset class, the Group has a proprietary approach to extrapolate its best estimate of the point-in-time PD from 12 months to behavioural maturity, using economic response models that have been developed specifically to forecast the sensitivity of PD to key macroeconomic variables.

Exposure at default
EAD is an estimate of the exposure at a future default date, taking into account expected changes in the exposure after the reporting date, including repayments of principal and interest, whether scheduled by contract or otherwise, expected drawdowns on committed facilities, and accrued interest from missed payments.

EAD is designed to address increases in utilisation of committed limits and unpaid interest and fees that the Group would ordinarily expect to observe to the point of default, or through to the point of realisation of the collateral.

The Group determines EADs by modelling the range of possible exposure outcomes at various points in time, corresponding to the multiple scenarios.

5. **Creditworthiness risk** (continued)

5.3. **Impairment under IFRS 9 (from 1 January 2018)** (continued)

Loss given default
LGD is an estimate of the loss arising in the case where a default occurs at a given time. It is based on the difference between the contractual cash flows due and those that the lender would expect to receive, including from the realisation of any collateral. It is usually expressed as a percentage of the EAD.

The Group segments its lending products into smaller homogenous portfolios. In all cases the LGD or its components are tested against recent experience to ensure that they remain current.

- **Property Finance:** the LGD is generally broken down into two parts. These include the Group's estimate of the probability of possession given default, combined with the loss given possession. The Group has continued to focus on the proportion of accounts that have not cured over an emergence period, rather than the proportion of accounts that enter possession to be appropriately conservative. The LGD is based on the Group's estimate of a shortfall, based on the difference between the property value after the impact of a forced sale discount and sale costs, and the loan balance with the addition of unpaid interest and fees and first charge claims with regards to first charge residential mortgages.
- **Business Finance:** the LGD is based on experience of losses on repossessed assets. The LGD on Block and Wholesale portfolios is based on experience of losses supported by key judgements.
- **Consumer Lending:** the Group uses an estimate of the probability of charge-off, defined as six or more payments in arrears, combined with an estimate of the expected write-off based on established contractual forward flow arrangements for the sale of charge-off debt. There is no recovery portfolio.

Measurement of expected credit losses
The measurement of ECLs requires the use of complex models and significant assumptions and key judgements.

Significant increase in credit risk
The Group applies a series of quantitative, qualitative and backstop criteria to determine if an account has demonstrated a significant increase in credit risk and should therefore be moved to Stage 2:

- **Quantitative criteria:** this considers the increase in an account's remaining lifetime PD at the reporting date compared to the expected residual lifetime PD when the account was originated. The Group segments its credit portfolios into PD bands and has determined a relevant threshold for each PD band, where a movement in excess of threshold is considered to be significant. These thresholds have been determined separately for each portfolio based on historical evidence of delinquency.
- **Qualitative criteria:** this includes the observation of specific events such as short-term forbearance, payment cancellation, historical arrears or extension to customer terms.
- **Backstop criteria:** IFRS 9 includes a rebuttable presumption that 30 days past due is an indicator of a significant increase in credit risk. The Group considers 30 days past due to be an appropriate backstop measure and does not rebut this presumption.

Assessment of whether there has been a significant increase in credit risk incorporates forward looking information. The Group undertakes a review of the forward looking economic scenarios at least quarterly and more frequently if required. The results of this review are recommended to the Audit Committee and Board prior to any changes being implemented.

As a general indicator, credit risk of a particular exposure is deemed to have increased significantly since initial recognition if, based on the Group's quantitative modelling:

Property Finance – Commercial

- External mortgage payments in arrears from the credit reference agencies. The external arrears information is statistically a lead indicator of financial difficulties and potential arrears on the loan book;
- for short-term loans with a modelled PD, PD > 0.38% and the absolute movement in remaining lifetime PD is more than four times the estimate at origination;
- for term loans with a modelled PD, PD > 0.38% and the absolute movement in remaining lifetime PD is more than two times the estimate at origination; or
- for all portfolios with a slotted PD, PD > 0.38% and the absolute movement in remaining lifetime PD is more than three times the estimate at origination.

5. **Creditworthiness risk** (continued)

5.3. **Impairment under IFRS 9 (from 1 January 2018)** (continued)

Property Finance - Residential

- All exposures are graded under the modelled approach. Where the modelled PD > 0.38% and the absolute movement in remaining lifetime PD is more than 5.1 times the estimate at origination;
- where the customer has ever been six or more payments in arrears on any fixed term account at the credit reference agency;
- where the customer has missed a mortgage payment in the last six months at the credit reference agency; or
- loan account is forborne.

Business Finance

- Entry on to watch-list;
- loan account is forborne;
- for accounts with a modelled PD, where the absolute movement in the remaining lifetime PD is more than 4.6 times the estimate at origination; or
- for accounts with a slotted PD, where the absolute movement in the remaining lifetime PD is more than three times the estimate at origination.

Consumer Lending

- Non-personal loans PD > 0.38% and the absolute movement in remaining lifetime PD is more than 3.7 times the estimate at origination;
- personal loans PD > 038% and the absolute movement in remaining lifetime PD is more than 4.6 times the estimate at origination;
- county court judgements registered at the credit reference agencies of > £150 or > £1,000 in last 3-years; or
- loan account is forborne.

For low credit risk exposures, the Group is permitted to assume, without further analysis, that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low credit risk at the reporting date. The Group has opted not to apply this low credit risk exemption in the year ended 31 December 2018.

The Group undertakes an update of all its key impairment judgements in advance of the interim report and accounts and the annual report and accounts. This includes (and is not limited to) a review of model monitoring, validation of key assumptions based on trends in actual performance, monitoring of stage effectiveness and the forward economic scenarios used to support the lifetime ECL calculations. All key judgements are reviewed and recommended to the Audit Committee for approval prior to implementation. Stage 2 criteria are designed to be effective early indicators of a significant deterioration in credit risk. As part of its six-monthly review of key impairment judgements the Group undertakes detailed analysis to confirm that the Stage 2 criteria remain effective. This includes (and is not limited to):

- **Criteria effectiveness:** this includes the emergence to default for each Stage 2 criterion when compared to Stage 1, Stage 2 outflow as a percentage of Stage 2, percentage of new defaults in Stage 2 in the months prior to default, time in Stage 2 prior to default and percentage of the book in Stage 2 that are not progressing to default or curing.
- **Stage 2 stability:** this incudes stability of inflows and outflows from Stage 2 and 3.
- **Portfolio analysis:** this includes the percentage of the portfolio that is in Stage 2 and not defaulted, the percentage of the Stage 2 transfer driven by Stage 2 criterion other than the back stops and back-testing of the defaulted accounts.

During 2018, the Group used this process to remove some PD floors as they were not appropriately considering a significant increase in credit risk. In addition, the Group considered the roll back to Stage 1 (ignoring curing requirements) to ensure that the Stage 2 criteria was picking up any significant deterioration in credit risk.

The Group calculates the ECL on an EAD basis and then separately considers how much of the ECL is attributable to loan balances and loan commitments which are then reported separately.

5. **Creditworthiness risk** (continued)

5.3. **Impairment under IFRS 9 (from 1 January 2018)** (continued)

Definition of default and credit-impaired assets
The Group's definition of default is fully aligned with the definition of credit-impaired. The Group applies a series of quantitative and qualitative criteria to determine if an account meets the definition of default and should therefore be moved to Stage 3. These criteria include:

- when the borrower is unlikely to pay its credit obligations to the Group in full, without recourse by the Group to actions such as realising security (if any is held);
- when the borrower is more than 90 days past due on any material credit obligation to the Group; and
- when a material credit obligation to the Group has gone past maturity or there is a degree of doubt that the exit strategy for the obligation is likely.

Inputs into the assessment of whether a financial instrument is in default and their significance may vary over time to reflect changes in circumstances.

Curing
A financial instrument is considered to be 'cured' and therefore reclassified back to a lower stage when none of the assessed criteria that caused movement into the higher stage have been present for a consecutive period of at least 12 months (the 'curing period').

For Stage 3 loans with forbearance arrangements in place, the loan must first successfully complete its 12-month curing period to be moved to Stage 2. Following this, the loan must then successfully complete its 24-month forbearance probation period before the forbearance classification can be discontinued.

The Group has not implemented curing for forborne loans as at 31 December 2018. The Group believes that the nature of the cycle and the narrow range of forbearance treatments used means that curing is not material. The Group has decided to focus on stabilising the ECL during 2018 with a view to implementing curing in Q2 2019.

Forward looking information
The Group incorporates forward looking information into the calculation of ECLs and the assessment of whether there has been a significant increase in credit risk.

Scenario analysis
The Group's central view is informed by the HM Treasury Central forecast that is published quarterly and used as part of the Group's corporate planning activity. Intra-quarter, the Group considers survey-based data and lead indicators to inform whether the central view continues to be appropriate. In the calculation of the ECL and stage transfer the Group uses two further scenarios to reflect an alternative upside view and an alternative downside view. These are chosen to be plausible alternative base cases and are not stress-testing scenarios. The probabilities assigned to the scenarios are a matter of judgement but are generally set to ensure that there is an asymmetry in the ECL.

The Group is not large enough to have an internal economist and therefore works with a third party on the narrative of the alternative scenarios and the rate paths to ensure that the scenarios are internally consistent using the UK Treasury model. The rate paths used in the scenarios are consistent with the core UK macroeconomic factors that are published by the Bank of England as part of the annual stress testing exercise. These scenarios are reviewed at the Audit Committee and recommended to Board for approval at least quarterly.

The Group has regularly considered Brexit within its economic scenarios and specifically the nature and probability of the alternative downside scenario. In the latter part of 2018, the Board agreed to move from a 50% / 30% / 20% central view / downside view / upside view respectively to a 40% / 40% / 20% central view / downside view / upside view respectively. The Board also agreed to change the nature of the alternative downside view from an orderly no-deal Brexit to a disorderly no-deal Brexit as a result of there being no parliamentary majority for any option.

5. **Creditworthiness risk** (continued)

5.3. **Impairment under IFRS 9 (from 1 January 2018)** (continued)

Estimating forward looking expected credit losses
The Group has developed a proprietary approach to assess the impact of the changes in economic scenarios on the obligor level ECL. The Group has mapped each asset class to an external long-run benchmark series that is believed to behave in a similar way to the Group's portfolio over the cycle. The Group has developed econometric models to establish how much of the historical series can be explained by movements in the UK macroeconomic factors. The models deliver an estimate of the impact of a unit increase in default arising from a 1% increase in the underlying macroeconomic factors. The models are developed in line with the Group's model governance framework and are subject to review at least every six-months. The models are tested across multiple sets of scenarios to ensure that they work in a range of scenarios, the output of the scenarios is a series of scalars by asset class and a scenario that can be applied to the underlying PDs to deliver a forward looking ECL. The Group has developed a proprietary approach to extrapolating its 12-month PDs over the behavioural maturity of the loans that the scalars can be applied to. The nature of the scenarios means that there will be an impact on both the PD and the number of obligors moving from Stage 1 to Stage 2.

Critical accounting estimates and judgements and key sensitivity analysis
Individual Stage 3 ECL on loans and advances to customers are calculated based on an assessment of the expected cash flows and the underlying collateral. For individual Stage 3 ECL, statistical models are used for Consumer Lending and Residential Property Finance, whilst provisions for Business Finance and Commercial Property Finance are assessed on a loan-by-loan basis and reviewed at Group Impairment Committee where the impairment is in excess of £75,000. Where models are used for individual Stage 3 ECLs, score cards are used to calculate PDs based on the recent performance of the portfolios. These PD estimates are translated to lifetime PDs using the approach outlined above. LGDs are calculated taking into account the valuations of available collateral and the experienced forced sale discounts when collateral has been realised. These factors are applied to all the aged portfolios of debt at each statement of financial position reporting date to derive the individual impairment requirement.

For Stage 1 impairment, financial assets are grouped on the basis of similar risk characteristics. In all situations a 12-month PD is multiplied by the EAD and LGD to derive an ECL requirement which is incurred at the statement of financial position reporting date but not yet individually identified.

The key assumptions, being the forced sale discount on the Residential Property Finance portfolio and Commercial Property Finance portfolio, PD of the portfolios and LGD of the Consumer Lending portfolio are monitored regularly to ensure the ECL requirement is entirely reflective of the current portfolio. The accuracy of the ECL calculation would therefore be affected by unanticipated changes to the economic situation and assumptions which differ from actual outcomes. For example, for loans and advances to customers:

Probability of default
The PD is based on internal and external individual customer information that is updated for each reporting period. The external customer information is sourced from credit reference agencies and includes information from a broad range of financial services firms.

- A 10% increase in the PD for each customer would increase the ECL by c.£3.9 million.

Loss given default
For loans where property is taken as collateral the LGD calculates the loss in the event of possession. Not all cases that have reached Stage 3 will enter possession and the Group calculates as part of its judgements the probability of possession given default. The loss in the event of possession is driven predominantly by future property value inflation (or deflation) and changes in force sales discount which affect the underlying value of the collateral.

- A 10-percentage point reduction in property prices would increase the ECL by c.£6.1 million.
- A 5% absolute increase in the force sales discount would increase the ECL by c.£4.1 million.

For loans within Business Finance, the assumption with most judgement is the absolute LGD value calculated through the twice-yearly judgements.

- A 5% absolute increase in the LGD's applied in Business Finance would increase the ECL by c.£3.0 million.

5. **Creditworthiness risk** (continued)

5.3. **Impairment under IFRS 9 (from 1 January 2018)** (continued)

For loans originated within Consumer Lending, the assumption with most judgement applied is the LGD. Not all loans are simultaneously charged-off at 180 days past due so the LGD includes a judgement about the number of loans expected to enter charge-off from default and then the loss given charge-off.

- A 10-percentage point increase in the loss given charge-off would increase the ECL by c.£2.9 million.

5.4. Impairment under IAS 39 (prior to 1 January 2018)

Audited: *The following section is covered by the independent auditor's report.*

Prior to 1 January 2018, impairment of financial assets was based on the incurred loss model under IAS 39. The Group's accounting policy is detailed in Note 1.7(v) of the financial statements.

Under the requirements of IAS 39, loans and advances to customers was the only financial asset category for which impairments were recognised.

Loans and advances to customers were regularly reviewed to determine if there was any objective evidence of impairment. They were categorised as follows:

Type of impairment assessment	**Description**
Individual impairment	Where specific circumstances indicated that a loss was likely to be incurred.
Collective impairment	Impairment allowances were calculated for each portfolio on a collective basis, given the homogenous nature of the assets in the portfolio.

Risk categorisation	**Description**
Neither past due nor impaired	Loans that were not in arrears and which did not meet the impaired asset definition. This segment could include assets subject to forbearance measures.
Past due but not impaired	This consisted predominantly of loans in Property Finance and Business Finance that were past due and individually assessed as not being impaired. This definition also included unsecured loans in Consumer Lending that were past due but not more than 90 days.
Impaired assets	Loans that were in arrears or where there was objective evidence of impairment and where the carrying amount of the loan exceeded the expected recoverable amount. This definition also included unsecured loans in Consumer Lending that were more than 90 days in arrears and carried identified impairment.

5. **Creditworthiness risk** (continued)

5.4. **Impairment under IAS 39 (prior to 1 January 2018)** (continued)

The following table provides an analysis of loans and advances to customers by reportable segment and impairment risk categorisation:

As at 31 December 2017	Property Finance £m	Business Finance £m	Consumer Lending £m	Total £m
Neither past due nor impaired	3,114.8	1,015.7	611.3	4,741.8
Past due but not impaired				
Up to 30 days	9.2	10.4	1.0	20.6
30-60 days	32.8	4.0	7.4	44.2
60-90 days	7.8	1.2	2.6	11.6
Over 90 days	18.1	2.1	-	20.2
Total past due but not impaired	67.9	17.7	11.0	96.6
Impaired assets	13.3	21.5	4.9	39.7
Gross loans and advances to customers	3,196.0	1,054.9	627.2	4,878.1
Impairment allowance	(6.3)	(15.0)	(10.3)	(31.6)
Fair value adjustments for hedged risk	(2.7)	-	0.5	(2.2)
Total loans and advances to customers	3,187.0	1,039.9	617.4	4,844.3

5.5. **Credit risk grading**

Audited: *The following section is covered by the independent auditor's report.*

The Group uses the following credit risk grades when assessing the credit risk of its financial assets, financial guarantee contracts and loan commitments:

Cash and balances at central banks, loans and advances to banks and investment securities
The Group assesses credit risk using the rating agency designation on the reporting date. Ratings are based on Moody's long-term ratings.

Loans and advances to customers and financial guarantee contracts and loan commitments
The Group assesses credit risk using the Group's internal classifications based on the point-in-time PD of individual agreements. Classifications are defined as follows:

- **Low risk:** assets have a point-in-time PD less than or equal to 0.38%.
- **Medium risk:** assets have a point-in-time PD greater than 0.38% and less than or equal to 1.76%.
- **High risk:** assets have a point-in-time PD greater than 1.76%.

In 2017, each of the risk classifications detailed above had the additional criteria that loans were 'neither past due nor impaired', as defined in Section 5.4. Loans that were 'past due but not impaired' or 'impaired assets', as defined in Section 5.4, were 'ungraded'.

5. Creditworthiness risk (continued)

5.6. Credit risk exposure

Audited: *The following section is covered by the independent auditor's report.*

Financial assets subject to impairment

The following tables contain an analysis of the credit risk exposure of financial assets for which a loss allowance is recognised. For financial assets, the gross carrying amount represents the Group's maximum exposure to credit risk.

The below also provides an analysis of the credit risk exposure of financial guarantee contracts and loan commitments for which a loss allowance is also recognised. For financial guarantee contracts, amounts represent the amount guaranteed. For loan commitments, amounts represent the amounts committed. In both instances, these amounts represent the Group's maximum exposure to credit risk.

Information provided below is based on the credit risk grades defined in Section 5.5 and, for 2018, the year-end stage classification. It should be noted that the credit risk grading assessment is a point-in-time assessment whereas IFRS 9 stages are determined based on the change in credit risk from initial recognition. As such, for non-credit impaired financial instruments, there is not a direct relationship between the credit risk assessment and IFRS 9 stage.

				2018	2017
Cash and balances at central banks	**Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total £m**	Total £m
Credit grade					
AA2	**645.2**	-	-	**645.2**	752.5
Gross carrying amount	**645.2**	-	-	**645.2**	752.5
Loss allowance	-	-	-	-	-
Total cash and balances at central banks	**645.2**	-	-	**645.2**	752.5

				2018	2017
Loans and advances to banks	**Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total £m**	Total £m
Credit grade					
AA3	**12.3**	-	-	**12.3**	12.2
A1	**7.0**	-	-	**7.0**	2.5
A2	**31.3**	-	-	**31.3**	-
A3	-	-	-	-	14.1
Gross carrying amount	**50.6**	-	-	**50.6**	28.8
Loss allowance	-	-	-	-	-
Total loans and advances to banks	**50.6**	-	-	**50.6**	28.8

5. **Creditworthiness risk** (continued)

5.6. **Credit risk exposure** (continued)

Loans and advances to customers	Stage 1 £m	Stage 2 £m	Stage 3 £m	2018 Total £m	2017 Total £m
Credit grade					
Low risk	**1,906.5**	**26.2**	**7.7**	**1,940.4**	1,945.9
Medium risk	**1,910.4**	**464.5**	**33.3**	**2,408.2**	2,103.7
High risk	**1,105.1**	**380.9**	**80.2**	**1,566.2**	692.2
Ungraded	**-**	**-**	**-**	**-**	136.3
Gross carrying amount	**4,922.0**	**871.6**	**121.2**	**5,914.8**	4,878.1
Loss allowance	**(23.5)**	**(20.7)**	**(23.6)**	**(67.8)**	(31.6)
	4,898.5	**850.9**	**97.6**	**5,847.0**	4,846.5
Fair value adjustments for hedged risk				**(1.1)**	(2.2)
Total loans and advances to customers				**5,845.9**	4,844.3

Investment securities	Stage 1 £m	Stage 2 £m	Stage 3 £m	2018 Total £m	2017 Total £m
Credit grade					
Low risk	**139.9**	**-**	**-**	**139.9**	-
Gross carrying amount	**139.9**	**-**	**-**	**139.9**	-
Loss allowance	**-**	**-**	**-**	**-**	-
Total investment securities	**139.9**	**-**	**-**	**139.9**	-

Financial guarantee contracts	Stage 1 £m	Stage 2 £m	Stage 3 £m	2018 Total £m	2017 Total £m
Credit grade					
Low risk	**2.5**	**-**	**-**	**2.5**	2.5
Gross amount guaranteed	**2.5**	**-**	**-**	**2.5**	2.5
Loss allowance	**-**	**-**	**-**	**-**	-
Total amount guaranteed[1]	**2.5**	**-**	**-**	**2.5**	2.5

[1] The Group has one financial guarantee contract amounting to £2.5 million (2017: £2.5 million). The contract is fully collateralised through a first fixed charge over a blocked deposit account. As such, the amount the Group should have to pay should the guarantee be called upon is £nil (2017: £nil).

5. Creditworthiness risk (continued)

5.6. Credit risk exposure (continued)

Loan commitments	Stage 1 £m	Stage 2 £m	Stage 3 £m	2018 Total £m	2017 Total £m
Credit grade					
Low risk	**462.1**	**-**	**-**	**462.1**	467.6
Medium risk	**70.5**	**-**	**-**	**70.5**	-
High risk	**9.9**	**6.8**	**-**	**16.7**	-
Gross amount committed	**542.5**	**6.8**	**-**	**549.3**	467.6
Loss allowance	**(1.0)**	**-**	**-**	**(1.0)**	-
Total loan commitments	**541.5**	**6.8**	**-**	**548.3**	467.6

Financial assets not subject to impairment
The following table contains an analysis of the maximum exposure to credit risk from financial assets not subject to impairment:

	2018 £m	2017 £m
Derivative financial assets	**1.6**	1.8

5.7. Collateral held and other credit enhancements

Audited: *The following section is covered by the independent auditor's report.*

The Group holds collateral and other credit enhancements against certain of its credit exposures. The amount and type of collateral required depends on an assessment of the credit risk of the counterparty.

The Group has internal policies on the acceptability of specific classes of collateral or credit risk mitigation. The Group's policies regarding obtaining collateral have not significantly changed during the reporting period and there has been no significant change in the overall quality of the collateral held by the Group since the prior period.

No collateral or other credit enhancements are held against the Group's loans and advances to banks and investment securities.

Details of collateral held against the Group's loans and advances to customers and derivative financial assets are set out below:

Loans and advances to customers
The main types of collateral obtained are:

- **Loan receivables:** includes amounts secured by a first or second charge over commercial and residential property, debt receivables and other assets such as asset backed loans and invoice receivables.
- **Finance lease receivables and instalment credit receivables:** secured on the underlying assets which can be repossessed in the event of a default.

5. Creditworthiness risk (continued)

5.7. Collateral held and other credit enhancements (continued)

The following table sets out the security profile of loans and advances to customers. The amounts in the table represent gross carrying amounts:

	2018 £m	2017 £m
Secured on commercial and residential property	**3,908.1**	3,197.6
Secured on debt receivables	**517.3**	456.6
Secured on other assets	**93.1**	68.3
Total secured loan receivables	**4,518.5**	3,722.5
Secured by finance lease assets	**95.0**	88.9
Secured by instalment credit assets	**409.4**	350.8
Total secured loans and advances to customers	**5,022.9**	4,162.2
Unsecured loan receivables	**891.9**	715.9
Gross loans and advances to customers	**5,914.8**	4,878.1

Collateral held in relation to secured loans is capped, after taking into account the first charge balance, at the amount outstanding on an individual loan basis.

Derivative financial assets
Credit risk derived from derivative transactions is mitigated by entering into master netting agreements and holding collateral. Such collateral is subject to the standard industry Credit Support Annex and is paid or received on a regular basis. As at 31 December 2018, net cash collateral posted is £4.5 million (2017: £3.9 million).

Quantification of the collateral arrangements relating to derivatives is set out in Note 31(c) of the financial statements.

Credit-impaired financial assets
The Group closely monitors collateral held for financial assets considered to be credit-impaired (Stage 3), as it becomes more likely that the Group will take possession of collateral to mitigate potential credit losses. Financial assets that are credit-impaired and related collateral held in order to mitigate potential losses are set out below:

As at 31 December 2018	Gross carrying amount £m	Loss allowance £m	Carrying amount £m	Fair value of collateral held £m
Credit-impaired loans and advances to customers				
Property Finance	**60.6**	**(6.2)**	**54.4**	**54.4**
Business Finance	**54.0**	**(13.0)**	**41.0**	**41.0**
Consumer Lending	**6.6**	**(4.4)**	**2.2**	**-**
Total credit-impaired loans and advances to customers	**121.2**	**(23.6)**	**97.6**	**95.4**

5. **Creditworthiness risk** (continued)

5.7. **Collateral held and other credit enhancements** (continued)

The following table shows the distribution of loan-to-value (LTV) ratios for the Group's credit-impaired Property Finance portfolio:

As at 31 December 2018	Gross carrying amount £m
LTV ratio	
Less than 50%	**13.3**
50-70%	**23.6**
71-90%	**22.7**
91-100%	**0.5**
More than 100%	**0.5**
Total Property Finance credit-impaired assets	**60.6**

5.8. Repossessions

Audited: *The following section is covered by the independent auditor's report.*

There were twelve property repossessions in the year ended 31 December 2018 (2017: seven). The total carrying value of repossessed assets in the year ended 31 December 2018 is £2.1 million (2017: £1.1 million). Of the twelve repossessions made during the year, five were disposed of by 31 December 2018 and seven remained on the market. A further one repossession made during 2017 remained on the market as at 31 December 2018.

5.9. Forbearance

Audited: *The following section is covered by the independent auditor's report.*

The Group maintains a forbearance policy for the servicing and management of customers who are in financial difficulty and require some form of concession to be granted, even if this concession entails a loss for the Group. A concession may be either of the following:

- a modification of the previous terms and conditions of an agreement, which the borrower is considered unable to comply with due to its financial difficulties, to allow for sufficient debt service ability, that would not have been granted had the borrower not been in financial difficulties; or
- a total or partial refinancing of an agreement that would not have been granted had the borrower not been in financial difficulties.

Forbearance in relation to an exposure can be temporary or permanent depending on the circumstances, progress on financial rehabilitation and the detail of the concession(s) agreed. The Group includes short-term repayment plans within its definition of forbearance.

Year ended 31 December 2018

During the year ended 31 December 2018, the Group adopted the European Banking Authority (EBA) Technical Standards on forbearance and non-performing exposures as defined in Annex V of Commission Implementing Regulation (EU) 2015/227. Under these standards loans are classified as performing or non-performing in accordance with the EBA rules.

5. Creditworthiness risk (continued)

5.9. Forbearance (continued)

The EBA standards stipulate that a forbearance classification can be discontinued when all of the following conditions have been met[1]:

- the exposure is considered to be performing, including where it has been reclassified from the non-performing category, after an analysis of the financial condition of the debtor showed that it no longer met the conditions to be considered as non-performing;
- a minimum two-year probation period has passed from the date the forborne exposure was considered to be performing;
- regular payments of more than an insignificant aggregate amount of principal or interest have been made during at least half of the probation period; and
- none of the exposures to the debtor is more than 30 days past-due at the end of the probation period.

The following tables provide a summary of forborne loans and advances to customers as at 31 December 2018 by reportable segment:

	Performing			Non-performing			
As at 31 December 2018	Instruments with modification to their T&Cs £m	Refinancing £m	Total £m	Instruments with modification to their T&Cs £m	Refinancing £m	Total £m	Total forborne loans £m
Property Finance	9.5	-	9.5	40.1	-	40.1	49.6
Business Finance	9.1	5.1	14.2	28.3	0.8	29.1	43.3
Consumer Lending	2.9	-	2.9	10.1	-	10.1	13.0
Total	**21.5**	**5.1**	**26.6**	**78.5**	**0.8**	**79.3**	**105.9**

		Gross amount of forborne loans			Loss allowance on forborne loans			
As at 31 December 2018	Number	Performing £m	Non-performing £m	Total £m	Performing £m	Non-performing £m	Total £m	Coverage %
Property Finance	1,011	9.5	40.1	49.6	(0.2)	(4.1)	(4.3)	8.7
Business Finance	313	14.2	29.1	43.3	(0.3)	(3.8)	(4.1)	9.5
Consumer Lending	4,687	2.9	10.1	13.0	(0.3)	(5.3)	(5.6)	43.1
Total	**6,011**	**26.6**	**79.3**	**105.9**	**(0.8)**	**(13.2)**	**(14.0)**	**13.2**

[1] The forbearance probation period of two years (the second condition listed) was not applied in the year ended 31 December 2017 and as such results are not directly comparable.

5. **Creditworthiness risk** (continued)

5.9. **Forbearance** (continued)

The following tables provide a summary of forborne loans and advances to customers as at 31 December 2018 by the year-end stage classification:

As at 31 December 2018	Performing: Instruments with modification to their T&Cs £m	Performing: Refinancing £m	Performing: Total £m	Non-performing: Instruments with modification to their T&Cs £m	Non-performing: Refinancing £m	Non-performing: Total £m	Total forborne loans £m
Stage 1	6.5	-	6.5	6.8	-	6.8[1]	13.3
Stage 2	15.0	5.1	20.1	40.5	-	40.5	60.6
Stage 3	-	-	-	31.2	0.8	32.0	32.0
Total	**21.5**	**5.1**	**26.6**	**78.5**	**0.8**	**79.3**	**105.9**

As at 31 December 2018	Number	Gross amount of forborne loans: Performing £m	Gross amount of forborne loans: Non-performing £m	Gross amount of forborne loans: Total £m	Loss allowance on forborne loans: Performing £m	Loss allowance on forborne loans: Non-performing £m	Loss allowance on forborne loans: Total £m	Coverage %
Stage 1	1,097	6.5	6.8[1]	13.3	(0.1)	(0.4)[1]	(0.5)	3.8
Stage 2	1,421	20.1	40.5	60.6	(0.7)	(2.9)	(3.6)	5.9
Stage 3	3,493	-	32.0	32.0	-	(9.9)	(9.9)	30.9
Total	**6,011**	**26.6**	**79.3**	**105.9**	**(0.8)**	**(13.2)**	**(14.0)**	**13.2**

Year ended 31 December 2017

In the year ended 31 December 2017, the conditions to discontinue the forbearance classification did not include the forbearance probation period of two years applied in the year ended 31 December 2018 and as such results are not directly comparable.

The following table provides a summary of forborne loans and advances to customers as at 31 December 2017:

As at 31 December 2017	Number	Capital balances £m	Provisions £m	Coverage %
Property Finance	239	16.2	1.0	6.2
Business Finance	361	35.8	5.3	14.8
Consumer Lending	830	5.3	2.8	52.8
Total	1,430	57.3	9.1	15.9

[1] As detailed in Section 5.3 on page 39, the Group has not implemented IFRS 9 curing for forborne loans during 2018. Loans are classified as non-performing and Stage 1 where the latest forbearance measure was extended more than a year ago and the number of days past due at the current reporting period is more than zero but less than 30.

5. Creditworthiness risk (continued)

5.10. Concentrations of credit risk

Audited: *The following section is covered by the independent auditor's report.*

The Group monitors concentrations of credit risk from its loans and advances to customers by geographic location and by loan size.

Geographic location

An analysis of credit risk from loans and advances to customers by geographic location is shown below:

As at 31 December 2018	Property Finance £m	Business Finance £m	Consumer Lending £m	Total £m
East Anglia	**117.8**	**69.6**	**32.3**	**219.7**
East Midlands	**120.6**	**58.2**	**58.8**	**237.6**
Greater London	**1,454.9**	**300.8**	**82.3**	**1,838.0**
Guernsey / Jersey / Isle of Man	**24.5**	**46.3**	**0.1**	**70.9**
North East	**52.8**	**31.4**	**35.3**	**119.5**
North West	**305.6**	**171.4**	**92.0**	**569.0**
Northern Ireland	**9.6**	**1.8**	**2.1**	**13.5**
Scotland	**222.1**	**93.2**	**89.4**	**404.7**
South East	**747.4**	**221.4**	**141.1**	**1,109.9**
South West	**263.6**	**113.3**	**61.3**	**438.2**
Wales	**80.0**	**95.0**	**31.3**	**206.3**
West Midlands	**141.6**	**151.4**	**74.9**	**367.9**
Yorkshire / Humberside	**179.4**	**68.4**	**71.8**	**319.6**
Gross loans and advances to customers	**3,719.9**	**1,422.2**	**772.7**	**5,914.8**

As at 31 December 2017	Property Finance £m	Business Finance £m	Consumer Lending £m	Total £m
East Anglia	99.0	75.3	25.6	199.9
East Midlands	100.5	34.7	48.6	183.8
Greater London	1,233.8	169.8	64.9	1,468.5
Guernsey / Jersey / Isle of Man	18.6	47.0	0.1	65.7
North East	45.5	16.4	29.9	91.8
North West	264.5	159.9	75.4	499.8
Northern Ireland	13.6	2.8	1.7	18.1
Scotland	183.0	71.0	76.9	330.9
South East	648.3	169.3	109.9	927.5
South West	239.5	89.7	48.3	377.5
Wales	69.4	84.8	24.4	178.6
West Midlands	125.0	74.8	62.0	261.8
Yorkshire / Humberside	155.3	59.4	59.5	274.2
Gross loans and advances to customers	3,196.0	1,054.9	627.2	4,878.1

5. **Creditworthiness risk** (continued)

5.10. **Concentrations of credit risk** (continued)

Loan size
An analysis of credit risk from loans and advances to customers by loan size is shown below:

As at 31 December 2018	**Property Finance £m**	**Business Finance £m**	**Consumer Lending £m**	**Total £m**
0 - £50k	**215.3**	**140.5**	**772.5**	**1,128.3**
£50k - £100k	**378.5**	**72.3**	**0.2**	**451.0**
£100k - £250k	**883.5**	**120.4**	**-**	**1,003.9**
£250k - £500k	**797.2**	**107.9**	**-**	**905.1**
£500k - £1.0 million	**609.3**	**135.6**	**-**	**744.9**
£1.0 million - £2.5 million	**463.8**	**200.2**	**-**	**664.0**
£2.5 million - £5.0 million	**208.7**	**156.1**	**-**	**364.8**
£5.0 million - £10.0 million	**108.4**	**157.3**	**-**	**265.7**
£10.0 million - £25.0 million	**55.2**	**331.9**	**-**	**387.1**
Gross loans and advances to customers	**3,719.9**	**1,422.2**	**772.7**	**5,914.8**

As at 31 December 2017	Property Finance £m	Business Finance £m	Consumer Lending £m	Total £m
0 - £50k	246.1	164.6	627.0	1,037.7
£50k - £100k	369.2	79.7	0.2	449.1
£100k - £250k	784.9	113.3	-	898.2
£250k - £500k	657.0	80.3	-	737.3
£500k - £1.0 million	478.1	106.1	-	584.2
£1.0 million - £2.5 million	379.2	153.7	-	532.9
£2.5 million - £5.0 million	167.1	80.2	-	247.3
£5.0 million - £10.0 million	61.8	77.4	-	139.2
£10.0 million - £25.0 million	52.6	199.6	-	252.2
Gross loans and advances to customers	3,196.0	1,054.9	627.2	4,878.1

6. Liquidity risk

***Audited:** The following section is covered by the independent auditor's report.*

Liquidity risk is the risk that the Group is unable to meet its current and future financial obligations as they fall due, or is only able to do so at excessive cost.

The Group has, therefore, developed comprehensive funding and liquidity policies to ensure that it maintains sufficient liquid assets to be able to meet all its financial obligations and maintain public confidence.

The Group's Treasury function is responsible for the day-to-day management of the Group's liquidity and wholesale funding. The Board sets limits over the level, composition, and maturity of liquidity and deposit funding balances, reviewing these at least annually. Compliance with these limits is monitored daily by Finance and Risk personnel independent of Treasury. Additionally, a series of liquidity stress tests are performed weekly by Risk and formally reported to the ALCo and the Board to ensure that the Group maintains adequate liquidity for business purposes even under stressed conditions.

The Group reports its liquidity position against its liquidity coverage ratio (LCR), net stable funding ratio (NSFR) and other key regulatory ratios for regulatory purposes.

6. **Liquidity risk** (continued)

A liquid asset buffer of government Treasury bills acquired under the Funding for Lending Scheme, and reserves with the Bank of England, are maintained as a source of high-quality liquid assets that can be called upon to create sufficient liquidity in order to meet liabilities on demand. The Group also holds extremely high-quality covered bonds.

Further details of the Group's funding sources are as follows:
- **Funding for Lending Scheme:** see Note 1.7(o) of the financial statements.
- **Term Funding Scheme:** see Note 1.7(o) of the financial statements.

Stress testing is a major component of liquidity risk management and the Group has developed a range of scenarios covering a range of market wide and firm specific factors. A comprehensive stress testing exercise is conducted at least annually, and the methodology is incorporated into the Group's statement of financial position risk management model to ensure that stress tests are run on a regular basis. The output of stress testing is circulated to the Board and to the ALCo who use the results to decide whether to amend the Group's risk appetite and liquidity limits.

Maturity analysis for financial assets and liabilities
The table below segments the Group's contractual undiscounted cash flows of its non-derivative financial assets and liabilities into relevant maturity groupings:

As at 31 December 2018	Carrying amount £m	Gross nominal inflow / (outflow) £m	Less than 1 month £m	1-3 months £m	3 months - 1 year £m	1-2 years £m	2-5 years £m	More than 5 years £m
Financial assets								
Cash and balances at central banks	645.2	645.2	636.3	-	-	-	-	8.9
Loans and advances to banks	50.6	50.6	50.6	-	-	-	-	-
Loans and advances to customers	5,845.9	5,944.1	285.4	212.9	817.3	814.0	1,269.1	2,545.4
Investment securities	139.9	140.2	0.2	-	-	-	140.0	-
Total financial assets	6,681.6	6,780.1	972.5	212.9	817.3	814.0	1,409.1	2,554.3
Financial liabilities								
Amounts due to banks	(1,029.4)	(1,039.9)	(1.9)	-	-	(273.9)	(764.1)	-
Customer deposits	(4,977.9)	(5,083.8)	(1,507.3)	(292.1)	(1,800.2)	(820.2)	(598.4)	(65.6)
Subordinated debt liability	(76.1)	(120.8)	-	-	(7.5)	(6.4)	(19.1)	(87.8)
Total financial liabilities	(6,083.4)	(6,244.5)	(1,509.2)	(292.1)	(1,807.7)	(1,100.5)	(1,381.6)	(153.4)

6. **Liquidity risk** (continued)

As at 31 December 2017	Carrying amount £m	Gross nominal inflow / (outflow) £m	Less than 1 month £m	1-3 months £m	3 months - 1 year £m	1-2 years £m	2-5 years £m	More than 5 years £m
Financial assets								
Cash and balances at central banks	752.5	752.5	748.2	-	-	-	-	4.3
Loans and advances to banks	28.8	28.8	28.8	-	-	-	-	-
Loans and advances to customers	4,844.3	4,989.8	211.8	218.7	646.3	690.8	1,222.7	1,999.5
Total financial assets	5,625.6	5,771.1	988.8	218.7	646.3	690.8	1,222.7	2,003.8
Financial liabilities								
Amounts due to banks	(607.3)	(612.4)	(2.4)	-	-	-	(610.0)	-
Customer deposits	(4,376.2)	(4,448.7)	(1,026.3)	(317.1)	(1,818.7)	(837.3)	(440.1)	(9.2)
Subordinated debt liability	(76.1)	(127.1)	-	-	(7.5)	(6.4)	(19.1)	(94.1)
Total financial liabilities	(5,059.6)	(5,188.2)	(1,028.7)	(317.1)	(1,826.2)	(843.7)	(1,069.2)	(103.3)

Amounts due to banks include £875.0 million of drawings made under the Bank of England's Term Funding Scheme (2017: £605.0 million) and £152.0 million of secured bank borrowings (2017: £nil). See Note 23 of the financial statements.

Liquidity buffer
The following table sets out the components of the Group's liquidity buffer:

	2018 £m	2017 £m
Cash and withdrawable central bank reserves	**636.1**	747.9
Extremely high-quality covered bonds	**129.5**	-
Debt securities	**-**	100.9
Total liquidity buffer	**765.6**	848.8

Debt securities are Treasury bills issued by the Bank of England under its Funding for Lending Scheme which are not recognised on the statement of financial position but are available to be sold under repurchase agreements and are therefore included in the liquidity buffer (see Note 1.7(o) of the financial statements).

The average liquidity buffer throughout the year is £805.1 million (2017: £669.3 million).

Liquidity coverage ratio and net stable funding ratio
Liquidity is actively monitored on a daily basis and reported on a monthly basis through the ALCo and the Risk Committee. A range of early warning indicators are monitored for early signs of liquidity risk. These include a range of quantitative and qualitative measures that include the close monitoring of the LCR and NSFR.

6. **Liquidity risk** (continued)

The Group's LCR aims to monitor the resilience of the Group to a liquidity risk over a 30-day period. New guidelines were issued by the European Banking Authority (EBA) in March 2017 to complement the disclosure of liquidity risk management under Article 435 of Regulation (EU) No 575/2013. The following table sets out the LCR as at 31 December:

	2018	2017
Liquidity buffer (£m)	**765.6**	848.8
Total net cash outflows (£m)	**312.6**	292.1
Liquidity coverage ratio (%)	**244.9**	290.6

The Group's NSFR aims to ensure that the Group has an acceptable amount of stable funding to support assets over a one-year period of extended stress. Based on current interpretations of regulatory requirements and guidance, the NSFR as at 31 December 2018 is 128.5% (2017: 129.2%). This is in excess of the minimum level of 100% proposed by the Basel Committee on Banking Supervision and European Commission[1].

Assets available to support future funding
The Group's assets can be used to support collateral requirements for central bank operations or third party repurchase transactions. Assets that have been set aside for such purposes are classified as encumbered assets and cannot be used for other purposes. The majority of asset encumbrance arises from participation in the Bank of England's Term Funding Scheme, Funding for Lending Scheme and investment securities.

All other assets are defined as unencumbered assets. These comprise assets that are readily available to secure funding or meet collateral requirements ('available as collateral'), and assets that are not subject to any restrictions but are not readily available for use ('other').

The table below sets out the availability of the Group's assets to support future funding:

	Encumbered		**Unencumbered**		
As at 31 December 2018	**Pledged as collateral £m**	**Other £m**	**Available as collateral £m**	**Other £m**	**Total £m**
Cash and balances at central banks	-	**8.9**	-	**636.3**	**645.2**
Loans and advances to banks	**5.3**	-	**45.3**	-	**50.6**
Loans and advances to customers	**1,603.4**	-	**4,242.5**	-	**5,845.9**
Investment securities	-	-	-	**139.9**	**139.9**
Derivative financial assets	-	-	-	**1.6**	**1.6**
Non-financial assets	-	-	**34.1**	**101.8**	**135.9**
Total assets	**1,608.7**	**8.9**	**4,321.9**	**879.6**	**6,819.1**

	Encumbered		Unencumbered		
As at 31 December 2017	Pledged as collateral £m	Other £m	Available as collateral £m	Other £m	Total £m
Cash and balances at central banks	-	4.3	-	748.2	752.5
Loans and advances to banks	-	-	28.8	-	28.8
Loans and advances to customers	1,081.7	-	3,762.6	-	4,844.3
Derivative financial assets	-	-	-	1.8	1.8
Non-financial assets	-	-	36.1	88.5	124.6
Total assets	1,081.7	4.3	3,827.5	838.5	5,752.0

[1] The Basel Committee on Banking Supervision issued its final recommendations for the implementation of the NSFR in October 2016, proposing an implementation date of 1 January 2018 and a minimum ratio of 100%. The European Commission also proposed a NSFR of at least 100% as part of the CRR 2 package of legislative proposals in November 2016. The timing of a binding NSFR in the United Kingdom remains subject to uncertainty.

6. **Liquidity risk** (continued)

Encumbered assets pledged as collateral includes:

- Loans and advances to banks of £5.3 million (2017: £nil) pledged as collateral against derivative contracts.
- Loans and advances to customers of £1,402.7 million (2017: £1,081.7 million) positioned with the Bank of England for use as collateral under its funding schemes. This comprises £1,402.7 million (2017: £902.2 million) for the Term Funding Scheme and £nil (2017: £179.5 million) for the Funding for Lending scheme.
- Loans and advances to customers of £200.7 million (2017: £nil) pledged as collateral against secured bank borrowings.

Other encumbered assets are assets that cannot be used for secured funding due to legal or other reasons and includes:

- Mandatory deposits with central banks of £8.9 million (2017: £4.3 million).

7. Market risk

Audited: *The following section is covered by the independent auditor's report.*

Market risk is the risk that the value of, or income arising from, the Group's assets and liabilities change as a result of changes in market prices, the principal element being interest rate risk.

The Group's objective is to manage and control market risk exposures while maintaining a market profile consistent with the Group's risk appetite.

The Group's Treasury function is responsible for managing the Group's exposure to all aspects of market risk within the operational limits set out in the Group's treasury policies. The ALCo approves the Group's treasury policies and receives regular reports on all aspects of market risk exposure, including interest rate risk.

Basis risk

Basis risk is the risk of loss arising from changes in the relationship between interest rates which have similar but not identical characteristics (for example, London Inter Bank Offer Rate (LIBOR) and the Bank of England Bank Rate). This is monitored closely and regularly reported to the ALCo. The ALCo is monitoring the Group's transition from LIBOR to the Sterling Overnight Index Average in advance of 2021. This risk is managed by matching and, where appropriate and necessary, through the use of derivatives, with established risk limits and other control procedures.

The Group's forecasts and plans take account of the risk of interest rate changes and are prepared and stressed accordingly, in line with PRA guidance.

Foreign exchange risk

Foreign exchange risk is the risk that the value of, or net income arising from, assets and liabilities changes as a result of movements in exchange rates. The Group has low levels of foreign exchange risk which is managed by natural hedging and appropriate financial instruments including derivatives.

The table below sets out the Group's exposure to foreign exchange risk:

As at 31 December 2018	**Euros £m**	**US Dollars £m**	**Australian Dollars £m**
Loans and advances to banks	**4.4**	**2.1**	**(0.1)**
Loans and advances to customers	**28.7**	**5.7**	**0.1**
Net position	**33.1**	**7.8**	**-**

As at 31 December 2017	Euros £m	US Dollars £m	Australian Dollars £m
Loans and advances to banks	1.9	(0.8)	(0.1)
Loans and advances to customers	24.4	7.7	0.1
Net position	26.3	6.9	-

7. **Market risk** (continued)

The Group estimates that a 5% movement in exchange rates would have no greater impact on the Group's profit before taxation than an increase or decrease of £2.0 million (2017: £1.7 million).

Interest rate risk
Interest rate risk is the risk of loss arising from adverse movements in market interest rates. Interest rate risk arises from the loan and savings products that the Group offers. This risk is managed through the use of appropriate financial instruments, including derivatives, with established risk limits, reporting lines, mandates and other control procedures.

The following is a summary of the Group's interest rate gap position. Items are allocated to time bands by reference to the earlier of the next contractual interest rate change and the maturity date.

As at 31 December 2018	Within 3 months £m	3 months but <6 months £m	6 months but <1 year £m	1 year but <5 years £m	>5 years £m	Non-interest bearing £m	Total £m
Assets							
Cash and balances at central banks	**636.3**	**-**	**-**	**-**	**-**	**8.9**	**645.2**
Loans and advances to banks	**50.6**	**-**	**-**	**-**	**-**	**-**	**50.6**
Loans and advances to customers	**2,941.0**	**240.9**	**520.4**	**1,963.1**	**172.9**	**7.6**	**5,845.9**
Investment securities	**139.9**	**-**	**-**	**-**	**-**	**-**	**139.9**
Derivative financial assets	**-**	**-**	**-**	**-**	**-**	**1.6**	**1.6**
Non-financial assets	**1.7**	**2.0**	**4.7**	**22.3**	**3.4**	**101.8**	**135.9**
Total assets	**3,769.5**	**242.9**	**525.1**	**1,985.4**	**176.3**	**119.9**	**6,819.1**
Equity and liabilities							
Amounts due to banks	**1,027.5**	**-**	**-**	**-**	**-**	**1.9**	**1,029.4**
Customer deposits	**1,765.2**	**813.5**	**1,002.9**	**1,382.3**	**14.0**	**-**	**4,977.9**
Derivative financial liabilities	**-**	**-**	**-**	**-**	**-**	**5.7**	**5.7**
Subordinated debt liability	**-**	**-**	**-**	**76.1**	**-**	**-**	**76.1**
Non-financial liabilities	**-**	**-**	**-**	**-**	**-**	**56.6**	**56.6**
Equity	**-**	**-**	**-**	**-**	**-**	**673.4**	**673.4**
Total equity and liabilities	**2,792.7**	**813.5**	**1,002.9**	**1,458.4**	**14.0**	**737.6**	**6,819.1**
Notional values of derivatives	**430.7**	**(10.0)**	**40.0**	**(433.4)**	**(27.3)**	**-**	**-**
Interest rate sensitivity gap	**1,407.5**	**(580.6)**	**(437.8)**	**93.6**	**135.0**	**(617.7)**	**-**
Cumulative gap	**1,407.5**	**826.9**	**389.1**	**482.7**	**617.7**	**-**	**-**

7. **Market risk** (continued)

As at 31 December 2017	Within 3 months £m	3 months but <6 months £m	6 months but <1 year £m	1 year but <5 years £m	>5 years £m	Non-interest bearing £m	Total £m
Assets							
Cash and balances at central banks	748.2	-	-	-	-	4.3	752.5
Loans and advances to banks	28.8	-	-	-	-	-	28.8
Loans and advances to customers	2,495.5	210.1	363.6	1,533.5	296.4	(54.8)	4,844.3
Derivative financial assets	-	-	-	-	-	1.8	1.8
Non-financial assets	3.6	2.1	4.1	22.2	4.8	87.8	124.6
Total assets	3,276.1	212.2	367.7	1,555.7	301.2	39.1	5,752.0
Equity and liabilities							
Amounts due to banks	607.3	-	-	-	-	-	607.3
Customer deposits	1,412.4	787.7	955.6	1,212.6	7.9	-	4,376.2
Derivative financial liabilities	-	-	-	-	-	3.4	3.4
Subordinated debt liability	-	-	-	-	76.1	-	76.1
Non-financial liabilities	-	-	-	-	-	74.0	74.0
Equity	-	-	-	-	-	615.0	615.0
Total equity and liabilities	2,019.7	787.7	955.6	1,212.6	84.0	692.4	5,752.0
Notional values of derivatives	578.0	(25.0)	(282.0)	(240.0)	(31.0)	-	-
Interest rate sensitivity gap	1,834.4	(600.5)	(869.9)	103.1	186.2	(653.3)	-
Cumulative gap	1,834.4	1,233.9	364.0	467.1	653.3	-	-

The Group considers a parallel 250 basis points (bps) (2017: 200 bps) movement to be appropriate for scenario testing given the current economic outlook and industry expectations.

The Group estimates that a +/- 250 bps (2017: +/- 200 bps) movement in interest rates paid/received would have impacted the economic value of equity as follows:

+250 bps: £10.9 million negative (2017: £10.5 million negative, based on 200 bps)
-250 bps: £31.9 million positive (2017: £41.0 million positive, based on 200 bps)

In addition, the effect of the same two interest rate shocks is applied to the statement of financial position at year end, to determine how net interest income may change on an annualised basis for one year, as follows:

+250 bps: £65.5 million positive (2017: £20.8 million positive, based on 200 bps)
-250 bps: £0.7 million positive (2017: £4.0 million positive, based on 200 bps)

In preparing the above sensitivity analyses, the Group makes certain assumptions consistent with expected and contractual re-pricing behaviour as well as behavioural repayment profiles, under the two interest scenarios, of the underlying statement of financial position items. The results also include the impact of hedge transactions.

8. Operational risk

The Risk Committee received regular reports across the spectrum of operational risks and information security. These reports cover incidents that have arisen to allow the Committee to assess Management's response and proposed remedial actions. Although a number of incidents were raised during the course of 2018, none of these were material in nature and the Risk Committee was satisfied that the action taken was appropriate and that the control of operational incidents continued to improve. A fire-drill test of the Recovery Plan was completed in September 2018 to test the end to end Recovery Plan playbook and to identify priorities for more targeted testing in 2019. The operational risk reports were developed throughout 2018 to include more focus on forward looking risks which permits a more strategic discussion at Risk Committee level.

9. Conduct, legal and compliance risk

The Group continually reviews its risk management approach to reflect the regulatory and legal environment in which the Group operates.

The Group has no appetite for knowingly behaving inappropriately, resulting in unfair outcomes for its customers. During 2018, the Group appointed a new Chief Compliance Officer to further develop its risk appetite for conduct risk and to introduce and embed measures across the conduct risk lifecycle, which includes product design, sales or after sales processes and culture. It also embedded revisions to annual product reviews and risk appetite to support the management of brokers, intermediaries and outsource partners. These measures are reported to the Board monthly and provide the basis for demonstrating that the Group is operating within its risk appetite. The Group also invested in its financial crime capability within the second line of defence and latterly in 2018 invested in additional capacity and capability within the first line of defence. Where the Group identifies potential unintended outcomes for customers the Group uses its risk management process to proactively escalate, agreeing appropriate actions and communicating clearly with its customers to ensure a fair outcome is achieved.

The Group invested in its information risk capability through the appointment of a Data Privacy Officer in 2018 and implemented a Privacy Working Group as a sub-group of Enterprise Risk Management Committee to oversee the Group's privacy framework.

10. Strategic risk

Strategic risk focusses on large, long-term risks that could become a material issue for the delivery of the Group's goals and objectives. Management of strategic risk is primarily the responsibility of Executive Management. The management of strategic risk is intrinsically linked to the corporate planning and stress testing processes and is further supported by the regular provision of consolidated business performance and risk reporting to the Executive Committee and the Board. The Board received and approved a number of reports during 2018 including the Strategy Update and the 2018 Annual Review of Risk Appetite. It has also been engaged actively in the formation of the Group's ICAAP, ILAAP and RRP which are critical tools to managing strategic risk.

11. Systems and change risk

Customer expectations for service availability are rising with the rapid pace of new technologies leading to a significantly lower tolerance for service disruption. The Group recognises that in order to continue to be recognised for very high levels of customer satisfaction it needs to continually monitor systems risk and ensure that change is delivered with minimum disruption to customers. During 2018, the Group reviewed its operational resilience and appointed a new Chief Technology Officer to oversee the Group's strategic technology requirements.

12. Capital risk and management

Capital risk is the risk that the Group has insufficient capital to cover regulatory requirements and/or to support its own growth plans. Liquidity risk is the risk that the Group is not able to meet its financial obligations as they fall due or can do so only at excessive cost.

The Group's objective in managing Group capital is to maintain appropriate levels of capital to support the Group's business strategy and meet regulatory requirements.

12. Capital risk and management (continued)

Policies and processes for managing the Group's capital
The Group's approach to capital management is driven by strategic and organisational requirements, while also taking into account the regulatory and commercial environments in which it operates.

The Group's principal objectives when managing capital are to:
- address the expectation of the Shareholders and optimise business activities to ensure return on capital targets are achieved though efficient capital management;
- ensure that the Group and Bank hold sufficient risk capital. Risk capital caters for unexpected losses that may arise, protects Shareholders and depositors and thereby supports the sustainability of the Group and Bank through the business cycles; and
- comply with capital supervisory requirements and related regulations.

The PRA supervises the Group on a consolidated basis and receives information on the capital adequacy of, and sets capital requirements for, the Group as a whole. In addition, a number of subsidiaries are regulated for prudential purposes by either the PRA or the FCA. The aim of the capital adequacy regime is to promote safety and soundness in the financial system and embed the requirements of Pillar 3 on market discipline. Under Pillar 2, the Group completes an annual self-assessment of risks known as the ICAAP. The ICAAP is reviewed by the PRA which culminates in the PRA setting a Total Capital Requirement on the level of capital the Group and its regulated subsidiaries are required to hold. Pillar 3 requires firms to publish a set of disclosures which allow market participants to assess information on that firm's capital, risk exposures and risk assessment process. The Group's Pillar 3 disclosures can be found on the Group's website.

The Group maintains a strong capital base with the aim of supporting the development of the business and to ensure it meets the Total Capital Requirement at all times. As a result, the Group maintains capital adequacy ratios above minimum regulatory requirements. The Group's individual regulated entities complied with all of the externally imposed capital requirements to which they are subject for the years ended 2018 and 2017.

Regulation
Capital Requirements Directive IV (CRD IV) requires the Group to hold Common Equity Tier 1 capital to account for capital conservation, countercyclical and systemic risk buffers. A capital conservation buffer of 0.625% was introduced on 1 January 2016 and will increase each year to 2019 in line with regulations. As at 31 December 2018 the capital conservation buffer is set at 1.875% (2017: 1.250%).

CRD IV also introduced a new leverage ratio requirement. The leverage calculation determines a ratio based on the relationship between Tier 1 capital and total consolidated exposure, being the sum of on-balance sheet exposures, derivative exposures, securities financing transaction exposures and off-balance sheet exposures. This leverage ratio is a risk-based measure that is designed to act as a supplement to risk-based capital requirements.

Minimum requirements for own funds and eligible liabilities (MREL) are applicable from 1 January 2016 and will be phased in fully by 1 January 2020. Prior to 31 December 2019, MREL will be equal to an institution's minimum regulatory capital requirements. The Bank of England has provided MREL guidance to the Group, as well as guidance on the transitional arrangements until 1 January 2020.

The Common Equity Tier 1 capital ratio for the Group is 12.2% as at 31 December 2018 (31 December 2017: 12.8%), compared with a regulatory minimum of 4.5%. The Total Tier 1 capital ratio for the Group is 15.2% as at 31 December 2018 (31 December 2017: 16.5%), compared with a regulatory minimum of 6.0%.

The leverage ratio for the Group (based on the Basel III definition of January 2014, and the CRD IV definition of October 2014) is 9.1% (2017: 9.4%), compared to the minimum requirement of 3.0%. The Group is not required to comply with the PRA leverage ratio framework until its retail deposits exceed the £50 billion threshold; however, the Group maintains a prudent risk appetite for leverage.

The Total Capital Requirement of the Group is 10.27% of risk-weighted assets (2017: 10.50%)[1].

---

[1] On 28 November 2018, the Prudential Regulation Authority granted permission for the Group to reduce its Total Capital Requirement.

12. Capital risk and management (continued)

IFRS 9 transitional arrangements

The Group has elected to use a transitional approach when recognising the impact of adopting IFRS 9. The transitional approach involves phasing in the full impact using transitional factors published in Regulation (EU) 2017/2395. This permits the Group to add back to their capital base a proportion of the impact that IFRS 9 has upon their loss allowances during the first five years of use. The proportion that the Group may add back in 2018 is 95%. Further details are set out in Note 2.3 of the financial statements.

In the following tables, unless otherwise stated, the 2018 figures are prepared under IFRS 9 adjusted for transitional arrangements and the 2017 figures are prepared under IAS 39.

Capital resources

The following table shows the regulatory capital resources managed by the Group and Company:

	Group 2018 £m	**Company 2018 £m**	Group 2017 £m	Company 2017 £m
Share capital	**175.5**	**175.5**	175.5	175.5
Share premium account	**81.0**	**81.0**	81.0	81.0
Capital redemption reserve	**16.4**	**16.4**	16.7	16.7
Merger reserve	**1.6**	**1.6**	1.6	1.6
Retained earnings	**273.9**	**260.8**	215.2	201.2
Intangible assets	**(60.7)**	**(46.4)**	(59.4)	(44.6)
Transitional adjustment[1]	**25.7**	**25.5**	-	-
Common Equity Tier 1 capital	**513.4**	**514.4**	430.6	431.4
Capital securities	**125.0**	**125.0**	125.0	125.0
Additional Tier 1 capital	**125.0**	**125.0**	125.0	125.0
Total Tier 1 capital	**638.4**	**639.4**	555.6	556.4
Subordinated debt liability[2]	**75.0**	**75.0**	75.0	75.0
Collective impairment allowance	**-**	**-**	11.1	11.0
Tier 2 capital	**75.0**	**75.0**	86.1	86.0
Total regulatory capital	**713.4**	**714.4**	641.7	642.4

[1] The year ended 31 December 2018 includes adjustments for phasing in the impact of IFRS 9 adoption in accordance with EU regulatory transitional arrangements.

[2] For the purpose of regulatory capital calculations, capitalised interest of £1.1 million is excluded for Group (2017: £1.1 million) and £1.1 million is excluded for Company (2017: £1.1 million). Accrued interest is payable semi-annually and is therefore excluded from capital reserves.

12. Capital risk and management (continued)

Regulatory capital reconciles to total equity per the statement of financial position as follows:

	Group 2018 £m	Company 2018 £m	Group 2017 £m	Company 2017 £m
Total regulatory capital	**713.4**	**714.4**	641.7	642.4
Subordinated debt liability[1]	**(75.0)**	**(75.0)**	(75.0)	(75.0)
Collective impairment allowance	**-**	**-**	(11.1)	(11.0)
Intangible assets	**60.7**	**46.4**	59.4	44.6
Transitional adjustment[2]	**(25.7)**	**(25.5)**	-	-
Total equity	**673.4**	**660.3**	615.0	601.0

The following table shows the movement in Total Tier 1 capital during the year:

	Group 2018 £m	Company 2018 £m	Group 2017 £m	Company 2017 £m
Total Tier 1 capital as at 1 January	**555.6**	**556.4**	367.5	367.6
Impact of adopting IFRS 9[3]	**(16.0)**	**(15.7)**	-	-
Restated balance as at 1 January	**539.6**	**540.7**	367.5	367.6
Movement in Common Equity Tier 1 capital:				
(Decrease) / increase in capital redemption reserve	**(0.3)**	**(0.3)**	7.5	7.5
Movement in retained earnings:				
Profit for the year	**82.0**	**82.6**	74.2	74.9
Dividend paid	**-**	**-**	(19.5)	(19.5)
Coupon paid on capital securities (net of tax)	**(7.3)**	**(7.3)**	-	-
Increase in intangible assets	**(1.3)**	**(1.8)**	(5.8)	(5.8)
Transitional adjustment[2]	**25.7**	**25.5**	-	-
Decrease in foreseeable dividend	**-**	**-**	6.7	6.7
Total movement in Common Equity Tier 1 capital	**98.8**	**98.7**	63.1	63.8
Movement in Additional Tier 1 capital:				
Increase in capital securities	**-**	**-**	125.0	125.0
Total movement in Additional Tier 1 capital	**-**	**-**	125.0	125.0
Total Tier 1 capital as at 31 December	**638.4**	**639.4**	555.6	556.4

[1] For the purpose of regulatory capital calculations, capitalised interest of £1.1 million is excluded for Group (2017: £1.2 million) and £1.1 million is excluded for Company (2017: £1.1 million). Accrued interest is payable semi-annually and is therefore excluded from capital reserves.

[2] The year ended 31 December 2018 includes adjustments for phasing in the impact of IFRS 9 adoption in accordance with EU regulatory transitional arrangements.

[3] Further details of the impact of IFRS 9 adoption is set out in Note 2 of the financial statements.

12. Capital risk and management (continued)

Risk-weighted assets

	Group 2018 £m	Company 2018 £m	Group 2017 £m	Company 2017 £m
Property Finance	**1,660.7**	**1,660.7**	1,529.1	1,529.1
Business Finance	**1,464.3**	**1,476.2**	967.2	945.3
Consumer Lending	**560.2**	**560.2**	489.8	489.8
Other	**134.4**	**133.8**	70.7	65.8
Operational risk	**383.8**	**383.8**	304.0	304.5
Credit valuation adjustment	**3.4**	**3.4**	0.9	0.9
Total risk-weighted assets	**4,206.8**	**4,218.1**	3,361.7	3,335.4

Capital ratios

	Group 2018 %	Company 2018 %	Group 2017 %	Company 2017 %
Common Equity Tier 1 capital ratio	**12.2**	**12.2**	12.8	12.9
Total Tier 1 capital ratio	**15.2**	**15.2**	16.5	16.7
Total capital ratio	**17.0**	**16.9**	19.1	19.3

Leverage

	Group 2018 £m	Company 2018 £m	Group 2017 £m	Company 2017 £m
Total Tier 1 capital	**638.4**	**639.4**	555.6	556.4
Exposure measure				
Total statutory assets (excluding derivatives)	**6,817.5**	**6,804.0**	5,750.2	5,699.6
Off-balance sheet items	**197.7**	**197.6**	224.7	224.7
Exposure value for derivatives	**6.3**	**6.3**	2.2	2.2
Transitional adjustment[1]	**25.7**	**25.5**	-	-
Other regulatory adjustments	**(60.7)**	**(46.4)**	(59.4)	(44.6)
Total exposures	**6,986.5**	**6,987.0**	5,917.7	5,881.9
Leverage ratio (%)	**9.1%**	**9.2%**	9.4%	9.5%

Off-balance sheet items comprise pipeline and committed facilities balances which have a credit conversion factor of medium risk attached to them.

Exposure values associated with derivatives have been reported in compliance with CRD IV rules. The derivative measure is calculated as the replacement cost for the current exposure plus an add-on for future exposure and is not reduced for any collateral received or grossed up for collateral provided.

Other regulatory adjustments comprise net replacement costs of securities financing transactions and derivatives to the leverage ratio exposure.

[1] The year ended 31 December 2018 includes adjustments for phasing in the impact of IFRS 9 adoption in accordance with EU regulatory transitional arrangements.

12. Capital risk and management (continued)

IFRS 9 transitional arrangements impact analysis

To illustrate the impact of IFRS 9 adoption, the following table provides an overview of the Group's capital metrics under IFRS 9 adjusted for transitional arrangements, compared to if IFRS 9 transitional arrangements had not been applied (i.e. full adoption):

	Group		Company	
As at 31 December 2018	**Adjusted for IFRS 9 transitional arrangements**	**IFRS 9 transitional arrangements not applied**	**Adjusted for IFRS 9 transitional arrangements**	**IFRS 9 transitional arrangements not applied**
Capital resources				
Common Equity Tier 1 capital (£m)	**513.4**	**487.7**	**514.4**	**488.9**
Total Tier 1 capital (£m)	**638.4**	**612.7**	**639.4**	**613.9**
Total regulatory capital (£m)	**713.4**	**687.7**	**714.4**	**688.9**
Risk-weighted assets				
Total risk-weighted assets (£m)	**4,206.8**	**4,189.5**	**4,218.1**	**4,202.9**
Capital ratios				
Common Equity Tier 1 capital ratio (%)	**12.2**	**11.6**	**12.2**	**11.6**
Total Tier 1 Capital Ratio (%)	**15.2**	**14.6**	**15.2**	**14.6**
Total capital ratio (%)	**17.0**	**16.4**	**16.9**	**16.4**
Leverage				
Leverage ratio total exposures (£m)	**6,986.5**	**6,960.8**	**6,987.0**	**6,961.5**
Leverage ratio (%)	**9.1**	**8.8**	**9.2**	**8.8**

13. ICAAP, ILAAP and stress testing

The ICAAP, ILAAP and associated stress testing exercises represent important elements of the Group's on-going risk management processes. The results of the risk assessment contained in these documents is embedded in the strategic planning process and risk appetite to ensure that sufficient capital and liquidity are available to support the Group's growth plans as well as cover its regulatory requirements at all times and under varying circumstances.

The ICAAP and ILAAP are reviewed at least annually, and more often in the event of a material change in capital or liquidity. On-going stress testing and scenario analysis outputs are used to inform the formal assessments and determination of required buffers, the strategy and planning for capital and liquidity management as well as the setting of risk appetite limits.

The Board and Executive Management have engaged in a number of exercises which have considered and developed stress test scenarios. The output analysis enables Management to evaluate the Group's capital and funding resilience in the face of severe but plausible risk shocks. In addition to the UK Annual Cyclical Scenario on capital prescribed by the Regulator, the stress tests have included a range of Group wide, multi-risk category stress tests, generic and idiosyncratic financial shocks as well as operational risk scenario analyses. Stress testing is an integral part of the adequacy assessment processes for liquidity and capital, and the setting of tolerances under the annual review of Group risk appetite.

The Group also performed reverse stress tests to help Executive Management understand the full continuum of adverse impact and therefore the level of stress at which the Group would breach its individual capital and liquidity guidance requirements as set by the Regulator under the ICAAP and ILAAP processes.

14. Recovery Plan and Resolution Pack

The Group has prepared an RRP in accordance with PRA Supervisory Statements SS9/17 and SS19/13.

The plan represents the Group's 'Living Will' and examines in detail:

- the consequences of severe levels of stress (i.e. beyond those in the ICAAP) impacting the Group at a future date;
- the state of preparedness and contingency plan to respond to and manage through such a set of circumstances; and
- the options available to Executive Management to withstand and recover from such an environment.

This plan is prepared annually, or more frequently in the event of a material change in the Group's status, capital or liquidity position. The Board of Directors and Executive Management are fully engaged in considering the scenarios and options available for remedial actions to be undertaken.

The Board considers that the Group's business model, its supportive owners and the diversified nature of its business markets provides it with the flexibility to consider selective business or portfolio disposals, loan book run off, equity raising or a combination of these actions. The Group would invoke the RRP in the event they are required.

15. Group viability statement

The Directors have assessed the outlook for the Group over a longer period than the 12 months required by the 'going concern' statement in line with good governance practice and reporting.

The assessment relied on the following:

- the Board considered updates to the strategy and four-year plan at various times during 2018. The Board approved the Strategic Update in February 2019 that outlines the business plans and financial projections from 31 December 2018 to 31 December 2022;
- the amount of capital resources available to support the delivery of the Group's objectives following the addition of further verified profits and completion of an issuance of £125 million of Additional Tier 1 in December 2017;
- the ICAAP and ILAAP (as detailed in Section 13);
- a review and evaluation of its top and emerging risks (as reported in Section 3);
- the Group funding plan and the Management plans to manage the refinance of the Term Funding Scheme;
- consideration of the effect of a moving regulatory landscape on the Total Capital Requirement, Pillar 2B and the CRD IV combined buffer requirements, together with the effect of the Group's capital contingency plan to restore the capital position in scenarios of capital headwinds; and
- the effect of the implementation of IFRS 9, taking into account the transitional arrangements published in Regulation (EU) 2017/2395 (as detailed in Section 12 and Note 2 of the financial statements).

The Group is not large enough to participate in the annual Bank of England concurrent stress testing programme but has, as part of its ICAAP, performed a variety of equivalent stress tests and reverse stress tests of its business. These include two market wide stress tests and five Group specific (idiosyncratic) stress tests. The stress tests were derived through discussions with Executive Management and the Board, after considering the Group's top risks. The Group also considered its funding and liquidity adequacy in the context of the reverse stress testing. The risk of the UK leaving the EU has been considered and the Board believe this risk was captured within its stress testing scenarios and will keep this risk under review.

The stress tests enable the Group to assess the impact of a number of severe but plausible scenarios on its business model. In the case of reverse stress testing, the Board is able to assess scenarios and circumstances that would render its business model unviable, thereby identifying business vulnerabilities and ensuring the development of early warning indicators and potential mitigating actions.

The Board aims to build a sustainable lending and savings bank for SMEs and consumers over the medium to long term. The Board monitors a four-year strategic plan that provides a robust planning tool against which strategic decisions are made. Whilst the Board has no reason to believe that the Group will not be viable for a four-year period, given the inherent uncertainty involved, the Board concluded that a three-year period is an appropriate length of time to perform a viability assessment with a greater level of certainty.

15. Group viability statement (continued)

Based on the results of the above mentioned assessments, the Directors have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over a period of at least three years.

Statement of Directors' responsibilities in respect of the Annual Report & Accounts

The Directors are responsible for preparing the Annual Report & Accounts and the Group and Parent Company financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare Group and Parent Company financial statements for each financial year. Under that law they are required to prepare the Group financial statements in accordance with IFRSs as adopted by the EU and applicable law and have elected to prepare the Parent 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 Group and Parent Company and of their profit or loss for that period. In preparing each of the Group and Parent 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 IFRSs as adopted by the EU;
- assess the Group and Parent 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 Group or the Parent 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 Parent Company's transactions and disclose with reasonable accuracy at any time the financial position of the Parent 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 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 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 Group's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Responsibility statement of the Directors in respect of the annual financial report

The Directors as at the date of this statement whose names are set out on page 3 confirm that to the best of their knowledge:

- the financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Group and the undertakings included in the consolidation taken as a whole; and
- the strategic report and Directors' report includes a fair review of the development and performance of the business and the position of the Group and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

This responsibility statement was approved by the Board of Directors and is signed on its behalf by:

Daniel Rushbrook
Company Secretary

18 April 2019

KPMG

Independent auditor's report

to the members of Shawbrook Bank Limited

1. **Our opinion is unmodified**

We have audited the financial statements of Shawbrook Bank Limited ("the Group") for the year ended 31 December 2018 which comprise the *Consolidated statement of profit and loss and other comprehensive income, Consolidated and Company statement of financial position, Consolidated statement in changes in equity, Consolidated and Company statement of cash flows*, and the related notes, including the accounting policies in note 1.

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 2018 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union (IFRSs as adopted by the EU);
- the parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU 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.

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 directors in June 2011. The period of total uninterrupted engagement is for the eight financial years ended 31 December 2018. 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.

Overview		
Materiality: group financial statements as a whole	£4.3m (2017:3.1m) 4.6% (2017: 4.8%) of normalised profit before tax	
Coverage	100% (2017:100%) of Group profit before tax	
Key audit matters		**vs 2017**
Event driven	New: Impact of uncertainties due to Britain exiting the European Union on our audit	New
Recurring risks	New: Expected Credit Loss provisioning	▲
	Effective interest rate accounting	◄►
	Provisions related to conduct matters	▲
	Valuation of goodwill	◄►

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

Key audit matters are those matters that, in our professional judgment, 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 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.

The impact of uncertainties due to Britain exiting the European Union on our audit

Refer to page 30 (Risk Management Report) and page 64 (viability statement)

The risk	Our response
Unprecedented levels of uncertainty All audits assess and challenge the reasonableness of estimates, in particular as described in expected credit loss provisioning, effective interest rate accounting and valuation of goodwill below, and related disclosures and the appropriateness of the going concern basis of preparation of the financial statements (see below). All of these depend on assessments of the future economic environment and the Group and parent Company's future prospects and performance. In addition, we are required to consider the other information presented in the Annual Report including the principal risks disclosure and the viability statement and to consider the directors' statement that the annual report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group and parent Company's position and performance, business model and strategy. Brexit is one of the most significant economic events for the UK and at the date of this report its effects are subject to unprecedented levels of uncertainty of outcomes, with the full range of possible effects unknown	We developed a standardised firm-wide approach to the consideration of the uncertainties arising from Brexit in planning and performing our audits. Our procedures included: • **Our Brexit knowledge** – We considered the directors' assessment of Brexit-related sources of risk for the Group 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. • **Sensitivity analysis** – When addressing expected credit loss provisioning and goodwill, we compared the directors' analysis to our assessment of the full range of reasonably possible scenarios resulting from Brexit uncertainty. • **Assessing transparency** – As well as assessing individual disclosures as part of our procedures on expected credit loss provisioning, effective interest rate accounting and valuation of goodwill, we considered all of the Brexit related disclosures together, including those in the strategic report, comparing the overall picture against our understanding of the risks. **Our results** As reported under expected credit loss provisioning, effective interest rate accounting, and valuation of goodwill we found the resulting estimates and related disclosures of credit impairment provisioning, effective interest rate accounting and valuation of goodwill and disclosures in relation to going concern to be acceptable. However, no audit should be expected to predict the unknowable factors or all possible future implications for a company and this is particularly the case in relation to Brexit.

KPMG

Expected Credit Loss provisioning

Group: £67.8 million; 2017: £31.6 million
Company: £67.8 million; 2017: £31.6 million

Refer to pages 34-43 (Risk Management Report), pages 95 -101 (accounting policy) and pages 127-129 (financial disclosures).

The risk	Our response
Subjective estimate This is a key judgemental area due to the level of subjectivity inherent in estimating the recoverability of loan balances on an Expected Credit Loss basis ("ECL"). As a result of the transition to IFRS 9 – Financial Instruments in 2018, the Group is to determine the loan loss provisioning using the 3 stage model: (i) For loans where the credit risk has not increased significantly since initial recognition, a provision is recognized for the expected 12 month credit losses expected to be incurred. (ii) For loans where there is deemed to be a significant increase in credit risk, a provision for the expected lifetime credit loss is recognized across this portfolio. (iii) For loans that are credit impaired, the Group will need to undertake a specific impairment assessment. For loans classified as either stage 1 or 2, an assessment is performed on a portfolio wide basis for impairment, with the key judgements and estimates being: - The determination of significant increase in credit risk, - The probability of an account falling into arrears and subsequently defaulting, - Loss given default, and - Forward economic guidance. For loans classified as stage 3, an impairment assessment is required at an individual loan level, based on estimated future cash flows discounted to present value at the rate inherent in the loan. This includes estimating the cost of obtaining and selling the repossessed collateral, and probable sale proceeds. There is a risk that the overall provision is not reflective of the expected losses at the end of the period due to changes in customer credit quality resulting in unrepresentative probabilities of default. Given the Group's lending has not experienced a full economic cycle, there is increased risk that actual experience may differ from the Group's current expectations. The effect of these matters is that, as part of our risk assessment, we determined that ECL provisioning 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. The risk management report (note 5.3) disclose the sensitivity estimated by the Group. **Disclosure quality** The disclosures regarding the Group's application of IFRS 9 are key to understanding the change from IAS 39 as well as explaining the key judgements and material inputs to the IFRS 9 ECL results.	**Our procedures included:** — **Controls testing:** We performed end to end process walk-throughs to identify the key systems, applications and controls used in the ECL processes. We tested the relevant general IT and applications controls over key systems used in the ECL process. — **Test of details:** For a sample of loans and advances we conducted credit file reviews to assess the appropriateness of the stage allocation and associated ECL estimate. — **Historical comparisons:** We critically assessed the Group's assumptions in respect of significant increase in credit risk; likely collateral valuations, including timing of recovery; and the probability of possession given default by comparing them to the Group's historical experience. For the Group's probability of default models we assessed the reasonableness of the model predictions by comparing them against actual results. — **Benchmarking assumptions:** We compared the Group's key assumptions on significant increase in credit risk; likely collateral valuations, including timing of recovery; probability of possession given default; and the probability weightings attached to each economic scenario to comparable peer group organizations. — **Our sector experience:** We challenged the Group's key assumptions on significant increase in credit risk; the definition of default; likely collateral valuations, including timing of recovery; probability of default; probability of possession given default based on our knowledge of the Group and experience of the industry in which it operates. 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. — **Sensitivity analysis:** We performed sensitivity analysis over the Group's key assumptions on significant increase in credit risk; likely collateral valuations, including timing of recovery; probability of possession given default; and the probability weightings attached to each economic scenario. — **Assessing transparency:** We evaluated whether the disclosures appropriately reflect and address the uncertainty which exists when determining the expected credit losses. As a part of this, we assessed the sensitivity analysis that is disclosed. In addition, we challenged whether the disclosure of the key judgements and assumptions made was sufficiently clear. **Our Results:** We found the resulting estimate and related disclosures of the provision for expected credit loss to be acceptable (2017 result: acceptable).

KPMG

Effective interest rate accounting

Interest paid by customer
Group: £351.1 million; 2017: £307.1 million
Company: £351.1 million; 2017: £307.1 million

Refer to pages 85-86 (accounting policy) and page 119 (financial disclosures).

The risk	Our response
Subjective estimate Using a model, interest earned and fees earned and incurred on loans and advances to customers are recognised using the effective interest rate method that spreads directly attributable expected income over the expected lives of the loans. The Group applies judgement in deciding which cash flows are spread on an EIR basis and assessing the redemption profiles used to spread those cash flows. The most critical element of judgement in this area is the estimation of the redemption profiles of the loans, informed by past customer behaviour of when loans have been paid off.	Our procedures included: — **Methodology choice:** We tested the accuracy of data inputs from the underlying systems into the effective interest rate models and the consistency of methodology and applications across the Group's loan portfolios; — **Independent re-performance:** We evaluated the mathematical accuracy of models through re-performance of the model calculations; — **Sensitivity analysis:** We assessed and challenged the reasonableness of the models key assumptions, expected lives and forecast future cash flows by comparing these to historical trends within the Group and performing stress tests; and — **Assessing transparency:** Considering the adequacy of the Group's disclosures in respect of the sensitivity of revenue to these assumptions. **Our results** We found the amount of EIR income recognised in the year to be acceptable. (2017: acceptable)

KPMG

Provision relating to conduct matters

Group: £10.2 million; 2017: £2.5 million
Company: £10.2 million; 2017: £2.5 million

Refer to page 32 (Risk Management Report), page 105 (accounting policy) and pages 138-139 (financial disclosures).

The risk	Our response
Estimation of exposure Certain of the Group's lending activities give rise to ongoing exposure under Section 75 of the Consumer Credit Act. Due to the uncertainties that can arise in measuring potential obligations resulting from operational, legal and regulatory matters, the directors apply judgement in estimating the value of any associated liabilities. There is a judgement in how the directors determine the appropriate methodologies to calculate the value of potential liabilities and the assumptions used in these methodologies. During the prior year, the Group saw an increase in customer complaints relating to its solar lending product where the original supplier is no longer solvent. Management has increased the associated provision in the year as a result of further customer complaints and claim correspondence. The key element of judgement is the estimation of future customer complaints rate. This judgement is informed by the Group's past complaint and claim experience. Given the limited historical information, there is a risk that the actual experience may differ from the Group's expectation. The effect of these matters is that, as part of our risk assessment, we determined that the provision related to conduct matters 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.	**Our procedures included:** — **Our sector experience:** We compared common industry issues with those areas provided for by the Group to determine whether these issues were relevant to the business and to consider completeness of the provisions assessed by the directors. — **Independent evaluation:** We have critically challenged and evaluated management's assumptions in estimating the expected exposure including re-performance of management's calculations; — **Sensitivity analysis:** We assessed and challenged the reasonableness of the model's key assumption, future customer complaints rate, by comparing this to historical trends within the Group and performing stress tests; — **Methodology implementation:** We assessed the methodologies used by the Group in determining the estimated values of liabilities by considering whether they are appropriate to the liability being estimated. — **Assessing transparency:** We considered the adequacy of the Group's disclosures in detailing significant conduct related matters and potential liabilities. **Our results** We found the resulting estimate of the conduct provisions to be acceptable (2017: acceptable).

KPMG

Valuation of goodwill

Group: £43.7 million; 2017: £44.8 million
Company: £38.3 million; 2017: £38.0 million

Refer to page 92 (accounting policy) and pages 134-135 (financial disclosures).

The risk	Our response
Forecast-based evaluation The carrying value of goodwill is tested for impairment on the occurrence of an impairment trigger or otherwise annually. The estimated recoverable amount is subjective due to the inherent uncertainty involved in forecasting future cash flows and selecting an appropriate discount rate. £34.7 million of the total goodwill balance relates to Business Finance, being the area of most significant judgement in light of the size of the balance and weaker than expected financial performance in the year.	**Our procedures included:** — **Our sector experience:** Evaluating assumptions used, in particular those relating to forecast revenue growth, discount rate and incremental capital requirements in Business Finance; — **Benchmarking assumptions:** Comparing the Group's assumptions to external comparable data in relation to key inputs such as projected economic growth and discount rates; — **Sensitivity analysis:** Performing breakeven analysis on the assumptions noted above using our data analytic capabilities; — **Assessing transparency:** Assessing whether the Group'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 goodwill. **Our results** We found the resulting estimate of the carrying value of goodwill to be acceptable (2017: acceptable)

A key audit matter was reported in 2017 in respect of Impairment Provisioning. As a result of the Group's transition to IFRS 9, this key audit matter has been replaced with Expected Credit Loss Provisioning in 2018.

KPMG

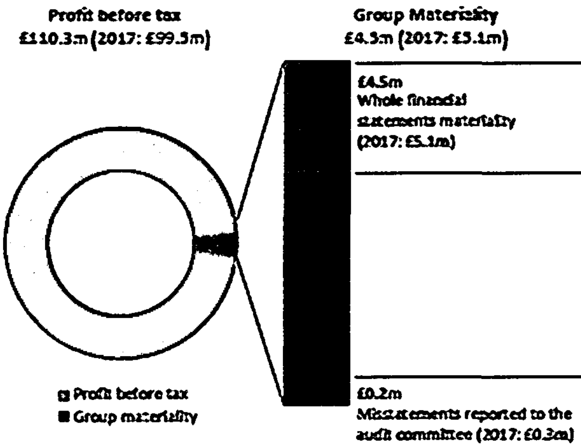
Independent auditor's report (continued)

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

Materiality for the Group financial statements as a whole was set at £4.3m (2017: £5.1m), determined with reference to a benchmark of Group profit before tax, normalised to exclude this year's insurance recoveries as disclosed in note 12, of £13.0m, of which it represents 4.6% (2017: 4.8%).

Materiality for the parent Company financial statements as a whole was set at £4.3m (2017: £5.1m), consistent with that of Group as the Parent company represents 100% of the Group.

We agreed to report to the Audit Committee any corrected or uncorrected identified misstatements exceeding £0.2, in addition to other identified misstatements that warranted reporting on qualitative grounds.



Team structure

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 level set out above.

4. We have nothing to report on going concern

The Directors have prepared the financial statements on the going concern basis as they do not intend to liquidate the Company or the Group or to cease their operations, and as they have concluded that the Company's and the Group'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").

Our responsibility is to conclude on the appropriateness of the Directors' conclusions and, had there been a material uncertainty related to going concern, to make reference to that in this audit report. 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 absence of reference to a material uncertainty in this auditor's report is not a guarantee that the group or the company will continue in operation.

In our evaluation of the Directors' conclusions, we considered the inherent risks to the Group's and Company's business model and analysed how those risks might affect the Group's and Company's financial resources or ability to continue operations over the going concern period. The risks that we considered most likely to adversely affect the Group's and Company's available financial resources over this period were:

- availability of funding and liquidity in the event of a market wide stress scenario including the impact of Brexit, and
- impact on regulatory capital requirements in the event of an economic slowdown or recession.

As these were risks that could potentially cast significant doubt on the Group's and the Company's ability to continue as a going concern, we considered sensitivities over the level of available financial resources indicated by the Group's financial forecasts taking account of reasonably possible (but not unrealistic) adverse effects that could arise from these risks individually and collectively and evaluated the achievability of the actions the Directors consider they would take to improve the position should the risks materialise. We also considered less predictable but realistic second order impacts, such as the impact of Brexit and the erosion of customer or supplier confidence, which could result in a rapid reduction of available financial resources.

Based on this work, we are required to report to you if we have concluded that the use of the going concern basis of accounting is inappropriate or there is an undisclosed material uncertainty that may cast significant doubt over the use of that basis for a period of at least a year from the date of approval of the financial statements.

We have nothing to report in these respects, and we did not identify going concern as a key audit matter.

KPMG

Independent auditor's report (continued)

5. **We have nothing to report on other information in the Annual Report**

   The directors are responsible for the other information in the Annual 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 other information 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 the other information.

   Strategic report and directors' report

   Based solely on our work on the other information:

   - we have not identified material misstatements in the strategic report and the directors' report;
   - in our opinion the information given in those reports 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.

6. **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.

7. **Respective responsibilities**

   Directors' responsibilities

   As explained more fully in their statement set out on page 66, 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 other irregularities (see below), 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, other irregularities 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.

   Irregularities – ability to detect

   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. 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 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 the company legislation recognising the financial and regulated nature of the Group'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. Through these procedures, we became aware of actual or suspected non-compliance and considered the effect as part of our procedures on the related financial statement items. Further detail in respect of conduct related matters is set out in the key audit matter disclosures in section 2 of this report.

KPMG

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 (irregularities) 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 irregularities, as these may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal controls. We are not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

8. **The purpose of our audit work and to whom we owe our responsibilities**

This report is made solely to the 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 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 Company and the Company's members, as a body, for our audit work, for this report, or for the opinions we have formed.

S. Ryder

Simon Ryder (Senior Statutory Auditor)
for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants
15 Canada Square
London
E14 5GL
18 April 2019

KPMG

Consolidated statement of profit and loss and other comprehensive income

For the year ended 31 December 2018

	Note	2018 £m	2017 £m
Interest income calculated using the effective interest rate method	4	**356.0**	308.9
Other interest and similar income	4	**0.8**	4.4
Interest expense and similar charges	5	**(87.2)**	(75.9)
Net interest income		**269.6**	237.4
Operating lease rentals		**10.0**	12.3
Other operating lease expense		**(0.6)**	-
Depreciation on operating leases	17	**(7.6)**	(10.6)
Net income from operating leases		**1.8**	1.7
Fee and commission income	6	**10.7**	12.3
Fee and commission expense		**(9.7)**	(13.5)
Net fee and commission income / (expense)		**1.0**	(1.2)
Net gains on financial instruments mandatorily at fair value through profit or loss	16(c)	**0.5**	0.2
Net operating income		**272.9**	238.1
Administrative expenses	7	**(128.8)**	(113.2)
Impairment losses on financial assets[1]	12	**(23.2)**	(23.3)
Provisions for liabilities and charges	25	**(10.1)**	(2.1)
Total operating expenses		**(162.1)**	(138.6)
Share of results of associates	20	**(0.5)**	-
Profit before taxation		**110.3**	99.5
Taxation	13	**(28.3)**	(25.3)
Profit after taxation, being total comprehensive income, attributable to owners		**82.0**	74.2

The notes on pages 81 to 149 are an integral part of these financial statements.

[1] Impairment losses on financial assets in the year ended 31 December 2018 reflect expected credit losses calculated in accordance with IFRS 9. Impairment losses on financial assets in the year ended 31 December 2017 reflect impairment losses calculated in accordance with IAS 39. As such, results are not directly comparable.

Consolidated and Company statement of financial position

As at 31 December 2018

	Note	Group 2018 £m	Company 2018 £m	Group 2017 £m	Company 2017 £m
Assets					
Cash and balances at central banks		**645.2**	**645.2**	752.5	752.5
Loans and advances to banks		**50.6**	**50.1**	28.8	28.5
Loans and advances to customers	14	**5,845.9**	**5,805.7**	4,844.3	4,799.3
Investment securities	15	**139.9**	**139.9**	-	-
Derivative financial assets	16(a)	**1.6**	**1.6**	1.8	1.8
Property, plant and equipment	17	**39.1**	**38.1**	39.6	39.2
Intangible assets	18	**60.7**	**46.4**	59.4	44.6
Deferred tax assets	19	**18.0**	**18.0**	15.7	15.7
Investment in associates	20	**5.5**	**5.5**	-	-
Other assets	21	**12.6**	**55.1**	9.9	19.8
Total assets		**6,819.1**	**6,805.6**	5,752.0	5,701.4
Liabilities					
Amounts due to banks	23	**1,029.4**	**1,029.4**	607.3	607.3
Customer deposits	24	**4,977.9**	**4,977.9**	4,376.2	4,376.2
Provisions for liabilities and charges	25	**11.6**	**11.6**	2.8	2.8
Derivative financial liabilities	16(a)	**5.7**	**5.7**	3.4	3.4
Current tax liabilities		**3.9**	**3.9**	7.8	7.8
Other liabilities	26	**41.1**	**40.7**	63.4	26.8
Subordinated debt liability	27	**76.1**	**76.1**	76.1	76.1
Total liabilities		**6,145.7**	**6,145.3**	5,137.0	5,100.4
Equity					
Share capital	28	**175.5**	**175.5**	175.5	175.5
Share premium account		**81.0**	**81.0**	81.0	81.0
Capital securities	29	**125.0**	**125.0**	125.0	125.0
Merger reserve		**1.6**	**1.6**	1.6	1.6
Capital redemption reserve		**16.4**	**16.4**	16.7	16.7
Retained earnings		**273.9**	**260.8**	215.2	201.2
Total equity		**673.4**	**660.3**	615.0	601.0
Total equity and liabilities		**6,819.1**	**6,805.6**	5,752.0	5,701.4

The notes on pages 81 to 149 are an integral part of these financial statements.

These financial statements were approved by the Board of Directors on 18 April 2019 and were signed on its behalf by:

Ian Cowie
Chief Executive Officer

Dylan Minto
Chief Financial Officer

Registered number 00388466

Consolidated statement of changes in equity

For the year ended 31 December 2018

Year ended 31 December 2018	**Share capital £m**	**Share premium account £m**	**Capital securities £m**	**Merger reserve £m**	**Capital redemption reserve £m**	**Retained earnings £m**	**Total equity £m**
As at 1 January 2018	**175.5**	**81.0**	**125.0**	**1.6**	**16.7**	**215.2**	**615.0**
Impact of adopting IFRS 9[1]	-	-	-	-	-	**(16.0)**	**(16.0)**
Restated balance as at 1 January 2018	**175.5**	**81.0**	**125.0**	**1.6**	**16.7**	**199.2**	**599.0**
Profit for the year	-	-	-	-	-	**82.0**	**82.0**
Coupon paid on capital securities (net of tax)	-	-	-	-	-	**(7.3)**	**(7.3)**
Share-based payments	-	-	-	-	**(0.3)**	-	**(0.3)**
As at 31 December 2018	**175.5**	**81.0**	**125.0**	**1.6**	**16.4**	**273.9**	**673.4**

Year ended 31 December 2017	Share capital £m	Share premium account £m	Capital securities £m	Merger reserve £m	Capital redemption reserve £m	Retained earnings £m	Total equity £m
As at 1 January 2017	175.5	81.0	-	1.6	9.2	160.5	427.8
Profit for the year	-	-	-	-	-	74.2	74.2
Dividend paid	-	-	-	-	-	(19.5)	(19.5)
Issue of capital securities	-	-	125.0	-	-	-	125.0
Share-based payments	-	-	-	-	7.5	-	7.5
As at 31 December 2017	175.5	81.0	125.0	1.6	16.7	215.2	615.0

The notes on pages 81 to 149 are an integral part of these financial statements.

[1] See Note 1.6(a) and Note 2 for details.

Company statement of changes in equity

For the year ended 31 December 2018

Year ended 31 December 2018	Share capital £m	Share premium account £m	Capital securities £m	Merger reserve £m	Capital redemption reserve £m	Retained earnings £m	Total equity £m
As at 1 January 2018	**175.5**	**81.0**	**125.0**	**1.6**	**16.7**	**201.2**	**601.0**
Impact of adopting IFRS 9[1]	-	-	-	-	-	**(15.7)**	**(15.7)**
Restated balance as at 1 January 2018	**175.5**	**81.0**	**125.0**	**1.6**	**16.7**	**185.5**	**585.3**
Profit for the year	-	-	-	-	-	**82.6**	**82.6**
Coupon paid on capital securities (net of tax)	-	-	-	-	-	**(7.3)**	**(7.3)**
Share-based payments	-	-	-	-	**(0.3)**	-	**(0.3)**
As at 31 December 2018	**175.5**	**81.0**	**125.0**	**1.6**	**16.4**	**260.8**	**660.3**

Year ended 31 December 2017	Share capital £m	Share premium account £m	Capital securities £m	Merger reserve £m	Capital redemption reserve £m	Retained earnings £m	Total equity £m
As at 1 January 2017	175.5	81.0	-	1.6	9.2	145.8	413.1
Profit for the year	-	-	-	-	-	74.9	74.9
Dividend paid	-	-	-	-	-	(19.5)	(19.5)
Issue of capital securities	-	-	125.0	-	-	-	125.0
Share-based payments	-	-	-	-	7.5	-	7.5
As at 31 December 2017	175.5	81.0	125.0	1.6	16.7	201.2	601.0

The notes on pages 81 to 149 are an integral part of these financial statements.

[1] See Note 1.6(a) and Note 2 for details.

Consolidated and Company statement of cash flows
For the year ended 31 December 2018

	Note	Group 2018 £m	Company 2018 £m	Group 2017 £m	Company 2017 £m
Cash flows from operating activities					
Profit before taxation		**110.3**	**110.9**	99.5	100.2
Adjustments for non-cash items and other adjustments included within the statement of profit and loss	30(a)	**39.7**	**39.2**	54.4	54.3
Increase in operating assets	30(b)	**(1,050.5)**	**(1,087.2)**	(816.5)	(780.9)
Increase in operating liabilities	30(c)	**590.0**	**626.2**	471.8	435.3
Tax paid		**(26.4)**	**(26.4)**	(29.5)	(29.5)
Net cash used by operating activities		**(336.9)**	**(337.3)**	(220.3)	(220.6)
Cash flows from investing activities					
Purchase of investment securities		**(139.7)**	**(139.7)**	-	-
Purchase of property, plant and equipment		**(3.6)**	**(3.4)**	(1.6)	(1.6)
Purchase of intangible assets		**(9.8)**	**(9.8)**	(9.8)	(9.8)
Purchase of shares in associates		**(6.0)**	**(6.0)**	-	-
Net cash used by investing activities		**(159.1)**	**(158.9)**	(11.4)	(11.4)
Cash flows from financing activities					
Increase in amounts due to banks		**422.1**	**422.1**	459.6	459.6
Payment of subordinated debt interest		**(6.4)**	**(6.4)**	(6.4)	(6.4)
Net proceeds from the issue of capital securities		**-**	**-**	125.0	125.0
Coupon paid to holders of capital securities		**(9.8)**	**(9.8)**	-	-
Dividends paid to Shareholders		**-**	**-**	(19.5)	(19.5)
Net cash generated from financing activities		**405.9**	**405.9**	558.7	558.7
Net (decrease) / increase in cash and cash equivalents		**(90.1)**	**(90.3)**	327.0	326.7
Cash and cash equivalents as at 1 January		**777.0**	**776.7**	450.0	450.0
Cash and cash equivalents as at 31 December	30(d)	**686.9**	**686.4**	777.0	776.7

The notes on pages 81 to 149 are an integral part of these financial statements.

Notes to the financial statements

For the year ended 31 December 2018

1. Basis of preparation and significant accounting policies

1.1. Reporting entity

Shawbrook Bank Limited (the 'Company') is domiciled in the UK. The registered office is Lutea House, Warley Hill Business Park, The Drive, Great Warley, Brentwood, Essex, CM13 3BE. The consolidated financial statements of Shawbrook Bank Limited, for the year ended 31 December 2018, comprise the results of the Company and its subsidiaries (together, the 'Group'). The ultimate parent company is detailed in Note 32.

The principal activities of the Group are lending and savings.

1.2. Basis of accounting and measurement

Both the consolidated and Company financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board and as adopted by the EU, including interpretations issued by the IFRS Interpretations Committee and those parts of the Companies Act 2006 applicable to companies reporting under IFRS. No individual statement of profit and loss or related notes are presented for the Company as permitted by section 408 (4) of the Companies Act 2006.

As detailed in the Directors' report, the Directors believe that it remains appropriate to prepare the financial statements on a going concern basis.

The financial statements have been prepared on a historical cost basis, except as required in the valuation of certain financial instruments which are carried at fair value.

1.3. Functional and presentation currency

The financial statements are presented in Pounds Sterling, which is the functional currency of the Company and all of its subsidiaries. All amounts have been rounded to the nearest million, except where otherwise indicated.

Foreign currency transactions are translated into functional currency using the spot exchange rate at the date of the transaction.

Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency using the spot exchange rate at the reporting date. Foreign exchange gains and losses resulting from the restatement and settlement of such transactions are recognised in the statement of profit and loss.

Non-monetary assets and liabilities that are measured on a historical cost basis and denominated in foreign currencies are translated into the functional currency using the spot exchange rate at the date of the transaction. Non-monetary assets and liabilities that are measured at fair value and denominated in foreign currencies are translated into the functional currency at the spot exchange rate at the date of valuation. Where these assets and liabilities are held at fair value through profit and loss, exchange differences are reported as part of the fair value gain or loss.

1.4. Basis of consolidation

The consolidated financial statements comprise the financial statements of the Company and its subsidiaries (the 'Group'). The Group's subsidiaries are detailed in Note 33.

Subsidiaries are entities controlled by the Group. Control is achieved when the Group:

- has power over the investee;
- is exposed, or has rights, to variable returns from its involvement with the investee; and
- has the ability to use its power over the investee to affect its returns.

The Group reassesses whether or not it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control.

Subsidiaries are consolidated from the date on which control is transferred to the Group and are deconsolidated from the date that control ceases. Accounting policies are applied consistently across the Group. Intragroup transactions and balances are eliminated in full on consolidation.

1. Basis of preparation and significant accounting policies (continued)

1.4. Basis of consolidation (continued)

The Group's interests in associates are accounted for using the equity method of accounting as detailed in Note 1.7(n).

1.5. Presentation of risk and capital management disclosures

The disclosures required under IFRS 7 'Financial Instruments: Disclosures' concerning the nature and extent of risks relating to financial instruments and under IAS 1 'Presentation of Financial Statements' concerning objectives, policies and processes for managing capital have been included within the audited section of the risk management report. Where information is marked as 'audited' these are covered by the independent auditor's report.

1.6. Adoption of new and revised standards and interpretations

On 1 January 2018, a number of new and revised standards issued by the International Accounting Standards Board, and endorsed for use in the EU, came into effect. New and revised standards adopted in the period that are deemed significant to the Group are outlined below. A number of other new standards are also effective from 1 January 2018 but they do not have a material effect on the Group's financial statements.

(a) IFRS 9 'Financial Instruments'

On 1 January 2018, the Group adopted the requirements of IFRS 9 as issued in July 2014 and the amendments to IFRS 9 'Prepayment Features with Negative Compensation'. The amendments to IFRS 9 are effective for annual periods beginning on or after 1 January 2019, with early adoption permitted. The Group elected to early adopt the amendments. The new standard replaces IAS 39 'Financial Instruments: Recognition and Measurement'.

To reflect the difference between IFRS 9 and IAS 39, consequential amendments were also made to other standards including IFRS 7 'Financial Instruments: Disclosures' and IAS 1 'Presentation of Financial Statements'. The Group adopted these consequential amendments, along with IFRS 9, on 1 January 2018.

Changes in accounting policies

IFRS 9 introduces new requirements for the classification and measurement, impairment and hedge accounting of financial assets and liabilities. The key changes to the Group's accounting policies are as follows:

Classification of financial assets

Under IFRS 9 there are three principal classification categories for financial assets: measured at amortised cost, fair value through other comprehensive income and fair value through profit or loss. The IAS 39 categories of held-to-maturity, loans and receivables and available-for-sale are eliminated.

Classification of financial assets is dependent on the outcome of two assessments which evaluates the *business model in which financial assets are managed and their cash flow characteristics.*

Full details of the accounting policies relating to the classification and measurement of financial assets and financial liabilities are set out in Note 1.7(u).

Impairment of financial assets

IFRS 9 replaces the incurred loss model implemented under IAS 39 with an expected credit loss (ECL) model which results in earlier recognition of credit losses. The new model applies to all financial assets not held at fair value through profit or loss, together with financial guarantee contracts and loan commitments. Equity instruments are not subject to impairment.

Full details of the accounting policies relating to impairment of financial assets are set out in Note 1.7(v).

Consequential amendments to IFRS 7, introduces the requirement for detailed qualitative and quantitative information about the ECL calculations such as assumptions and inputs. These additional disclosures are set out in Note 1.9(d) and Section 5.3 of the risk management report.

Hedge accounting

As permitted by IFRS 9, the Group has elected to continue to apply the hedge accounting requirements of IAS 39.

Full details of the accounting policies relating to hedge accounting are set out in Note 1.7(j).

1. Basis of preparation and significant accounting policies (continued)

1.6. Adoption of new and revised standards and interpretations (continued)

Consequential amendments to IFRS 7 introduce the requirement for additional and more detailed disclosures for hedge accounting. These disclosures are required even when continuing to apply the hedge accounting requirements of IAS 39 and are set out in Note 16(b). As permitted by IFRS 7, the Group has not provided comparative information for periods before the date of initial application of IFRS 9 for the new disclosures.

Changes in presentation
Consequential amendments to IAS 1 require interest income calculated using the effective interest rate method, as detailed in Note 1.7(b), to be presented separately on the face of the statement of profit and loss. Comparatives have been restated accordingly to reflect this change in presentation.

Transition
The Group has adjusted the opening balance of retained earnings to reflect the application of the new requirements of IFRS 9. In accordance with the transition requirements, comparative information is not restated. As such, the comparative information for 2017 is reported under the requirements of IAS 39 and is not comparable to the information presented for 2018.

Full details regarding the impact of IFRS 9 adoption and transition disclosures required by IFRS 7 are set out in Note 2.

(b) IFRS 15 'Revenue from Contracts with Customers'
On 1 January 2018, the Group adopted the requirements of IFRS 15. The new standard replaces IAS 18 'Revenue', IAS 11 'Construction Contracts' and related interpretations.

Changes in accounting policies
IFRS 15 establishes the principles to apply when reporting information about the nature, amount, timing and uncertainty of revenue and cash flows from a contract with a customer. The standard introduces a five step revenue recognition model to be applied to all contracts with customers to determine whether, how much, and when revenue is recognised. IFRS 15 does not apply to insurance contracts, financial instruments or lease contracts, which fall under the scope of other IFRSs. It also does not apply if two companies in the same line of business exchange non-monetary assets to facilitate sales to other parties. Of particular note, interest income, the main source of revenue for the Group, falls outside the scope of IFRS 15.

Transition
The Group has adopted IFRS 15 using the cumulative effect method (without practical expedients). As such, the standard is applied as of 1 January 2018 with the cumulative effect recognised as an adjustment to the opening balance of retained earnings. Comparative information for 2017 is not restated.

The Group assessed its non-interest revenue streams that fall under the scope of IFRS 15 and determined that the approach to revenue recognition was unchanged and there was no impact on the amount or timing of revenue to be recognised as a result of the adoption of IFRS 15. As such, there is no adjustment to the opening balance of retained earnings or related tax balances. Furthermore, there is no impact to the consolidated statement of financial position or the consolidated statement of profit and loss and other comprehensive income. Revenue is disaggregated by reportable segment as detailed in Note 3.

(c) IFRS 2 amendment 'Classification and Measurement of Share-based Payment Transactions'
On 1 January 2018, the amendments to IFRS 2 became effective in relation to the classification and measurement of share-based payment transactions.

Changes in accounting policies
The amendments to IFRS 2 specifically relate to: effects of vesting conditions on the measurement of a cash-settled share-based payment transaction; classification of a share-based payment transaction with net settlement features for withholding tax obligations; accounting where a modification to the terms and conditions of a share-based payment transaction changes its classification from cash-settled to equity-settled.

Transition
As at 1 January 2018, the Group had no share schemes in operation. The amendments will be adopted for any new share schemes introduced after this date.

1. Basis of preparation and significant accounting policies (continued)

1.7. Significant accounting policies

With the exception of changes to the Group's accounting policies resulting from new and revised accounting standards adopted in the year (see Note 1.6), the Group has consistently applied the following accounting policies to all periods presented in the financial statements.

(a) Operating segments

See disclosures at Note 3

Operating segments are identified on the basis of internal reports and components of the Group which are regularly reviewed by the Chief Operating Decision Maker to allocate resources to segments and to assess their performance. For this purpose, the Group Executive Committee has been determined to be the Chief Operating Decision Maker for the Group.

The Group determines operating segments according to similar economic characteristics and the nature of its products and services. Segment performance is evaluated on an underlying basis which excludes certain items included in the statement of profit and loss determined under IFRS as adopted by the EU.

(b) Interest income and expense

See disclosures at Note 4 and Note 5

Financial instruments measured at amortised cost

Under both IFRS 9 and IAS 39, interest income and expense are recognised in the statement of profit and loss for all instruments measured at amortised cost using the effective interest rate method.

Under IFRS 9 (from 1 January 2018)

The effective interest rate method calculates the amortised cost of a financial asset or financial liability, and allocates the interest income or expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash flows through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset, or the amortised cost of a financial liability.

Amortised cost is the amount at which the financial instrument is measured on initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest rate method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

The gross carrying amount of a financial asset is the amortised cost of a financial asset before adjusting for any loss allowance.

When calculating the effective interest rate for financial instruments, with the exception of credit-impaired financial assets, the Group estimates future cash flows considering all contractual terms of the financial instrument, for example prepayment options, but does not consider the loss allowance. The calculation includes all fees paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial instrument.

For credit-impaired financial assets, a credit-adjusted effective interest rate is calculated using estimated future cash flows including loss allowances.

In calculating interest income and expense, the calculated effective interest rate is applied to the gross carrying amount of the financial asset (when the asset is not credit-impaired), or to the amortised cost of the financial liability.

For financial assets that were credit-impaired on initial recognition, interest income is calculated by applying a credit-adjusted effective interest rate to the amortised cost of the financial asset. The calculation of interest income does not revert to the gross basis, even if the credit risk of the asset improves.

Where a financial asset becomes credit-impaired subsequent to initial recognition, interest income is calculated by applying the effective interest rate to the amortised cost of the financial asset. If the asset is no longer credit-impaired, the calculation of interest income reverts to the gross basis.

A financial asset is deemed to be credit-impaired when it is in Stage 3 as detailed in Note 1.7(v).

1. Basis of preparation and significant accounting policies (continued)

1.7. Significant accounting policies (continued)

Under IAS 39 (prior to 1 January 2018)
Interest income and expense were recognised in the statement of profit and loss using the effective interest rate method. The effective interest rate was the rate that exactly discounted the estimated future cash flows through the expected life of the financial instrument (or, where appropriate, a shorter period) to the carrying amount of the financial instrument.

When calculating the effective interest rate, the Group estimated future cash flows considering all contractual terms of the financial instrument, for example prepayment options, but did not consider impairment allowances. The calculation included all fees paid or received between parties to the contract that were an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

Derivative financial instruments
The Group recognises net interest income on derivative financial instruments forming part of hedging relationships and economic hedging relationships based on the underlying hedged items. For derivative financial instruments hedging assets, the net interest income is recognised in interest income. For derivative financial instruments hedging liabilities, the net interest income is recognised in interest expense.

(c) Fee and commission income
See disclosures at Note 6

Where fees and commissions are not included in the effective interest rate calculation (see Note 1.7(b)), they are recognised as follows:

Under IFRS 15 (from 1 January 2018)
Income is recognised when performance obligations attached to the fee or commission have been satisfied. Where income is earned from the provision of a service, for example an account maintenance fee, the performance obligations are deemed to have been satisfied when the service is delivered. Where income is earned upon the execution of a significant act, for example CHAPS payment charges, the performance obligations are deemed to have been satisfied when the act is completed for the customer.

Under IAS 18 (prior to 1 January 2018)
Income was recognised on an accruals basis when the service had been provided, or on the completion of the act the fee related to.

(d) Administrative expenses
See disclosures at Note 7

Administrative expenses are recognised on an accruals basis. The Group's significant accounting policies relating to specific components of administrative expenses are as follows:

Payroll costs
Salaries and social security costs are recognised over the period in which the employees provide the service to which the payments relate.

Cash bonus awards are recognised to the extent that the Group has a present obligation to its employees that can be measured reliably and are recognised over the period that employees are required to provide services.

The Group operates defined contribution pension schemes for eligible employees and does not operate any defined benefit pension schemes. Under the defined contribution pension arrangements, the Group pays fixed contributions into employees' personal pension plans, with no further payment obligations once the contributions have been paid. The Group's contributions to such arrangements are recognised as an expense when they fall due.

The accounting policies for employee share-based payments are detailed in Note 1.7(e).

Depreciation and amortisation
See Note 1.7(k) for details of depreciation and Note 1.7(m) for details of amortisation.

1. Basis of preparation and significant accounting policies (continued)

1.7. Significant accounting policies (continued)

Operating lease payments
The Group leases land and buildings under operating lease agreements. See Note 1.7(l) for details.

(e) Share-based payments
See disclosures at Note 10

The Group historically operated a number of equity-settled share-based payment schemes in respect of services received from certain employees. All such schemes fully vested in 2017. In 2018, no share-based payment schemes have been in operation.

Accounting policies implemented by the Group when share-based payment schemes are in operation are as follows:

The grant date fair value of a share-based payment transaction is recognised as a payroll cost in administrative expenses in the statement of profit and loss, with a corresponding increase in retained earnings in equity, on a straight-line basis over the period that the employees become unconditionally entitled to the awards (the vesting period). In the absence of market prices, the grant date fair value is estimated using an appropriate valuation technique.

The amount recognised as an expense is adjusted to reflect the number of awards for which the related service and non-market vesting conditions are expected to be met, such that the amount ultimately recognised as an expense is based on the number of awards that meet the related service and non-market performance conditions at the vesting date.

For share-based payment awards with market performance conditions or non-vesting conditions, the grant date fair value of the award is measured to reflect such conditions and there is no true-up for differences between expected and actual outcomes.

Taxation on the amount recognised as an expense is recognised in the statement of profit and loss. Tax benefits of equity-settled share-based payment transactions that exceed the tax effected cumulative remuneration expenses are considered to relate to an equity item and are recognised directly in equity.

Expected volatility is determined by reviewing the share price volatility for the expected life of each option/scheme up to the date of the grant.

Cancellations of share-based payments during the vesting period are accounted for as accelerated vesting. The share-based payment is recognised immediately at the amount that would have been recognised for services received over the remainder of the vesting period, as if the service and the non-market performance conditions were met for the cancelled awards.

(f) Taxation
See disclosures at Note 13 and Note 19

Taxation comprises current tax and deferred tax. Taxation is recognised in the statement of profit and loss except to the extent that it relates to items recognised directly in equity or other comprehensive income.

Current tax
Current tax comprises the expected tax payable or receivable on the taxable income or loss for the year and any adjustment to the tax payable or receivable in respect of previous years. It is measured using tax rates enacted or substantively enacted at the reporting date.

Deferred tax
Deferred tax is provided in full using the liability method on temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the reporting date.

1. Basis of preparation and significant accounting policies (continued)

1.7 Significant accounting policies (continued)

A deferred tax asset is recognised for unused tax losses, unused tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which they can be utilised. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

(g) Loans and advances
See disclosures at Note 14

Loans and advances comprise both loans and advances to banks and loans and advances to customers.

Under IFRS 9 (from 1 January 2018)
Loans and advances are classified as financial assets measured at amortised cost. See Note 1.7(u) for details.

Under IAS 39 (prior to 1 January 2018)
Loans and advances were classified as loans and receivables. See Note 1.7(u) for details.

Included within loans and advances to customers are assets acquired in exchange for loans, instalment credit and finance lease receivables as part of an orderly realisation. The difference between the gross receivable and the present value of the receivable is recognised as unearned finance income.

(h) Investment securities
See disclosures at Note 15

Investment securities are held for long-term yield. These securities may be sold, but such sales are not expected to be more than infrequent. As such, the Group considers these securities to be held within a business model whose objective is to hold assets to collect the contractual cash flows. Accordingly the securities are classified as financial assets measured at amortised cost. See Note 1.7(u) for details.

(i) Derivative financial instruments
See disclosures at Note 16

Derivatives are entered into only for the purposes of matching or eliminating risk from potential movements in interest rates and foreign exchange rates in the Group's assets and liabilities. Derivatives are not used for trading or speculative purposes. The Group uses the International Swaps and Derivatives Association Master Agreement to document these transactions in conjunction with a Credit Support Annex.

Derivatives are mandatorily classified as fair value through profit and loss. They are initially recognised at fair value on the date on which the derivative contract is entered into and are subsequently remeasured at fair value.

To calculate fair values, the Group typically uses discounted cash flow models using yield curves that are based on observable market data. For collateralised positions, the Group uses discount curves based on overnight indexed swap rates. For non-collateralised positions, the Group uses discount curves based on term London Inter Bank Offer Rate (LIBOR). See Note 1.7(u) for further details.

Where derivatives are not designated as part of an accounting hedge relationship, gains and losses arising from changes in fair value are recognised in net gains/(losses) on financial instruments at fair value through profit or loss in the statement of profit and loss. Where derivatives are designated within an accounting hedge relationship, the treatment of the changes in fair value are as described in the hedge accounting section in Note 1.7(j).

Derivatives are classified as financial assets where their fair value is positive and financial liabilities where their fair value is negative. Where there is the legal right and intention to settle net, then the derivative is classified as a net asset or net liability, as appropriate.

1. Basis of preparation and significant accounting policies (continued)

1.7. Significant accounting policies (continued)

The Group enters into master netting and margining agreements with all derivative counterparties. In general, under master netting agreements the amounts owed by each counterparty that are due on a single day in respect of all transactions outstanding under the agreement are aggregated into a single net amount payable by one party to the other. In certain circumstances, for example when a credit event such as a default occurs, all outstanding transactions under the agreement are aggregated into a single net amount payable by one party to the other and the agreements terminated.

Under margining agreements where the Group has a net asset position valued at current market values, in respect of its derivatives with a counterparty, then that counterparty will place collateral, usually cash, with the Group in order to cover the position. Similarly, the Group will place collateral, usually cash, with the counterparty where it has a net liability position.

(j) Hedge accounting
See disclosures at Note 16

The Group applies the exemption under IFRS 9 to continue to apply the hedge accounting rules set out in IAS 39. However, the Group has adopted the requirements for additional and more detailed disclosures for hedge accounting introduced by IFRS 9's consequential amendments to IFRS 7. As permitted by IFRS 7, the Group has not provided comparative information for periods before the date of initial application of IFRS 9 for the new disclosures.

IAS 39 permits hedge accounting when documentation, eligibility and testing criteria are met. As such, at the inception of the hedge relationship, the Group formally designates and documents the hedge relationship (the link between the hedging instrument and the hedged item) to which it wishes to apply hedge accounting and the risk management objective and strategy for undertaking the hedge. The Group also documents the method that will be used to assess the effectiveness of the hedging relationship. From March 2018, the Group changed the methodology of hedge effectiveness testing from linear regression to the dollar-offset method. This was an interim operational decision to enable the Group to bring hedge effectiveness testing in-house. The Group makes an assessment, both at inception and on a periodic basis (monthly), of whether the derivatives used in hedging transactions are highly effective in offsetting the exposure to changes in the hedged item's fair value. The hedge is deemed to be highly effective where the actual results of the hedge are within a range of 80-125%.

Currently, the Group designates certain derivatives as fair value hedges. The Group does not currently designate any derivatives as cash flow hedges or net investment hedges.

Fair value hedges
The Group applies fair value hedge accounting for portfolio hedges of interest rate risk. The hedged items are portfolios that are identified as part of the risk management process. These comprise either fixed rate assets only, or fixed rate liabilities only, in respect of a benchmark interest rate (currently mainly GBP three- month LIBOR). Each portfolio is grouped into repricing time periods based on expected repricing dates, by scheduling cash flows into the periods in which they are expected to occur. Interest rate swaps are used as the hedging instruments to manage this interest rate risk to swap the fixed rate interest flows to floating.

Sources of ineffectiveness on the hedged asset portfolios is predominantly driven by the prepayment behaviour deviating from forecast behaviour.

Sources of ineffectiveness on the hedged liabilities portfolios is driven by the repayment behaviour deviating from forecast behaviour.

The Group also holds floating rate assets in the form of property loan portfolios. These contain non-separated embedded purchased floors with the interest rate floors being referenced to the three-month LIBOR index, but with a minimum reference rate of 0.75%. These floors form part of a fair value hedge of interest rate risk due to changes in the benchmark rate. This portfolio of purchased interest rate floors is behaviouralised by the expected prepayment behaviour. The hedging instrument is a series of sold floors (interest rate options). Any changes to the actual prepayment behaviour compared to the expected prepayment behaviour is a source of ineffectiveness.

1.7. Significant accounting policies (continued)

Changes in the fair value of derivatives designated as fair value hedges and changes in the fair value of the hedged asset or liability attributable to the hedged risk are recognised in net gains/(losses) on financial instruments at fair value through profit or loss in the statement of profit and loss. The hedging gain or loss on the hedged items are included in interest income in the statement of profit and loss.

If the hedge no longer meets the criteria for hedge accounting, hedge accounting is discontinued prospectively. The cumulative fair value adjustment to the carrying amount of the hedged item is amortised to the statement of profit and loss over the remaining period to maturity.

(k) Property, plant and equipment and depreciation
See disclosures at Note 17

Property, plant and equipment is divided into the following asset categories:
- Leasehold property;
- Fixtures, fittings and equipment; and
- Assets on operating leases.

Assets on operating leases refers to assets that are leased to customers under operating lease agreements. The accounting policies relating to such assets can be found at Note 1.7(l). Accounting policies for all other asset categories are detailed below.

Property, plant and equipment are measured at cost less accumulated depreciation and any accumulated impairment losses.

Cost includes the original purchase price of the asset and any directly attributable costs of bringing the asset to the location and condition necessary for its intended use. Subsequent expenditure is only capitalised when it improves the expected future economic benefits of the asset. Ongoing repairs and maintenance are expensed to administrative expenses in the statement of profit and loss as incurred.

Gains and losses on disposals are determined by comparing the net disposal proceeds with the carrying amount of the asset and are included in administrative expenses in the statement of profit and loss.

Depreciation is calculated to write off the cost of the asset less its estimated residual value on a straight line basis over its estimated useful life, as follows:
- Leasehold property: Life of the lease
- Fixtures and fittings: 10 years
- Office equipment: 3-5 years
- Motor vehicles: 4 years

Depreciation methods, useful lives and residual values are reviewed at each reporting date.

Depreciation is charged to administrative expenses in the statement of profit and loss.

Assets are reviewed for 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. Impairment losses are charged to administrative expenses in the statement of profit and loss.

(l) Leases

Group acting as a lessee – finance leases
A lease that transfers substantially all the risks and rewards of ownership to the Group is recorded as a finance lease. The leased asset is initially recognised at the lower of the present value of the minimum lease payments or fair value. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policies detailed in Note 1.7(k). Lease payments are apportioned between finance charges and a reduction of the lease liability to achieve a constant rate of interest on the remaining balance of the liability.

1. Basis of preparation and significant accounting policies (continued)

1.7. Significant accounting policies (continued)

Group acting as a lessee – operating leases
An operating lease is a lease other than a finance lease. Operating leases are not recognised in the Group's statement of financial position. Operating lease payments are charged to administrative expenses in the statement of profit and loss on a straight-line basis over the lease term, unless a different systematic basis is more appropriate. Where an operating lease is terminated before the lease period has expired, any payment required to be made to the lessor in compensation is charged to administrative expenses in the statement of profit and loss in the period in which termination is made.

Group acting as a lessor – finance leases
Lease agreements in which the Group transfers substantially all the risks and rewards of ownership of the underlying asset to the lessee are classified as finance leases. A finance lease receivable equal to the net investment in the lease (representing the future lease payments less profit and costs allocated to future periods) is recognised and is presented within loans and advances to customers. Lease payments are apportioned between interest income and a reduction of the finance lease receivable to achieve a constant rate of interest on the remaining balance of the receivable.

Group acting as a lessor – operating leases
Lease agreements in which the Group does not transfer substantially all the risks and rewards of ownership of the underlying asset to the lessee are classified as operating leases. The leased asset is included in property, plant and equipment in the statement of financial position at the lower of its fair value (less costs to sell) and the carrying amount of the lease (net of impairment allowance) at the date of exchange. Depreciation is calculated to write off the cost of the asset less its estimated residual value on a straight line basis over the life of the lease. Depreciation is charged to depreciation on operating leases in the statement of profit and loss. No depreciation is charged in respect of assets held for sale. Assets on operating leases are reviewed annually for impairment as detailed in Note 1.7(k). Impairment losses are charged to other operating lease income in the statement of profit and loss.

Operating lease income is recognised in the statement of profit and loss on a straight-line basis over the lease term unless a different systematic basis is deemed to be more appropriate. Where an operating lease is terminated before the lease period has expired, any payment required to be made by the lessee in compensation is charged to other operating lease income in the statement of profit and loss in the period in which termination is made.

Where an agreement is classified as an operating lease at inception but is subsequently reclassified as a finance lease following a change to the agreement or an extension beyond the primary term, then the agreement is accounted for as a finance lease.

(m) Intangible assets and amortisation
See disclosures at Note 18

Intangible assets held by the Group primarily consists of computer software and goodwill.

Computer software
Externally acquired computer software is measured at cost less accumulated amortisation and any accumulated impairment losses. Cost includes the original purchase price of the asset and any directly attributable costs of preparing the asset for its intended use.

Internally developed computer software is recognised as an asset only when the Group is able to demonstrate that the following conditions have been met:

- expenditure can be reliably measured;
- the product or process is technically and commercially feasible;
- future economic benefits are probable; and
- the Group has the intention and ability to complete development and subsequently use or sell the asset.

If these conditions are not met, expenditure is recognised in administrative expenses in the statement of profit and loss as incurred. Capitalised costs include all costs directly attributable in preparing the asset so that it is capable of operating in its intended manner. Internally developed computer software is measured at capitalised cost less accumulated amortisation and any accumulated impairment losses.

1. Basis of preparation and significant accounting policies (continued)

1.7. Significant accounting policies (continued)

Subsequent expenditure on software assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is recognised in administrative expenses in the statement of profit and loss as incurred.

Computer software is amortised on a straight line basis over its estimated useful life of between three and seven years. Amortisation is recognised in administrative expenses in the statement of profit and loss. The amortisation method, useful lives and residual values are reviewed at each reporting date and adjusted if appropriate.

Computer software is reviewed for indicators of impairment at each reporting date. If such an indication exists, the asset's recoverable amount, being the greater of value in use and fair value less costs to sell, is estimated and compared to the carrying amount. If the carrying amount of the asset exceeds the recoverable amount an impairment loss is recognised in administrative expenses in the statement of profit and loss.

Goodwill
Goodwill may arise on the acquisition of subsidiaries and represents the excess of the aggregate of the fair value of consideration transferred and the fair value of any non-controlling interest over the fair value of identifiable net assets at the date of acquisition. Goodwill is stated at cost less any accumulated impairment losses.

Goodwill is not amortised but is tested annually for impairment and additionally whenever there is an indication that impairment may exist. For the purpose of impairment testing, goodwill is allocated to cash generating units (CGUs). A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. An impairment loss is recognised if the carrying amount of a CGU exceeds its recoverable amount. Recoverable amount is the greater of the CGUs value in use and fair value less costs to sell. Value in use is based on estimated future cash flows less a residual value, discounted at a risk-adjusted discount rate appropriate to the CGU. Where impairment is required, the amount is recognised in administrative expenses in the statement of profit and loss and cannot subsequently be reversed.

(n) Investment in associates
See disclosures at Note 20

An associate is an entity over which the Group has significant influence and that is neither a subsidiary undertaking nor an interest in a joint venture. Significant influence is the power to participate in the financial and operating policy decisions of the investee, but is not control or joint control over those policies.

The results and assets and liabilities of associates are incorporated in these consolidated financial statements using the equity method of accounting. Investments are initially measured at cost, which includes transaction costs, and are presented as investment in associates in the statement of financial position.

Subsequent to initial recognition, the Group includes its share of the post-acquisition profit or loss and other comprehensive income of the associate. The cumulative post-acquisition movements are adjusted against the carrying amount of the investment. Dividends receivable from associates are recognised as a reduction in the carrying amount of the investment.

Where the Group's share of losses in an associate equals or exceeds its interest in the associate, the Group does not recognise further losses, unless it has incurred obligations or made payments on behalf of the associate.

Investment in associates is reviewed for 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 investment is written down immediately to the estimated recoverable amount.

The Group continues to use the equity method of accounting until the date on which significant influence ceases.

1.7. Significant accounting policies (continued)

(o) Amounts due to banks
See disclosures at Note 23

Amounts due to banks are classified as financial liabilities measured at amortised cost. See Note 1.7(u) for details.

Amounts due to banks includes amounts drawn under the Bank of England's Funding for Lending Scheme and Term Funding Scheme. The Funding for Lending Scheme and Term Funding Scheme were closed to new drawdowns in January 2018 and February 2018 respectively.

Funding for Lending Scheme
The Funding for Lending Scheme allows the Group to borrow highly liquid UK Treasury bills in exchange for eligible collateral.

Receipt of Treasury bills under the Funding for Lending Scheme does not involve the transfer of substantially all the risks and rewards associated with the collateral assets, or the right to receive its related cash flows. As such, the derecognition criteria outlined in Note 1.7(u) are not satisfied and the collateral assets continue to be recognised in their entirety in the statement of financial position. The Treasury bills are not recognised in the statement of financial position as ownership remains with the Bank of England.

Where Treasury bills are sold to third parties under repurchase agreements, the associated liability to the counterparty is recognised in amounts due to banks in the statement of financial position.

Costs of borrowing are recognised in interest expense and similar charges in the statement of profit and loss using the effective interest rate method.

Term Funding Scheme
The Term Funding Scheme allows the Group to borrow central bank reserves in exchange for eligible collateral at rates close to Bank Base Rate.

The Group does not transfer substantially all the risks and rewards associated with the collateral assets. As such, the derecognition criteria outlined in Note 1.7(u) are not satisfied and the collateral assets continue to be recognised in their entirety in the statement of financial position.

Drawings from the scheme are included in amounts due to banks in the statement of financial position.

Costs of borrowing are recognised in interest expense and similar charges in the statement of profit and loss using the effective interest rate method.

(p) Customer deposits
See disclosures at Note 24

Customer deposits are classified as financial liabilities measured at amortised cost. See Note 1.7(u) for details.

(q) Provisions
See disclosures at Note 25

Provisions are recognised when:
- there is a present obligation arising as a result of a past event;
- it is probable (more likely than not) that an outflow of resources will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

The Group has an obligation to contribute to the Financial Services Compensation Scheme to enable it to meet compensation claims from, in particular, retail depositors of failed banks. A provision is recognised, to the extent that it can be reliably estimated, when the Group has an obligation and the levy is legally enforceable. Provisions for levies are recognised when the conditions that trigger the payment of the levy are met.

1. Basis of preparation and significant accounting policies (continued)

1.7. Significant accounting policies (continued)

(r) Subordinated debt liability
See disclosures at Note 27

Under both IFRS 9 (from 1 January 2018) and IAS 39 (prior to 1 January 2018) the subordinated debt liability is classified as a financial liability measured at amortised cost. See Note 1.7(u) for details.

Interest costs arising on the subordinated debt liability are capitalised in accordance with the agreed terms and are incorporated into the total debt payable. Interest costs are recognised on an effective interest rate basis.

(s) Capital securities
See disclosures at Note 29

Capital instruments are classified on initial recognition as either financial liabilities or equity instruments in accordance with the substance of the contractual arrangements. Where the contractual arrangements do not result in the Group having a present obligation to deliver cash, another financial asset or a variable number of equity instruments, the capital instrument is classified as an equity instrument. Where the Group does have a present obligation, the capital instrument is classified as a financial liability.

Based on the characteristics associated with redemption and interest payments, the capital securities are classified as equity instruments. As such, capital securities are measured at the fair value of the proceeds from the issuance less any costs that are incremental and directly attributable to the issuance (net of applicable tax). Distributions to holders of the capital securities are recognised when they become irrevocable and are deducted, net of tax where applicable, from retained earnings in equity.

(t) Cash flows
See disclosures at Note 30

For the purposes of the statement of cash flows, cash and cash equivalents comprise cash and balances at central banks, loans and advances to banks and short-term highly liquid debt securities with less than three months to maturity from the date of acquisition. Loans and advances to banks comprise cash balances and call deposits.

(u) Financial instruments
See disclosures at Note 31

Recognition
Financial assets and liabilities are recognised when the Group becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of financial assets are recognised on trade date.

Classification and measurement
Under IFRS 9 (from 1 January 2018)
Financial assets
There are three principal classification categories for financial assets: measured at amortised cost, fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVTPL).

To classify financial assets the Group performs two assessments to evaluate the business model in which financial assets are managed and their cash flow characteristics.

The 'business model assessment' determines whether the Group's objective is to generate cash flows from collecting contractual cash flows, or by both collecting contractual cash flows and selling financial assets. The assessment is performed at a portfolio level as this best reflects the way business is managed and how information is provided to Management. The assessment is based on expected scenarios. If cash flows are realised in a manner that is different from the original expectation, the classification of the remaining assets in that portfolio is not changed but such information is used when assessing new financial assets going forward.

1. Basis of preparation and significant accounting policies (continued)

1.7. Significant accounting policies (continued)

The assessment of cash flow characteristics determines whether the contractual cash flows of the financial asset are solely payments of principal and interest on the principal amount outstanding (SPPI) and is referred to as the 'SPPI test'. For the purposes of the SPPI test, principal is defined as the fair value of the financial asset at initial recognition. Interest is defined as consideration for the time value of money and credit risk associated with the principal amount outstanding and for other basic lending risks and costs (e.g. liquidity risk and administrative costs), as well as a reasonable profit margin. The SPPI test is performed at an instrument level based on the contractual terms of the instrument at initial recognition. Only debt instruments can meet the SPPI test. Derivative financial instruments and equity instruments will always fail the SPPI test.

Based on the two assessments, financial assets are classified as follows:

A financial asset is classified as measured at amortised cost if it meets both of the following conditions and is not designated as at FVTPL:

- it is held within a business model whose objective is to hold assets to collect contractual cash flows; and
- its contractual terms give rise on specified dates to cash flows that are SPPI.

A financial asset is classified as FVOCI if it meets both of the following conditions and is not designated as at FVTPL:

- it is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and
- its contractual terms give rise on specified dates to cash flows that are SPPI.

Financial assets not classified as measured at amortised cost or FVOCI are classified as FVTPL. This includes all derivative financial assets.

On initial recognition, the Group may irrevocably designate a financial asset that otherwise meets the requirements to be classified as measured at amortised cost or FVOCI as FVTPL if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise.

Equity instruments are normally classified as FVTPL. However, on initial recognition of an equity instrument that is not held for trading, the Group may irrevocably elect to present subsequent changes in fair value in the statement of other comprehensive income. This election is made on an investment-by-investment basis.

Derivatives embedded in contracts where the host is a financial asset are never separated. Instead, the hybrid financial instrument as a whole is assessed for classification.

Subsequent to initial recognition, financial assets are reclassified only when the Group changes its business model for managing financial assets. Where this is the case, the Group reclassifies all affected financial assets in accordance with the new business model. The reclassification is applied prospectively.

Initial measurement of financial assets is as follows:

- **Financial assets at FVTPL:** initially measured at fair value.
- **All other financial assets:** initially measured at fair value plus incremental direct transaction costs.

Subsequent measurement of financial asset categories held by the Group is as follows:

- **Financial assets at FVTPL:** subsequently measured at fair value. Net gains and losses, including any interest or dividend income, are recognised in the statement of profit and loss.
- **Financial assets at amortised cost:** subsequently measured at amortised cost using the effective interest rate method. Amortised cost is reduced by impairment losses. Interest income, foreign exchange gains and losses and impairment losses are recognised in the statement of profit and loss. Any gain or loss on derecognition is also recognised in the statement of profit and loss.

Financial liabilities

The classification of financial liabilities under IFRS 9 largely retains the requirements prescribed in IAS 39 as detailed below. The exception is the presentation of changes in fair value due to own credit risk under other comprehensive income for financial liabilities designated at FVTPL. The Group currently has no financial liabilities designated at FVTPL that this applies to.

1. Basis of preparation and significant accounting policies (continued)

1.7. Significant accounting policies (continued)

Under IAS 39 (prior to 1 January 2018)
Financial assets
The Group classified its financial assets as either loans and receivables or FVTPL. The Group had no financial assets classified as held-to-maturity or available-for-sale.

Financial assets classified as loans and receivables were defined as non-derivative financial assets with fixed or determinable payments that were not quoted in an active market. Loans and receivables were initially recognised at fair value plus incremental direct transaction costs. Subsequent recognition was at amortised cost using the effective interest rate method, less any impairment allowance.

Financial assets categorised as FVTPL were initially recognised at fair value and were subsequently remeasured at fair value. Net gains and losses were recognised in the statement of profit and loss.

Financial liabilities
The Group classified its financial liabilities as either measured at amortised cost or FVTPL.

Financial liabilities categorised as measured at amortised cost were initially recognised at fair value minus incremental direct transaction costs. Subsequent recognition was at amortised cost using the effective interest rate method.

Financial liabilities categorised as FVTPL were initially recognised at fair value and were subsequently remeasured at fair value. Net gains and losses were recognised in the statement of profit and loss.

Derecognition
Derecognition is the point at which the Group ceases to recognise a financial asset or financial liability on its statement of financial position.

Financial assets
The Group derecognises a financial asset (or a part of a financial asset) when:

- the contractual rights to the cash flows from the financial asset have expired;
- the Group transfers the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred; or
- the Group transfers the financial asset in a transaction in which the Group neither transfers nor retains substantially all the risks and rewards of ownership and it does not retain control of the asset. If the Group retains control of the asset it continues to recognise the transferred asset only to the extent of its continuing involvement and derecognises the remainder.

On derecognition of a financial asset the difference between the carrying amount (or the carrying amount allocated to the portion being derecognised) and the sum of the consideration received (including any new asset obtained less any new liability assumed) is recognised in the statement of profit and loss.

Financial liabilities
The Group derecognises a financial liability (or a part of a financial liability) when its contractual obligations are extinguished (i.e. discharged, cancelled, or expired).

On derecognition of a financial liability, the difference between the carrying amount (or the carrying amount allocated to the portion being derecognised) and the sum of the consideration paid (including any new asset obtained less any new liability assumed) is recognised in the statement of profit and loss.

1. Basis of preparation and significant accounting policies (continued)

1.7. Significant accounting policies (continued)

Modifications
Financial assets
The Group sometimes renegotiates or otherwise modifies the contractual cash flow of a financial asset. When this happens, the Group assesses whether or not the new terms are substantially different to the original terms. The Group does this by considering, among others, the following factors:

- if the borrower is in financial difficulty, whether the modification merely reduces the contractual cash flows to amounts the borrower is expected to be able to pay;
- whether any substantial new terms are introduced that substantially affects the risk profile of the loan;
- significant extension of the loan term when the borrower is not in financial difficulty;
- significant change in the interest rate; and
- insertion of collateral, other security or credit enhancements that significantly affect the credit risk associated with the loan.

If the terms and cash flows of the modified asset are deemed to be substantially different, the contractual rights to cash flows from the original financial asset are deemed to have expired. This meets the derecognition criteria outlined above and as such the original financial asset is derecognised and a 'new' financial asset is recognised at fair value. The difference between the carrying amount of the derecognised financial asset and the new financial asset with modified terms is recognised in the statement profit and loss.

Under IFRS 9 (from 1 January 2018)
If the cash flows of the modified asset are not deemed to be substantially different, the financial asset is not derecognised and the Group recalculates the gross carrying amount of the financial asset based on the revised cash flows of the financial asset and recognises any associated gain or loss in the statement of profit and loss. The new gross carrying amount is recalculated by discounting the modified cash flows at the original effective interest rate.

Financial liabilities
The Group derecognises a financial liability when there is deemed to be a substantial modification of the terms. Where this is the case, the contractual obligations from the original financial liability are deemed to have been extinguished. This meets the derecognition criteria outlined above and as such the original financial liability is derecognised and a 'new' financial liability based on the modified terms is recognised at fair value. The difference between the carrying amount of the derecognised financial liability and the new financial liability with modified terms is recognised in the statement profit and loss.

Under IFRS 9 (from 1 January 2018)
When a financial liability measured at amortised cost is modified without this resulting in derecognition, a gain or loss is recognised in the statement profit and loss. The gain or loss is calculated as the difference between the original contractual cash flows and the modified cash flows discounted at the original effective interest rate.

Fair value of financial instruments
Fair value is defined as 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 in the principal, or in its absence, the most advantageous market to which the Group has access at that date. The fair value of a liability reflects its non-performance risk.

Where possible, fair value is determined with reference to quoted prices in an active market or dealer price quotations. A market is regarded as active if transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

Where quoted prices are not available, the Group uses generally accepted valuation techniques to estimate fair value. The valuation techniques used include discounted cash flow models and Black-Scholes option pricing. Wherever possible these valuation techniques use independently sourced market parameters, such as interest rate yield curves, option volatilities and currency rates. This reduces the need for Management judgement and estimation, as well as the uncertainty related with the estimated fair value.

On initial recognition, the best evidence of the fair value of a financial instrument is normally transaction price (i.e. the fair value of the consideration given or received). If the Group determines that the fair value on initial recognition differs from the transaction price, the Group accounts for such differences as follows:

- if fair value is evidenced by a quoted price in an active market for an identical asset or liability or based on a valuation technique that uses only data from observable markets, then the difference is recognised in the statement of profit and loss on initial recognition (i.e. day 1 profit or loss);
- in all other cases, the fair value will be adjusted to bring it in line with the transaction price (i.e. day 1 profit or loss will be deferred by including it in the initial carrying amount of the asset or liability). Subsequently, the deferred gain or loss will be released to the statement of profit and loss on an appropriate basis over the life of the instrument but no later than when the valuation is wholly supported by observable market data or the transaction is closed out.

If an asset or a liability measured at fair value has a bid price and an ask price, the Group measures assets at bid price and liabilities at ask price.

The Group does not adjust fair value estimates derived from models for any factors such as credit risk, liquidity risk or model uncertainties.

For measuring derivatives that might change the classification from being an asset to a liability or vice versa, fair values do not take into consideration either the credit valuation adjustment or the debit valuation adjustment as the Group's portfolio is fully collateralised and it is deemed to be immaterial.

The Group uses a fair value hierarchy that categorises financial instruments into three different levels as detailed in Note 31(b). Levels are reviewed at each reporting date and this determines whether transfers between levels are required.

Offsetting financial instruments
Financial assets and liabilities are offset and the net amount reported in the statement of financial position when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

(v) Impairment of financial assets
See disclosures at Note 12

Under IFRS 9 (from 1 January 2018)
Measurement of ECLs
Impairment of financial assets is calculated using a forward looking ECL model. The Group records an allowance for ECLs ('loss allowance') for all financial assets not held at FVTPL, together with an allowance for ECLs for financial guarantee contracts and loan commitments. Equity instruments are not subject to impairment.

ECLs are an unbiased probability-weighted estimate of credit losses determined by evaluating a range of possible outcomes. They are measured in a manner that reflects the time value of money and uses reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

1. Basis of preparation and significant accounting policies (continued)

1.7. Significant accounting policies (continued)

Measurement of ECLs depends on the 'stage' of the financial asset, based on changes in credit risk occurring since initial recognition, as described below:

- **Stage 1:** when a financial asset is first recognised it is assigned to Stage 1. If there is no significant increase in credit risk from initial recognition the financial asset remains in Stage 1. Stage 1 also includes financial assets where the credit risk has improved and the financial asset has been reclassified back from Stage 2. For financial assets in Stage 1, a 12-month ECL is recognised.
- **Stage 2:** when a financial asset shows a significant increase in credit risk from initial recognition it is moved to Stage 2. Stage 2 also includes financial assets where the credit risk has improved and the financial asset has been reclassified back from Stage 3. For financial assets in Stage 2, a lifetime ECL is recognised.
- **Stage 3:** when there is objective evidence of impairment and the financial asset is considered to be in default, or otherwise credit-impaired, it is moved to Stage 3. For financial assets in Stage 3, a lifetime ECL is recognised.
- **Purchased or originated credit-impaired (POCI):** POCI assets are financial assets that are credit-impaired on initial recognition. On initial recognition they are recorded at fair value. ECLs are only recognised or released to the extent that there is a subsequent change in the ECLs. Their ECL is always measured on a lifetime basis.

In relation to the above:

- **Lifetime ECL** is defined as ECLs that result from all possible default events over the expected behavioural life of a financial instrument.
- **12-month ECL** is defined as the portion of lifetime ECL that will result if a default occurs in the 12 months after the reporting date, weighted by the probability of that default occurring.

For loan commitments, where the loan commitment relates to the undrawn component of a facility, it is assigned to the same stage as the drawn component of the facility. For pipeline loans, the loan commitment is assigned to Stage 1.

For financial guarantee contracts, the Group assigns a stage using the definitions described above.

A summary of ECL measurement is as follows:

- **Financial assets that are not credit-impaired at the reporting date:** as the present value of all cash shortfalls. Cash shortfalls are the difference between the contractual cash flows due to the Group and the cash flows that the Group expects to receive.
- **Financial assets that are credit-impaired at the reporting date:** as the difference between the gross carrying amount and the present value of estimated future cash flows.
- **Financial guarantee contracts:** as the expected payments to reimburse the holder less any amounts that the Group expects to recover.
- **Loan commitments:** as the present value of the difference between the contractual cash flows that are due to the Group if the commitment is drawn down and the cash flows the Group expects to receive.

Credit-impaired is defined by the Group as a financial asset in Stage 3 as detailed above.

The Group can elect as an accounting policy choice, to use the 'simplified approach' for trade receivables, contract assets and lease receivables. The Group has chosen not to use the simplified approach.

Further details of the measurement and calculation of ECLs are set out in Section 5.3 of the risk management report.

1. Basis of preparation and significant accounting policies (continued)

1.7. Significant accounting policies (continued)

Modifications
If a financial asset is modified, an assessment is made to determine whether the asset should be derecognised as detailed in Note 1.7(u). Subsequently ECLs are measured as follows:

- if the modification does not result in derecognition of the existing asset, then the expected cash flows arising from the modified financial asset are included in calculating the cash shortfalls from the existing asset; or
- if the modification does result in derecognition of the existing asset, then the expected fair value of the new asset is treated as the final cash flow from the existing financial asset at the time of its derecognition. This amount is included in calculating the cash shortfalls from the existing financial asset that are discounted from the expected date of derecognition to the reporting date using the original effective interest rate of the existing financial asset. The date of renegotiation is considered to be the date of initial recognition for impairment calculation purposes, including in determining whether a significant increase in credit risk has occurred and whether the new financial asset is deemed to be credit-impaired on initial recognition.

Write-offs
Loans and debt securities are written off (either partially or in full) when there is no realistic prospect of recovery. This is generally the case when the Group determines that the borrower does not have assets or sources of income that could generate sufficient cash flows to repay the amounts subject to the write-off. Write-offs constitute a derecognition event as detailed in Note 1.7(u). Financial assets that are written off can still be subject to enforcement activities in order to comply with the Group's procedures for recovery of amounts due. Amounts subsequently recovered on assets previously written off are recognised in impairment losses on financial assets in the statement of profit and loss.

Presentation of loss allowances in the statement of financial position
Loss allowances are presented in the statement of financial position as follows:

- **financial assets measured at amortised cost:** as a deduction from the gross carrying amount of the financial assets;
- **financial guarantee contracts and loan commitments:** generally, as a provision; and
- where a financial instrument includes both a drawn and an undrawn component, and the Group cannot identify the ECL on the undrawn loan commitment component separately from those on the drawn component: the Group presents a combined loss allowance for both components. The combined amount is presented as a deduction from the gross carrying amount of the drawn component. Any excess of the loss allowance over the gross amount of the drawn component is presented as a provision.

Under IAS 39 (prior to 1 January 2018)
Objective evidence of impairment
On an ongoing basis, the Group assessed whether there was objective evidence that a financial asset or group of financial assets was impaired. A financial asset or a group of financial assets was impaired and impairment losses incurred if, and only if, there was objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) had an impact on the estimated future cash flows of the financial asset or group of financial assets that could be reliably estimated.

The criteria that the Group used to determine whether there was objective evidence of an impairment loss included, but was not limited to, the following:

- delinquency in contractual payments of principal or interest;
- cash flow difficulties experienced by the borrower;
- initiation of bankruptcy proceedings;
- the customer being granted a concession that would otherwise not be considered; and
- observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the portfolio.

1. Basis of preparation and significant accounting policies (continued)

1.7. Significant accounting policies (continued)

If there was objective evidence that an impairment loss on an individual financial asset had occurred, the amount of the loss was measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. The carrying amount of the asset was reduced through the use of an allowance account ('impairment allowance') and the amount of the loss was recognised in impairment losses on financial assets in the statement of profit and loss. If a loan had a variable interest rate, the discount rate for measuring any impairment loss was the current effective interest rate determined under the contract.

Individual and collective impairment

If the Group determined that no objective evidence of impairment existed for an individually assessed financial asset, whether significant or not, it included the asset in a group of financial assets with similar credit risk characteristics and collectively assessed the group for impairment. Objective evidence of impairment of a portfolio of receivables existed if objective data indicated a decrease in expected future cash flows from the collection of receivables and the decrease could be measured reliably but could not be identified with the individual receivables in the portfolio. When this was the case a collective provision was applied.

Modifications

If a financial asset was modified, an assessment was made to determine whether the asset should be derecognised as detailed in Note 1.7(u). Subsequently impairments were measured as follows:

- if the modified asset did not result in derecognition of the existing asset, then the estimated cash flows arising from the modified financial asset were included in the measurement of the existing asset based on their expected timing and amounts discounted at the original effective interest rate of the existing financial asset; or
- if the modified asset did result in derecognition of the existing asset, then the expected fair value of the new asset was treated as the final cash flow from the existing financial asset at the time of its derecognition. This amount was then discounted from the expected date of derecognition to the reporting date using the original effective interest rate of the existing financial asset.

Write-offs

When a loan or receivable was not economic to recover, it was written off against the related impairment allowance. Such loans were written off after all the necessary procedures had been completed and the amount of the loss had been determined. Subsequent recoveries of amounts previously written off were recognised directly in the statement of profit and loss through the impairment losses on financial assets line as post write-off recoveries. If, in a subsequent period, the amount of impairment loss decreased and the decrease could be related objectively to an event that occurred after the impairment was recognised (such as an improvement in the customer's credit rating), the previously recognised impairment loss was reversed by adjusting the impairment allowance. The amount of reversal was recognised in impairment losses on financial assets in the statement of profit and loss.

(w) Contingent liabilities

See disclosures at Note 37

Contingent liabilities are possible obligations that arise from past events whose existence will be confirmed only by the occurrence, or non-occurrence, of one or more uncertain future events not wholly within the control of the Group. Alternatively, they are present obligations that have arisen from past events where the outflow of resources is uncertain or cannot be reliably measured. Contingent liabilities are not recognised in the financial statements but are disclosed, unless the probability of settlement is remote.

1. Basis of preparation and significant accounting policies (continued)

1.7. Significant accounting policies (continued)

(x) Financial guarantee contracts and loan commitments

See disclosures at Note 38

Financial guarantee contracts

Financial guarantee contracts are contracts that require the Group to make specified payments to reimburse the holder for a loss that it incurs because a specified debtor fails to make payment when it is due in accordance with the terms of a debt instrument. They are included in provisions for liabilities and charges in the statement of financial position. Initially financial guarantees are measured at their fair value, being the premium received. Subsequently, financial guarantees are measured as follows:

Under IFRS 9 (from 1 January 2018)

At the higher of the amount initially recognised less the cumulative amount of income recognised in the statement of profit and loss in accordance with the principles of IFRS 15, and the amount of loss allowance determined in accordance with the policies set out in Note 1.7(v).

Under IAS 39 (prior to 1 January 2018)

At the higher of the amount initially recognised less cumulative amortisation, and the present value of expected payment to settle the liability when a payment under the contract becomes probable.

Loan commitments

Loan commitments are firm commitments to provide credit under pre-specified terms and conditions. The Group has not provided any commitment to provide loans at below-market interest rate, or that can be settled net in cash or by delivering or issuing another financial instrument.

Under IFRS 9 (from 1 January 2018)

The Group recognises loss allowances in accordance with the policies set out in Note 1.7(v). Loss allowances are included within provisions for liabilities and charges in the statement of financial position.

Under IAS 39 (prior to 1 January 2018)

The Group recognised a provision in the statement of financial position only when the contract was considered onerous.

(y) Other reserves

Merger reserve

The merger reserve represents the fair value of the consideration given in excess of the nominal value of the ordinary shares issued in acquisitions made by the issue of shares.

Capital redemption reserve

The capital redemption reserve is a statutory, non-distributable reserve into which amounts are transferred following the redemption or purchase of a company's own shares. The provisions relating to the capital redemption reserve are set out in section 733 of the Companies Act 2006.

1.8. New and revised standards and interpretations not yet adopted

A number of new and revised standards issued by the International Accounting Standards Board have not yet come into effect. Those deemed relevant to the Group are as follows:

(a) IFRS 16 'Leases'

IFRS 16 becomes effective for annual reporting periods beginning on or after 1 January 2019. Early adoption is permitted if IFRS 15 'Revenue from Contracts with Customers' has also been applied. The Group will adopt IFRS 16 from its effective date of 1 January 2019 and will not early adopt. The new standard will replace IAS 17 'Leases' and related interpretations.

IFRS 16 will apply to all leasing arrangements and sets outs the requirements for both lessor and lessee accounting.

The Group will adopt IFRS 16 on 1 January 2019 using the modified retrospective approach. As such, the cumulative effect of initially applying IFRS 16 will be recognised as an adjustment to the opening balance of retained earnings. Comparative information will not be restated.

1. Basis of preparation and significant accounting policies (continued)

1.8. New and revised standards and interpretations not yet adopted (continued)

The Group will utilise the practical expedient set out in IFRS 16 to not reassess whether a contract is, or contains, a lease at the date of initial application and will only apply the new requirements of IFRS 16 to contracts previously identified as leases under IAS 17.

The Group has assessed the estimated impact of IFRS 16 adoption, as described below.

Lessor accounting
Lessor accounting under IFRS 16 is largely unchanged from IAS 17 and lessors will continue to classify leases as either finance or operating leases. Based on information currently available, no significant impact is expected for leases in which the Group acts as a lessor.

Lessee accounting
IFRS 16 introduces a single lessee accounting model that requires a lessee to recognise all leases (subject to certain optional exemptions) on-balance sheet. A lessee will recognise a right-of-use asset representing its right to use the underlying asset and a lease liability representing its obligation to make lease payments. There are optional exemptions for short-term leases and leases of low value items.

On initial application of IFRS 16, lease liabilities will be recognised at the present value of the remaining lease payments and the right-of-use asset will be recognised at the amount of the lease liability.

The Group will apply the optional exemptions for short-term leases and leases of low value items. As such, the Group will not apply the new requirement of IFRS 16 to leases for which the lease term ends within 12 months of the date of initial application. Lease payments under such contracts will continue to be recognised directly to administrative expenses on a straight line basis.

No significant impact is expected in relation to leases currently classified as finance leases under IAS 17.

In relation to leases currently classified as operating leases under IAS 17, based on information currently available, the Group estimates it will recognise:

- additional lease liabilities of £10.2 million, representing the present value of future lease payments for leasehold properties.
- right-of-use assets of £10.2 million, representing the amount of the lease liability.

Under IFRS 16, the income statement charge comprises the right-of-use asset depreciation charge and interest expense on the lease liability. When comparing the income statement charge under IFRS 16 and IAS 17, the total income statement charge over the life of the lease will not change, however the Group estimates there will be immaterial timing differences when comparing the annual charge of up to £0.1 million per annum.

1.9. Critical accounting estimates and judgements

The preparation of financial statements in conformity with IFRS requires Management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimates are revised and in any future periods affected.

The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements, are as follows:

(a) Effective interest rate

See accounting policies at Note 1.7(b) and disclosures at Note 4

Under both IFRS 9 and IAS 39, interest income is recorded using the effective interest rate method. Management must use judgement to estimate the expected life of each instrument and hence the expected cash flows relating to it. Management reviews the expected lives on a segmental basis, whereby products of a similar nature are grouped into cohorts that exhibit homogenous behavioural attributes.

1.9. *Critical accounting estimates and judgements* (continued)

Key assumptions
The key assumption applied by Management in the effective interest rate methodology is the behavioural life of the assets. The expected life behaviours are subjected to changes in internal and external factors and may result in adjustments to the carrying amount of loans which must be recognised in the statement of profit and loss. The effective interest rate behavioural models are based on market trends and experience. The actual behaviour of the portfolios is compared to the modelled behaviour on a quarterly basis and the modelled behaviours are adjusted if the modelled behaviour materially deviates from actual behaviour, with adjustments recognised in net interest income in the statement of profit and loss.

Sensitivity analysis
Sensitivity analysis was performed to assess the impact of a 10% decrease in the redemption curves used. A 10% decrease in the redemption curves would result in a net expense to the Group's statement of profit and loss of £0.7 million. This is attributable to the Property Finance and Consumer Lending divisions. Property Finance would see income of £0.3 million, mainly due to income received from early settlement fees. Consumer Lending would see an expense of £1.0 million, mainly attributable to the acceleration of the amortisation of broker commissions.

(b) Impairment testing of goodwill
See accounting policies at Note 1.7(m) and disclosures at Note 18

The review of goodwill for impairment reflects Management's best estimate of future cash flows of the Group's cash generating units (CGUs) and the rates used to discount these cash flows. Both these variables are subject to judgement and estimation uncertainty as follows:

- the future cash flows of the CGUs are sensitive to projected cash flows based on the forecasts and assumptions regarding the projected periods and the long-term pattern of sustainable cash flows thereafter;
- the rates used to discount future expected cash flows can have a significant effect on their valuations and are based on the price-to-book ratio method which incorporates inputs reflecting a number of variables.

An impairment is recognised if impairment testing finds that the carrying amount of a CGU exceeds its recoverable amount. The recoverable amount of the CGU is calculated based on its value in use, determined by discounting the future cash flows (post-tax profits) to be generated from its continuing use. Forecast cash flows are reduced by any earnings retained to support the growth in the underlying CGU's loan books through higher regulatory capital requirements. Forecast post-tax profits are based on expectations of future outcomes taking into account past experience and adjusted for anticipated revenue growth.

Key assumptions
The key assumptions used in the calculation of value in use are as follows:

Discount rate
The post-tax discount rate is an estimate of the return that investors would require if they were to choose an investment that would generate cash flows of amount, timing and risk profile equivalent to those that the entity expects to derive from the asset. The Group calculates discount rates using the price-to-book ratio method which incorporates target return on equity, growth rate and price-to-book ratio. The discount rate for each CGU is adjusted to reflect the risks inherent to the individual CGU. Discount rates used were as follows:

	2018		2017	
	Post-tax	**Pre-tax**[1]	Post-tax	Pre-tax[1]
Discount rate				
Property Finance	**12.7%**	**15.1%**	12.0%	16.6%
Business Finance	**13.2%**	**15.9%**	12.5%	16.3%
Consumer Lending	**13.7%**	**16.3%**	13.0%	16.8%

[1] Management applies post-tax discount rates to post-tax cash flows when testing the CGU for impairment. The pre-tax discount rate is disclosed in accordance with IAS 36.

1. Basis of preparation and significant accounting policies (continued)

1.9. Critical accounting estimates and judgements (continued)

Cash flow period
Five years of cash flows (post-tax profits) (2017: four years) are included in the discounted cash flow model based on the Group's business plan.

Terminal value growth rate
A terminal value growth rate is applied into perpetuity to extrapolate cash flows beyond the cash flow period. The terminal value growth rate of 2.0% (2017: 2.0%) is estimated by Management taking into account rates disclosed by comparable institutions.

Sensitivity analysis
The key assumptions described above may change in response to changes in economic and market conditions. Sensitivity analysis was performed for the Property Finance and Business Finance CGUs to assess the impact of reasonable changes in the discount rate, cash flows and terminal value growth rate on the outcome of impairment testing. As detailed in Note 18, Goodwill in the Consumer Lending CGU has been fully impaired in the year ended 31 December 2018. As such, no sensitivity analysis was required for this CGU.

Sensitivity analysis on the discount rate identified that an increase of 2.0% to the individual CGU's discount rate would not result in any impairment to goodwill.

Sensitivity analysis on the cash flows identified that a decrease in cash flows of 10.0% would not result in any impairment to goodwill.

Sensitivity analysis on the terminal value growth rate identified that a decrease in the terminal value growth rate to 0% would not result in any impairment to goodwill.

(c) Customer remediation and conduct issues
See accounting policies at Note 1.7(q) and disclosures at Note 25

Provisions have been recognised in respect of potential instances of misrepresentation or breaches of contract by suppliers where the suppliers have become insolvent, and therefore the Group has limited recourse to those suppliers. The provisions represent Management's best estimate of the likely costs.

Key assumptions
The key factors driving the provision are the estimated number of complaints and the estimated redress costs per case.

Key considerations in deriving the estimated number of complaints include:
- complaint volumes taking into account both the status of current claims and Management's estimate of potential future claims based on existing complaint data;
- the origin of the claim. For example, if the claim relates to a solvent or insolvent supplier, or if the route of the claim is via a claims management company;
- the statutory limitation period (6 years from the date of the loan); and
- Management's estimate of claim uphold rates based on existing complaint data.

Key considerations in deriving the estimated redress costs per case include:
- Management's expected method of redress should claims be upheld based on agreed redress strategies; and
- Management's estimate of legal and complaint handling costs based on existing complaint data.

1. Basis of preparation and significant accounting policies (continued)

1.9. Critical accounting estimates and judgements (continued)

(d) Impairment losses on financial assets
See accounting policies at Note 1.7(v) and disclosures at Note 12

The measurement of ECLs prescribed by the new requirements of IFRS 9 requires a number of significant judgements. ECL calculations are outputs of complex models with a number of underlying assumptions regarding the choice of variable inputs and their interdependencies. Specifically, judgements and estimation uncertainties relate to assessment of whether credit risk on the financial asset has increased significantly since initial recognition, incorporation of forward-looking information in the measurement of ECLs and key assumptions used in estimating recoverable cash flows. These estimates are driven by a number of factors that are subject to change which may result in different levels of loss allowances.

Key assumptions and sensitivities associated with ECL calculations are detailed in Section 5.3 of the risk management report.

(e) Investment in associates
See accounting policies at Note 1.7(n) and disclosures at Note 20

Note 20 describes that The Mortgage Lender Limited is an associate of the Group, even though the Group holds only 19.99% of ownership interest. Management concluded the Group has significant influence as demonstrated by its representation on the board of directors, the expectation for material transactions occurring between the Group and the associate and the capacity for the Group to influence policy-making processes and decisions.

2. IFRS 9 adoption

On 1 January 2018, the Group adopted the requirements of IFRS 9 and the amendments to IFRS 9 'Prepayment Features with Negative Compensation' (see Note 1.6(a)).

Impacts of adopting IFRS 9 and transition disclosures are provided in the following sections.

2.1. Classification and measurement

(a) Impact of adopting IFRS 9 as at 1 January 2018
Financial assets

As detailed in Note 1.7(u), classification of financial assets under IFRS 9 is dependent on the outcome of two assessments which evaluates the business model in which financial assets are managed (the 'business model assessment') and their cash flow characteristics (the 'SPPI test').

Under IFRS 9, derivative financial instruments are classified as mandatorily at FVTPL as they fail the SPPI test. This is unchanged from the classification under IAS 39.

In relation to debt instruments, the outcomes of the business model assessment and SPPI test are summarised below:

- **Business model assessment:** this assessment is performed at a portfolio level. For all portfolios, the Group concluded that the objective of Management's strategy is to hold the assets to earn contractual cash flows. The intention is not to sell the assets. For portfolios where sales have taken place in the past, Management concluded that the sales were due to increases in credit risk for the purposes of managing credit risk.
- **SPPI test:** the Group considered the contractual terms at an instrument level and concluded that the contractual cash flows of the debt instruments were SPPI.

The conclusions from the business model assessment and SPPI test mean debt instruments meet the conditions to be classified as measured at amortised cost. This is unchanged from the loans and receivables classification under IAS 39.

2. IFRS 9 adoption (continued)

2.1. Classification and measurement (continued)

Financial liabilities

There were no changes in the classification and measurement of financial liabilities. The Group continues to classify all financial liabilities as measured at amortised cost, with the exception of derivatives which are mandatorily at FVTPL.

(b) Transition disclosures

The following table shows the original measurement categories in accordance with IAS 39 and the new measurement categories under IFRS 9 for the Group and Company's financial assets and financial liabilities as at 1 January 2018:

Group	Original classification under IAS 39	**New classification under IFRS 9**	Original carrying amount under IAS 39 as at 31 December 2017 £m	**New carrying amount under IFRS 9 as at 1 January 2018 £m**
Financial assets				
Cash and balances at central banks	Loans and receivables	**Amortised cost**	752.5	**752.5**
Loans and advances to banks	Loans and receivables	**Amortised cost**	28.8	**28.8**
Loans and advances to customers	Loans and receivables	**Amortised cost**	4,844.3	**4,823.2**
Derivative financial assets	FVTPL	**Mandatorily at FVTPL**	1.8	**1.8**
Total financial assets			5,627.4	**5,606.3**
Financial liabilities				
Amounts due to banks	Amortised cost	**Amortised cost**	607.3	**607.3**
Customer deposits	Amortised cost	**Amortised cost**	4,376.2	**4,376.2**
Derivative financial liabilities	FVTPL	**Mandatorily at FVTPL**	3.4	**3.4**
Subordinated debt liability	Amortised cost	**Amortised cost**	76.1	**76.1**
Total financial liabilities			5,063.0	**5,063.0**

2. IFRS 9 adoption (continued)

2.1. Classification and measurement (continued)

Company	Original classification under IAS 39	New classification under IFRS 9	Original carrying amount under IAS 39 as at 31 December 2017 £m	New carrying amount under IFRS 9 as at 1 January 2018 £m
Financial assets				
Cash and balances at central banks	Loans and receivables	**Amortised cost**	752.5	**752.5**
Loans and advances to banks	Loans and receivables	**Amortised cost**	28.5	**28.5**
Loans and advances to customers	Loans and receivables	**Amortised cost**	4,799.3	**4,778.5**
Derivative financial assets	FVTPL	**Mandatorily at FVTPL**	1.8	**1.8**
Total financial assets			5,582.1	**5,561.3**
Financial liabilities				
Amounts due to banks	Amortised cost	**Amortised cost**	607.3	**607.3**
Customer deposits	Amortised cost	**Amortised cost**	4,376.2	**4,376.2**
Derivative financial liabilities	FVTPL	**Mandatorily at FVTPL**	3.4	**3.4**
Subordinated debt liability	Amortised cost	**Amortised cost**	76.1	**76.1**
Total financial liabilities			5,063.0	**5,063.0**

There were no reclassifications as a result of the transition to IFRS 9. Going forward it is expected that reclassifications will be very rare, occurring only when there is a change in the business model for managing financial assets.

2. **IFRS 9 adoption** (continued)

2.1. **Classification and measurement** (continued)

The following table sets out the impact of adopting IFRS 9 on the statement of financial position carrying amounts and retained earnings as at 1 January 2018. Only balances impacted by the transition to IFRS 9 are included in the table; all other balances are unchanged.

Group	IAS 39 carrying amount as at 31 December 2017 £m	Reclassification £m	Remeasurement £m	IFRS 9 carrying amount as at 1 January 2018 £m	Retained profits impact as at 1 January 2018 £m
Assets					
Loans and advances to customers					
Opening balance	4,844.3	-	-	**4,844.3**	
Remeasurements:					
Expected credit loss	-	-	**(21.1)**	**(21.1)**	**(21.1)**
Total loans and advances to customers	4,844.3	-	**(21.1)**	**4,823.2**	**(21.1)**
Deferred tax assets					
Opening balance	15.7	-	-	**15.7**	
Remeasurements:					
Expected credit loss	-	-	**5.6**	**5.6**	**5.6**
Total deferred tax assets	15.7	-	**5.6**	**21.3**	**5.6**
Total change to assets	N/a	-	**(15.5)**	**N/a**	**(15.5)**
Liabilities					
Provisions for liabilities and charges					
Opening balance	2.8	-	-	**2.8**	
Remeasurements:					
Expected credit loss	-	-	**0.5**	**0.5**	**(0.5)**
Total provisions for liabilities and charges	2.8	-	**0.5**	**3.3**	**(0.5)**
Total change to liabilities	N/a	-	**0.5**	**N/a**	**(0.5)**
Equity					
Retained earnings					
Opening balance	215.2	-	-	**215.2**	
Increases/decreases:					
Remeasurements due to impairment (after tax)	-	-	**(16.0)**	**(16.0)**	**(16.0)**
Total retained earnings	215.2	-	**(16.0)**	**199.2**	**(16.0)**
Total change to equity	N/a	-	**(16.0)**	**N/a**	**(16.0)**

2. IFRS 9 adoption (continued)

2.1. Classification and measurement (continued)

Company	IAS 39 carrying amount as at 31 December 2017 £m	Reclassification £m	Remeasurement £m	IFRS 9 carrying amount as at 1 January 2018 £m	Retained profits impact as at 1 January 2018 £m
Assets					
Loans and advances to customers					
Opening balance	4,799.3	-	-	**4,799.3**	
Remeasurements:					
Expected credit loss	-	-	**(20.8)**	**(20.8)**	**(20.8)**
Total loans and advances to customers	4,799.3	-	**(20.8)**	**4,778.5**	**(20.8)**
Deferred tax assets					
Opening balance	15.7	-	-	**15.7**	
Remeasurements:					
Expected credit loss	-	-	**5.6**	**5.6**	**5.6**
Total deferred tax assets	15.7	-	**5.6**	**21.3**	**5.6**
Total change to assets	N/a	-	**(15.2)**	**N/a**	**(15.2)**
Liabilities					
Provisions for liabilities and charges					
Opening balance	2.8	-	-	**2.8**	
Remeasurements:					
Expected credit loss	-	-	**0.5**	**0.5**	**(0.5)**
Total provisions for liabilities and charges	2.8	-	**0.5**	**3.3**	**(0.5)**
Total change to liabilities	N/a	-	**0.5**	**N/a**	**(0.5)**
Equity					
Retained earnings					
Opening balance	201.2	-	-	**201.2**	
Increases/decreases:					
Remeasurements due to impairment (after tax)	-	-	**(15.7)**	**(15.7)**	**(15.7)**
Total retained earnings	201.2	-	**(15.7)**	**185.5**	**(15.7)**
Total change to equity	N/a	-	**(15.7)**	**N/a**	**(15.7)**

2. IFRS 9 adoption (continued)

2.2. Impairment of financial assets

(a) Impact of adopting IFRS 9 as at 1 January 2018

The most significant impact on the Group's financial statements from the adoption of IFRS 9 results from the new impairment requirements as detailed in Note 1.7(v). On the adoption of IFRS 9 on 1 January 2018, the increase in loss allowance (before tax) was £21.6 million for the Group and £21.3 million for the Company. The associated deferred tax impact was an increase in deferred tax assets of £5.6 million for both the Group and the Company.

The deferred tax adjustment is spread, for tax purposes, on a straight-line basis over the following ten years with the first accounting period beginning on 1 January 2018. This is with the exception of financial instruments maturing in the first accounting period, which are taxed or relieved in full in that accounting period.

(b) Transition disclosures

The following table reconciles the closing impairment allowance for financial assets in accordance with IAS 39 and provisions for financial guarantee contracts and loan commitments in accordance with IAS 37 as at 31 December 2017, to the opening loss allowance determined in accordance with IFRS 9 as at 1 January 2018:

					Of which:		
Group	Impairment allowance under IAS 39 / provision under IAS 37 as at 31 December 2017 £m	**Reclassi-fication £m**	**Remeasu-rement £m**	**Loss allowance under IFRS 9 as at 1 January 2018 £m**	**Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**
Financial assets							
Loans and advances to customers	31.6	-	**21.1**	**52.7**	**17.3**	**12.5**	**22.9**
Total financial assets	31.6	-	**21.1**	**52.7**	**17.3**	**12.5**	**22.9**
Loan commitments	-	-	**0.5**	**0.5**	**0.5**	-	-
Total allowance and provision	31.6	-	**21.6**	**53.2**	**17.8**	**12.5**	**22.9**

2. **IFRS 9 adoption** (continued)

2.2. **Impairment of financial assets** (continued)

Company	Impairment allowance under IAS 39 / provision under IAS 37 as at 31 December 2017 £m	Reclassification £m	Remeasurement £m	Loss allowance under IFRS 9 as at 1 January 2018 £m	Of which: Stage 1 £m	Stage 2 £m	Stage 3 £m
Financial assets							
Loans and advances to customers	31.5	-	**20.8**	**52.3**	**16.9**	**12.5**	**22.9**
Total financial assets	31.5	-	**20.8**	**52.3**	**16.9**	**12.5**	**22.9**
Loan commitments	-	-	**0.5**	**0.5**	**0.5**	-	-
Total allowance and provision	31.5	-	**21.3**	**52.8**	**17.4**	**12.5**	**22.9**

Allowances for cash and balances at central banks and loans and advances to banks are immaterial, totalling less than £0.1 million for both the Group and the Company.

Allowance for financial guarantee contracts is £nil because the contract is fully collateralised through a first fixed charge over a blocked deposit account. As such, the amount the Group should have to pay should the guarantee be called upon is £nil.

2.3. Regulatory capital

(a) Impact of adopting IFRS 9 as at 1 January 2018

The Group's regulator has issued guidelines regarding transition requirements when adopting IFRS 9. The guidelines allow a choice of two approaches to recognise the impact of adopting IFRS 9 on regulatory capital:

- **Transitional:** this involves phasing in the full impact using transitional factors published in Regulation (EU) 2017/2395; or
- **Full adoption:** recognising the full impact on the day of adoption.

The Group has elected the transitional approach and will phase in the full impact using the EU regulatory transitional arrangements. This permits the Group to add back to their capital base a proportion of the impact that IFRS 9 has upon their loss allowances during the first five years of use. The proportion that the Group may add back starts at 95% in 2018 and reduces to 25% by 2022. The impact in relation to loss allowances is the sum of the increase in loss allowances on day one of IFRS 9 adoption plus any subsequent increase in ECLs in the non-credit- impaired book thereafter. Any add-back must be tax-affected and accompanied by a recalculation of capital deduction thresholds, exposure and risk weighted assets.

2. **IFRS 9 adoption** (continued)

2.3. **Regulatory capital** (continued)

(b) Transition disclosures

Group

The following table shows the Group's total regulatory capital as at 1 January 2018 calculated under IAS 39 compared with IFRS 9 full adoption and IFRS 9 transitional.

	As at 31 December 2017		As at 1 January 2018
Group	IAS 39 £m	**IFRS 9 transitional £m**	**IFRS 9 full adoption £m**
Share capital	175.5	**175.5**	**175.5**
Share premium account	81.0	**81.0**	**81.0**
Merger reserve	1.6	**1.6**	**1.6**
Capital redemption reserve	16.7	**16.7**	**16.7**
Retained earnings	215.2	**199.2**	**199.2**
Intangible assets	(59.4)	**(59.4)**	**(59.4)**
Transitional adjustment	-	**15.2**	**-**
Common Equity Tier 1 capital	430.6	**429.8**	**414.6**
Capital securities	125.0	**125.0**	**125.0**
Additional Tier 1 capital	124.0	**125.0**	**125.0**
Total Tier 1 capital	555.6	**554.8**	**539.6**
Subordinated debt liability[1]	75.0	**75.0**	**75.0**
Collective impairment allowance	11.1	**-**	**-**
Tier 2 capital	86.1	**75.0**	**75.0**
Total regulatory capital	641.7	**629.8**	**614.6**

Full adoption

Full adoption of IFRS 9 on 1 January 2018 results in a reduction in the Group's Common Equity Tier 1 capital of £16.0 million. This is as a result of the following movements:

- a £21.6 million reduction in retained earnings due to a rise in ECLs; and
- a £5.6 million increase in retained earnings due to the impact of these changes on deferred tax.

Total regulatory capital is reduced by an additional £11.1 million due to the reduction of the collective impairment allowance included in Tier 2 capital. This results in an overall reduction to total regulatory capital of £27.1 million.

The corresponding impact of full adoption of IFRS 9 to risk-weighted assets is a decrease of £24.8 million.

Transitional

Under the EU regulatory transitional arrangements, the add back is £15.2 million. This results in an increase in Common Equity Tier 1 capital and total regulatory capital of £15.2 million, when comparing to full adoption. The corresponding impact of the transitional adjustment to risk-weighted assets is an increase of £12.6 million, when comparing to full adoption.

---

[1] Excludes capitalised interest of £1.1 million. Accrued interest is payable semi-annually and is therefore excluded from capital reserves.

2. IFRS 9 adoption (continued)

2.3. Regulatory capital (continued)

Company
The following table shows the Company's total regulatory capital as at 1 January 2018 calculated under IAS 39 compared with IFRS 9 full adoption and IFRS 9 transitional.

	As at 31 December 2017		As at 1 January 2018
Company	IAS 39 £m	**IFRS 9 transitional £m**	**IFRS 9 full adoption £m**
Share capital	175.5	**175.5**	**175.5**
Share premium account	81.0	**81.0**	**81.0**
Merger reserve	1.6	**1.6**	**1.6**
Capital redemption reserve	16.7	**16.7**	**16.7**
Retained earnings	201.2	**185.5**	**185.5**
Intangible assets	(44.6)	**(44.6)**	**(44.6)**
Transitional adjustment	-	**14.9**	**-**
Common Equity Tier 1 capital	431.4	**430.6**	**415.7**
Capital securities	125.0	**125.0**	**125.0**
Additional Tier 1 capital	125.0	**125.0**	**125.0**
Total Tier 1 capital	556.4	**555.6**	**540.7**
Subordinated debt liability[1]	75.0	**75.0**	**75.0**
Collective impairment allowance	11.0	**-**	**-**
Tier 2 capital	86.0	**75.0**	**75.0**
Total regulatory capital	642.4	**630.6**	**615.7**

Full adoption
Full adoption of IFRS 9 on 1 January 2018 results in a reduction in the Company's Common Equity Tier 1 capital of £15.7 million. This is as a result of the following movements:
- a £21.3 million reduction in retained earnings due to a rise in ECLs; and
- a £5.6 million increase in retained earnings due to the impact of these changes on deferred tax.

Total regulatory capital is reduced by an additional £11.0 million due to the reduction of the collective impairment allowance included in Tier 2 capital. This results in an overall reduction to total regulatory capital of £26.7 million.

The corresponding impact of full adoption of IFRS 9 to risk-weighted assets is a decrease of £24.5 million.

Transitional
Under the EU regulatory transitional arrangements, the add back is £14.9 million. This results in an increase in Common Equity Tier 1 capital and total regulatory capital of £14.9 million, when comparing to full adoption. The corresponding impact of the transitional adjustment to risk-weighted assets is an increase of £12.5 million, when comparing to full adoption.

[1] Excludes capitalised interest of £1.1 million. Accrued interest is payable semi-annually and is therefore excluded from capital reserves.

2. IFRS 9 adoption (continued)

2.4. Governance and risk management

The Group governed the implementation of IFRS 9 through a steering committee that represented finance, risk and information technology. Subsequent to the implementation of IFRS 9, all governance and risk management processes were adapted to ensure adequate governance and control exist over the IFRS 9 ECL model.

The main change to the governance framework is the implementation of the Model Management Group. This group comprises risk and finance subject matter experts. The purpose of the group is to continuously review and challenge the inputs to the IFRS 9 ECL models, to review and challenge the outputs of the models and to recommend model calibrations where needed.

The Group and Divisional Impairment Committees were adapted to ensure compliance with the new IFRS 9 target operating model, and various layers of review were implemented to ensure appropriate review at divisional level.

3. Operating segments

See accounting policies in Note 1.7(a)

The Group has four reportable operating segments. These are the Group's three lending divisions plus a central segment representing the savings business, central functions and shared central costs. The following summary describes the operations of each of the reportable operating segments:

Property Finance
Provides mortgages to investors, businesses and personal customers. It serves professional landlords and property traders in residential and commercial asset classes across long-term and shorter-term funding solutions. The division lends to trading businesses to fund the acquisition, refinancing and development of business premises.

The division also serves the needs of personal customers through the provision of loans secured by a second charge on the main residence, for a range of purposes including; home improvements, loan consolidation and larger consumer purchases. It also lends in specialist areas of first charge mortgages, introducing the lending into retirement products.

Business Finance
Provides the following propositions:

- the Regional Business Centres provide finance solutions to established businesses in the UK Small and Medium Enterprises (SME) markets, principally through a direct product offering. The centres primarily provide leasing finance for business critical assets operated by established UK SME businesses, and working capital solutions in the form of invoice discounting and asset-based lending;
- the Structured Finance proposition includes lending to SME finance companies with security against receivables within their portfolios. The Structured Finance product set provides wholesale finance and block discounting to smaller UK financial institutions to allow customers to release cash and grow their businesses;
- the Development Finance proposition provides finance solutions to SME developers looking to build or refurbish properties in the residential and commercial sectors for sale or investment;
- the Specialist Asset Finance proposition includes leasing and hire purchase finance solutions in specialist UK SME market segments such as marine, aviation, healthcare and agriculture; and
- Shawbrook International Limited provides finance solutions to consumers and SMEs in the Channel Islands, with a growing range of products designed to address a breadth of needs in the Jersey and Guernsey market.

Consumer Lending
Provides a broad range of lending products enabling the delivery of unsecured loans to consumers for a variety of purposes, including home improvements, holiday ownership, personal loans and retail finance.

Central
As well as common costs, Central includes the Group's Treasury function and Consumer Savings business which are responsible for raising funding to support the lending divisions.

Information regarding the results of each reportable segment and their reconciliation to the total results of the Group is included below. Performance is measured based on the product contribution as included in the internal management reports. All revenue for each operating segment is earned from external customers.

The underlying basis is the basis on which financial information is presented to the Chief Operating Decision Maker, which excludes certain items included in the statutory results. The table on the following page includes a reconciliation between the statutory results and the underlying basis.

Current taxes, deferred taxes and certain financial assets and liabilities are not allocated to segments as they are managed on a Group basis.

3. Operating segments (continued)

Year ended 31 December 2018	Property Finance £m	Business Finance £m	Consumer Lending £m	Central £m	Total £m
Interest income calculated using the effective interest rate method	194.9	87.1	69.1	4.9	356.0
Other interest and similar income	-	-	-	0.8	0.8
Interest expense and similar charges	(50.5)	(15.8)	(10.0)	(10.9)	(87.2)
Net interest income / (expense)	**144.4**	**71.3**	**59.1**	**(5.2)**	**269.6**
Operating lease rentals	-	10.0	-	-	10.0
Other operating lease expense	-	(0.6)	-	-	(0.6)
Depreciation on operating leases	-	(7.6)	-	-	(7.6)
Net income from operating leases	**-**	**1.8**	**-**	**-**	**1.8**
Fee and commission income	0.3	9.6	0.8	-	10.7
Fee and commission expense	(3.0)	(0.4)	(4.6)	(1.7)	(9.7)
Net fee and commission income / (expense)	**(2.7)**	**9.2**	**(3.8)**	**(1.7)**	**1.0**
Net gains on financial instruments mandatorily at fair value through profit or loss	-	-	-	0.5	0.5
Net operating income / (expense)	**141.7**	**82.3**	**55.3**	**(6.4)**	**272.9**
Administrative expenses	(16.6)	(23.1)	(20.0)	(69.1)	(128.8)
Impairment losses on financial assets[1]	(5.6)	10.9	(28.5)	-	(23.2)
Provisions for liabilities and charges	(0.2)	(0.5)	(9.3)	(0.1)	(10.1)
Total operating expenses	**(22.4)**	**(12.7)**	**(57.8)**	**(69.2)**	**(162.1)**
Share of results of associates	(0.5)	-	-	-	(0.5)
Statutory profit / (loss) before taxation	**118.8**	**69.6**	**(2.5)**	**(75.6)**	**110.3**
Underlying adjustments	-	-	-	-	-
Profit / (loss) before taxation on an underlying basis	**118.8**	**69.6**	**(2.5)**	**(75.6)**	**110.3**
Taxation on an underlying basis					(28.3)
Profit after taxation on an underlying basis					**82.0**
Assets	3,705.6	1,433.4	741.0	939.1	6,819.1
Liabilities	-	-	-	(6,145.7)	(6,145.7)
Net assets / (liabilities)	**3,705.6**	**1,433.4**	**741.0**	**(5,206.6)**	**673.4**

[1] Impairment losses on financial assets in the year ended 31 December 2018 reflect expected credit losses calculated in accordance with IFRS 9.

3. **Operating segments** (continued)

Year ended 31 December 2017	Property Finance £m	Business Finance £m	Consumer Lending £m	Central £m	Total £m
Interest income calculated using the effective interest rate method	178.5	76.5	52.2	1.7	308.9
Other interest and similar income	(0.1)	-	(0.4)	4.9	4.4
Interest expense and similar charges	(41.1)	(13.2)	(8.2)	(13.4)	(75.9)
Net interest income / (expense)	137.3	63.3	43.6	(6.8)	237.4
Operating lease rentals	-	12.3	-	-	12.3
Depreciation on operating leases	-	(10.6)	-	-	(10.6)
Net income from operating leases	-	1.7	-	-	1.7
Fee and commission income	0.4	11.2	0.7	-	12.3
Fee and commission expense	(3.3)	(0.7)	(8.5)	(1.0)	(13.5)
Net fee and commission (expense) / income	(2.9)	10.5	(7.8)	(1.0)	(1.2)
Net gains / (losses) on financial instruments at fair value through profit or loss	0.1	-	0.5	(0.4)	0.2
Net operating income / (expense)	134.5	75.5	36.3	(8.2)	238.1
Administrative expenses	(17.1)	(16.7)	(13.0)	(66.4)	(113.2)
Impairment losses on financial assets[1]	(2.4)	(8.5)	(12.4)	-	(23.3)
Provisions for liabilities and charges	-	-	(2.5)	0.4	(2.1)
Total operating expenses	(19.5)	(25.2)	(27.9)	(66.0)	(138.6)
Statutory profit / (loss) before taxation	115.0	50.3	8.4	(74.2)	99.5
Underlying adjustments	0.4	-	-	6.1	6.5
Profit / (loss) before taxation on an underlying basis	115.4	50.3	8.4	(68.1)	106.0
Taxation on an underlying basis					(26.8)
Profit after taxation on an underlying basis					79.2
Assets	3,187.0	1,076.0	617.4	871.6	5,752.0
Liabilities	-	-	-	(5,137.0)	(5,137.0)
Net assets / (liabilities)	3,187.0	1,076.0	617.4	(4,265.4)	615.0

[1] Impairment losses on financial assets in the year ended 31 December 2017 reflect impairment losses calculated in accordance with IAS 39.

4. Interest and similar income

See accounting policies in Note 1.7(b)

	2018 £m	2017 £m
Interest income calculated using the effective interest rate method		
On cash and balances at central banks	**4.7**	1.8
On loans and advances to customers	**351.1**	307.1
On investment securities	**0.2**	-
Total interest income calculated using the effective interest rate method	**356.0**	308.9
Other interest and similar income		
On derivative financial instruments	**0.8**	4.4
Total other interest and similar income	**0.8**	4.4
Total interest and similar income	**356.8**	313.3

Interest income recognised during the year on Stage 3 loans under the requirements of IFRS 9 is £7.6 million. In 2017, interest on impaired loans under the requirements of IAS 39 was £2.7 million.

The Group did not capitalise any interest income during 2018 (2017: £nil).

The amounts reported above include £356.0 million (2017: £308.9 million) of interest income on financial assets measured at amortised cost.

5. Interest expense and similar charges

See accounting policies in Note 1.7(b)

	2018 £m	2017 £m
On amounts due to banks	**6.2**	1.8
On customer deposits	**74.3**	67.3
On derivative financial instruments	**(0.2)**	-
On subordinated debt liability	**6.4**	6.4
Other interest	**0.5**	0.4
Total interest expense and similar charges	**87.2**	75.9

The amounts reported above include £87.4 million (2017: £75.9 million) of interest expense on financial liabilities measured at amortised cost.

6. Fee and commission income

See accounting policies in Note 1.7(c)

	2018 £m	2017 £m
Fee income on loans and advances to customers	**8.3**	10.4
Credit facility related fees	**2.4**	1.9
Total fee and commission income	**10.7**	12.3

7. Administrative expenses
See accounting policies in Note 1.7(d)

	2018 £m	2017 £m
Payroll costs (Note 9)	**64.9**	66.1
Depreciation (excluding operating lease assets)	**2.0**	2.6
Loss on disposal of property, plant and equipment	**0.1**	-
Amortisation of intangible assets	**6.1**	4.0
Impairment of goodwill	**0.5**	-
Loss on disposal of intangible assets	**1.9**	-
Operating lease payments	**2.4**	1.6
Other administrative expenses	**50.9**	38.9
Total administrative expenses	**128.8**	113.2

Other administrative expenses include fees paid to the Group's auditor as detailed in Note 8.

8. Auditor's remuneration

Fees payable to the Group's auditor, KPMG LLP, are analysed below:

	2018 £000	2017 £000
Audit of these annual accounts	**515**	451
Audit of the annual accounts of the subsidiaries of the Company	**15**	15
Adjustments in respect of prior year and IFRS 9	**45**	-
Other tax advisory services	**19**	2
Audit related assurance services	**-**	50
All other assurance services	**59**	105
All other services	**90**	33
Total auditor's remuneration	**743**	656

9. Employees
See accounting policies in Note 1.7(d)

The average number of persons employed by the Group on a full-time equivalent basis (including Executive Directors) was as follows:

	2018 No.	2017 No.
Property Finance	**99**	143
Business Finance	**170**	133
Consumer Lending	**51**	43
Central	**411**	352
Average employees	**731**	671

9. **Employees** (continued)

The aggregate payroll costs of these persons were as follows:

	2018 £m	2017 £m
Wages and salaries	**56.6**	58.0
Social security costs	**5.2**	5.6
Pension costs	**3.1**	2.5
Total payroll costs	**64.9**	66.1

Wages and salaries include share-based payment charges as detailed in Note 10.

Pension costs represent contributions to defined contribution pension schemes. The Group does not operate any defined benefit pension schemes.

10. Employee share-based payment transactions

See accounting policies in Note 1.7(e)

The employee share-based payment charge comprises:

	Status	2018 £m	2017 £m
Save-as-you-earn schemes	Fully vested in 2017	-	0.8
Performance share plan – 2015	Fully vested in 2017	-	1.4
Performance share plan – 2016	Fully vested in 2017	-	1.7
Performance share plan – 2017	Fully vested in 2017	-	2.4
Deferred share bonus plan – 2017	Fully vested in 2017	-	1.2
Total share-based payments		-	7.5

In 2018, no share-based payment schemes have been in operation.

Fully vested schemes

In 2017, following the acquisition of the Group by Marlin Bidco Limited, there was an issue of 2,586,879 £0.01 shares and the vesting of all of the share option schemes in operation was accelerated. The acceleration of the share options were recognised as if the service and the non-market performance conditions of all schemes had been met. Subsequent to vesting, all shares were repurchased by Marlin Bidco Limited at the offer price of £3.40. The total charge relating to the accelerated vesting in 2017 was £5.9 million, with the total share-based payment charge for the year ended 31 December 2017 being £7.5 million. Full details of the share schemes fully vested during 2017 can be found in the 2017 Annual Report and Accounts.

11. Directors' remuneration

	2018 £000	2017 £000
Directors' emoluments[1]	**3,499.6**	5,285.3
Total Directors' remuneration	**3,499.6**	5,285.3

Included in Directors' emoluments is £1.2 million (2017: £nil) relating to termination payments.

[1] Following the resignation of Steve Pateman in July 2018, Ian Cowie assumed the role as Interim Chief Executive Officer. He was not however formally appointed to the Board of the Company until 2019 and therefore his remuneration is not included in the table.

12. Impairment losses on financial assets

See accounting policies in Note 1.7(v)

Impairment losses on financial assets relate to loans and advances to customers, as set out below:

	2018 £m	2017 £m
Movement in loss allowance / impairment allowance in the year[1]	**15.1**	7.2
Loan balances written-off in the year	**25.6**	18.6
Amounts recovered in the year in respect of loan balances previously written-off[2]	**(17.5)**	(2.5)
Total impairment losses on financial assets	**23.2**	23.3

Impairment losses on cash and balances at central banks, loans and advances to banks and investment securities in the year to 31 December 2018 are immaterial, totalling less than £0.1 million.

13. Taxation

See accounting policies in Note 1.7(f)

Taxation charge recognised in the statement of profit and loss includes:

	2018 £m	2017 £m
Current tax		
Current year	**25.5**	24.2
Adjustment in respect of prior years	**(0.5)**	(1.1)
Total current tax	**25.0**	23.1
Deferred tax		
Origination and reversal of temporary differences	**3.5**	1.3
Adjustment in respect of prior years	**(0.2)**	0.9
Total deferred tax	**3.3**	2.2
Total taxation charge	**28.3**	25.3

[1] Movement in loss allowance in the year to 31 December 2018 reflect expected credit losses calculated in accordance with IFRS 9. Movement in impairment allowance in the year to 31 December 2017 reflect impairment losses calculated in accordance with IAS 39. See Note 14(b) for further detail of movements.

[2] During 2018, the Group received £13.0 million relating to the Group's insurance claim in respect of the controls breach identified in the Business Finance division in 2016.

13. Taxation (continued)

A reconciliation of profit before taxation per the statement of profit and loss to the total taxation charge per the statement of profit and loss is as follows:

	2018 £m	2017 £m
Profit before taxation	**110.3**	99.5
Implied tax charge thereon at 19.00% (2017: 19.25%)	**20.9**	19.2
Adjustments		
Banking surcharge	**6.7**	5.1
Adjustment in respect of prior years	**(0.7)**	(0.2)
Disallowable expenses and other permanent differences	**0.6**	1.2
Effect of tax rate changes	**0.8**	-
Total taxation charge	**28.3**	25.3

Reduction in the UK corporation tax rate from 20% to 19% (effective from 1 April 2017) and further reductions to 17% (effective 1 April 2020) were substantively enacted on 16 March 2016. This will reduce the Company's future current taxation charge accordingly.

Tax of £2.5 million arising on the £9.8 million coupon paid on capital securities is recognised directly in equity.

The deferred tax asset as at 31 December 2018 has been calculated based on an aggregation rate of 25% (2017: 26%). This is based on a rate of 17% substantively enacted at the reporting date (2017: 18%) and the additional 8% of tax suffered in relation to the banking surcharge that will unwind over the remaining life of the underlying assets with which they are associated.

14. Loans and advances to customers

See accounting policies in Note 1.7(g)

(a) Analysis of loans and advances to customers

			2018			2017
Group	Gross carrying amount £m	Loss allowance[1] £m	Carrying amount £m	Gross carrying amount £m	Impairment allowance[1] £m	Carrying amount £m
Loan receivables	**5,410.4**	**(54.1)**	**5,356.3**	4,438.4	(19.7)	4,418.7
Finance lease receivables	**95.0**	**(7.2)**	**87.8**	88.9	(9.1)	79.8
Instalment credit receivables	**409.4**	**(6.5)**	**402.9**	350.8	(2.8)	348.0
	5,914.8	**(67.8)**	**5,847.0**	4,878.1	(31.6)	4,846.5
Fair value adjustments for hedged risk			**(1.1)**			(2.2)
Total loans and advances to customers			**5,845.9**			4,844.3

[1] Loss allowance as at 31 December 2018 reflect expected credit losses calculated in accordance with IFRS 9. Impairment allowance as at 31 December 2017 reflect impairment losses calculated in accordance with IAS 39.

14. Loans and advances to customers (continued)

Company	2018 Gross carrying amount £m	2018 Loss allowance[1] £m	2018 Carrying amount £m	2017 Gross carrying amount £m	2017 Impairment allowance[1] £m	2017 Carrying amount £m
Loan receivables	**5,398.3**	**(54.0)**	**5,344.3**	4,433.5	(19.7)	4,413.8
Finance lease receivables	**94.7**	**(7.2)**	**87.5**	88.9	(9.1)	79.8
Instalment credit receivables	**381.1**	**(6.1)**	**375.0**	310.6	(2.7)	307.9
	5,874.1	**(67.3)**	**5,806.8**	4,833.0	(31.5)	4,801.5
Fair value adjustments for hedged risk			**(1.1)**			(2.2)
Total loans and advances to customers			**5,805.7**			4,799.3

Total loans and advances to customers, for both the Group and the Company include:

- £1,402.7 million (2017: £1,081.7 million) positioned with the Bank of England for use as collateral under its funding schemes. This comprises £1,402.7 million (2017: £902.2 million) for the Term Funding Scheme and £nil (2017: £179.5 million) for the Funding for Lending scheme.
- £206.9 million (2017: £nil) pledged as collateral against secured bank borrowings.

Finance lease receivables and instalment credit receivables
The Group provides finance lease and instalment credit agreements to customers for a variety of assets including, but not limited to, plant and machinery. The underlying assets provide security against the gross receivables.

[1] Loss allowance as at 31 December 2018 reflect expected credit losses calculated in accordance with IFRS 9. Impairment allowance as at 31 December 2017 reflect impairment losses calculated in accordance with IAS 39.

14. Loans and advances to customers (continued)

The following table provides further analysis of finance lease receivables:

	Group 2018 £m	**Company 2018 £m**	Group 2017 £m	Company 2017 £m
Gross amounts receivable:				
within one year	**46.0**	**45.9**	47.0	47.0
in the second to fifth year inclusive	**50.0**	**49.8**	49.5	49.5
after five years	**10.0**	**9.9**	3.0	3.0
	106.0	**105.6**	99.5	99.5
Less: unearned finance income	**(11.0)**	**(10.9)**	(10.6)	(10.6)
Gross carrying amount	**95.0**	**94.7**	88.9	88.9
Less: loss allowance / impairment allowance[1]	**(7.2)**	**(7.2)**	(9.1)	(9.1)
Total finance lease receivables	**87.8**	**87.5**	79.8	79.8
Amounts falling due:				
within one year	**38.0**	**37.9**	37.5	37.5
in the second to fifth year	**41.3**	**41.2**	39.7	39.7
after five years	**8.5**	**8.4**	2.6	2.6
Total finance lease receivables	**87.8**	**87.5**	79.8	79.8

[1] Loss allowance as at 31 December 2018 reflect expected credit losses calculated in accordance with IFRS 9. Impairment allowance as at 31 December 2017 reflect impairment losses calculated in accordance with IAS 39.

14. Loans and advances to customers (continued)

The following table provides further analysis of instalment credit receivables:

	Group 2018 £m	**Company 2018 £m**	Group 2017 £m	Company 2017 £m
Gross amounts receivable:				
within one year	**173.7**	**165.2**	162.5	148.4
in the second to fifth year inclusive	**249.2**	**231.3**	204.9	183.9
after five years	**26.5**	**21.2**	18.1	10.2
	449.4	**417.7**	385.5	342.5
Less: unearned finance income	**(40.0)**	**(36.6)**	(34.7)	(31.9)
Gross carrying amount	**409.4**	**381.1**	350.8	310.6
Less: loss allowance / impairment allowance[1]	**(6.5)**	**(6.1)**	(2.8)	(2.7)
Total instalment credit receivables	**402.9**	**375.0**	348.0	307.9
Amounts falling due:				
within one year	**151.9**	**144.9**	143.3	130.2
in the second to fifth year	**226.1**	**210.2**	186.8	167.3
after five years	**24.9**	**19.9**	17.9	10.4
Total instalment credit receivables	**402.9**	**375.0**	348.0	307.9

Included within instalment credit receivables for both the Group and the Company are block discounting *facilities of £157.2 million (2017: £106.6 million).*

The cost of equipment acquired during the year under finance lease and instalment credit agreements is as follows:

	Group 2018 £m	**Company 2018 £m**	Group 2017 £m	Company 2017 £m
Finance leases	**58.9**	**58.9**	40.1	40.1
Instalment credit	**140.2**	**135.5**	161.5	120.8
Total cost of equipment acquired during the year	**199.1**	**194.4**	201.6	160.9

(b) Analysis of impairment losses on loans and advances to customers

	2018				2017
Group	**Stage 1 £m**	**Stage 2 £m**	**Stage 3 £m**	**Total £m**	Total £m
Loan receivables	**20.5**	**18.3**	**15.3**	**54.1**	19.7
Finance lease receivables	**0.5**	**1.1**	**5.6**	**7.2**	9.1
Instalment credit receivables	**2.5**	**1.3**	**2.7**	**6.5**	2.8
Loss allowance / impairment allowance[1]	**23.5**	**20.7**	**23.6**	**67.8**	31.6

[1] Loss allowance as at 31 December 2018 reflect expected credit losses calculated in accordance with IFRS 9. Impairment allowance as at 31 December 2017 reflect impairment losses calculated in accordance with IAS 39.

14. Loans and advances to customers (continued)

Company	Stage 1 £m	Stage 2 £m	Stage 3 £m	2018 Total £m	2017 Total £m
Loan receivables	**20.4**	**18.3**	**15.3**	**54.0**	19.7
Finance lease receivables	**0.5**	**1.1**	**5.6**	**7.2**	9.1
Instalment credit receivables	**2.2**	**1.3**	**2.6**	**6.1**	2.7
Loss allowance / impairment allowance[1]	**23.1**	**20.7**	**23.5**	**67.3**	31.5

The below table shows an analysis of movements in the loss allowance during 2018 under IFRS 9, together with the loss allowance coverage:

Group	Stage 1 £m	Stage 2 £m	Stage 3 £m	2018 Total £m
As at 1 January	10.5	7.5	13.6	31.6
Impact of adopting IFRS 9[2]	6.8	5.0	9.3	21.1
Restated balance as at 1 January	17.3	12.5	22.9	52.7
Movements in loss allowance				
Transfer to Stage 1	4.3	(3.8)	(0.5)	-
Transfer to Stage 2	(1.4)	3.2	(1.8)	-
Transfer to Stage 3	(0.8)	(2.7)	3.5	-
New financial assets originated or purchased	13.2	1.3	0.5	15.0
Financial assets that have been derecognised	(3.2)	(1.8)	(3.9)	(8.9)
Changes in models / risk parameters	(5.8)	11.4	11.1	16.7
Modifications without derecognition	(0.1)	0.6	2.9	3.4
Write-offs	-	-	(11.1)	(11.1)
Total movement in loss allowance	6.2	8.2	0.7	15.1
As at 31 December	23.5	20.7	23.6	67.8
Loss allowance coverage as at 31 December (%)	0.5%	2.4%	19.5%	1.1%

1 Loss allowance as at 31 December 2018 reflect expected credit losses calculated in accordance with IFRS 9. Impairment allowance as at 31 December 2017 reflect impairment losses calculated in accordance with IAS 39.

2 See Note 1.6(a) and Note 2 for details.

14. Loans and advances to customers (continued)

Company	Stage 1 £m	Stage 2 £m	Stage 3 £m	2018 Total £m
As at 1 January	**10.4**	**7.5**	**13.6**	**31.5**
Impact of adopting IFRS 9[1]	**6.5**	**5.0**	**9.3**	**20.8**
Restated balance as at 1 January	**16.9**	**12.5**	**22.9**	**52.3**
Movements in loss allowance				
Transfer to Stage 1	**4.3**	**(3.8)**	**(0.5)**	**-**
Transfer to Stage 2	**(1.4)**	**3.2**	**(1.8)**	**-**
Transfer to Stage 3	**(0.8)**	**(2.7)**	**3.5**	**-**
New financial assets originated or purchased	**13.0**	**1.3**	**0.5**	**14.8**
Financial assets that have been derecognised	**(3.1)**	**(1.8)**	**(3.9)**	**(8.8)**
Changes in models / risk parameters	**(5.7)**	**11.4**	**11.0**	**16.7**
Modifications without derecognition	**(0.1)**	**0.6**	**2.9**	**3.4**
Write-offs	**-**	**-**	**(11.1)**	**(11.1)**
Total movement in loss allowance	**6.2**	**8.2**	**0.6**	**15.0**
As at 31 December	**23.1**	**20.7**	**23.5**	**67.3**
Loss allowance coverage as at 31 December (%)	**0.5%**	**2.4%**	**19.4%**	**1.1%**

Significant changes in the gross carrying amount of loans and advances to customers that contributed to changes in the Group's loss allowance were as follows:

- The Group originated c.£2,346 million of loans in 2018 that generated an increase in loss allowance of £15.0 million. The increase in loss allowance was largely attributable to Consumer Lending originations of £490 million (loss allowance £9.1 million) due to the higher loss allowance coverage ratio, Business Finance originations of £813 million (loss allowance £4.8 million) and Property Finance originations of £1,043 million (loss allowance £1.1 million). Property Finance exposure benefits from strong collateral values as set out in the Group's lending policy and therefore has a low loss allowance coverage ratio.
- Financial assets that have been derecognised refers to the loss allowance reduction at the point a loan is redeemed (loss allowance £8.9 million). This is largely due to redemptions in Business Finance (loss allowance £4.5 million) and Consumer Lending (loss allowance £3.2 million) where there is a higher loss allowance coverage.
- Changes in models / risk parameters account for an increase in loss allowance of £16.7 million. These are largely attributable to an increase of £6.8 million due to changes in the nature and probability of the IFRS 9 scenarios used in the ECL. During the year, the Group changed its forward forecast to a central view / disorderly no-deal Brexit / alternative upside view with probability of 40% / 40% / 20% at 31 December 2018. The remainder of the impact is due to updated PD and LGD judgements across the loan portfolios.
- The Group continued to operate a simultaneous charge-off and write-off policy during 2018. The reduction in loss allowance of the write-offs in Consumer Lending accounts for £10.8 million of the £11.1 million Group reduction in loss allowance.

The difference in the gross carrying amount of loans and advances to customers between the Group and the Company is £40.2 million. The corresponding movement in loss allowance for these loans is £0.1 million. This is all attributable to the Business Finance division.

[1] See Note 1.6(a) and Note 2 for details.

14. Loans and advances to customers (continued)

(c) Modifications

The Group sometimes modifies the terms of loans provided to customers due to commercial renegotiations, or for distressed loans, with a view to maximising recovery.

During 2018, loans with a gross carrying amount as at 31 December 2018 of £50.3 million were modified by the Group and £50.2 million by the Company. No material net modification gain or loss was recognised by the Group or the Company.

Further details of forborne loans are set out in Section 5.9 of the risk management report.

(d) Write-offs still under enforcement activity

Loans that are written off can still be subject to enforcement activities in order to comply with the Group's procedures for recovery of amounts due. The contractual amount outstanding on loans and advances that were written off during the reporting period, and are still subject to enforcement activity, is £13.5 million (2017: £6.3 million).

15. Investment securities

See accounting policies in Note 1.7(h)

Group and Company	**2018 £m**	2017 £m
As at 1 January	**-**	-
Additions	**139.7**	-
Accrued interest	**0.2**	-
As at 31 December	**139.9**	-

Loss allowance for investment securities as at 31 December 2018 is immaterial, totalling less than £0.1 million.

16. Derivative financial instruments and hedge accounting

See accounting policies in Note 1.7(i) and Note 1.7(j)

(a) Derivatives held for risk management

The following table analyses derivatives held for risk management purposes by type of instrument:

	2018				2017			
	Assets		Liabilities		Assets		Liabilities	
Group and Company	Notional value £m	Fair value £m	Notional value £m	Fair value £m	Notional value £m	Fair value £m	Notional value £m	Fair value £m
Interest rate swaps	431.5	1.4	559.2	1.2	389.0	1.8	189.0	0.3
Interest rate options	-	-	1,150.0	4.3	-	-	500.0	2.8
Cross-currency swaps	28.7	0.2	11.6	0.2	-	-	33.3	0.3
Total derivative financial instruments	**460.2**	**1.6**	**1,720.8**	**5.7**	389.0	1.8	722.3	3.4

The Group's property loan portfolio includes loans where interest rate terms are referenced to the three-month LIBOR index, but with a minimum reference rate of 0.75%. In March 2017 and March 2018, the Group sold interest rate options with a nominal value of £500.0 million and £650.0 million respectively into the wholesale market in order to hedge the Group's interest rate position against possible increases in the reference rate. Of the £650.0 million interest rate options sold in March 2018, £575.0 million are forward starting, with an effective date beyond 2018.

(b) Hedge accounting

As at 31 December 2018, the Group held interest rate swaps and options as hedging instruments in fair value hedges as detailed in the tables below. The Group's cross-currency swaps are not in hedge accounting relationships.

	Maturity					
Group and Company As at 31 December 2018	**Less than 1 month**	**1 - 3 months**	**3 months - 1 year**	**1 - 5 years**	**More than 5 years**	**Total**
Interest rate swaps						
Nominal amount (£m)	-	-	**50.0**	**913.4**	**27.3**	**990.7**
Average fixed interest rate	-	-	**1.20%**	**1.12%**	**1.34%**	**1.16%**
Interest rate options						
Nominal amount (£m)	-	-	-	**850.0**	**300.0**	**1,150.0**
Average fixed interest rate	-	-	-	**0.75%**	**0.75%**	**0.75%**

16. Derivative financial instruments and hedge accounting (continued)

The amounts relating to items designated as hedging instruments and hedge ineffectiveness were as follows:

Group and Company As at 31 December 2018	Nominal amount £m	Carrying amount £m	Statement of financial position line item	Change in fair value used for calculating hedge ineffectiveness £m	Ineffectiveness recognised in statement of profit and loss £m	Statement of profit and loss line item
Interest rate swaps						
Assets	**431.5**	**1.4**	**(i)**	**(0.7)**	**(0.5)**	**(iii)**
Liabilities	**559.2**	**1.2**	**(ii)**	**1.7**	**0.2**	**(iii)**
Interest rate options						
Liabilities	**1,150.0**	**4.3**	**(ii)**	**1.6**	**0.3**	**(iii)**

(i) Derivative financial assets

(ii) Derivative financial liabilities

(iii) Net gains / (losses) on financial instruments mandatorily at fair value through profit or loss

In these hedge relationships, the main sources of ineffectiveness relate to the modelled prepayment behaviour and the assumptions that are used in modelling this behaviour.

The amounts relating to items designated as hedged items were as follows:

Group and Company As at 31 December 2018	Carrying amount £m	Accumulated amount of fair value hedge adjustments on the hedged item included in the carrying amount of the hedged item £m	Statement of financial position line item	Change in value used for calculating hedge ineffectiveness £m	Accumulated amount of fair value hedge adjustments £m
Assets					
Loans and advances to customers	**1,740.6**	**(6.0)**	**Loans and advances to customers**	**(1.1)**	**(6.0)**
Liabilities					
Customer deposits	**280.0**	**(0.1)**	**Customer deposits**	**(1.4)**	**(0.1)**

(c) Net fair value gains and losses on derivative financial instruments and hedge accounting

Gains and losses on derivative financial instruments and hedge accounting per the statement of profit and loss are summarised as follows:

	2018 £m	2017 £m
Fair value gains on derivative financial instruments	**3.0**	3.9
Fair value losses on hedged risk	**(2.5)**	(3.7)
Net fair value gains on financial instruments	**0.5**	0.2

17. Property, plant and equipment

See accounting policies in Note 1.7(k)

Group	Leasehold property £m	Fixtures, fittings and equipment £m	Assets on operating leases £m	Total £m
Cost				
As at 1 January 2017	0.1	10.4	65.9	76.4
Additions	0.7	0.9	11.7	13.3
Disposals	-	(0.1)	(7.2)	(7.3)
Transfer to finance leases	-	-	(6.7)	(6.7)
As at 31 December 2017	0.8	11.2	63.7	75.7
Additions	**-**	**3.6**	**8.2**	**11.8**
Disposals	**(0.1)**	**-**	**(9.8)**	**(9.9)**
Transfer to finance leases	**-**	**-**	**(3.8)**	**(3.8)**
As at 31 December 2018	**0.7**	**14.8**	**58.3**	**73.8**
Depreciation				
As at 1 January 2017	0.1	5.9	27.7	33.7
Charge for the year	0.4	2.2	10.6	13.2
Disposals	-	(0.1)	(5.5)	(5.6)
Transfer to finance leases	-	-	(5.2)	(5.2)
As at 31 December 2017	0.5	8.0	27.6	36.1
Charge for the year	**0.1**	**1.9**	**7.6**	**9.6**
Disposals	**-**	**-**	**(8.0)**	**(8.0)**
Transfer to finance leases	**-**	**-**	**(3.0)**	**(3.0)**
As at 31 December 2018	**0.6**	**9.9**	**24.2**	**34.7**
Carrying amount				
As at 31 December 2017	0.3	3.2	36.1	39.6
As at 31 December 2018	**0.1**	**4.9**	**34.1**	**39.1**

Certain prior year figures in assets on operating leases have been restated. This is to ensure compliance with IFRS 3 'Business Combinations', which requires assets to be recognised at their fair value as at the date of acquisition. There is no change to the prior year carrying amount as a result of this restatement.

17. **Property, plant and equipment** (continued)

Company	Leasehold property £m	Fixtures, fittings and equipment £m	Assets on operating leases £m	Total £m
Cost				
As at 1 January 2017	0.1	10.4	65.9	76.4
Additions	0.7	0.9	11.3	12.9
Disposals	-	(0.1)	(7.2)	(7.3)
Transfer to finance leases	-	-	(6.7)	(6.7)
As at 31 December 2017	0.8	11.2	63.3	75.3
Additions	**-**	**3.4**	**7.7**	**11.1**
Disposals	**(0.1)**	**-**	**(9.8)**	**(9.9)**
Transfer to finance leases	**-**	**-**	**(3.8)**	**(3.8)**
As at 31 December 2018	**0.7**	**14.6**	**57.4**	**72.7**
Depreciation				
As at 1 January 2017	0.1	5.9	27.7	33.7
Charge for the year	0.4	2.2	10.6	13.2
Disposals	-	(0.1)	(5.5)	(5.6)
Transfer to finance leases	-	-	(5.2)	(5.2)
As at 31 December 2017	0.5	8.0	27.6	36.1
Charge for the year	**0.1**	**1.9**	**7.5**	**9.5**
Disposals	**-**	**-**	**(8.0)**	**(8.0)**
Transfer to finance leases	**-**	**-**	**(3.0)**	**(3.0)**
As at 31 December 2018	**0.6**	**9.9**	**24.1**	**34.6**
Carrying amount				
As at 31 December 2017	0.3	3.2	35.7	39.2
As at 31 December 2018	**0.1**	**4.7**	**33.3**	**38.1**

Certain prior year figures in assets on operating leases have been restated. This is to ensure compliance with IFRS 3 'Business Combinations', which requires assets to be recognised at their fair value as at the date of acquisition. There is no change to the prior year carrying amount as a result of this restatement.

18. Intangible assets

See accounting policies in Note 1.7(m)

Group	Goodwill £m	Computer software £m	Total £m
Cost			
As at 1 January 2017	38.5	19.3	57.8
Additions	-	9.8	9.8
As at 31 December 2017	38.5	29.1	67.6
Additions	**-**	**9.8**	**9.8**
Disposals	**-**	**(2.6)**	**(2.6)**
As at 31 December 2018	**38.5**	**36.3**	**74.8**
Amortisation			
As at 1 January 2017	-	4.2	4.2
Charge for the year	-	4.0	4.0
As at 31 December 2017	-	8.2	8.2
Charge for the year	**-**	**6.1**	**6.1**
Impairment in the year	**0.5**	**-**	**0.5**
Disposals	**-**	**(0.7)**	**(0.7)**
As at 31 December 2018	**0.5**	**13.6**	**14.1**
Carrying amount			
As at 31 December 2017	38.5	20.9	59.4
As at 31 December 2018	**38.0**	**22.7**	**60.7**

Company	Goodwill £m	Computer software £m	Total £m
Cost			
As at 1 January 2017	23.7	19.3	43.0
Additions	-	9.8	9.8
As at 31 December 2017	23.7	29.1	52.8
Additions	**-**	**9.8**	**9.8**
Disposals	**-**	**(2.6)**	**(2.6)**
As at 31 December 2018	**23.7**	**36.3**	**60.0**
Amortisation			
As at 1 January 2017	-	4.2	4.2
Charge for the year	-	4.0	4.0
As at 31 December 2017	-	8.2	8.2
Charge for the year	**-**	**6.1**	**6.1**
Disposals	**-**	**(0.7)**	**(0.7)**
As at 31 December 2018	**-**	**13.6**	**14.7**
Carrying amount			
As at 31 December 2017	23.7	20.9	44.6
As at 31 December 2018	**23.7**	**22.7**	**46.4**

18. Intangibles assets (continued)

Computer software additions in both the Group and the Company include £9.6 million of internally generated assets (2017: £8.5 million).

Impairment testing of goodwill
For the purposes of impairment testing, goodwill is allocated to the Group's cash generating units (CGUs), which are also the Group's reportable operating segments. These are: Property Finance, Business Finance and Consumer Lending.

Details of impairment testing, including key assumptions and sensitivity analysis, are set out in Note 1.9(b).

For the Company, no impairment loss is recognised in either of the reported years.

For the Group, an impairment loss of £0.5 million is recognised in 2018 against the goodwill allocated to the Consumer Lending CGU. This was predominantly due to a change in forecast originations as the Group stabilises the portfolio against the backdrop of general macroeconomic uncertainty, resulting in revised cash flow forecasts. The impairment loss is recognised in administrative expenses in the statement of profit and loss. The impairment reduces the carrying amount of goodwill in the Consumer Lending CGU from £0.5 million to £nil. No impairment losses are recognised against the goodwill allocated to the Property Finance or Business Finance CGUs.

No impairment losses were recognised in the Group in 2017.

As at 31 December, the carrying amount of goodwill allocated to each CGU, after impairment losses, is as follows:

	Group 2018 £m	**Company 2018 £m**	Group 2017 £m	Company 2017 £m
Property Finance	**5.4**	**-**	5.4	-
Business Finance	**32.6**	**23.7**	32.6	23.7
Consumer Lending	**-**	**-**	0.5	-
Total goodwill	**38.0**	**23.7**	38.5	23.7

19. Deferred tax assets

See accounting policies in Note 1.7(f)

Deferred tax assets are attributable to the following items:

Group and Company	**2018 £m**	2017 £m
Decelerated tax depreciation	**12.1**	13.6
IFRS 9 adjustment	**4.9**	-
Bad debt provision	**0.7**	2.0
Other	**0.3**	0.1
Total deferred tax assets	**18.0**	15.7

19. Deferred tax assets (continued)

Movements in deferred tax assets are attributable to the following items:

Group and Company	2018 £m	2017 £m
As at 1 January	**15.7**	17.9
Impact of adopting IFRS 9[1]	**5.6**	-
Restated balance as at 1 January	**21.3**	17.9
Current period movement - recognised in income	**(2.2)**	(0.4)
Adjustment in respect of prior years	**0.2**	(0.9)
Share-based payments	**-**	(1.1)
Bad debt provision	**(1.3)**	0.2
As at 31 December	**18.0**	15.7

Deferred tax assets result primarily from decelerated capital allowances. The business plan projects profits in future years sufficient to fully recognise the deferred tax assets. The tax assets will unwind over the remaining life of the underlying assets with which they are associated.

A reduction in the UK corporation tax rate from 20% to 19% (effective from 1 April 2017) and further reductions to 17% (effective 1 April 2020) were substantively enacted on 16 March 2016. The deferred tax asset as at 31 December 2018 has been calculated based on an aggregation of a rate of 17% substantively enacted at the reporting date and the additional 8% of tax suffered in relation to the banking surcharge that will unwind over the remaining life of the underlying assets with which they are associated.

20. Investment in associates

See accounting policies in Note 1.7(n)

The Group acquired 19.99% of the ordinary shares of The Mortgage Lender Limited on 26 March 2018, in exchange for consideration, inclusive of transaction costs, of £6.0 million. Although the Group holds less than 20% of the ordinary shares of The Mortgage Lender Limited, the Group is deemed to have significant influence as detailed in Note 1.9(e).

Details of material associates at the end of the reporting period is as follows:

Name of associate	Principal activity	Place of incorporation and principal place of business	Proportion of ownership interest / voting rights held as at 31 December 2018
The Mortgage Lender Limited	**Mortgage finance**	**UK**	**19.99%**

The above associate is accounted for using the equity method in these consolidated financial statements as detailed in Note 1.7(n).

The carrying amount of the investment as at 31 December 2018 is £5.5 million. This includes a £0.5 million share of loss of associate recognised in the statement of profit and loss for the year ended 31 December 2018.

The financial year end date of The Mortgage Lender Limited is 31 August. For the purposes of applying the equity method of accounting, both the financial statements for the year to 31 August 2018 and monthly unaudited management accounts for September to December 2018 were used.

[1] See Note 1.6(a) and Note 2 for details.

20. Investment in associates (continued)

Summarised financial information in respect of The Mortgage Lender Limited is set out below:

	As at 31 December 2018[1] £m
Current assets	**3.9**
Non-current assets	**0.5**
Current liabilities	**(0.5)**
Non-current liabilities	**(0.1)**
Net assets	**3.8**

	9 months from acquisition to 31 December 2018[2] £m
Revenue	**4.3**
Loss from continuing operations	**(2.3)**
Other comprehensive income for the period	**-**
Total comprehensive income for the period	**(2.3)**
Dividends received from the associate during the period	**-**

A reconciliation of the above summarised financial information to the carrying amount of the interest in The Mortgage Lender Limited recognised in the consolidated financial statements is shown below:

Group and Company	As at 31 December 2018
Net assets of the associate (£m)	**3.8**
Proportion of ownership interest in the associate	**19.99%**
Share of net assets (£m)	**0.8**
Goodwill (£m)	**4.7**
Carrying amount of interest in the associate (£m)	**5.5**

21. Other assets

	Group 2018 £m	Company 2018 £m	Group 2017 £m	Company 2017 £m
Other debtors	**2.9**	**2.9**	0.5	0.5
Prepayments	**9.7**	**9.6**	9.4	9.4
Amounts due from Group companies	**-**	**42.6**	-	9.9
Total other assets	**12.6**	**55.1**	9.9	19.8

[1] Based on unaudited monthly management accounts as at 31 December 2018.

[2] Calculated based on the financial statements for the year to 31 August 2018 and monthly unaudited management accounts for the months of September to December 2018.

22. Investment in subsidiaries

As at 31 December 2018, the total investment in subsidiaries held at cost amounted to £102 (2017: £102).

23. Amounts due to banks

See accounting policies in Note 1.7(o)

Group and Company	2018 £m	2017 £m
Central bank facilities	**876.6**	605.6
Secured bank borrowings	**152.0**	-
Derivative collateral	**0.8**	1.7
Total amounts due to banks	**1,029.4**	607.3

Total amounts due to banks include:

- £875.0 million (2017: £605.0 million) drawn under the Bank of England's Term Funding Scheme which fall due for repayment between 2020 and 2022. These amounts are collateralised by loan assets of £1,402.7 million (2017: £902.2 million).
- Secured bank borrowings of £152.0 million (2017: £nil). These amounts are secured on loan assets of £206.9 million (2017: £nil).

24. Customer deposits

See accounting policies in Note 1.7(p)

Group and Company	2018 £m	2017 £m
Instant access	**1,365.6**	878.2
Term deposits and notice accounts	**3,612.2**	3,496.0
Fair value adjustments for hedged risk	**0.1**	2.0
Total customer deposits	**4,977.9**	4,376.2

25. Provisions for liabilities and charges

See accounting policies in Note 1.7(q) and Note 1.7(x)

			2018		2017
Group and Company	**Loss provision £m**	**Other provisions £m**	**Total £m**	Other provisions £m	Total £m
As at 1 January	-	**2.8**	**2.8**	1.3	1.3
Impact of adopting IFRS 9[1]	**0.5**	-	**0.5**	-	-
Restated balance as at 1 January	**0.5**	**2.8**	**3.3**	1.3	1.3
Provisions utilised during the year	-	**(1.8)**	**(1.8)**	(0.6)	(0.6)
Provisions made during the year	**0.5**	**9.6**	**10.1**	2.1	2.1
As at 31 December	**1.0**	**10.6**	**11.6**	2.8	2.8

Loss provision

Loss provision represents the IFRS 9 loss allowance on financial guarantee contracts and loan commitments. Further details are set out in Note 38.

[1] See Note 1.6(a) and Note 2 for details.

25. Provisions for liabilities and charges (continued)

Other provisions

Other provisions include:

- £0.4 million (2017: £0.3 million) relating to the Financial Services Compensation Scheme. The amount provided is based on information received from the Financial Services Compensation Scheme, forecast future interest rates and the Group's historic share of industry protected deposits.
- £10.2 million (2017: £2.5 million) relating to potential instances of misrepresentation or breaches of contract by suppliers where the suppliers have become insolvent, and therefore the Group has limited recourse to those suppliers. See Note 1.9(c) for further details.

26. Other liabilities

	Group 2018 £m	Company 2018 £m	Group 2017 £m	Company 2017 £m
Other creditors	**19.5**	**19.5**	46.2	10.7
Accruals	**19.9**	**19.5**	16.2	16.1
Amounts due to Group companies	**1.7**	**1.7**	1.0	-
Total other liabilities	**41.1**	**40.7**	63.4	26.8

Other creditors include amounts relating to sundry creditors and other taxes.

27. Subordinated debt

See accounting policies in Note 1.7(r)

In October 2015, the Company issued £75.0 million subordinated debt to its parent company, Shawbrook Group plc. The terms of the issued loan notes are consistent with the loan notes listed by Shawbrook Group plc on the London Stock Exchange on 28 October 2015. The notes bear interest on their principal amount at an initial rate of 8.5% per annum until the first reset date of 28 October 2020. Interest is payable semi-annually in arrears.

Group and Company	2018 £m	2017 £m
As at 1 January	**76.1**	76.1
Interest expense and similar charges	**6.4**	6.4
Repayment of interest	**(6.4)**	(6.4)
As at 31 December	**76.1**	76.1

28. Share capital

Ordinary shares of £1.00 each: issued and fully paid

Group and Company	2018 No.	2018 £	2017 No.	2017 £
Ordinary £1.00 shares	**175,487,207**	**175,487,207**	175,487,207	175,487,207

There have been no movements in share capital in either of the reported years.

Holders of the shares are entitled to dividends as declared from time to time and are entitled to one vote per share at general meetings of the Company. There are no restrictions on the rights implicit to the shares.

29. Capital securities

See accounting policies in Note 1.7(s)

Group and Company	2018 £m	2017 £m
As at 1 January	**125.0**	-
Issue of capital securities	**-**	125.0
As at 31 December	**125.0**	125.0

In December 2017, the Company issued £125.0 million fixed rate reset perpetual Additional Tier 1 write down capital securities to its parent company, Shawbrook Group plc. The terms of the issued capital securities are consistent with the capital securities listed by Shawbrook Group plc on the Irish Stock Exchange on 8 December 2017.

During 2018, the Group paid a coupon of £9.8 million (2017: £nil) to Shawbrook Group Plc, the holders of the capital securities, before deduction of taxation.

30. Notes to the cash flow statement

See accounting policies in Note 1.7(t)

(a) Adjustments for non-cash items and other adjustments included within the statement of profit and loss

	Group 2018 £m	Company 2018 £m	Group 2017 £m	Company 2017 £m
Subordinated debt interest and costs	**6.4**	**6.4**	6.4	6.4
Investment securities accrued interest	**(0.2)**	**(0.2)**	-	-
Depreciation of property, plant and equipment	**9.6**	**9.6**	13.2	13.2
Loss on disposal of property, plant and equipment	**0.1**	**0.1**	-	-
Amortisation of intangible assets	**6.1**	**6.1**	4.0	4.0
Impairment of goodwill	**0.5**	**-**	-	-
Loss on disposal of intangible assets	**1.9**	**1.9**	-	-
Loss allowance / impairment allowance on financial assets[1]	**15.1**	**15.1**	23.3	23.2
Share of results of associates	**0.5**	**0.5**	-	-
Share-based payments	**(0.3)**	**(0.3)**	7.5	7.5
Total non-cash items	**39.7**	**39.2**	54.4	54.3

(b) Net change in operating assets

	Group 2018 £m	Company 2018 £m	Group 2017 £m	Company 2017 £m
Increase in mandatory deposits with central banks[2]	**(4.6)**	**(4.6)**	(0.3)	(0.3)
Increase in loans and advances to customers	**(1,037.8)**	**(1,042.3)**	(817.2)	(772.1)
Decrease in derivative financial assets	**0.2**	**0.2**	3.4	3.4
Increase in operating lease assets	**(5.6)**	**(5.2)**	(8.6)	(8.2)
(Increase) / decrease in other assets	**(2.7)**	**(35.3)**	6.2	(3.7)
Increase in operating assets	**(1,050.5)**	**(1,087.2)**	(816.5)	(780.9)

[1] Loss allowance as at 31 December 2018 reflect expected credit losses calculated in accordance with IFRS 9. Impairment allowance as at 31 December 2017 reflect impairment losses calculated in accordance with IAS 39.

[2] Mandatory deposits with central banks are not available for use in day-to-day operations and are non-interest bearing.

30. Notes to the cash flow statement (continued)

(c) Net change in operating liabilities

	Group 2018 £m	Company 2018 £m	Group 2017 £m	Company 2017 £m
Increase in customer deposits	**601.7**	**601.7**	432.7	432.7
Increase in provisions for liabilities and charges	**8.3**	**8.3**	1.5	1.5
Increase in derivative financial liabilities	**2.3**	**2.3**	3.0	3.0
(Decrease) / increase in other liabilities	**(22.3)**	**13.9**	34.6	(1.9)
Increase in operating liabilities	**590.0**	**626.2**	471.8	435.3

(d) Cash and cash equivalents

	Group 2018 £m	Company 2018 £m	Group 2017 £m	Company 2017 £m
Cash and balances at central banks	**645.2**	**645.2**	752.5	752.5
Loans and advances to banks	**50.6**	**50.1**	28.8	28.5
Less: mandatory deposits with central banks[1]	**(8.9)**	**(8.9)**	(4.3)	(4.3)
Total cash and cash equivalents	**686.9**	**686.4**	777.0	776.7

31. Financial instruments

See accounting policies in Note 1.7(u)

(a) Classification of financial instruments

The following tables summarise the classification and carrying amounts of the Group and Company's financial assets and liabilities:

Group As at 31 December 2018 Under IFRS 9	**Mandatorily at FVTPL £m**	**Amortised cost £m**	**Total carrying amount £m**
Financial assets			
Cash and balances at central banks	-	**645.2**	**645.2**
Loans and advances to banks	-	**50.6**	**50.6**
Loans and advances to customers	-	**5,845.9**	**5,845.9**
Investment securities	-	**139.9**	**139.9**
Derivative financial assets	**1.6**	-	**1.6**
Total financial assets	**1.6**	**6,681.6**	**6,683.2**
Financial liabilities			
Amounts due to banks	-	**1,029.4**	**1,029.4**
Customer deposits	-	**4,977.9**	**4,977.9**
Derivative financial liabilities	**5.7**	-	**5.7**
Subordinated debt liability	-	**76.1**	**76.1**
Total financial liabilities	**5.7**	**6,083.4**	**6,089.1**

[1] Mandatory deposits with central banks are not available for use in day-to-day operations and are non-interest bearing.

31. Financial instruments (continued)

Company **As at 31 December 2018** **Under IFRS 9**	**Mandatorily at FVTPL** **£m**	**Amortised cost** **£m**	**Total carrying amount** **£m**
Financial assets			
Cash and balances at central banks	-	**645.2**	**645.2**
Loans and advances to banks	-	**50.1**	**50.1**
Loans and advances to customers	-	**5,805.7**	**5,805.7**
Investment securities	-	**139.9**	**139.9**
Derivative financial assets	**1.6**	-	**1.6**
Total financial assets	**1.6**	**6,640.9**	**6,642.5**
Financial liabilities			
Amounts due to banks	-	**1,029.4**	**1,029.4**
Customer deposits	-	**4,977.9**	**4,977.9**
Derivative financial liabilities	**5.7**	-	**5.7**
Subordinated debt liability	-	**76.1**	**76.1**
Total financial liabilities	**5.7**	**6,083.4**	**6,089.1**

There were no reclassifications of financial assets or liabilities during the year ended 31 December 2018 for the Group or the Company.

Group As at 31 December 2017 Under IAS 39	FVTPL £m	Loans and receivables £m	Other amortised cost £m	Total carrying amount £m
Financial assets				
Cash and balances at central banks	-	752.5	-	752.5
Loans and advances to banks	-	28.8	-	28.8
Loans and advances to customers	-	4,844.3	-	4,844.3
Derivative financial assets	1.8	-	-	1.8
Total financial assets	1.8	5,625.6	-	5,627.4
Financial liabilities				
Amounts due to banks	-	-	607.3	607.3
Customer deposits	-	-	4,376.2	4,376.2
Derivative financial liabilities	3.4	-	-	3.4
Subordinated debt liability	-	-	76.1	76.1
Total financial liabilities	3.4	-	5,059.6	5,063.0

31. Financial instruments (continued)

Company As at 31 December 2017 Under IAS 39	FVTPL £m	Loans and receivables £m	Other amortised cost £m	Total carrying amount £m
Financial assets				
Cash and balances at central banks	-	752.5	-	752.5
Loans and advances to banks	-	28.5	-	28.5
Loans and advances to customers	-	4,799.3	-	4,799.3
Derivative financial assets	1.8	-	-	1.8
Total financial assets	1.8	5,580.3	-	5,582.1
Financial liabilities				
Amounts due to banks	-	-	607.3	607.3
Customer deposits	-	-	4,376.2	4,376.2
Derivative financial liabilities	3.4	-	-	3.4
Subordinated debt liability	-	-	76.1	76.1
Total financial liabilities	3.4	-	5,059.6	5,063.0

There were no reclassifications of financial assets or liabilities during the year ended 31 December 2017 for the Group or the Company.

(b) Fair value of financial instruments

A summary of the Group's valuation methods used to calculate the fair values of its financial assets and financial liabilities is as follows:

- **Cash and balances at central banks:** fair value approximates to carrying amount as cash and balances at central banks have minimal credit losses and are either short-term in nature or re-price frequently.
- **Loans and advances to banks, customer deposits and amounts due to banks:** fair value is estimated using discounted cash flows applying either market rates where practicable or rates offered with similar characteristics by other financial institutions. The fair value of floating rate placements, fixed rate placements with less than six months to maturity and overnight deposits is considered to approximate to their carrying amount.
- **Loans and advances to customers:** fair value is calculated based on the present value of future principal and interest cash flows, discounted at the market rate of interest at the reporting date, and adjusted for future credit losses if considered material.
- **Derivative financial instruments:** fair values of derivatives are obtained from quoted market prices in active markets and, where these are not available, from valuation techniques including discounted cash flows.
- **Investment securities and subordinated debt liability:** fair values are based on quoted prices where available or by discounting cash flows using market rates.

The Group uses a fair value hierarchy which reflects the significance of the inputs used in making the measurements. There are three levels to the hierarchy as follows:

- **Level 1:** quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date;
- **Level 2:** inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices). A Level 2 input must be observable for substantially the full term of the instrument. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves observable at commonly quoted intervals, implied volatilities and credit spreads. Assets and liabilities classified as Level 2 have been valued using models whose inputs are observable in an active market; and
- **Level 3:** inputs for the asset or liabilities that are not based on observable market data (unobservable inputs).

31. Financial instruments (continued)

The consideration of factors such as the scale and frequency of trading activity, the availability of prices and the size of bid/offer spreads assists in the assessment of whether a market is active. If, in the opinion of Management, a significant proportion of an instrument's carrying amount is driven by unobservable inputs, the instrument in its entirety is classified as valued at Level 3 of the fair value hierarchy. Level 3 in this context means that there is little or no current market data available from which to determine the level at which an arm's length transaction would be likely to occur. It generally does not mean that there is no market data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used).

The table below analyses the Group's financial instruments measured at amortised cost into the fair value hierarchy:

			2018			2017
	Level 3	**Level 2**	**Level 1**	Level 3	Level 2	Level 1
Group	**£m**	**£m**	**£m**	£m	£m	£m
Financial assets (at amortised cost)						
Cash and balances at central banks	**-**	**-**	**645.2**	-	-	752.5
Loans and advances to banks	**-**	**50.6**	**-**	-	28.8	-
Loans and advances to customers	**5,845.9**	**-**	**-**	4,844.3	-	-
Investment securities	**-**	**-**	**139.9**	-	-	-
Financial liabilities (at amortised cost)						
Amounts due to banks	**-**	**1,029.4**	**-**	-	607.3	-
Customer deposits	**-**	**4,977.9**	**-**	-	4,376.2	-
Subordinated debt liability	**-**	**76.1**	**-**	-	76.1	-

There were no transfers between the levels of the fair value hierarchy during the year (2017: £nil).

The table below analyses the Company's financial instruments measured at amortised cost into the fair value hierarchy:

			2018			2017
	Level 3	**Level 2**	**Level 1**	Level 3	Level 2	Level 1
Company	**£m**	**£m**	**£m**	£m	£m	£m
Financial assets (at amortised cost)						
Cash and balances at central banks	**-**	**-**	**645.2**	-	-	752.5
Loans and advances to banks	**-**	**50.1**	**-**	-	28.5	-
Loans and advances to customers	**5,805.7**	**-**	**-**	4,799.3	-	-
Investment securities	**-**	**-**	**139.9**	-	-	-
Financial liabilities (at amortised cost)						
Amounts due to banks	**-**	**1,029.4**	**-**	-	607.3	-
Customer deposits	**-**	**4,977.9**	**-**	-	4,376.2	-
Subordinated debt liability	**-**	**76.1**	**-**	-	76.1	-

There were no transfers between the levels of the fair value hierarchy during the year (2017: £nil).

31. Financial instruments (continued)

The table below analyses the Group and Company's financial instruments measured at fair value into the fair value hierarchy:

Group and Company	2018 Level 3 £m	2018 Level 2 £m	2018 Level 1 £m	2017 Level 3 £m	2017 Level 2 £m	2017 Level 1 £m
Financial assets (at fair value)						
Derivative financial assets	-	**1.6**	-	-	1.8	-
Financial liabilities (at fair value)						
Derivative financial liabilities	-	**5.7**	-	-	3.4	-

There were no transfers between the levels of the fair value hierarchy during the year (2017: £nil).

The below table shows a comparison of the carrying amounts per the statement of financial position, and the fair values of those financial instruments measured at amortised cost:

Group	2018 Carrying amount £m	2018 Fair value £m	2017 Carrying amount £m	2017 Fair value £m
Financial assets (at amortised cost)				
Cash and balances at central banks	**645.2**	**645.2**	752.5	752.5
Loans and advances to banks	**50.6**	**50.6**	28.8	28.8
Loans and advances to customers	**5,845.9**	**6,105.8**	4,844.3	5,045.9
Investment securities	**139.9**	**139.0**	-	-
Total financial assets (at amortised cost)	**6,681.6**	**6,940.6**	5,625.6	5,827.2
Financial liabilities (at amortised cost)				
Amounts due to banks	**1,029.4**	**1,014.8**	607.3	594.5
Customer deposits	**4,977.9**	**4,972.8**	4,376.2	4,369.3
Subordinated debt liability	**76.1**	**78.0**	76.1	81.0
Total financial liabilities (at amortised cost)	**6,083.4**	**6,065.6**	5,059.6	5,044.8

Company	2018 Carrying amount £m	2018 Fair value £m	2017 Carrying amount £m	2017 Fair value £m
Financial assets (at amortised cost)				
Cash and balances at central banks	**645.2**	**645.2**	752.5	752.5
Loans and advances to banks	**50.1**	**50.1**	28.5	28.5
Loans and advances to customers	**5,805.7**	**6,065.4**	4,799.3	5,001.7
Investment securities	**139.9**	**139.0**	-	-
Total financial assets (at amortised cost)	**6,640.9**	**6,899.7**	5,580.3	5,782.7
Financial liabilities (at amortised cost)				
Amounts due to banks	**1,029.4**	**1,014.8**	607.3	594.5
Customer deposits	**4,977.9**	**4,972.8**	4,376.2	4,369.3
Subordinated debt liability	**76.1**	**78.0**	76.1	81.0
Total financial liabilities (at amortised cost)	**6,083.4**	**6,065.6**	5,059.6	5,044.8

31. Financial instruments (continued)

(c) Offsetting financial assets and financial liabilities

The Group has financial assets and financial liabilities for which there is a legally enforceable right to offset the recognised amounts, and there is an intention to settle on a net basis, or realise the asset and liability simultaneously.

The following table shows the impact on financial assets and financial liabilities relating to transactions where:

- there is an enforceable master netting arrangement or similar agreement in place and an unconditional right to offset is in place (amounts offset);
- there is an enforceable master netting arrangement or similar agreement in place but the offset criteria are otherwise not satisfied (master netting arrangements); and
- financial collateral is paid and received (financial collateral).

The table excludes financial instruments not subject to offset and those that are subject to collateral arrangements only (e.g. loans and advances).

	Amounts subject to enforceable netting arrangements					
	Effect of offsetting on statement of financial position			**Related amounts not offset**		
Group and Company As at 31 December 2018	**Gross amount £m**	**Amount offset £m**	**Net amount reported on statement of financial position £m**	**Cash collateral[1] £m**	**Net amount £m**	**Amount not subject to enforceable netting arrangements £m**
Financial assets						
Derivative financial assets	**1.6**	**-**	**1.6**	**1.6**	**-**	**-**
Total financial assets	**1.6**	**-**	**1.6**	**1.6**	**-**	**-**
Financial liabilities						
Derivative financial liabilities	**5.7**	**-**	**5.7**	**5.7**	**-**	**-**
Total financial liabilities	**5.7**	**-**	**5.7**	**5.7**	**-**	**-**

	Amounts subject to enforceable netting arrangements					
	Effect of offsetting on statement of financial position			Related amounts not offset		
Group and Company As at 31 December 2017	Gross amount £m	Amount offset £m	Net amount reported on statement of financial position £m	Cash collateral[1] £m	Net amount £m	Amount not subject to enforceable netting arrangements £m
Financial assets						
Derivative financial assets	1.8	-	1.8	1.8	-	-
Total financial assets	1.8	-	1.8	1.8	-	-
Financial liabilities						
Derivative financial liabilities	3.4	-	3.4	3.4	-	-
Total financial liabilities	3.4	-	3.4	3.4	-	-

[1] Collateral amounts (cash and non-cash financial collateral) are reflected at their fair value; however, this amount is limited to the net statement of financial position exposure in order not to include any over-collateralisation.

32. Ultimate parent company

The Company is a subsidiary undertaking of its ultimate parent company, Shawbrook Group plc. Shawbrook Group plc is incorporated in England and Wales and is the largest company in which the results of the Company and its subsidiaries are consolidated. The consolidated financial statements of the Group are available on request from Lutea House, Warley Hill Business Park, Brentwood, Essex CM13 3BE.

33. Subsidiary companies

See accounting policies in Note 1.4

The Company has the following subsidiary companies as at 31 December 2018 whose results are included in these consolidated financial statements:

	Country of incorporation	Class of shares	Ownership %	Principal activity
Shawbrook International Limited	Jersey	Ordinary	100	Banking
Shawbrook Buildings and Protection Limited	England and Wales	Ordinary	100	Dormant
Singers Corporate Asset Finance Limited	England and Wales	Ordinary	100	Dormant
Singers Healthcare Finance Limited	England and Wales	Ordinary	100	Dormant
Coachlease Limited	England and Wales	Ordinary	100	Dormant
Hermes Group Limited	England and Wales	Ordinary	100	Dormant
Singer & Friedlander Commercial Finance Limited	Scotland	Ordinary	100	Dormant
Link Loans Limited	England and Wales	Ordinary	100	Dormant
Centric SPV 1 Limited	England and Wales	Ordinary	100	Dormant
Resource Partners SPV Limited	England and Wales	Ordinary	100	Dormant
Centric Group Holdings Limited and its subsidiary, as follows:	England and Wales	Ordinary	100	Dormant
Centric Group Finance Limited	England and Wales	Ordinary	100	Dissolved[1]

All subsidiaries have the same registered address as the Company (see Note 1.1), except the following:

- **Shawbrook International Limited:** 1st Floor Kensington Chambers, Kensington Place, St Helier, JE4 0ZE, Jersey.
- **Singer & Friedlander Commercial Finance Limited:** 8 Nelson Mandela Place, Glasgow, Scotland, G2 1BT.

On 9 October 2018, Centric Group Finance Limited sold Centric SPV1 Limited and Resource Partners SPV Limited to Shawbrook Bank Limited.

During 2018, the following subsidiary companies were struck off the Company Register:

- Centric Commercial Finance Limited (company no: 06406043), a subsidiary of Centric Group Finance Limited, was dissolved on 7 August 2018.
- Centric SPV 2 Limited (company no: 06675843), a subsidiary of Centric Group Finance Limited, was dissolved on 7 August 2018.
- Centric Group Finance 2 Limited (company no: 06675856), a subsidiary of Centric Group Holdings Limited, was dissolved on 7 August 2018.

[1] Centric Group Finance Limited (company no: 06405442), a subsidiary of Centric Group Holdings Limited was dissolved on 12 February 2019.

34. Related party transactions

The ultimate parent and controlling party of the Group is detailed in Note 32. Subsidiaries of the Group are detailed in Note 33.

(a) Transactions with key management personnel
Key management personnel refer to the Executive Management team and Directors of the Group.

Total compensation for key management personnel for the year is as follows:

Group and Company	2018 £m	2017 £m
Short-term employee benefits	**7.0**	6.4
Other long-term benefits	**0.2**	0.1
Termination benefits	**1.4**	-
Share-based payments	**-**	4.7
Total key management personnel compensation	**8.6**	11.2

(b) Transactions with associates
During the period from 26 March 2018 to 31 December 2018, the Group held a 19.99% holding in its associate, The Mortgage Lender Limited (see Note 20). During this period the Group paid £0.8 million of commission and servicing fees to the associate. As at 31 December 2018, the balance outstanding is £nil.

(c) Transactions between the Company and its parent company
Movement in amounts owed by the Company to its parent company, Shawbrook Group plc, are as follows:

	Company 2018 £m	Company 2017 £m
As at 1 January	**1.0**	1.7
Issue of capital securities	**-**	125.0
Investment in subsidiaries	**-**	(125.0)
Dividend paid to Shawbrook Group plc	**-**	19.5
Coupon on capital securities paid	**(9.8)**	-
Coupon on capital securities received	**9.8**	-
Professional fees and other costs	**1.5**	(17.8)
Transfer of funds	**(0.8)**	(2.4)
As at 31 December	**1.7**	1.0

In 2015, £75.0 million subordinated debt was issued from the Company to its parent company, Shawbrook Group plc. The terms of the issued loan notes are consistent with the loan notes listed by Shawbrook Group plc on the London Stock Exchange on 28 October 2015 (see Note 27).

In 2017, £125.0 million Fixed Rate Reset Perpetual Additional Tier 1 Write Down Capital Securities were issued from the Company to its parent company, Shawbrook Group plc. The terms of the issued capital securities are consistent with the capital securities listed by Shawbrook Group plc on the Irish Stock Exchange on 8 December 2017 (see Note 29).

(d) Transactions between the Company and its subsidiaries
In the year ended 31 December 2018, the Company made payments of £31.4 million (2017: £11.0 million) to Shawbrook International Limited to support its on-going activities and to fund repayment of amounts owing to a bank by Shawbrook International Limited in relation the purchase of a loan book in December 2017. As at 31 December 2018, the balance outstanding from Shawbrook International Limited to the Company is £42.6 million (2017: £11.2 million).

34. Related party transactions (continued)

(e) Other transactions

The Group extends a €20.0 million revolving credit facility to Capitalflow (Asset Finance) DAC, which is 100% owned by PSC Nominee 3 Limited, a Pollen Street Capital Limited company[1]. As at 31 December 2018, the balance outstanding is £14.7 million (2017: £5.8 million).

The Group extends a £20.0 million senior revolving facility to 1st Stop Funding Limited, whose ultimate parent is 1st Stop Holdings Limited. 1st Stop Holdings Limited is 100% owned by PSC Nominee 3 Limited, a Pollen Street Capital Limited company[1]. As at 31 December 2018, the balance outstanding is £15.4 million (2017: £20.3 million).

35. Operating lease commitments

See accounting policies in Note 1.7(l)

(a) Operating leases as a lessee

Non-cancellable operating lease rentals on land and buildings are payable as follows:

Group and Company	2018 £m	2017 £m
Less than 1 year	**1.4**	2.0
Between 1 and 5 years	**7.4**	5.8
More than 5 years	**4.9**	1.8
Total leases as lessee	**13.7**	9.6

(b) Operating leases as a lessor

Operating lease rentals receivable from agreements classified as property, plant and equipment, as disclosed in Note 17, are receivable as follows:

	Group 2018 £m	Company 2018 £m	Group 2017 £m	Company 2017 £m
Less than 1 year	**8.4**	**8.2**	8.6	8.6
Between 1 and 5 years	**16.2**	**15.8**	16.7	16.5
More than 5 years	**0.9**	**0.9**	1.5	1.5
Total leases as lessor	**25.5**	**24.9**	26.8	26.6

36. Capital commitments

The Group and Company had no capital commitments as at 31 December 2018 (2017: £nil).

37. Contingent liabilities

See accounting policies in Note 1.7(w)

Part of the Group's business is regulated by the Consumer Credit Act (CCA), which contains very detailed and highly technical requirements. The Group continues to commission external reviews of its compliance with the CCA and other consumer regulations. The Group has identified some areas of potential non-compliance which are not considered to be material. While the Group considers that no material present obligation in relation to non-compliance with the CCA and other consumer regulations is likely, there is a risk that the eventual outcome may differ.

The Group's Consumer Lending division is exposed to risk under Section 75 of the CCA, in relation to any misrepresentations or breaches of contract by suppliers of goods and services to customers where the purchase of those goods and services is financed by the Group. While the Group would have recourse to the supplier in the event of such liability, if the supplier becomes insolvent then that recourse would have limited value.

[1] Pollen Street Capital Limited are the ultimate parent company of Shawbrook Group Plc, the Company's parent company.

38. Financial guarantee contracts and loan commitments

See accounting policies in Note 1.7(x)

Financial guarantee contracts

In 2015, the Group entered into a financial guarantee contract to an amount of £2.5 million. This contract is a continuous obligation which may be terminated by the Group on giving three months written notice.

Loss allowance for financial guarantee contracts is £nil (2017: £nil), because the contract is fully collateralised through a first fixed charge over a blocked deposit account. As such, the amount the Group should have to pay should the guarantee be called upon is £nil (2017: £nil).

Loan commitments

The below table shows an analysis of movements in the loss allowance in respect of loan commitments during 2018 under IFRS 9:

Group and Company	Stage 1 £m	2018 Total £m
As at 1 January	-	-
Impact of adopting IFRS 9[1]	**0.5**	**0.5**
Restated balance as at 1 January	**0.5**	**0.5**
Movements in loss allowance		
New financial assets originated or purchased	**0.6**	**0.6**
Financial assets that have been derecognised	**(0.1)**	**(0.1)**
Total movement in loss allowance	**0.5**	**0.5**
As at 31 December	**1.0**	**1.0**

39. Country by country reporting

The Capital Requirements (Country by Country Reporting) Regulations 2013 came into effect on 1 January 2014 and place certain reporting obligations on financial institutions that are within the scope of the Capital Requirements Directive IV.

Shawbrook Bank Limited and its subsidiaries are all UK or Channel Island registered entities. The activities of the Group and its subsidiaries are detailed in the strategic report and Note 33.

Required disclosures for the Group are summarised below:

Group	2018	2017
Net operating income (£m)	**272.9**	238.1
Profit before taxation (£m)	**110.3**	99.5
Income taxation charge (£m)	**28.3**	25.3
Tax paid (£m)	**26.4**	29.5
Average number of employees on a full-time equivalent basis	**731**	671

The Group received no public subsidies during the year (2017: £nil).

40. Post balance sheet events

There have been no significant events between 31 December 2018 and the date of approval of the 2018 Annual Report and Accounts that require a change or additional disclosure in the financial statements.

[1] See Note 1.6(a) and Note 2 for details.

Other information

Abbreviations

ALCo	Asset and Liability Committee
bps	Basis point
CCA	Consumer Credit Act
CET1	Common Equity Tier 1
CGU	Cash generating unit
CRD IV	Capital Requirements Directive IV
EAD	Exposure at default
EBA	European Banking Authority
ECL	Expected credit loss
EU	European Union
FCA	Financial Conduct Authority
FVOCI	Fair value through other comprehensive income
FVTPL	Fair value through profit or loss
GDPR	*General Data Protection Regulation*
IAS	International Accounting Standard
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standard
ILAAP	Internal Liquidity Adequacy Assessment Process
LCR	Liquidity coverage ratio
LGD	Loss given default
LIBOR	London Inter Bank Offer Rate
LTV	Loan-to-value
MREL	Minimum requirements for own funds and eligible liabilities
NSFR	Net stable funding ratio
PD	Probability of default
POCI	Purchased or originated credit-impaired
PRA	Prudential Regulation Authority
PRC	Prudential Regulation Committee
RMF	Risk Management Framework
RRP	Recovery Plan and Resolution Pack
SME(s)	Small and medium enterprise(s)
SPPI	Solely payments of principal and interest on the principal amount outstanding

Other information (continued)

Alternative performance measures

Certain financial measures disclosed in the Annual Report and Accounts do not have a standardised meaning prescribed by International Financial Reporting Standards (IFRS) and may therefore not be comparable to similar measures presented by other issuers. These measures are deemed to be 'alternative performance measures'. Definitions of the Group's key performance indicators are set out below:

Average principal employed	The average of monthly closing loans and advances to customers (net of loss allowance / impairment allowance[1] and fair value adjustments for hedged risk) and assets on operating leases included in property, plant and equipment.
Common Equity Tier 1 (CET1) capital ratio[2]	CET1 capital, divided by, risk-weighted assets.
Cost of risk	Impairment losses on financial assets, divided by, average principal employed.
Cost to income ratio	The sum of administrative expenses and provisions for liabilities and charges, divided by, net operating income.
Gross asset yield	The sum of interest and similar income, net income from operating leases, net fee and commission income and net gains on financial instruments mandatorily at fair value through profit and loss, divided by, average principal employed.
Leverage ratio[2]	Total Tier 1 capital, divided by, total leverage ratio exposure measure. Total leverage ratio exposure measure is total assets excluding derivatives and intangible assets, and adjusted for off-balance sheet items such as pipeline and undrawn collateral, exposure value for derivatives and transitional adjustments[3].
Liability yield	Interest expense and similar charges, divided by, average principal employed.
Liquidity coverage ratio[4]	Liquidity buffer, divided by, total 30-day net cash outflows in a standardised stress scenario.
Loans and advances to customers	The sum of loans and advances to customers (net of loss allowance / impairment allowance[1] and fair value adjustments for hedged risk) and assets on operating leases included in property, plant and equipment.
Management expenses ratio	The sum of administrative expenses and provisions for liabilities and charges, divided by, average principal employed.
Net interest margin	Net operating income, divided by, average principal employed.
Ratio of past due over 90 days and impaired loans	Sum of loans and advances to customers classified as over 90 days past due and loans and advances to customers classified as impaired assets, divided by, total gross loans and advances to customers.
Ratio of Stage 3 loans	Total of loans and advances to customers classified as Stage 3, divided by, total gross loans and advances to customers.
Return on lending assets after tax	Profit after taxation, divided by, average principal employed.
Return on lending assets before tax	Profit before taxation, divided by, average principal employed.
Return on tangible equity	Profit after taxation (adjusted to deduct distributions made to holders of capital securities), divided by, average tangible equity. Average tangible equity is calculated as, total equity less capital securities and intangible assets at the beginning of the period, plus total equity less capital securities and intangible assets at the end of the period, divided by two.
Total capital ratio[2]	Total regulatory capital, divided by, risk-weighted assets.
Total Tier 1 capital ratio[2]	Total Tier 1 capital, divided by, risk-weighted assets.

[1] Loss allowance in 2018 reflect expected credit losses calculated in accordance with IFRS 9. Impairment allowance in 2017 reflect impairment losses calculated in accordance with IAS 39.

[2] See Section 12 of the risk management report for further details.

[3] The year ended 31 December 2018 includes adjustments for phasing in the impact of IFRS 9 adoption in accordance with EU regulatory transitional arrangements.

[4] See Section 6 of the risk management report for further details.