**RIS Announcement**

**Date 26 March 2013**
**On behalf of: OneSavings Bank plc ("the Bank")**

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## OneSavings Bank plc

## Final results for the year ended 31 December 2012

OneSavings Bank plc ("OSB"), the mutual Bank, announces its Group results for the year ended 31 December 2012.

The highlights for the year are:

- Andy Golding appointed permanent Chief Executive from 3 January 2012 and Stephan Wilcke appointment Chairman from 28 February 2012
- A post tax profit of £8.0m (post tax loss of £11.1m for the prior period[1])
- Positive net interest margin ('NIM') of £15.7m reflecting the positive impact of higher margin new lending and acquired mortgages (prior period negative NIM of £1.4m)
- A management expense ratio[2] of 0.72% (prior period annualised 0.88%) reflecting continued focus on the Group's cost base
- Total assets of £3bn up 28% during the year as a result of new organic origination and mortgage book and company acquisitions
- Four mortgage book purchases during the year for a total of £283m with a gross value of £355m
- Additional mortgage assets fair valued at £106m acquired through the purchase of the Interbay Group, a specialist small and medium enterprise mortgage lender in August 2012 and Prestige Finance Limited and its sister company Swingcastle Limited, second charge mortgage lenders in September 2012
- Further capital injection[3] of £15m on 30 June 2012
- Equity as at 31 December 2012 of £114.0m (31 December 2011 £89.4m)
- Total capital ratio of 14.0% as at 31 December 2012 (31 December 2011 15.2%)

[1] The prior period refers to the period from incorporation to 31 December 2011. OneSavings Bank began trading as a bank on 1 February 2011 when the trade and assets of Kent Reliance Building Society were transferred into the business

[2] Administrative expenses, including depreciation, expressed as a percentage of average total assets

[3] Received from OSB Holdco Ltd a shareholder of OSB owned by funds advised by J.C. Flowers & Co. LLP

**Commenting on the results and outlook, Stephan Wilcke, Chairman of OneSavings Bank plc, said:**

"I am delighted that the turnaround in OSB's financial position has been achieved significantly quicker than planned, resulting in a full year profit after tax of £8.0m for the year.

A key driver of the change in profitability was the benefit from negative goodwill on acquisitions. However it is especially pleasing to note that net interest margin, which has improved every quarter of the year, is now very significantly positive.

Another major milestone achieved during 2012 has been a move away from requiring a formal letter of support from our shareholder. OSB's directors are now able to sign off the business as a going concern without this additional comfort. This is a significant achievement in the turnaround of the Bank.

The underpinning of this financial turnaround has been a significant focus on and improvement in other dimensions including our product offering and internal control, risk management and

governance frameworks. In addition, we now have a fully functioning and complete team of motivated and capable executives, who have tackled a virtual re-build of the organisation's operating model to create a solid platform to continue our growth."

**Andy Golding, Chief Executive of OneSavings Bank plc, added:**

"The year has been one of growth, change, people and diversification. The Board and staff have worked extremely hard during the year to put the business on a growing and firm foundation and I would like to thank them for their dedication. Our ability to focus on supporting growth in lending to small and medium enterprises, deliver value for money to our members and customers whilst turning around the financial position of the Bank significantly faster than planned, shows that our hybrid model based on mutual roots works. It is our intention to become a large-scale niche mortgage lender through taking advantage of our capability, the current market opportunities and our enviable access to capital and funding to deliver that growth. I am delighted with the 2012 outturn, and with the significant uplift in net interest income, which provides a firm bedrock on which to continue to build a strong and profitable business during 2013. I remain very excited about the opportunities ahead of us and the opportunity to create a real challenger to the homogeneous big banks."

**ENDS**

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**About OneSavings Bank plc**

- Kent Reliance, krbs.com, Reliance Property Loans, Jersey Home Loans, Guernsey Home Loans, Interbay Group, Prestige Finance Limited and Swingcastle Limited are all trading names of OneSavings Bank plc. The Bank originates from mutual roots and has operated for over 150 years. Today, it operates as a hybrid offering long term sustainable value for money, but with the capital advantages of a bank.
- OneSavings Bank plc is registered at Reliance House, Sun Pier, Chatham, Kent (registered number 7312896) and is authorised and regulated by the Financial Services Authority (registered number 530504).
- One Savings Bank plc is a member of the Council of Mortgage Lenders.
- OneSavings Bank plc is a member of the Financial Services Compensation Scheme.
- OneSavings Bank plc was formed as Sevco 5067 Limited on 13 July 2010; it changed its name to OneSavings Limited on 3 August 2010 and was converted to OneSavings plc on 8 October 2010 and became OneSavings Bank Plc on 1 February 2011 and, following confirmation by the members of Kent Reliance Building Society (KRBS) and the Financial Services Authority (FSA), began trading as a bank on this date when the trade and assets of KRBS were transferred into the business.

## Chairman’s Statement

OneSavings Bank plc (‘OSB’) was created in 2011 through the rescue of the failing Kent Reliance Building Society (‘KRBS’) by funds advised by private equity firm J.C. Flowers & Co. LLP (‘JC Flowers’) to create a hybrid mutual bank. OSB continued to enjoy further capital injections from JC Flowers in 2011 and 2012 and while the 2011 capital injection was required to offset trading losses from the back book inherited from KRBS, the capital support in 2012 was dedicated towards supporting growth in lending to small and medium enterprises (SMEs) and consumers, and for acquisitions.

The turnaround in OSB’s financial position has been achieved significantly quicker than planned, resulting in a full year profit after tax of £8.0m.

A key driver of the change in profitability was the benefit from negative goodwill on acquisitions. However it is especially pleasing to note that net interest margin, which has improved every quarter of the year, is now very significantly positive providing a solid platform to continue to build a strong and profitable business during 2013.

Another major milestone achieved during 2012 has been a move away from requiring a formal letter of support from our shareholder. OSB’s Directors are now able to sign off the business as a going concern without this additional comfort. This is a significant achievement in the turnaround of the business.

As Andy Golding elaborates in his report, the underpinning of this financial turnaround has been a significant focus on and improvement in other key dimensions. We now have a fully functioning and complete team of motivated and capable Executives, who have tackled a virtual re-build of the organisation’s operating model to create a solid platform to continue our growth.

It is our intention to become a large-scale niche mortgage lender through taking advantage of our capability, the current market opportunities and our enviable access to capital and funding to deliver that growth.

2012 was about recruiting and settling in a completely new senior team, tackling immediate priorities that stood in the way of our plans, shoring up our risk management capabilities and the control environment and achieving growth through both organic lending and tactical and strategic acquisitions.

It is pleasing to report that our strategy is delivering ahead of plan and I would like to thank Andy and all the staff at OSB for their hard work and energy as well as our customers for their continued loyalty.

**Stephan Wilcke**
Chairman

# Chief Executive's Report

I am delighted to report on the OneSavings Bank plc group (the 'Group') accounts for 2012, after my first full year as Chief Executive. In essence I would characterise the year as one of growth, change, people and diversification.

The key financial achievements are detailed below. They show strong improvement in all key measures. The Group is now profitable and we expect this to continue in 2013. We have worked hard on both acquisitions and organic growth, resulting in a significant improvement to our net interest income. Our cost base has been a key management focus and we have achieved a lower overall management expense ratio than in the prior period. Our asset base now exceeds £3bn and we maintain healthy liquidity and capital ratios.

| Profit / (loss) after tax | Increased by £19.1m |
|---|---|
| Net interest margin | Up by 70bps |
| Total assets | Increased by £653m |
| Management expense ratio | Down by 16bps |

The Group has expanded during the year. As we diversify, we continue to build on our Balanced Business Scorecard (BBS) philosophy to track our performance in the areas which are important to the Board. These are key to delivering a quality customer proposition, a strong mortgage lending offering and a safe home for our customers and members to deposit their savings.

We divide the measurement of the business into equally-weighted quadrants:

- **Customers and members** – a strategic and operational desire to have our customers' needs at the heart of everything we do.
- **Quality** – to never forget that our customers and members entrust us to safeguard their interests and their money. Therefore a cultural and diligent approach to risk management is central to our plans.
- **Staff** – great service is provided by great people. The engagement, development and management of staff is critical.
- **Financial** – a key focus and one which in my view is principally driven by the above three categories.

The BBS headings have been used to frame the balance of this report.

### Customers and members

Our raison d'être is to provide long-term value for money savings products and use our funding to provide loans to SME businesses and consumers secured on property. This is a business model that has stood the test of time and with the undersupply of products currently available we have made use of this opportunity to grow.

Following feedback from members and customers about what they didn't like, we made some core changes to our savings proposition during 2012. We did away with introductory bonus accounts in favour of long-term value for money rates. We removed barriers to moving money around inside the Group, and now have no "new customer only" offers. This strategy enabled us to grow our deposit base in 2012 with £663m growth in retail savings balances and over 20,000 new savings customers coming to the Kent Reliance brand in 2012.

We opened a new Kent Reliance branch in 2012 in the centre of Canterbury. The branch has already become our fastest growing outlet. We continue to seek a new retail unit for our small Hempstead Valley outlet.

In mortgage lending terms the Group had a record year in 2012, with over £300 million of new loans made through the Kent Reliance brand. In addition we expanded our customer offering through acquisition. In the summer of 2012 we completed on the purchase of two new lending operations for the Group. The Interbay Group, based in Fareham in Hampshire, specialises in mortgages to SME businesses to help fuel economic growth and Prestige Finance Ltd is a second charge mortgage lender based near Watford which is expected to re-launch into the market in March 2013. Both of these firms came with strong existing loan portfolios and the structure of these transactions helped the Group to generate our profitability in 2012.

We have also been engaging with members and customers during 2012 to find out more about how they want us to improve our service. Whilst feedback on our branches is excellent, it became clear that both our online offering and our offshore call centres needed work.

In late 2012 the process commenced to consolidate our two offshore centres into a single office in Bangalore, coupled with raising standards in terms of recruitment and the training regime undertaken by our staff. It is pleasing to report that the early signs are positive, with customer satisfaction scores improving month on month during the $4^{th}$ quarter of 2012.

Our online offering is the subject of a wider strategic review and during 2013 we will invest in core system development and replacement. This will enable us to improve the way our members and customers can make use of us and their accounts online.

Board members will be seeking to hear more from members on our journey and what else should be a focus at the Kent Reliance Provident Society AGM in June 2013.

**Quality**

The staff have worked hard during 2012, refreshing a number of our core processes to help make the business more efficient for our growth plans.

Whilst planning the offshore site consolidation mentioned above, we also re-worked our savings and investment processes to cope with the unprecedented demand for our extremely competitive savings products.

We introduced a new online case submission system for mortgages, enabling brokers to submit and track their cases electronically, cutting down on paper flow and speeding up the process. Whilst doing this we increased our mortgage underwriting headcount and reviewed the related processes. This has been instrumental in assisting us to write our mortgage volumes in 2012. There is still more work to do in this area and our focus on replacing core mortgage processing systems will help enable us to continue to grow whilst improving customer and broker satisfaction.

The Group’s treasury and risk functions have been completely re-built during 2012 to enable us to respond faster and more intelligently to rapidly changing market conditions and we are working with our internal auditors to embed a risk management framework throughout the business, looking top down starting with our customers’ needs and bottom up from our core systems and processes.

The Bank now has a head office IT replica functioning at a secure site in Sittingbourne in Kent. This disaster recovery unit has been fully tested and will enable continued operation in the event of a major issue with the Sun Pier building.

**Staff**

The staff at OneSavings Bank and Kent Reliance have continued to show loyalty and customer focus. As stated in the brief CEO report in the 2011 report and accounts, at the beginning of 2012 many of the senior staff were interim contractors.

During the first six months of 2012 we achieved the recruitment of a talented and focused senior team, including a new Finance Director, Chief Risk Officer, Operations Director and Sales and Marketing Director. Each of these new incumbents quickly found their feet and got to grips with their parts of the change program required to transform the business.

In early 2013 a new Chief Operating Officer joined to manage our acquired companies and third party servicing relationships, as has a new Chief Technology Officer who will work with us to upgrade our systems. We have also strengthened our credit risk management capability with the addition of a new Chief Credit Officer.

The Group now has the senior team capable of managing its strategy and growth and making the transition into a connected banking business with multiple customer-focused propositions in the secured and mortgage lending market place.

**Financial**

The Group's results are still impacted by the low income returned by the back book of mortgages of KRBS and will continue to suffer from this until interest rates return to what was once regarded as more normal levels. However our acquisition and growth strategy is a demonstration of the strength of the new business model, effectively diluting the lack of profitability in the back book.

The Directors' Report and the accounts contain full details on the financial results, however it is extremely pleasing to have returned profit more quickly than anticipated.

The Group's ongoing focus will be on mortgage and deposit growth to increase net interest income and further acquisitions where we see continuing opportunities to make tactical and strategic acquisitions that both generate immediate income and continue to broaden and deepen the customer offering.

Whilst we have, and will continue, to invest in the business, our cost base and management expense ratio will remain a key management focus. This ensures we achieve value for money for our members and shareholders.

**Summary**

It has been a strong year for the Group with significant growth, change and building a team for the future. We now have a firm bedrock on which to continue to build and I remain very excited about the opportunities ahead of us and the opportunity to create a real challenger to the homogeneous big banks.

Finally, I would like to thank our staff for their continuing dedication, the Board for its wise counsel and support through a period of significant change and our customers and members for their loyalty.

**Andy Golding**
Chief Executive

# Directors' Report

The Directors present their report and accounts for the year ended 31 December 2012.

## Principal activities

OneSavings Bank plc ('the Bank') began trading as a bank on 1 February 2011 when the trade and assets of Kent Reliance Building Society ('KRBS') were transferred into the business.

The principal activity of the OneSavings Bank Group (the Bank, together with its subsidiaries, 'the Group') is to provide mortgage finance to its borrowers and long-term value savings products to its investors. The strategic objective of the Group is to be a provider of secured financial lending across a broad range of markets including buy to let, residential, shared ownership, second charge and SME mortgages, funded by capital and retail deposits. To that end, the Bank acquired the Interbay Group (a specialist SME mortgage lender) and Prestige Finance Limited and its sister company Swingcastle Limited (second charge mortgage lenders) during the year.

The Bank has a number of other subsidiaries including Jersey Home Loans Limited and Guernsey Home Loans Limited in the Channel Islands (which provide mortgages in Jersey and Guernsey respectively) and Easioption BPO Services Pvt Limited and Easiprocess Pvt Limited in India (which provide back office processing services to the Bank).

## Business review

The Group still faces a number of challenges inherited from KRBS, including a back book of mortgages earning very low interest rates which are below the current cost of funding retail savings products. Significant progress has been made during the year to dilute the impact of this loss making back book by originating and acquiring higher margin mortgages and as a result the Group returned to a positive net interest margin position in 2012.

The Bank significantly increased its volume of new lending completions in 2012 and ended the year with a strong pipeline. The Bank also entered into two third-party flow agreements in 2012 where it agreed to purchase newly originated mortgages over an initial twelve month period. These agreements provide the Bank with additional operational capacity and access to new distribution channels.

The Bank purchased four books of mortgages in 2012 for a total of £283m with a gross value of £355m. In addition the Bank acquired mortgage assets fair valued at £106m through the purchase of the Interbay Group, Prestige Finance Limited and Swingcastle Limited.

The Bank secured a further capital injection of £15m on 30 June 2012 from OSB Holdco Ltd, one of its shareholders owned by funds advised by J.C. Flowers & Co. LLP, to help support its growth plans.

## Principal risks and uncertainties

The Group considers a range of stress scenarios as part of its business planning and risk management. The principal risks facing the Group revolve around the UK's economic downturn and sustainable recovery, unemployment levels, and the general tightening of household budgets. Retail savings rates remain at a high level compared to the Bank of England base rate, and a large part of the Group's assets are yielding low returns linked to market rates, imposing a significant strain on profitability.

A more detailed review of the risks faced by the Group and the actions taken to mitigate them are set out in the Risk Management Report.

**Financial results**

The Key Performance Indicators used by management in determining the Group's performance are shown in the following table:

| | **Group 31-Dec-12** | **Group 31-Dec-11** |
|---|---|---|
| Profit / (loss) after tax | £8.0m | £(11.1)m |
| Net interest margin | 63bps | (7)bps |
| Management expense ratio | 0.72% | 0.88% |
| Loans and advances | £2,196m | £1,640m |
| Total assets | £3,009m | £2,356m |
| Liquidity ratio | 25.4% | 28.3% |
| Total capital ratio | 14.0% | 15.2 % |

**Profit after tax**

The Group profit after tax for the year was £8.0m (2011: loss of £11.1m, based on 11 months of trading). This included negative goodwill on acquisitions of £17.6m (2011: nil) and a gain on sales of financial instruments of £2.9m (2011: £9.0m).

**Net interest margin**

The Group returned a positive net interest margin ('NIM') position during 2012, reporting net interest income of £15.7m for the year (2011: net interest expense of £1.4m) and a net interest margin of 63bps (2011: (7)bps). This reflects the positive impact of increased growth in lending, mortgage book purchases and the two acquired companies in 2012, all of which are providing the Group with higher returns than the loss-making back book. However, NIM continues to be adversely affected by the low prevailing interest rate environment; with the Bank of England base rate remaining throughout the year at its lowest ever level of 0.5% and LIBOR also remaining low. Competition for retail funds remained intense, with retail deposit rates at record levels compared to the Bank of England base rate for much of the year, imposing a significant strain on the Group's net interest margin. Savings rates did however start to fall in the autumn following the introduction of the Funding for Lending Scheme, although mortgage rates are expected to follow suit especially in mainstream buy to let and residential products.

**Management expense ratio**

Administrative expenses including depreciation were £19.3m for the year (2011: £17.4m based on 11 months of trading). The Group continued to incur additional costs during the year to improve skill sets in the business, enhance the control framework, pursue acquisition opportunities and run the acquired companies. However, savings were also made as interims and consultants were replaced by permanent executives. Overall, the management expense ratio of 0.72% fell versus the prior period (2011: 0.88% on an annualised basis).

**Loans and advances**

Loans and advances for the Group grew by 34% during the year to £2,196m as at 31 December 2012 (31 December 2011: £1,640m) due to the book and company acquisitions and increased new lending.

**Total assets**

Total assets grew by 28% during the year to £3,009m as at 31 December 2012 (31 December 2011: £2,356m). This growth was primarily due to the growth in loans and advances as described above.

**Liquidity**

The Group's liquidity ratio at 31 December 2012 was 25.4% (31 December 2011: 28.3%). The Group operates under the FSA's Individual Liquidity Adequacy Assessment (ILAA) regime and liquidity has been maintained in excess of the FSA minimum requirement.

**Capital**

The Group's capital adequacy and capital resources were managed and monitored in accordance with the regulatory capital requirements of the FSA, the UK regulator. Further details on capital management are provided in note 30 to the financial statements. The Bank's total capital ratio as at 31 December 2012 was 14.0% (31 December 2011: 15.2%).

**Key market and economic factors affecting the business**

The mortgage market remains subdued at present and is still some way from returning to a form of normality. The savings market also remains uncertain as household incomes continue to be squeezed due to slow economic growth, severe spending cuts and limited wage growth. Inflation remains high. Given the uncertain economic outlook and with changes to regulatory reform continuing to pose challenges, margin pressure continues in the financial services industry.

Interest rates are likely to stay at low levels for the foreseeable future, with very limited likelihood for base rate increases in 2013 and the possibility of a further rate fall, causing continued impact on savers and the Group's margins. The level of interest rates does, however, have a positive impact on residential mortgage arrears and repossessions.

Despite these concerns the Group is well placed to take advantage of profitable origination and acquisition opportunities that may present themselves during the year.

**Financial risk management objectives and policies**

During the year the Group offered mortgage and savings accounts together with wholesale money market investment and borrowing. There are formal structures in place to monitor, report upon and manage the risks associated with these activities. The financial instruments used by the Group to manage the structure of the balance sheet and to mitigate risks are disclosed in note 28 to the financial statements.

**Creditor payment policy**

The Group's policy concerning the payment of its trade creditors is to pay within the agreed terms of credit, usually 30 days from invoice, once the supplier has discharged its contractual obligations. These terms of payment were settled with suppliers when agreeing the terms of each transaction.

**Charitable donations**

Charitable donations made during the year amounted to £2,870 (2011: £5,000). The Group has made donations to various Kent charities. No political donations were made during the year (2011: £nil).

**Directors**

The full list of Directors serving on the Board during the year to 31 December 2012 was as follows:

R Duke (Independent Director, appointed 4 July 2012)
A Golding (Chief Executive)
T Hanford
M McCaig (Chairman of the Audit Committee from 30 May, previously Chairman of the Board)
Sir C McCarthy
D Mills (Senior Independent Director)
Dr D Morgan
A Newell (Chairman of the Audit Committee, resigned 29 May 2012)
A Talintyre (Finance Director, appointed 26 June 2012)
S Wilcke (Chairman of the Board from 28 February 2012, previously Independent Director)
P Williams
J Wood (Interim Chief Executive, resigned 10 January 2012)

As at 31 December 2012 no Director held, or had held during the period, any beneficial interest in the shares of any connected undertaking of the Group. On 28 February 2012, S Wilcke replaced M McCaig as Chairman of the Board of Directors. M McCaig replaced A Newell as Chairman of the Audit Committee following his resignation.

**UK Corporate Governance Code**

The Board remains committed to the achievement of high standards of corporate governance which it considers to be central to the effective management of the Group and to maintaining the confidence of investors. Considerable progress has been made during the year to continue to develop appropriate and adequate corporate governance arrangements.

**Going concern**

In preparing the financial statements the Directors must satisfy themselves that it is reasonable for them to consider whether it is appropriate to adopt the going concern basis.

The Directors have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. Projections for the Group have been prepared covering its future performance, capital and liquidity for a period in excess of 12 months from the date of approval of these accounts. These projections show that the Group has sufficient capital to continue to meet its regulatory capital requirements as set out by the Financial Services Authority. Therefore, the going concern basis of accounting has been used to prepare the financial statements.

**Auditors**

KPMG Audit Plc has remained in place as auditor of the Group.

On behalf of the Board

**Stephan Wilcke**
Chairman

# Risk Management Report

## Introduction

A core objective for the Group is the effective management of risk in order to protect depositors, borrowers and shareholders, and to ensure that the Group at all times has adequate capital and liquidity resources. Given the nature of the activities undertaken, the key risks that the Group faces are credit risk, market risk (including interest rate risk), liquidity risk and operational risk. The Group has a Chief Risk Officer who is responsible for ensuring each risk is adequately identified, monitored, managed and/or mitigated.

The Board is responsible for ensuring that an effective risk management framework is in place. The risk management framework consists of five key components:

1. **Strategy and Risk Appetite**: The Board's articulation of strategic intent and risk appetite, complemented by targets and risk limits set by the executive management.
2. **Organisation:** Clear roles, responsibilities, reporting lines, committees and mandates.
3. **Policies and Procedures:** A comprehensive set of risk policies, processes and control procedures.
4. **Reporting and Analytics:** Comprehensive and timely management reporting of risk exposures.
5. **IT, Systems and Data:** Robust IT systems and data quality.

To support the risk management framework, the Group operates a "three lines of defence" model:

- The first line of defence comes through the operational management in the business, which maintains appropriate systems and controls that are effectively implemented on a day-to-day basis.

- The second line of defence comprises Risk and Compliance as well as the governance and oversight carried out by the committees is shown below.

- The third line of defence is independent assurance checking and challenge. This is provided by Internal Audit and the external audit assurance reviews. Assurance reporting is provided to the Audit Committee.

The Group's risk committee structure ensures proper governance and oversight and is illustrated below.

**Risk oversight and committee structure**

| | **Board, Risk Committee and Audit Committee** | | | |
|---|---|---|---|---|
| | **Executive Committee** | | | |
| | **Credit Risk** | **Market Risk (incl. Interest Rate Risk)** | **Liquidity Risk** | **Operational Risk** |
| **Governance** | Credit committee | ALCO | ALCO | Operational Risk Committee |
| **Key control documents** | Lending, Arrears Handling and Provisions Policies | Interest Rate Risk and Treasury Policies | Liquidity Policy and ILAA document | Operational Risk Policy |
| **Management information** | Credit MI Pack | ALCO MI Pack | ALCO MI Pack | Operational Risk Update |

* A sub-committee of the Operations Committee

Inorganic growth, acquisition of both mortgage portfolios and whole secured lending businesses, is an important part of the Bank's strategy. In addition to the committee structure shown in the preceding diagram the Bank has established an Executive Mergers and Acquisitions Committee (EMAC) which meets regularly to coordinate internal stakeholders, ensure due diligence covers all relevant aspects and oversee delivery of integration plans for completed deals. EMAC is chaired by the Chief Risk Officer.

**Credit risk**

Credit risk is the risk that unexpected losses may arise as a result of the Group's borrowers or market counterparties failing to meet their obligations. The Group's exposure to retail and commercial credit risk is managed by the Credit Committee which reports to the Executive Committee and the Risk Committee. The Group's exposure to wholesale and counterparty credit risk is managed by the Asset and Liability Committee (ALCO) which reports to the Risk Committee and the Board.

**Retail and wholesale credit risk**

Credit risk is managed within the Group's underwriting process, which seeks to ensure that borrowers only take on a debt they can afford to repay, safeguarding both the borrower and the Group. On occasions, borrowers find themselves in financial difficulties which impact their ability to meet their mortgage or loan service obligations. The Group has established procedures to manage such situations to a satisfactory conclusion, which adhere to the principles of Treating Customers Fairly. Usually this involves working with the borrower to clear arrears or making other arrangements commensurate with the borrower's circumstances. In rare cases where the situation deteriorates significantly and irreparably, the Group takes possession of the underlying security.

In situations where the Group determines that it is appropriate in order to meet borrower needs, it applies a policy of forbearance and may grant a concession. The Group considers forbearance on a case by case basis. This may arise where the Group considers that the financial stress of the customer is temporary and potentially recoverable. Such a concession, which will only be implemented after obtaining the borrower's consent, may involve capitalisation of arrears, temporary or permanent conversion to an interest only repayment basis, a reduced monthly payment or a mortgage term extension. By dealing with arrears at an early stage and monitoring continuously it is anticipated that a lower level of long-term arrears will be achieved, resulting in a more favourable outcome for both the customer and the business. Forbearance measures are considered in the review of loan impairment provisions.

**Table 1: Forbearance measures undertaken during the financial year**

| | Number | Loan Balance £'000 | Year-end arrears £'000 |
|---|---|---|---|
| Capitalisation | 69 | 7,804 | 62 |
| Temporary or permanent switch to interest only | 117 | 13,006 | 1,658 |
| Reduced monthly payments | 19 | 967 | 850 |
| Loan term extension | 3 | 2,222 | 2,222 |
| Assistance with voluntary sale of property | 18 | - | - |
| **Total** | **226** | **23,999** | **4,792** |
| **Percentage forborne** | **0.82%** | **1.03%** | **3.63%** |

| | | |
|---|---|---|
| **Collective provision** | **35** | **25** |
| **Specific provision** | **1** | **37** |

*Note: Includes acquired companies from the date of acquisition*

**Wholesale and counterparty credit risk**

Wholesale and counterparty credit risk arises from the risk that counterparties will be unable to repay loans and other financial instruments that the Group holds as part of its liquidity portfolio or for hedging purposes. This risk is managed by restrictions on the type of assets held, assessment of the creditworthiness of counterparties, maintenance of exposure limits with each counterparty, sector limits and collateral posting for derivatives. The Group has no direct exposure to the countries most affected by the Eurozone crisis (i.e. Portugal, Ireland, Italy, Greece and Spain) and very limited indirect exposure (less than £1m as at 31 December 2012). The Group has limited exposure to emerging markets (Indian operations) and non-investment grade debt, including investments with other building societies.

The Group's exposure to wholesale and counterparty credit risk is managed by the ALCO, which reports to the Risk Committee and the Board.

Further analysis of the Group's exposure to credit risk is provided in note 28 to the accounts.

**Market risk (including interest rate risk)**

Market risk is the risk of an adverse change in Group income or the Group's net worth arising from movement in interest rates, exchange rates or other market prices. Market risk exists, to some extent, in all of the Group's businesses. The Group recognises that the effective management of market risk is essential to the maintenance of stable earnings and preservation of customer value.
The primary market risk faced by the Group is interest rate risk. Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. It is most prevalent in mortgage lending where fixed rate mortgages are not funded by fixed rate deposits of the same duration, or where the fixed rate risk is not hedged by a fully matching interest rate derivative.

The Group is exposed to movements in interest rates reflecting the mismatch between the dates on which interest receivable on assets and interest payable on liabilities are next reset to market rates or, if earlier, the dates on which the instruments mature. The Group manages its interest risk exposure on a continuous basis through the use of derivatives within limits set by the ALCO and the Board.

The secondary market risk faced by the Group is basis risk. Basis risk arises when the Group finances an asset with a liability which re-prices from a different interest rate index. The Group manages this exposure on a continuous basis within limits set by the ALCO.

Further analysis of the Group’s exposure to interest rate risk is provided in note 28 to the accounts.

**Liquidity risk**

Liquidity risk is the risk of having insufficient liquid assets to fulfil obligations as they become due or of the cost of raising liquid funds becoming too expensive.

The Group's approach to managing liquidity risk is to maintain sufficient liquid resources to cover cash flow imbalances and fluctuations in funding in order to retain full public confidence in the solvency of the Group and to enable the Group to meet its financial obligations. This is achieved through maintaining a prudent level of liquid assets, through wholesale funding facilities and control of the growth of the business.

Liquidity management is governed by the Treasury Policy, which is developed, implemented and monitored by the ALCO, which also sets limits over the level and maturity profile of wholesale funding and monitors the composition of the Group balance sheet. A series of liquidity stress tests are performed daily to confirm that the limits are not at risk of being breached. Day-to-day management is delegated to the Treasury function.

Further analysis of the Group’s exposure to liquidity risk is provided in note 28 to the accounts.

**Operational risk**

Operational risk, which is inherent in all business activities, is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, or systems or from external events. It can occur in any of the Group’s businesses and includes errors, omissions, natural disasters and deliberate acts such as fraud. The Group manages this risk within an overall governance and control strategy. Within this structure, potential risk exposures are assessed to determine the appropriate type of controls to be applied. It is recognised that such risks can never be entirely eliminated and that the cost of controls in minimising these risks may outweigh the potential benefits. However, where required, the Group continues to invest in risk management and mitigation such as business continuity management and incident management. Each business area or function has appointed an operational risk champion who is responsible for the day-to-day identification and reporting of operational risk incidents. The Operational Risk Committee is responsible for the development, implementation and monitoring of the Operational Risk Policy.

**Conduct risk**

Conduct risk arises from the way the Group interacts with its customers and manages customer relationships. Conduct risk can arise through the design of products that do not meet customers’ needs, barriers to sale of a product or exit, mishandling of complaints where the Group has behaved inappropriately towards its customers and inappropriate sales processes. Conduct risk has been a key focus of the FSA and will be at the centre of the new Financial Conduct Authority’s approach to regulation.

One of the Group’s key strategic drivers is to put the customer at the heart of everything we do, and indeed this is one of the key metrics by which we measure our success. The Group has developed and implemented a framework to enable it to deliver the right outcomes for its customers which is supported by policies and standards in key areas, including product governance, customer treatment, responsible lending, customers in financial difficulties, claims and complaints handling.

### Regulatory risk

Regulatory risk is the risk of regulatory changes and enforcement, with the potential for fines and/or restrictions in business activities. Over recent years the financial services industry has seen increased regulatory scrutiny and supervision around governance, capital, liquidity and remuneration. There has also been focus on conduct and treating customers fairly. The Group regularly engages with the FSA to proactively manage this risk.

### Taxation risk

Taxation risk is the risk associated with changes in taxation law or in the interpretation of taxation law. It also includes the risk of changes in taxation rates and the risk of failure to comply with procedures required by taxation authorities. Failure to manage taxation risks could lead to an additional taxation charge.

### Internal control

The internal control processes and effectiveness are reviewed by the Board, executive management, and the Bank's internal audit team from Ernst & Young LLP.

### Capital management

The Basel Committee on Banking Supervision introduced the Basel II framework for calculating minimum capital requirements. The EU Capital Requirements Directive ("the CRD") is the means by which Basel II was implemented in the EU. In the UK this was overseen by our regulator, the FSA. Basel II encourages a risk-based approach to determining capital adequacy. By adopting more sophisticated analytical approaches, financial institutions may be able to carry less regulatory capital for credit and operational risk.

The Group adopts the provisions relating to the calculation of minimum capital requirements and has calculated its Pillar 1 minimum credit risk capital requirement on a standardised basis and operational risk capital requirement using the basic indicator approach.

The CRD requires the Group to conduct an assessment of its capital and financial resources, known as its Internal Capital Adequacy Assessment Process (ICAAP). An analysis of the components of the Group's capital is provided in note 30 to the accounts.

**Jens Bech**
Chief Risk Officer

# Corporate Governance Report

### Introduction

OneSavings Bank plc ("the Bank") is a retail bank focusing on providing a range of retail savings products and bespoke lending to SME businesses and consumers.

### The Board of Directors

Until 28 February 2012, the Board was chaired by M McCaig and constituted three Non-Executive Directors appointed by OSB Holdco Ltd (B Directors), three Non-Executive Directors (including the Chairman) appointed by Kent Reliance Provident Society (KRPS) (A Directors), two independent Non-Executive Directors and one Executive Director, being the Chief Executive Officer. From 28 February 2012, the Board was chaired by S Wilcke (who is also the Bank's executive lead on M&A activity) with M McCaig remaining on the Board as an A Director. A Newell resigned on 29 May 2012, but his role as an A Director was not replaced, and instead a further independent Non-Executive Director, R Duke, was appointed to the Board on 4 July 2012. A permanent Finance Director, A Talintyre, was appointed to the Board on 26 June 2012, and therefore at the date of these accounts the Board consisted of the Chairman, two Executive Directors, two independent Non-Executive Directors, three Non-Executive Directors appointed by OSB Holdco Ltd (B Directors) and two Non-Executive Directors appointed by KRPS (A Directors).

Representatives from each of the A and B shareholders also attend board meetings as observers to ensure that the views of both shareholders can be taken into account during Board discussions and also to ensure that the shareholders are kept informed on a timely basis. The structure of the Board and the presence of the observers ensure that the Board as a whole has a deep understanding of the views of its shareholders.

The Board meets formally monthly (with the exception of July and December in 2012), with ad-hoc meetings called as and when circumstances require.

The Board is responsible for setting the strategy for the Bank along with establishing the Bank's risk appetite and balance sheet strategy. The Board is also responsible for ensuring that there are appropriate financial and business systems and controls in place to safeguard the interests of the Bank's stakeholders. The Board is also responsible for ensuring the Bank's continuing commitment to carrying out its business fairly, honestly and openly, with a commitment to zero tolerance towards bribery.

At least once each year the Board undertakes a full strategic review of the business.

There is a formal schedule of Matters Reserved for the Board which has formally delegated authority to a number of committees, which are constituted under Board approved terms of reference. Day-to-day management of the business has been delegated to the Chief Executive Officer through the Executive Committee.

The Board has oversight of how management implement the strategy and retains control through challenge at the Board and committee meetings. All Board members receive accurate, timely and clear information to enable them to make an effective contribution to Board discussions. The scope and nature of such information is reviewed on an ongoing basis to ensure that it remains relevant and concise.

Directors have access to the advice and services of the Company Secretary, whose appointment is a matter for the Board and who is responsible for ensuring Board procedures are followed and for advising the Board, through the Chairman, on matters relating to governance.

**Board and Board Committee attendance record**

A table showing attendance at scheduled meetings is shown below. Against each Director's name is shown the number of meetings he or she attended in the year to 31 December 2012. The number in brackets is the maximum number of scheduled meetings that the Director was eligible to attend.

| Directors | Board | Audit | Risk | Remuneration | Nomination |
|---|---|---|---|---|---|
| | | | | | |
| R Duke | 5(6) | 3(3) | 3(4) | - | - |
| A Golding | 12(12) | - | - | - | - |
| T Hanford | 10(12) | - | 5(9) | 2(2) | - |
| M McCaig | 12(12) | 3(3) | - | - | 1(1) |
| Sir C McCarthy | 8(12) | 4(5) | - | - | - |
| D Mills | 11(12) | 5(5) | - | 2(2) | 1(1) |
| D Morgan | 11(12) | - | - | - | 1(1) |
| A Talintyre | 7(7) | - | 6(6) | - | - |
| S Wilcke | 12(12) | - | 7(9) | - | 1(1) |
| P Williams | 11(12) | - | - | 2(2) | - |
| A Newell | 5(5) | 2(2) | 4(4) | - | - |

**Board balance and independence**

The Board consists of the Chairman, two Executive Directors and seven Non-Executive Directors, two of which were considered by the Board to be independent in accordance with the criteria of the UK Code on Corporate Governance during the period, R Duke and D Mills. The size and composition of the Board is kept under review to ensure an appropriate balance of skills and experience is represented on the Board. Non-Executive Directors play a vital role in challenging and helping develop strategy, while providing independent judgement, experience and knowledge.

In addition to his responsibilities as Chairman, S Wilcke is the Bank's executive lead on mergers and acquisitions activity.

The Board appointed D Mills to fulfil the role of Senior Independent Director.

**Chairman and Chief Executive**

The roles of Chairman and Chief Executive are held by different persons and their respective purposes are clear and distinct. The role of each is set out in their contracts and further detailed in the Board Manual. The Chairman is responsible for leading the Board and ensuring it acts effectively and communicates with shareholders; the Chief Executive has overall responsibility for managing the Group and for implementing the strategies and policies agreed by the Board. The Chairman is elected by the Board and the Board is satisfied that during the period the Chairman was able to commit sufficient time to the Bank, despite the Chairman taking on further significant outside commitments during the period of these accounts.

**Appointments to the Board**

The Directors' Report details the appointments to and resignations from the Board.

The Board has a Nominations Committee to lead the process for Board appointments and succession planning. At least annually the Committee reviews the structure, size and composition of the Board to ensure that it contains the required balance of skills, knowledge and experience relevant to the

business. The Nominations Committee is also responsible for assessing potential Executive candidates identified by the CEO.

When searching for suitable Board candidates, the Nominations Committee will have regard to the existing skills matrix of the Board and look for candidates whose skills complement and enhance those already in place. The Nominations Committee will also have regard to the benefits of having a diverse Board, both in terms of ethnicity and gender. All Directors must meet the FSA's fit and proper standards and be registered with the FSA as an approved person to carry out the Controlled Function of a Director. Candidates for Board positions are identified in a number of ways, including the use of external search consultants and, where appropriate, open advertising.

**Re-election**

Directors are required to submit themselves for re-election at the first Annual General Meeting after their appointment and at least once in every three years thereafter. Succession planning for both Executive and Non-Executive members is reviewed and updated annually.

**Performance evaluation**

The Board undertakes a formal annual evaluation of its own performance and that of its Committees and individual Directors. Individual Non-Executive Directors are assessed on a one to one basis by the Chairman. The Chairman evaluates the Chief Executive's performance and the Senior Independent Director evaluates the Chairman's performance.

**Board committees**

The Board has established a number of committees with their own terms of reference, which are reviewed at least annually. The principal Board committees are set out below.

- The Audit Committee was chaired by A Newell until 29 May 2012 and thereafter by M McCaig. The Committee met quarterly to consider all Group audit matters, the system of internal control, financial reporting and whistle blowing.
- The Risk Committee was chaired by S Wilcke until 4 July 2012 and thereafter by R Duke. The Committee met monthly or as required to monitor the Group's overall exposure to risk. It oversaw the identification and management of risks across the Group and the monitoring of operational, credit, liquidity and market risks.
- The Remuneration Committee chaired by T Hanford considered the terms and conditions, and fees of Executive and Non-Executive Directors and Executive staff salaries.
- The Nominations Committee chaired by D Mills was responsible for keeping under review the size, structure and composition of the Board; nominating candidates to fill Board and Executive vacancies, taking into account the balance of skills, knowledge and experience on the Board; and for making appropriate recommendations to the Board.

Each of the newly acquired subsidiaries have monthly management meetings, attended by key members of the Bank's Executive team and quarterly Board meetings. At least one of the Bank's Executive team is a member of each subsidiary Board to ensure appropriate oversight and control.

**System of internal controls**

The Board is responsible for determining the Group's strategy for managing risk and overseeing its systems of internal control, and is committed to embedding internal control and risk management into the operation of the Bank. The Board has delegated oversight of internal control to the Audit

Committee. The Chief Executive Officer and the Executive management are responsible for designing, operating and monitoring risk management and internal controls.

The Board formally approves the Bank's risk appetite and management policy framework. The systems are designed to manage the risk within the Bank's risk appetite rather than eliminate the risk that the Bank does not meet its business objectives. The key risks facing the Bank, and the systems it has in place to manage those risks, are set out in the Risk Management Report.

The Bank has a Chief Risk Officer who heads up the Bank's Risk Function. The Chief Risk Officer provides monthly reports to the Board on key risks within the business and the effectiveness of controls in place to mitigate such risk.

The Bank has a Chief Legal and Compliance Officer who heads up the Bank's Compliance Function, supported by the Head of Compliance. The Chief Legal and Compliance Officer provides monthly reports to the Board on key compliance issues identified through thematic reviews and ongoing monitoring, along with an update on key regulatory developments. The Compliance Department also ensures that there is a framework of key controls within the business and that these are tracked and reported against.

Ernst & Young provide an internal audit function to the Group. The internal audit function is responsible for independently reviewing and reporting on the adequacy and effectiveness of internal controls put in place by management. The internal audit function agrees an internal audit plan annually with the Audit Committee. The internal audit reports assist management to evaluate and improve the effectiveness of risk management, regulatory compliance, control and governance processes and assist the Audit Committee to oversee the effectiveness of internal controls. The Board is satisfied that during the period the Group maintained an adequate and appropriate system of internal control.

**Audit Committee and auditors**

The role of the Audit Committee includes a review of the Group's accounting policies at least annually, a review of the financial statements including any significant financial reporting judgements on which they are based and monitoring the systems of internal control.

The Group has a policy on the use of the external auditors for non-audit work, which has been approved by the Audit Committee. The purpose of this policy, which requires the formal prior approval of the Audit Committee for any ancillary services, is to ensure the continued independence and objectivity of the external auditors. The Audit Committee reviews annually the relationship with external and internal auditors and approves their terms of engagement and remuneration.

**Financial reporting**

The responsibilities of the Directors in preparing the Group's accounts are set out in the Statement of Directors' Responsibilities.

**Stephan Wilcke**
Chairman

# Directors' Remuneration Report

### Introduction

The purpose of this report is to outline the Board's policy for the remuneration of the Group's Executive team and its Non-Executive Directors and explains the process for setting Directors' remuneration and how it applies the principles of the Code. The Code was developed by the Committee on Corporate Governance for listed companies: details can be downloaded from the Financial Reporting Council website which is www.frc.org.uk. The Remuneration Committee also takes the FSA Remuneration Code into account when setting Director and Senior Executive Remuneration as well as the draft EU legislation on bonus caps in banks.

### Remuneration of the Group's executive management team

The Remuneration Committee is chaired by T Hanford and the remuneration of each Executive Director is set out in note 7 to the report and accounts.

Executive management remuneration comprises a number of elements: basic salary, performance incentive pay and benefits:

### Basic salary

- Basic salary is determined by levels of responsibility, external market competitiveness and individual performance in the role. The Group's policy is to position salaries so that, on average, they are in line with salary packages for comparable positions in similarly performing financial institutions, taking account of the level of other benefits provided;

### Performance incentive pay

- The Executive Directors, Chairman (in his role as the Bank's executive lead on merger and acquisition activity) and other Executives participate in a non-pensionable medium term incentive plan under which cash bonuses are awarded at the discretion of the Board, when determined appropriate, according to success in the delivery of corporate and individual objectives. A proportion of the cash bonuses are deferred over a three-year period and are subject to claw back in the event that financial targets are not met or if there is a material financial downturn or failure of risk management before the end of the deferral period.

- In addition, a long-term incentive plan ('LTIP') has been approved by the B shareholder and OSB Board and has been offered to the Executive Directors, other Executives and Chairman for implementation in 2013. The aim of the LTIP is to provide an appropriate balance between short-, medium- and long-term objectives in the overall remuneration package;

### Benefits

- All of the executive management team receive car allowances and are members of a contributory defined contribution pension scheme. Some Executives also received relocation allowances when taking up their appointments.

Standard contractual terms for Executive level appointments include notice periods of between 3 and 12 months.

Specific remuneration and terms and conditions of employment of members of the Executive management team are determined annually by the Board on the basis of recommendations by the Remuneration Committee. The Committee ensures that the Group's policy remains appropriate to

attract, motivate and retain high-calibre Executives with the skills and experience needed to lead a business of this nature and complexity, and develop it for the long-term benefit of members.

The Remuneration Committee comprises three Non-Executive Directors, as set out in the Directors' Report, with attendance by the Chief Executive as appropriate. The Chief Executive withdraws from the meeting when his own remuneration is considered. The committee is provided with executive remuneration and benefits data from comparative organisations across the financial services industry and banking sector and procures such other relevant data from independent expert sources as appropriate.

**Non-Executive Directors' fees**

Fees for each Non-Executive Director are set out in note 7 to the report and accounts. Non-Executive Directors are remunerated solely by fees. They do not receive any salary, performance incentive, pension contribution or other taxable benefit for their services as non-Executive Directors. S Wilcke received a salary, performance incentive and pension contribution in respect of his role as the Bank's lead on merger and acquisition activity, as set out in note 7 to the report and accounts.

The Group's policy is to position fees so that they are in line with fees paid by similarly performing financial services organisations. Enhanced fees are paid to the chairmen of the Board and Audit and Risk Committees commensurate with the additional responsibilities inherent in these roles.

Fees are determined annually by the Board on the basis of recommendations by the Remuneration Committee. The Committee is provided with fee data from comparative organisations across the financial services industry and banking sector and procures such other relevant data from independent expert sources as appropriate.

**Summary**

This report, together with the disclosures in note 7 to the Report and Accounts, is provided to give members a full explanation of the policy and application of Directors' remuneration.

On behalf of the Board

**Zoe Bucknell**
Company Secretary

# Statement of Directors' Responsibilities

The Directors are responsible for preparing the Annual Report and accounts 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 have elected to prepare both the Group and the parent company financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and applicable law.

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 and prudent;
- state whether they have been prepared in accordance with IFRSs as adopted by the EU; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Group and the Bank's transactions and disclose with reasonable accuracy at any time the financial position of the Group and the Bank and enable them to ensure that its financial statements comply with the Companies Act 2006. They 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.

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

### Responsibility statement of the Directors in respect of the annual report and accounts

We confirm that to the best of our 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 company and the undertakings included in the consolidation taken as a whole; and
- The Directors' report includes a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

### Disclosure of information to Auditors

The Directors who held office at the date of approval of this Report and Accounts confirm that:

- so far as they are aware, there is no relevant audit information of which the Company's Auditors are unaware and
- each Director has taken all the steps that they ought to have taken as a Director to make themselves aware of any relevant audit information and to establish that the Company's Auditors are aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of Section 418 of the Companies Act 2006.

**Stephan Wilcke**
Chairman

# Independent Auditor's Report

## INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF ONE SAVINGS BANK PLC

We have audited the financial statements of OneSavings Bank plc for the year ended 31 December 2012. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU and, as regards the parent company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

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.

### Respective responsibilities of Directors and auditor

As explained more fully in the Directors' Responsibilities Statement, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

### Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate.
Opinion on financial statements

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 2012 and of the Group's profit for the year then ended;

- the Group financial statements have been properly prepared in accordance with 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.

### Opinion on other matter's prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

### Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us 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.

**Richard Gabbertas (Senior Statutory Auditor) for and on behalf of KPMG Audit Plc, Statutory Auditor**

Chartered Accountants
1 The Embankment
Neville Street
Leeds
LS1 4DW

26 March 2013

## Income Statement

| | Notes | Group Year ended 31-Dec-12 £'000 | Group Period ended 31-Dec-11 £'000 |
|---|---|---|---|
| Interest receivable and similar income | 2 | **86,872** | **42,043** |
| Interest payable and similar charges | 3 | **(71,132)** | **(43,450)** |
| Net interest income / (expense) | | **15,740** | **(1,407)** |
| Fair value gains and (losses) on financial instruments | 4 | **(561)** | **669** |
| Gain on sales of financial instruments | 5 | **2,893** | **9,035** |
| Fees and commissions receivable | | **2,582** | **1,486** |
| Fees and commissions payable | | **(3,060)** | **(2,039)** |
| External servicing fees | | **(1,601)** | **-** |
| **Total Income** | | **15,993** | **7,744** |
| Administrative expenses | 6 | **(18,836)** | **(17,061)** |
| Depreciation and amortisation | 15, 16 | **(460)** | **(314)** |
| **Operating Loss** | | **(3,303)** | **(9,631)** |
| FSCS and other provisions | 26 | **(2,331)** | **(703)** |
| Impairment losses | 13 | **(5,301)** | **(2,913)** |
| **Loss before goodwill** | | **(10,935)** | **(13,247)** |
| Negative goodwill | 14 | **17,603** | **-** |
| **Profit / (Loss) before taxation** | | **6,668** | **(13,247)** |
| Taxation credit | 8 | **1,297** | **2,135** |
| **Profit / (Loss) for the year** | | **7,965** | **(11,112)** |

The above results are derived wholly from continuing operations.
The notes form part of these accounts.
The accounts were approved by the Board of Directors on 26 March 2013.

## Statement of Comprehensive Income

| | Group Year ended 31-Dec-12 £'000 | Group Period ended 31-Dec-11 £'000 |
|---|---|---|
| **Other comprehensive income:** | | |
| Available for sale securities: valuation (losses) / gains taken to equity | **(467)** | **2,141** |
| Deferred taxation relating to components of other comprehensive income | **(70)** | **(319)** |
| **Other comprehensive (expense) / income for the period net of taxation** | **(537)** | **1,822** |
| Profit / (Loss) for the period | **7,965** | **(11,112)** |
| **Total comprehensive income / (expense) for the period** | **7,428** | **(9,290)** |

The notes form part of these accounts.

## Consolidated Statement of Financial Position

| Assets | Note | Group 31-Dec-12 £'000 | Bank 31-Dec-12 £'000 | Group 31-Dec-11 £'000 | Bank 31-Dec-11 £'000 |
|---|---|---|---|---|---|
| **Liquid assets** | | | | | |
| Cash in hand and balances with the Bank of England | | **282** | **282** | **253** | **253** |
| Loans and advances to credit institutions | 9 | **291,700** | **289,511** | **239,661** | **237,929** |
| Investment securities | 10 | **410,339** | **410,339** | **361,337** | **361,337** |
| Total liquid assets | | **702,321** | **700,132** | **601,251** | **599,519** |
| **Loans and advances to customers** | | | | | |
| Loans fully secured on residential property | 11 | **2,077,679** | **1,427,130** | **1,530,853** | **929,921** |
| Other loans | 11 | **118,371** | **69,723** | **109,093** | **77,133** |
| | | **2,196,050** | **1,496,853** | **1,639,946** | **1,007,054** |
| Derivative financial instruments | 28 | **-** | **-** | **683** | **683** |
| Fair value adjustments for hedged risk | | **86,501** | **86,501** | **93,498** | **93,498** |
| Current taxation asset | | **-** | **-** | **818** | **619** |
| Deferred taxation asset | 17 | **16,019** | **13,804** | **14,918** | **12,333** |
| Intangible fixed assets | 15 | **910** | **910** | **495** | **495** |
| Property, plant and equipment | 16 | **4,231** | **1,691** | **1,858** | **1,417** |
| Investments in group undertakings | 14 | **-** | **703,683** | **-** | **640,920** |
| Other assets | 18 | **3,175** | **1,423** | **2,925** | **1,749** |
| **Total assets** | | **3,009,207** | **3,004,997** | **2,356,392** | **2,358,287** |
| **Liabilities** | | | | | |
| Amounts owed to retail depositors | 19 | **2,744,646** | **2,744,646** | **2,081,590** | **2,081,590** |
| Amounts owed to credit institutions | 20 | **3,190** | **3,190** | **831** | **831** |
| Amounts owed to other customers | 21 | **21,763** | **21,763** | **38,394** | **38,394** |
| Derivative financial instruments | 28 | **63,949** | **63,949** | **95,222** | **95,222** |
| Fair value adjustments for hedged risk | | **3,475** | **3,475** | **1,094** | **1,094** |
| Deferred taxation liability | 17 | **389** | **389** | **562** | **562** |
| Other liabilities | 22 | **10,241** | **9,308** | **4,551** | **4,318** |
| FSCS and other provisions | 26 | **4,862** | **4,862** | **2,537** | **2,537** |
| Subordinated liabilities | 23 | **27,576** | **27,576** | **26,842** | **26,842** |
| Perpetual Subordinated Bonds | 24 | **15,189** | **15,189** | **15,327** | **15,327** |
| | | **2,895,280** | **2,894,347** | **2,266,950** | **2,266,717** |
| **Equity** | | | | | |
| Equity | | **113,927** | **110,650** | **89,442** | **91,570** |
| **Total equity and liabilities** | | **3,009,207** | **3,004,997** | **2,356,392** | **2,358,287** |

The notes form part of these accounts.
The accounts were approved by the Board of Directors on 26 March 2013.

**Andy Golding**
Chief Executive
26 March 2013

**April Talintyre**
Finance Director
26 March 2013

## Statement of Changes in Equity

| Group 2012 | Share capital* £'000 | Capital Contribution* £'000 | Share premium* £'000 | Foreign exchange reserve £'000 | Transfer reserve £'000 | Available for sale reserve £'000 | Retained earnings £'000 | 6.591% Perpetual Subordinated Bonds (PSBs) £'000 | Total £'000 |
|---|---|---|---|---|---|---|---|---|---|
| **Balance at 1st January 2012** | **361** | **-** | **90,639** | **-** | **(12,818)** | **1,822** | **(12,562)** | **22,000** | **89,442** |
| Profit for the year | **-** | **-** | **-** | **-** | **-** | **-** | **7,965** | **-** | **7,965** |
| Coupon paid on PSBs | **-** | **-** | **-** | **-** | **-** | **-** | **(1,450)** | **-** | **(1,450)** |
| Other comprehensive income | **-** | **-** | **-** | **-** | **-** | **(537)** | **-** | **-** | **(537)** |
| Capital injection 28 June 2012 | **490** | **-** | **14,510** | **-** | **-** | **-** | **-** | **-** | **15,000** |
| Revaluation of foreign subsidiary assets & liabilities | **-** | **-** | **-** | **31** | **-** | **-** | **-** | **-** | **31** |
| Capital contribution on acquisition of the Interbay group | **-** | **1,272** | **-** | **-** | **-** | **-** | **-** | **-** | **1,272** |
| Ordinary E Shares issued | **150** | **2,054** | **-** | **-** | **-** | **-** | **-** | **-** | **2,204** |
| **Balance at 31 December 2012** | **1,001** | **3,326** | **105,149** | **31** | **(12,818)** | **1,285** | **(6,047)** | **22,000** | **113,927** |

* See note 25.

| Bank 2012 | Share capital* £'000 | Capital Contribution* £'000 | Share premium* £'000 | Foreign exchange reserve £'000 | Transfer reserve £'000 | Available for sale reserve £'000 | Retained earnings £'000 | 6.591% Perpetual Subordinated Bonds (PSBs) £'000 | Total £'000 |
|---|---|---|---|---|---|---|---|---|---|
| **Balance at 1 January 2012** | 361 | - | 90,639 | - | (15,231) | 1,822 | (8,021) | 22,000 | 91,570 |
| Profit for the year | - | - | - | - | - | - | 5,917 | - | 5,917 |
| Coupon paid on PSBs | - | - | - | - | - | - | (1,450) | - | (1,450) |
| Other comprehensive income | - | - | - | - | - | (537) | - | - | (537) |
| Capital injection 28 June 2012 | 490 | - | 14,510 | - | - | - | - | - | 15,000 |
| Ordinary E Shares issued | 150 | - | - | - | - | - | - | - | 150 |
| **Balance at 31 December 2012** | 1,001 | - | 105,149 | - | (15,231) | 1,285 | (3,554) | 22,000 | 110,650 |

| Group 2011 | Share capital* £'000 | Share premium* £'000 | Transfer reserve £'000 | Available for sale reserve £'000 | Retained earnings £'000 | 6.591% Perpetual Subordinated Bonds (PSBs) £'000 | Total £'000 |
|---|---|---|---|---|---|---|---|
| **Balance at date of incorporation** | - | - | - | - | - | - | - |
| Transfer of business 1 February 2011 | - | 26,000 | (12,818) | - | - | 22,000 | 35,182 |
| Capital injection 1 February 2011 | 76 | 49,924 | - | - | - | - | 50,000 |
| Loss for the period | - | - | - | - | (11,112) | - | (11,112) |
| Coupon paid on PSBs | - | - | - | - | (1,450) | - | (1,450) |
| Other comprehensive income | - | - | - | 1,822 | - | - | 1,822 |
| Additional capital injection 31 August 2011 | 285 | 14,715 | - | - | - | - | 15,000 |
| **Balance at 31 December 2011** | 361 | 90,639 | (12,818) | 1,822 | (12,562) | 22,000 | 89,442 |

| Bank 2011 | Share capital* £'000 | Share premium* £'000 | Transfer reserve £'000 | Available for sale reserve £'000 | Retained earnings £'000 | 6.591% Perpetual Subordinated Bonds (PSBs) £'000 | Total £'000 |
|---|---|---|---|---|---|---|---|
| **Balance at date of incorporation** | - | - | - | - | - | - | - |
| Transfer of business 1 February 2011 | - | 26,000 | (15,231) | - | - | 22,000 | 32,769 |
| Capital injection 1 February 2011 | 76 | 49,924 | - | - | - | - | 50,000 |
| Loss for the period | - | - | - | - | (6,571) | - | (6,571) |
| Coupon paid on PSBs | - | - | - | - | (1,450) | - | (1,450) |
| Other comprehensive income | - | - | - | 1,822 | - | - | 1,822 |
| Additional capital injection 31 August 2011 | 285 | 14,715 | - | - | - | - | 15,000 |
| **Balance at 31 December 2011** | 361 | 90,639 | (15,231) | 1,822 | (8,021) | 22,000 | 91,570 |

* See note 25.

# Statement of Cashflows

| | Group year ended | Group period ended |
|---|---|---|
| | 31-Dec-12 | 31-Dec-11 |
| **Cash flows from operating activities** | £'000 | £'000 |
| Profit / (Loss) on ordinary activities before taxation | 6,668 | (13,247) |
| Depreciation and amortisation | 460 | 314 |
| Negative goodwill | (17,603) | - |
| Interest on subordinated liabilities | 1,299 | 1,142 |
| Interest on 7.875% PSBs | 1,254 | 1,043 |
| Net increase in impairment of loans and advances | 5,301 | 2,913 |
| Profit on sale of Gilts | (2,893) | (9,035) |
| Net increase in FSCS and other provisions | 2,331 | 703 |
| Net change in fair value gains and losses on financial instruments | 561 | (669) |
| Net increase in tax credit | 1,297 | 2,135 |
| Cash generated from operations | (1,325) | (14,701) |
| **Cash flows from operating assets and liabilities** | | |
| Net (increase) in loans and advances to credit institutions | (41,880) | (17,654) |
| Net (increase) in loans and advances to customers | (452,214) | (108,271) |
| Net increase in amounts owed to retail depositors | 663,056 | 376,193 |
| Decrease / (Increase) in other assets, current tax and deferred tax | (1,830) | (3,772) |
| Decrease in derivative financial instruments and fair value of hedged risk | (21,773) | - |
| Net (decrease) in amounts owed to credit institutions | (14,272) | (88,466) |
| Net increase in provisions and other liabilities | 5,511 | 1,665 |
| Cash from operating activities | 136,598 | 159,695 |
| **Cash flows from investing activities** | | |
| Cash and cash equivalents acquired | - | 70,683 |
| Net purchase of investment securities | (47,328) | (81,354) |
| Net purchase of property, plant and equipment | (2,654) | (279) |
| Net purchase of intangible assets | (594) | (459) |
| Cash paid on purchase of Prestige | (340) | - |
| Cash paid on purchase of Interbay | (869) | - |
| Cash (used in) investing activities | (51,785) | (11,409) |
| **Cash flows from financing activities** | | |
| Coupon paid on 6.591% PSBs | (1,450) | (1,450) |
| Interest paid on 7.875% PSBs and subordinated liabilities | (2,453) | (2,365) |
| Share capital issue | 15,000 | 65,000 |
| Repayment of Prestige funding on acquisition | (38,142) | - |
| Repayment of Interbay funding on acquisition | (46,255) | - |
| Cash generated from financing | (73,300) | 61,185 |
| | | |
| Net increase in cash and cash equivalents | 10,188 | 194,770 |
| Cash and cash equivalents at 31 December 2011 / incorporation | | |
| Cash in hand and balances with the Bank of England | 253 | - |
| Loans and advances to credit institutions repayable on demand | 194,517 | - |
| | 194,770 | - |
| Cash and cash equivalents at 31 December 2012 / 2011 | | |
| Cash in hand and balances with the Bank of England | 282 | 253 |
| Loans and advances to credit institutions repayable on demand | 204,676 | 194,517 |
| | 204,958 | 194,770 |
| Movement in cash and cash equivalent | 10,188 | 194,770 |

# Notes to the Accounts

## 1. Accounting Policies

The principal accounting policies applied in the preparation of the accounts for the Group and the Bank are set out below.

### a) Basis of preparation

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union (EU); and interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC).

The financial statements have been prepared on historical cost basis, as modified by the revaluation of available for sale financial assets, derivative contracts and financial assets held at fair value through the income statement.

As permitted by section 408 of the Companies Act 2006, no income statement is presented for the Bank.

### b) Going concern

The Board undertakes regular rigorous assessments of whether the Bank is a going concern in the light of current economic conditions and all available information about future risks and uncertainties.

Projections for OneSavings Bank plc have been prepared, covering its future performance, capital and liquidity, for a period in excess of 12 months from the date of approval of these accounts. These projections show that the Group has sufficient capital to continue to meet its regulatory capital requirements as set out by the FSA.

The Board has therefore concluded that the Group has sufficient resources to continue in operational existence for the foreseeable future and as a result it is appropriate to prepare these financial statements on a going concern basis.

### c) Basis of consolidation

The Group accounts include the results of the Bank and its subsidiary undertakings. Subsidiaries are fully consolidated from the date on which control is transferred to the Group and are de-consolidated from the date that control ceases. Upon consolidation inter-company transactions, balances and unrealised gains on transactions are eliminated.

In the Bank's accounts investments in subsidiary undertakings are stated at cost less provision for any impairment. Inter-company transactions, balances and unrealised gains on transactions between Group companies are eliminated in the Group accounts. Unrealised losses are also eliminated unless the transaction provides evidence of impairment of the asset transferred. Accounting policies of subsidiaries have been changed where necessary to ensure consistency with the policies adopted by the Group.

### d) Foreign currency translation

The consolidated financial statements are presented in sterling which is the functional currency of the Group. Foreign currency transactions are translated into sterling using the exchange rates prevailing at the date of the transactions. Monetary items denominated in foreign currencies are re-translated at the rate prevailing at the period end. Foreign exchange gains and losses resulting from the re-translation and settlement of these items are recognised in the income statement.

## e) Segmental reporting

IFRS 8 requires operating segments to be identified on the basis of internal reports and components of the Group regularly reviewed by the chief operating decision maker to allocate resources to segments and to assess their performance. For this purpose, the chief operating decision maker of the Group is the Board of Directors.

The Group operates solely within the retail and commercial financial service sector within the UK and the Channel Islands. The chief operating decision maker assesses the performance of the Group as a whole and as such no detailed segmental analysis is required.

## f) Taxation including deferred taxation

The credit for taxation is based on the result for the period and takes into account current and deferred taxation. Where items are recognised directly in equity the associated taxation charge or credit is also recognised in equity.

Current taxation is the expected taxation payable on the taxable income and gains in the period.

Deferred taxation is provided in full, using the balance sheet liability method, on temporary differences arising between the taxation bases of assets and liabilities and their carrying amounts in the financial statements. Deferred taxation is determined using the taxation rates and laws that have been enacted or substantively enacted by the balance sheet date and are expected to apply when the related deferred taxation asset is realised or the deferred taxation liability is settled.

Deferred taxation assets are recognised gross on the balance sheet and only recognised to the extent that recovery is probable.

Deferred taxation relating to the fair value re-measurement of available for sale investments, which are charged or credited directly to the available for sale reserve, is also credited or charged directly to the available for sale reserve and is subsequently recognised in the income statement together with the deferred gain or loss.

## g) Interest income and expense

Interest income and interest expense for all interest-bearing financial instruments measured at amortised cost are recognised in the income statement using the effective interest rate (EIR) method. The EIR is the rate which discounts the expected future cash flows, over the expected life of the financial instrument, to the net carrying value of the financial asset or liability.

In calculating the EIR the Group estimates the cash flows considering all contractual terms but does not consider future credit losses. Potential early repayment charges, origination fees received and paid on mortgage assets, together with premium / discount paid on / received on acquired mortgage books and acquisition costs of mortgage books are included within loans and advances to customers and are amortised over the expected life of the mortgage assets using the EIR method.

Interest income on available for sale investments is included in interest receivable and similar income, Interest on derivatives is included in interest receivable and similar income or interest expense and similar charges following the underlying instrument it is hedging.

## h) Fees and commissions

Fees and commissions which are an integral part of the EIR of a financial instrument are recognised as an adjustment to the EIR and recorded in interest income. Other fees and commissions are recognised on the accruals basis as services are provided or on the performance of a significant act.

### i) Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise balances with less than three months to maturity from the date of acquisition including cash, non-restricted balances with central banks and certificates of deposit.

### j) Intangible assets

Purchased software and costs directly associated with the development of computer software are capitalised as intangible assets where the software is a unique and identifiable asset controlled by the Group and will generate future economic benefits.

Costs to establish technological feasibility or to maintain existing levels of performance are recognised as an expense.

Amortisation is charged to the income statement by equal instalments over the estimated useful life of the software, which is generally five years. These assets are reviewed for impairment on an annual basis.

### k) Property, plant and equipment

The directly attributable costs of additions and major alterations to office premises, equipment, fixtures and motor vehicles are capitalised. These assets are reviewed for impairment annually and if they are considered to be impaired are written down immediately to their recoverable amounts.

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

The balance sheet value represents the original cost less cumulative depreciation. The costs less estimated residual values of assets are depreciated by equal instalments over their estimated useful economic lives as follows:

| | |
|---|---|
| Freehold land and buildings | 50 years |
| Equipment, fixtures and vehicles | 5 years |

The cost of repairs and renewals is charged to the income statement in the period in which the expenditure is incurred.

### l) Financial assets and liabilities

Purchases and sales of financial assets and liabilities are accounted for at trade date. The Group classifies its financial assets and liabilities in accordance with IAS 39 into the following categories:

**(i) Loans and receivables**: which are predominantly mortgage loans and advances to customers and money market advances that are not quoted in an active market. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the EIR method, less impairment losses. Where exposures are hedged by derivatives, designated and qualifying as fair value hedges, the carrying value of the loans and advances so hedged includes a fair value adjustment for the hedged risk only.

**(ii) Financial assets at fair value through the income statement**: are assets:

- which upon initial recognition are designated at fair value through the income statement to eliminate or significantly reduce a measurement recognition inconsistency or;
- which are acquired principally for the purpose of selling in the near term or forming part of the portfolio of financial instruments that are managed together and for which there is evidence of short-term profit taking.

The fair values are quoted market prices (where there is an active market) or are based on valuation techniques (where there is no active market or the securities are unlisted). Valuation techniques include the use of recent arm's length transactions, discounted cash flow analysis and other commonly used valuation techniques. During the year (and prior period) no financial assets were designated at fair value through the income statement.

**(iii) Available for sale financial assets**: comprise securities held for liquidity purposes (certificates of deposit, treasury bills and money market instruments in the nature of loans and advances to credit institutions). These assets are non-derivatives that are designated as available for sale and not categorised in any other financial asset categories. These are held at fair value with movements being taken to equity, except for impairment losses which are taken to the income statement. Profit or loss is recognised in the income statement on disposal. Available for sale financial assets are de-recognised when the rights to receive the cash flows have expired or the Group has transferred substantially all the risks and rewards of the ownership.

**(iv) Held to maturity investments**: are non-derivative financial assets with fixed or determinable payments and fixed maturity where the Group intends to hold to maturity (Long-term Gilt and Floating Rate Note). Assets are held at amortised cost using the EIR method less any impairment.

**(v) Financial liabilities**: are held at amortised cost. The Group classes the 7.875% Perpetual Subordinated Bond as a financial liability as it was issued with terms that include no discretion over the payment of interest. Interest is recognised on an EIR basis. The 6.591% Perpetual Subordinated Bond is classified as equity as it was issued with terms that include discretion over the payment of interest.

**m) Derivative financial instruments and hedge accounting**

The Group uses derivative financial instruments (interest rate swaps) for the purpose of reducing fair value interest rate risk to hedge its exposure to the interest rate risk arising from financing and investment activities. In accordance with its treasury policy, the Group does not hold or issue derivative financial instruments for trading.

Derivative financial instruments are recognised in the balance sheet at their fair value with changes in their fair value going through the income statement. Fair values are calculated by discounting cash flows at the prevailing interest rates.

All derivatives are carried as assets when their fair value is positive and as liabilities when their fair value is negative.

Certain derivatives embedded in financial instruments are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract and the host contract is not carried at fair value. These embedded derivatives are separately measured at fair value with changes in fair value recognised in the income statement.

The Group designates certain derivatives as a hedge of fair value of a portfolio of recognised assets or liabilities (macro fair value hedge). Hedge accounting is used for derivatives designated in this way provided the criteria specified in IAS 39 are met.

Where there is an effective hedge relationship for fair value hedges, the changes in fair value of the hedged item arising from the hedged risk are taken to the income statement. The fair value changes of both the hedged item and the derivative substantially offset each other to reduce profit volatility. To qualify for hedge accounting at inception, the hedge relationship must be clearly documented and the derivative must be expected to be highly effective in offsetting the hedged risk.

In addition, effectiveness must be tested throughout the life of the hedge relationship.

The Group discontinues hedge accounting when testing demonstrates that a derivative is not or has ceased to be highly effective as a hedge, the derivative ceases through expiry or sale or the underlying hedged item matures, is sold or is repaid.

If a derivative no longer meets the criteria for hedge accounting the cumulative fair value hedging adjustment is amortised over a period up to the maturity of the previously designated hedge relationship. If the underlying item is sold or repaid the unamortised fair value adjustment is immediately reflected in the income statement.

### n) Impairment of financial assets

The Group regularly assesses whether there is evidence that a financial asset or a portfolio of financial assets that is not carried at fair value through profit or loss is impaired. A financial asset or portfolio of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more loss events that occurred after the initial recognition of the asset and prior to the balance sheet date ('a loss event'), and that loss event or events has / or have had an impact on the estimated future cash flows of the financial asset or the portfolio that can be reliably estimated.

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If the Group determines that no objective evidence of impairment exists for an individually-assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment. An individual provision is also made where an account is not in arrears but the Group has exercised forbearance in the conduct of the account. Any provision is based on a management assessment of the propensity for the account to realise a loss had forbearance not been shown taking account of the amount recoverable on mortgage indemnity cover and additional security.

For loans, receivables and held-to-maturity investments, the amount of impairment loss is measured as the difference between the asset's carrying amount and the present value of the estimated future cash flows discounted at the asset's original EIR.

The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure and any costs for obtaining and selling the collateral, whether or not foreclosure is probable.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar risk characteristics, taking into account asset type, industry, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the counterparty's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in the Group and historical loss experience for assets with credit risk characteristics similar to those in the Group. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not currently exist. In addition, the Group uses its experienced judgement to estimate the amount of an impairment loss. This incorporates amounts calculated to overcome model deficiencies and systemic risks where appropriate and supported by historic loss experience data. The use of such judgements and reasonable estimates is considered by management to be an essential part of the process and does not impact reliability.

Following impairment, interest income is recognised using the original EIR which was used to discount the future cash flows for the purpose of measuring the impairment loss.

When a loan is uncollectible, it is written off against the related provision. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been

determined. Subsequent recoveries of amounts previously written off are taken through the income statement.

The Bank's objective in restructuring a loan will primarily be to maximise the potential recovery of its outstanding debt. A loan restructuring is the modification or elimination of a loan prior to or at its maturity date by means other than those prescribed under the contractual terms of the loan agreement. This may involve extending the payment arrangements and the agreement of new loan conditions. When the terms of the loan have been re-negotiated, the loan is no longer considered past due. The Bank continually reviews re-negotiated loans to ensure that all criteria are met and future payments are likely to occur. The loans continue to be subject to an individual or collective impairment assessment, calculated using the loan's original EIR.

**o) Provisions and contingent liabilities**

A provision is recognised when there is a present obligation as a result of a past event, it is probable that the obligation will be settled and the amount can be estimated reliably. Contingent liabilities have not been recognised.

**p) Employee benefits – defined contribution scheme**

Obligations for contributions to defined contribution pension arrangements are recognised as an expense in the income statement as incurred.

**q) Business combinations and goodwill**

Business combinations are accounted for using the purchase method of accounting. This involves recognising identifiable assets and liabilities of the acquired business at fair value. Any excess of the cost of acquisition over the fair values of the identifiable net assets is recognised as goodwill. If the cost of acquisition is less than the fair values of the identifiable net assets, the difference is treated as negative goodwill which is recognised directly in the income statement in the year of acquisition.

**r) Judgements in applying accounting policies and critical accounting estimates**

The Group makes judgements which affect the amounts recognised in the financial statements. In addition, estimates and assumptions are made which could affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgements are regularly reviewed based on past experience, expectations of future events and other factors. The key areas where estimates and judgements are made are as follows:

**(i) Impairment of financial assets**:
Specific provisions are based on the amount of impairment loss measured as the difference between the asset's carrying amount and the present value of the estimated future cash flows discounted at the asset's original EIR. Judgement is exercised in the estimation of future cash flows including the cost of obtaining and selling the collateral, the likely sale proceeds and any rental income prior to sale. The most critical estimate is of the level of house prices where a variance of 10% equates to a change of £5.4m (2011: £4.2m) in the provision.

Collective provisions are calculated using twelve month delinquency roll rates and one year probability of defaults on different segments of the mortgage book. These rates, along with forced sale discounts, are applied to calculate the expected losses. Judgement needs to be exercised in deciding how to apply historic experience to current market conditions. The most critical estimate is of the level of house prices where a variance of 10% equates to a change of £2.3m in the provision.

**(ii) Fair values**: The fair values used in the financial statements, including those for derivative financial instruments and available for sale assets, are, where market values are not available, calculated using valuation techniques utilising discounted cash flow models using yield curves based on observable market data. The fair values of mortgage assets acquired through company acquisitions are calculated utilising techniques including discounted cash flow models, which include assumptions based on loan and portfolio level attributes as well as macroeconomic assumptions,

including HPI, unemployment levels and interest rates, to derive prepayment rates, the probability and timing of defaults and amount of expected losses.

**(iii) Effective interest rate**: To calculate the appropriate EIR the Group makes a number of assumptions relating to the expected lives of financial instruments, likely redemption profiles and the anticipated level of early repayment charges. For acquired mortgage books EIRs are calculated utilising cash flow models which include assumptions on the likely macroeconomic environment, including HPI, unemployment levels and interest rates, as well as loan level and portfolio attributes and history to derive prepayment rates, the probability and timing of defaults and the amount of incurred losses. Estimates are reviewed in each reporting period to ensure they reflect current and expected future performance.

**(iv) Deferred taxation**: Deferred tax assets are recognised only to the extent that it is probable that future taxable profits will be available to utilise the asset. The recognition of deferred tax is mainly dependent on the projections of future taxable profits and future reversals of existing taxable temporary differences.

Tax losses were incurred in the Bank during the year. Management has evaluated the factors contributing to the losses to determine whether the factors leading to the losses are temporary or indicative of a permanent decline in earnings.

Management's projections of future taxable income are based on business plans, future capital requirements and ongoing tax planning strategies. These assumptions include the impact of credit losses, capital requirements and assumptions about the UK (macroeconomic) environment. The assumptions surrounding future expected credit losses represent the most subjective areas of judgement in Management's projections of future taxable income. Management's forecast supports the assumption that it is probable that the results of future operations will generate sufficient taxable income to utilise the deferred tax asset.

## 2. Interest receivable and similar income

| | Group Year ended 31-Dec-12 £'000 | Group Period ended 31-Dec-11 £'000 |
|---|---|---|
| On loans fully secured on residential property | **88,182** | **59,179** |
| On other loans | **8,153** | **3,852** |
| On investment securities: | | |
| Interest and similar income | **4,291** | **3,985** |
| On other liquid assets: | | |
| Interest and similar income | **2,787** | **647** |
| Net expense on derivative financial instruments | **(16,541)** | **(25,620)** |
| | **86,872** | **42,043** |

Included within interest receivable is £1,817k (2011: £2,737k) in respect of interest accrued on impaired financial assets.

## 3. Interest payable and similar charges

| | Group Year ended 31-Dec-12 £'000 | Group Period ended 31-Dec-11 £'000 |
|---|---|---|
| On retail deposits | **70,033** | **40,163** |
| Perpetual Subordinated Bonds | **1,254** | **1,043** |
| On wholesale deposits and other borrowings: | | |
| Subordinated liabilities | **1,299** | **1,142** |
| Other wholesale borrowings | **530** | **1,094** |
| Net (expense) / income on derivative financial instruments | **(1,984)** | **8** |
| | **71,132** | **43,450** |

## 4. Fair value gains and losses on financial instruments

| | Group Year ended 31-Dec-12 £'000 | Group Period ended 31-Dec-11 £'000 |
|---|---|---|
| Hedge ineffectiveness on effective hedges | **1,340** | **(1,903)** |
| Amortisation of cancelled swaps | **(841)** | **-** |
| Net (losses) / gains on unmatched swaps | **(1,060)** | **2,572** |
| | **(561)** | **669** |

## 5. Gain on sales of financial instruments

The Bank routinely buys and sells liquidity assets in order to confirm the ease with which cash can be realised and the robustness of the valuations assigned to such assets. During the year, transactions in liquidity assets led to the realisation of a net gain overall of £2.9m (2011: £9.0m).

## 6. Administrative expenses

| | Group<br>Year ended<br>31-Dec-12<br>£'000 | Group<br>Period ended<br>31-Dec-11<br>£'000 |
|---|---|---|
| Staff costs (see below) | **7,796** | **4,733** |
| Fees payable to the Group auditors and their associates (see below) | **598** | **452** |
| Legal costs | **2,450** | **1,802** |
| VAT expense | **1,340** | **1,460** |
| Consultants and interim management costs | **897** | **3,131** |
| Postage, telephone and travel | **643** | **1,171** |
| Marketing | **377** | **730** |
| Other administrative expenses | **4,735** | **3,582** |
| | **18,836** | **17,061** |

Other administrative expenses include facility costs, recruitment costs, IT support costs and other expenses.

| *Auditors remuneration:*<br><br>Fees payable to the Group auditors and their associates for: | Group<br>Year ended<br>31-Dec-12<br>£'000 | Group<br>Period ended<br>31-Dec-11<br>£'000 |
|---|---|---|
| Audit of the Bank and Group Annual Accounts | **132** | **126** |
| Audit of the Group's subsidiary undertakings' accounts pursuant to legislation | **68** | **30** |
| Tax advisory services | **137** | **6** |
| Audit-related assurance services | **23** | **40** |
| All other non-audit services | **238** | **250** |
| | **598** | **452** |

*Staff numbers and costs*

The average number of persons employed by the Group (including executive Directors) during the period was 291 (2011: 254).

| The aggregate costs of these persons were: | Group<br>Year ended<br>31-Dec-12<br>£'000 | Group<br>Period ended<br>31-Dec-11<br>£'000 |
|---|---|---|
| Salaries, incentive pay and other benefits | **6,735** | **4,020** |
| Social security costs | **562** | **345** |
| Other pension costs | **499** | **368** |
| | **7,796** | **4,733** |

## 7. Directors' emoluments and transactions

| | Salary & fees £'000 | Incentive Pay £'000 | Other benefits £'000 | Contribution to personal pension policy £'000 | Year ended 31-Dec-12 Total £'000 |
|---|---|---|---|---|---|
| *Executive Directors' emoluments – 2012* | | | | | |
| A Golding | **300** | **115** | **22** | **29** | **466** |
| A Talintyre | **145** | **50** | **5** | **20** | **220** |
| J Wood | **14** | **-** | **-** | **-** | **14** |
| Total executive emoluments | **459** | **165** | **27** | **49** | **700** |

| | Salary & fees £'000 | Incentive Pay £'000 | Other benefits £'000 | Contribution to personal pension policy £'000 | Period ended 31-Dec-11 Total £'000 |
|---|---|---|---|---|---|
| *Executive Directors' emoluments - 2011* | | | | | |
| J Wood | **280** | **-** | **-** | **-** | **280** |
| M Lazenby | **32** | **-** | **511** | **6** | **549** |
| R Scruton | **100** | **-** | **181** | **20** | **301** |
| Total executive emoluments | **412** | **-** | **692** | **26** | **1,130** |

* Incentive pay comprises cash bonuses. A proportion of these are deferred over a three-year period and subject to claw back in the event that financial targets are not met or if there is a material financial downturn or failure of risk management before the end of the deferral period.

**Non-Executive Directors' emoluments**

| | Year ended 31-Dec-12 £'000 | Period ended 31-Dec-11 £'000 |
|---|---|---|
| R Duke | **25** | **-** |
| T Hanford | **38** | **32** |
| M McCaig | **47** | **48** |
| Sir C McCarthy | **38** | **32** |
| D Mills | **47** | **40** |
| Dr D Morgan | **38** | **32** |
| A Newell | **21** | **40** |
| S Wilcke | **346** | **87** |
| P Williams | **38** | **32** |
| | **638** | **343** |
| Total Directors' emoluments | **1,338** | **1,473** |

The figures above include £Nil (2011:£692k) compensation for loss of office during the period.

S Wilcke’s remuneration is in respect of both his role as Chairman and as executive lead for M&A activity and comprises salary of £261k, performance incentive pay of £65k and pension contributions of £20k. During 2012 S Wilcke devoted the majority of his time to the Group.

The Directors' Remuneration Report explains the Board's policy on Directors' Remuneration and describes the process through which remuneration is determined.

At 31 December 2012 there were no outstanding loans granted in the ordinary course of business to Directors and their connected persons (2011:£nil)

## 8. Taxation credit

| | Group Year ended 31-Dec-12 £'000 | Group Period ended 31-Dec-11 £'000 |
|---|---|---|
| UK corporation taxation on losses for the period | - | - |
| Adjustments in respect of earlier periods relating to subsidiaries | 23 | 511 |
| Total current taxation | 23 | 511 |
| Deferred taxation | | |
| Total deferred taxation (see note 17) | 1,274 | 1,624 |
| Total taxation credit | 1,297 | 2,135 |

The taxation on the Group's profit / (loss) before taxation differs from the theoretical amount that would arise using the weighted average taxation rate applicable to profits / (losses) of the Group as follows:

| | Group Year ended 31-Dec-12 £’000 | Group Period ended 31-Dec-11 £’000 |
|---|---|---|
| Profit / (loss) before taxation | 6,668 | (13,247) |
| Profit / (loss) multiplied by the weighted average rate of corporation taxation in the UK at 2012 24.5% / 2011 26.4% taxation effects of: | (1,634) | 3,497 |
| Expenses not deductible for taxation purposes | (234) | 101 |
| Negative goodwill | 4,313 | - |
| Adjustments in respect of earlier periods | 23 | 511 |
| Coupon on PSBs | 355 | - |
| Capital allowances | 55 | 179 |
| Re-measurement of deferred taxation - change in taxation rate | (1,581) | (2,153) |
| Total taxation credit | 1,297 | 2,135 |

## 9. Loans and advances to credit institutions

| | Group 31-Dec-12 £'000 | Bank 31-Dec-12 £'000 | Group 31-Dec-11 £'000 | Bank 31-Dec-11 £'000 |
|---|---|---|---|---|
| Loans and advances to credit institutions have a remaining maturity as follows: | | | | |
| Repayable on demand | **204,676** | **202,487** | **194,517** | **193,469** |
| In one year or less | **87,024** | **87,024** | **44,936** | **44,460** |
| In more than one year but not more than five years | **-** | **-** | **208** | **-** |
| | **291,700** | **289,511** | **239,661** | **237,929** |

## 10. Investment securities

| | Group and Bank 31-Dec-12 £'000 | Group and Bank 31-Dec-11 £'000 |
|---|---|---|
| Government investment securities | **367,870** | **231,744** |
| Other investment securities: | | |
| Listed | **21,941** | **9,422** |
| Unlisted | **20,528** | **120,171** |
| | **410,339** | **361,337** |
| Investment securities have remaining maturities as follows: | | |
| Repayable on demand | **-** | **-** |
| In one year or less | **235,164** | **228,987** |
| In more than one year but less than five years | **69,606** | **71,225** |
| In more than five years | **105,569** | **61,125** |
| | **410,339** | **361,337** |

The Directors of the Bank consider that the primary purpose of holding investment securities is prudential. These securities are held as liquid assets with the intention of use on a continuing basis in the Bank's activities and hence are classified as financial assets, held as available for sale, held as loans and receivables or held to maturity as appropriate.

Movements during the year of investment securities held as available for sale financial assets are analysed as follows:

| | Group and Bank 31-Dec-12 £'000 | Group and Bank 31-Dec-11 £'000 |
|---|---|---|
| As at 1 January 2012 / date of incorporation | **350,571** | **-** |
| Transfer of business 1 February 2011 | **-** | **250,038** |
| Additions | **671,245** | **172,392** |
| Disposals and maturities | **(703,332)** | **(74,000)** |
| Changes in fair value | **1,674** | **2,141** |

| | | |
|---|---|---|
| At 31 December 2012 / 2011 | **320,158** | **350,571** |

Movements during the year of investment securities held to maturity are analysed as follows:

| | Group and Bank<br>31-Dec-12<br>£'000 | Group and Bank<br>31-Dec-11<br>£'000 |
|---|---|---|
| As at 1 January 2012 / date of incorporation | **10,766** | **-** |
| At date of transfer of business 1 February 2011 | **-** | **18,769** |
| Additions | **62,705** | **-** |
| Maturities | **(5,231)** | **(8,003)** |
| At 31 December 2012 / 2011 | **68,240** | **10,766** |

Movements during the period of investment securities held as loans and receivables are analysed as follows:

| | Group and Bank<br>31-Dec-12<br>£'000 | Group and Bank<br>31-Dec-11<br>£'000 |
|---|---|---|
| As at 1 January 2012 / date of incorporation | **-** | **-** |
| At date of transfer of business 1 February 2011 | **-** | **-** |
| Additions | **21,941** | **-** |
| Maturities | **-** | **-** |
| At 31 December 2012 / 2011 | **21,941** | **-** |

## 11. Loans and advances to customers

| | Group<br>31-Dec-12<br>£'000 | Bank<br>31-Dec-12<br>£'000 | Group<br>31-Dec-11<br>£'000 | Bank<br>31-Dec-11<br>£'000 |
|---|---|---|---|---|
| Loans fully secured on residential property | **2,077,679** | **1,427,130** | **1,530,853** | **929,921** |
| Other loans | **118,371** | **69,723** | **109,093** | **77,133** |
| | **2,196,050** | **1,496,853** | **1,639,946** | **1,007,054** |

**Maturity analysis**

Advances secured on residential property and other loans are repayable from the date of the balance sheet as follows:

| | Group<br>31-Dec-12<br>£'000 | Bank<br>31-Dec-12<br>£'000 | Group<br>31-Dec-11<br>£'000 | Bank<br>31-Dec-11<br>£'000 |
|---|---|---|---|---|
| In not more than three months | **42,883** | **41,395** | **19,235** | **16,989** |
| In more than three months but not more than one year | **14,257** | **9,345** | **19,592** | **17,537** |
| In more than one year but not more than | **136,476** | **96,635** | **91,808** | **64,664** |

| | | | | |
|---|---|---|---|---|
| five years | | | | |
| In more than five years | **2,033,406** | **1,376,015** | **1,541,603** | **935,310** |
| | **2,227,022** | **1,523,390** | **1,672,238** | **1,034,500** |
| Less: impairment losses on loans and advances (see Note 12) | **(30,972)** | **(26,537)** | **(32,292)** | **(27,446)** |
| | **2,196,050** | **1,496,853** | **1,639,946** | **1,007,054** |

It should be noted that the above analysis may not reflect actual experience of repayments, since many mortgage loans are repaid early.

The Bank purchased a number of mortgage books from other financial institutions during the year, for a total of £283m (gross value £355m). In addition the Bank acquired mortgage assets fair valued at £106m through the purchase of the Interbay Group, Prestige Finance Limited and Swingcastle Limited.

## 12. Provision for impairment losses on loans and advances

Movement in provision for impairment losses on loans and advances to customers is as follows:

| | Loans fully secured on residential property | | Other loans | | **2012** | | |
|---|---|---|---|---|---|---|---|
| | Individual £'000 | Collective £'000 | Individual £'000 | Collective £'000 | **Individual £'000** | **Collective £'000** | **Total £'000** |
| **Group** | | | | | | | |
| **At 1 January 2012** | **14,207** | **880** | **16,825** | **380** | **31,032** | **1,260** | **32,292** |
| Write offs in period | **(6,621)** | **-** | **-** | **-** | **(6,621)** | **-** | **(6,621)** |
| Charge / (credit) for the period net of recoveries | **2,525** | **1,284** | **1,492** | **-** | **4,017** | **1,284** | **5,301** |
| At 31 December 2012 | **10,111** | **2,164** | **18,317** | **380** | **28,428** | **2,544** | **30,972** |
| **Bank** | | | | | | | |
| **At 1 January 2012** | **9,141** | **464** | **17,441** | **400** | **26,582** | **864** | **27,446** |
| Write offs in period | **(6,621)** | **-** | **-** | **-** | **(6,621)** | **-** | **(6,621)** |
| Charge/(credit) for the period net of recoveries | **3,049** | **1,768** | **1,295** | **(400)** | **4,344** | **1,368** | **5,714** |
| At 31 December 2012 | **5,569** | **2,232** | **18,736** | **-** | **24,305** | **2,232** | **26,537** |

| | Loans fully secured on residential property | | Other loans | | **2011** | | |
|---|---|---|---|---|---|---|---|
| | Individual £'000 | Collective £'000 | Individual £'000 | Collective £'000 | **Individual £'000** | **Collective £'000** | **Total £'000** |
| **Group** | | | | | | | |
| **At date of incorporation** | **-** | **-** | **-** | **-** | **-** | **-** | **-** |
| Transfer of business 1 February 2011 | **17,369** | **920** | **16,825** | **380** | **34,194** | **1,300** | **35,494** |
| Write offs in period | **(6,115)** | **-** | **-** | **-** | **(6,115)** | **-** | **(6,115)** |
| Charge/(credit) for the period net of recoveries | **2,953** | **(40)** | **-** | **-** | **2,953** | **(40)** | **2,913** |
| At 31 December 2011 | **14,207** | **880** | **16,825** | **380** | **31,032** | **1,260** | **32,292** |
| **Bank** | | | | | | | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **At date of incorporation** | **-** | **-** | **-** | **-** | **-** | **-** | **-** |
| Transfer of business 1 February 2011 | **14,719** | **671** | **16,825** | **371** | **31,544** | **1,042** | **32,586** |
| Write offs in period | **(6,115)** | **-** | **-** | **-** | **(6,115)** | **-** | **(6,115)** |
| Charge/(credit) for the period net of recoveries | **537** | **(207)** | **616** | **29** | **1,153** | **(178)** | **975** |
| At 31 December 2011 | **9,141** | **464** | **17,441** | **400** | **26,582** | **864** | **27,446** |

## 13. Impairment losses

| | Group | Group |
|---|---|---|
| | 31-Dec-12 | 31-Dec-11 |
| | £'000 | £'000 |
| Impairment losses on loans and advances to customers (see note 12) | **5,301** | **2,913** |
| | **5,301** | **2,913** |

## 14. Related parties and investments in group undertakings

The Bank has the following subsidiary undertakings, all of which are wholly owned with the exception of OSB IGH Limited which is 99% owned.

| | Class of shares | Activity | Country of Registration | £'000 Interest & Similar Expense | £'000 Balance due (to) Bank |
|---|---|---|---|---|---|
| Jersey Home Loans Ltd | Ordinary | Mortgage provider | England | 503 | (12,966) |
| Jersey Home Loans Ltd | Ordinary | Mortgage provider | Jersey | 15,623 | (483,721) |
| Easioption Ltd | Ordinary | Holding company | England | - | - |
| Guernsey Home Loans Ltd | Ordinary | Mortgage provider | England | 1,546 | (43,420) |
| Guernsey Home Loans Ltd | Ordinary | Mortgage provider | Guernsey | 2,657 | (102,128) |
| Reliance Property Loans Ltd | Ordinary | Mortgage provider | England | (108) | (4,999) |
| Easiprocess Private Ltd | Ordinary | Back office processing | India | - | - |
| Easioption BPO Services Private Ltd | Ordinary | Back office processing | India | - | - |
| OSB IGH Ltd* | Ordinary | Holding company | England | 1,651 | (50,677) |
| Prestige Finance Ltd | Ordinary | Mortgage provider | England | 2,427 | (2,296) |
| Swingcastle Ltd | Ordinary | Mortgage provider | England | - | - |

* Holding company for the Interbay group

All the above investments are reviewed annually for impairment. All the subsidiaries are actively trading or operating and fully funded by the Bank; based on management's assessment of the future cashflows of each entity, no impairment has been recognised.

In addition to the above subsidiaries the Bank has transactions with Kent Reliance Provident Society (KRPS), the majority shareholder. KRPS provides agency services to the Bank, whilst the Bank provides ancillary services including IT, finance and other support functions to KRPS. The net amount charged to and payable by the Bank as at 31 December 2012 was £1.04m (2011 £751k).

All related party transactions were made on terms equivalent to those that prevail in arm's length transactions. During the period there were no related party transactions between the key management personnel and the Bank.

Investments in subsidiaries are classified as financial fixed assets. The net movement during the year is as follow:

| | 2012 £'000 | | |
|---|---|---|---|
| | **Shares in subsidiary undertakings** | **Loans to subsidiary undertakings** | **Total** |
| At 1 January 2012 | - | 640,920 | **640,920** |
| Additions | 3,476 | 95,539 | **99,015** |
| Repayments | - | (36,252) | **(36,252)** |
| At 31 December 2012 | 3,476 | 700,207 | **703,683** |

| | 2011 £'000 | | |
|---|---|---|---|
| | **Shares in subsidiary undertakings** | **Loans to subsidiary undertakings** | **Total** |
| At date of incorporation | | | |
| Transfer of business 1 February 2011 | - | 631,397 | **631,397** |
| Additions | - | 26,900 | **26,900** |
| Repayments | - | (17,377) | **(17,377)** |
| At 31 December 2011 | - | 640,920 | **640,920** |

### Transactions with Key Management Personnel

The Board considers the key management personnel to comprise Executive and Non-Executive Directors. Details of remuneration paid and mortgage loans made to key management personnel and connected persons are set out in note 7.

Key management personnel held deposits and shares with the Group of £2k.

## Acquisitions during the year

### Interbay Group acquisition

On 28 August 2012 the Bank purchased the Interbay Group, a specialist SME mortgage lender. A new subsidiary was set up by OSB for the purchase called OSB IGH Limited, which then purchased 100% of the shares and voting rights in Interbay Financial I Ltd and Interbay Financial II Ltd. The

seller received 1% of the shares in OSB IGH Limited, leaving OSB as the majority shareholder with a 99% shareholding.

The purchase was made to enable OSB to access the SME lending market. The impact of the Interbay purchase has been consolidated into the accounts of OSB group and the impact is as follows:

In the period to 31 December 2012 the Interbay business contributed interest income of £1.6m and a loss before tax of £0.5m.

The acquisition had the following effect on the Group's assets and liabilities:

| | **Fair values on acquisition £000** |
|---|---|
| **Acquiree's net assets** | |
| Loans and advances to customers | **50,955** |
| Borrowings and loan notes | **(46,254)** |
| Other net assets | **1,807** |
| **Net identifiable assets and liabilities** | **6,508** |
| | |
| **Consideration transferred** | |
| Cash | **869** |
| B Shares in OSB IGH Limited | **1,272** |
| **Total consideration** | **2,141** |
| | |
| **Negative goodwill on acquisition** | **4,367** |

None of the goodwill on acquisition recognised is expected to be taxable.

The B shares carry the rights to a dividend however payment is subject to the Bank's consent. OSB Holdco Ltd, one of the Bank's shareholders owned by funds advised by J.C. Flowers & Co. LLP, provided certain dividend protection on the B shares and additionally enhanced the value of the shares above their nominal value via a bilateral put/call agreement with the seller, which also included first loss protection from the seller. The resulting net enhancement is reflected in the value of the B shares shown above. The fair value of the total consideration paid was lower than the fair value of net assets acquired primarily as a result of the first loss protection provided by the seller.

**Prestige and Swingcastle acquisition**

On 14 September 2012 the Bank purchased 100% of the shares and voting rights of Prestige Finance Ltd and its sister company Swingcastle Ltd (the Prestige Group) both of whom are specialist second charge lenders.

The purchase was made to enable OSB to access the second charge lending market. The impact of the Prestige Group purchase has been consolidated into the accounts of OSB Group and the impact is as follows:

In the period to 31 December 2012 the Prestige acquisition contributed interest income of £1.9m and a profit before tax of £1.1m.

The acquisition had the following effect on the Group's assets and liabilities:

| | Fair values on acquisition £000 |
|---|---|
| **Acquiree's net assets** | |
| Loans and advances to customers | **55,000** |
| Borrowings and loan notes | **(38,142)** |
| Other net liabilities | **(1,078)** |
| **Net identifiable assets and liabilities** | **15,780** |
| | |
| **Consideration transferred** | |
| Cash | **340** |
| E shares in OSB | **2,204** |
| **Total consideration** | **2,544** |
| | |
| **Negative goodwill on acquisition** | **13,236** |

None of the goodwill on acquisition recognised is expected to be taxable.

The ordinary E shares are non-voting and have no entitlement to a dividend. The E shares issued have had their value enhanced over and above their nominal value by a bilateral put/call agreement between the holders and OSB Holdco Ltd, one of the Bank's shareholders. This enhancement is reflected in the value of the E shares shown above.

The negative goodwill on the purchase arose due to the distressed sale of the company owing to the non-extension of its funding line.

## 15. Intangible fixed assets

| | Group and Bank 31-Dec-12 £'000 | Group and Bank 31-Dec-11 £'000 |
|---|---|---|
| **Cost** | | |
| At 1 January 2012 / date of incorporation | **2,678** | **-** |
| Transfer of business 1 February 2011 | **-** | **2,219** |
| Additions | **594** | **459** |
| **At 31 December 2012 / 2011** | **3,272** | **2,678** |
| **Amortisation** | | |
| At 1 January 2012 / date of incorporation | **2,183** | **-** |
| Transfer of business 1 February 2011 | | **2,090** |
| Charged in period | **179** | **93** |
| **At 31 December 2012 / 2011** | **2,362** | **2,183** |
| **Net book value** | | |
| **At 31 December 2012** | **910** | **495** |

Intangible fixed assets consist of computer software. There were no capitalised borrowing costs related to the internal development of software during the period.

## 16. Property, plant and equipment

**Group 2012**

| | Freehold land and buildings £'000 | Equipment, fixtures and vehicles £'000 | 31-Dec-12 Total £'000 |
|---|---|---|---|
| **Cost** | | | |
| At 1 January 2012 | 1,259 | 6,046 | 7,305 |
| Additions on acquisition | - | 2,367 | 2,367 |
| Additions | 160 | 127 | 287 |
| **At 31 December 2012** | 1,419 | 8,540 | 9,959 |
| **Depreciation** | | | |
| At 1 January 2012 | 200 | 5,247 | 5,447 |
| Charged in period | 19 | 262 | 281 |
| **At 31 December 2012** | 219 | 5,509 | 5,728 |
| **Net book value** | | | |
| **At 31 December 2012** | 1,200 | 3,031 | 4,231 |

**Bank 2012**

| | Freehold land and buildings £'000 | Equipment, fixtures and vehicles £'000 | 31-Dec-12 Total £'000 |
|---|---|---|---|
| **Cost** | | | |
| At 1 January 2012 | 1,259 | 4,465 | 5,724 |
| Additions | 160 | 264 | 424 |
| **At 31 December 2012** | 1,419 | 4,729 | 6,148 |
| **Depreciation** | | | |
| At 1 January 2012 | 200 | 4,107 | 4,307 |
| Charged in period | 19 | 131 | 150 |
| **At 31 December 2012** | 219 | 4,238 | 4,457 |
| **Net book value** | | | |
| **At 31 December 2012** | 1,200 | 491 | 1,691 |

**Group 2011**

| | Freehold land and buildings £'000 | Equipment, fixtures and vehicles £'000 | 31-Dec-11 Total £'000 |
|---|---|---|---|
| **Cost** | | | |
| Date of incorporation | - | - | - |
| Transfer of business 1 February 2011 | 1,259 | 5,767 | 7,026 |
| Additions | - | 279 | 279 |

| | | | |
|---|---|---|---|
| **At 31 December 2011** | **1,259** | **6,046** | **7,305** |
| **Depreciation** | | | |
| Date of incorporation | **-** | **-** | **-** |
| Transfer of business 1 February 2011 | **182** | **5,044** | **5,226** |
| Charged in period | **18** | **203** | **221** |
| **At 31 December 2011** | **200** | **5,247** | **5,447** |
| **Net book value** | | | |
| **At 31 December 2011** | **1,059** | **799** | **1,858** |

**Bank 2011**

| | Freehold land and buildings £'000 | Equipment, fixtures and vehicles £'000 | 31-Dec-11 Total £'000 |
|---|---|---|---|
| **Cost** | | | |
| Date of incorporation | **-** | **-** | **-** |
| Transfer of business 1 February 2011 | **1,259** | **4,190** | **5,449** |
| Additions | **-** | **275** | **275** |
| **At 31 December 2011** | **1,259** | **4,465** | **5,724** |
| **Depreciation** | | | |
| Date of incorporation | **-** | **-** | **-** |
| Transfer of business 1 February 2011 | **182** | **4,024** | **4,206** |
| Charged in period | **18** | **83** | **101** |
| **At 31 December 2011** | **200** | **4,107** | **4,307** |
| **Net book value** | | | |
| **At 31 December 2011** | **1,059** | **358** | **1,417** |

## 17. Deferred taxation

| Deferred taxation asset | Group 31-Dec-12 £'000 | Bank 31-Dec-12 £'000 | Group 31-Dec-11 £'000 | Bank 31-Dec-11 £'000 |
|---|---|---|---|---|
| At 1 January 2012 / date of incorporation | **14,918** | **12,333** | **-** | **-** |
| Transfer of business 1 February 2011 | **-** | **-** | **11,789** | **11,789** |
| Tax taken directly to equity | **-** | **-** | **1,186** | **-** |
| Tax on acquisition of Prestige | **-** | **225** | **-** | **-** |
| Income statement credit | **1,101** | **1,246** | **1,943** | **544** |
| At 31 December 2012 / 2011 | **16,019** | **13,804** | **14,918** | **12,333** |
| This represents: | | | | |
| Carried forward taxation losses | **15,838** | **13,793** | **14,586** | **12,214** |
| Accelerated taxation depreciation | **181** | **11** | **332** | **119** |

| | | | | |
|---|---|---|---|---|
| | **16,019** | **13,804** | **14,918** | **12,333** |
| Deferred taxation liability | | | | |
| At 1 January 2012 / date of incorporation | **562** | **562** | **-** | **-** |
| Transfer of business 1 February 2011 | **-** | **-** | **243** | **243** |
| Income statement credit | **(173)** | **(173)** | **319** | **319** |
| At 31 December 2012 / 2011 | **389** | **389** | **562** | **562** |

The Chancellor's Autumn Statement on 5 December 2012 announced that the UK corporation tax rate will reduce to 21% by 2014. A reduction in the rate from 26% to 25% (effective from 1 April 2011) was substantively enacted on 5 July 2011, and further reductions to 24% (effective from 1 April 2012) and 23% (effective from 1 April 2013) were substantively enacted on 26 March 2012 and 3 July 2012 respectively. The Group's future current tax rate and deferred tax asset will reduce when the additional announced cuts are substantively enacted.

The deferred tax asset as at 31 December 2012 has been calculated using a rate of 23% being the rate substantively enacted at the balance sheet date. Recovery time horizons are based on the Group’s latest 5 year business plan projections out to 2017.

Refer to note 1(f) and note 1(r)(iv) for further detail in relation to key judgements on deferred taxation.

## 18. Other assets

| | **Group 31-Dec-12 £'000** | **Bank 31-Dec-12 £'000** | **Group 31-Dec-11 £'000** | **Bank 31-Dec-11 £'000** |
|---|---|---|---|---|
| Prepayments | **1,416** | **1,417** | **1,330** | **1,330** |
| Value added taxation repayable | **6** | **6** | **419** | **419** |
| Other assets | **1,753** | **-** | **1,176** | **-** |
| | **3,175** | **1,423** | **2,925** | **1,749** |

## 19. Amounts owed to retail depositors

| | **Group and Bank 31-Dec-12 £'000** | **Group and Bank 31-Dec-11 £'000** |
|---|---|---|
| Amounts owed to retail depositors | **2,744,646** | **2,081,590** |

Repayable from the date of the balance sheet in the ordinary course of business as follows:

| | | |
|---|---|---|
| On demand | **1,195,956** | **674,527** |
| In not more than three months | **261,910** | **129,562** |
| In more than three months but not more than one year | **743,346** | **576,755** |
| In more than one year but not more than five years | **543,434** | **700,746** |
| | **2,744,646** | **2,081,590** |

## 20. Amounts owed to credit institutions

| | Group and Bank 31-Dec-12 £'000 | Group and Bank 31-Dec-11 £'000 |
|---|---|---|
| Repayable from the date of the balance sheet in the ordinary course of business as follows: | | |
| In not more than three months | 3,190 | 831 |
| | 3,190 | 831 |

## 21. Amounts owed to other customers

| | Group and Bank 31-Dec-12 £'000 | Group and Bank 31-Dec-11 £'000 |
|---|---|---|
| Repayable from the date of the balance sheet in the ordinary course of the business as follows: | | |
| In not more than three months | 7,317 | 18,569 |
| In more than three months but not more than one year | 13,943 | 18,822 |
| In more than one year but not more than five years | 503 | 1,003 |
| | 21,763 | 38,394 |

## 22. Other liabilities

| | Group 31-Dec-12 £'000 | Bank 31-Dec-12 £'000 | Group 31-Dec-11 £'000 | Bank 31-Dec-11 £'000 |
|---|---|---|---|---|
| Falling due within one year | | | | |
| Tax deducted at source from interest paid | 2,480 | 2,480 | 1,434 | 1,434 |
| Other creditors | 1,909 | 1,360 | 9 | 9 |
| Accruals and deferred income | 5,852 | 5,468 | 3,108 | 2,875 |
| | 10,241 | 9,308 | 4,551 | 4,318 |

## 23. Subordinated liabilities

| | Group and Bank 31-Dec-12 £'000 | Group and Bank 31-Dec-11 £'000 |
|---|---|---|
| Linked to LIBOR (London Interbank Offered Rate): | | |
| Floating rate Subordinated Liabilities 2015 | 3,002 | 3,002 |
| Floating rate Subordinated Liabilities 2016 | 3,003 | 2,996 |
| Floating rate Subordinated Liabilities 2017 | 5,656 | 5,642 |
| Floating rate Subordinated Loans 2022 | 703 | - |
| Linked to the average standard mortgage rate of the five largest building societies: | | |
| Floating rate Subordinated Liabilities 2017 | 5,049 | 5,039 |
| Fixed rate: | | |
| 6.45% Subordinated Liabilities 2024 | 10,163 | 10,163 |

| | | |
|---|---|---|
| | **27,576** | **26,842** |

Subordinated liabilities are repayable at the dates stated or earlier at the option of the Group with the prior consent of the Financial Services Authority. All Subordinated Liabilities are denominated in sterling.

The rights of repayment of the holders of these issues are subordinated to the claims of all depositors and all creditors.

## 24. Perpetual Subordinated Bonds

| | Group and Bank 31-Dec-12 £'000 | Group and Bank 31-Dec-11 £'000 |
|---|---|---|
| 7.875% sterling Perpetual Subordinated Bonds | **15,189** | **15,327** |

The bonds were issued with no discretion over the payment of interest and are treated as debt and therefore classified as financial liabilities.

## 25. Share Capital

| | Group and Bank 31-Dec-12 Number of Shares | | | |
|---|---|---|---|---|
| | **Ordinary A shares** | **Ordinary B shares** | **Ordinary E shares** | **Convertible Preference shares** |
| As at 1 January 2012 | **26,000** | **19,997** | **-** | **314,814** |
| Additional capital injection 28 June 2012 | **-** | **900** | **-** | **489,340** |
| Shares issued 14 September 2012* | **-** | **-** | **1,000** | **-** |
| As at 31 December 2012 | **26,000** | **20,897** | **1,000** | **804,154** |

| | Group and Bank 31-Dec-12 £000's | | |
|---|---|---|---|
| | **Value** | **Premium** | **Total** |
| Ordinary A shares | **26** | **25,974** | **26,000** |
| Ordinary B shares | **21** | **78,393** | **78,414** |
| Ordinary E shares | **150** | **-** | **150** |
| Convertible Preference shares | **804** | **782** | **1,586** |
| As at 31 December 2012 | **1,001** | **105,149** | **106,150** |

* Shares issued to the sellers of the Prestige Group as part of the purchase consideration.

**Group and Bank**
**31-Dec-11**
**Number of Shares**

| | Ordinary A shares | Ordinary B shares | Ordinary E shares | Convertible Preference shares |
|---|---|---|---|---|
| Transfer of business 1 February 2011 | **26,000** | **-** | **-** | **-** |
| Capital injection 1 February 2011 | **-** | **17,426** | **-** | **32,574** |
| Additional capital injection 31 August 2011 | **-** | **2,571** | **-** | **282,240** |
| As at 31 December 2011 | **26,000** | **19,997** | **-** | **314,814** |

| | Group and Bank<br>31-Dec-11<br>£000's | | |
|---|---|---|---|
| | **Value** | **Premium** | **Total** |
| Ordinary A shares | **26** | **25,974** | **26,000** |
| Ordinary B shares | **20** | **63,883** | **63,903** |
| Convertible Preference shares | **315** | **782** | **1,097** |
| As at 31 December 2011 | **361** | **90,639** | **91,000** |

At 31 December 2012, the share capital comprised 47,897 fully allotted and paid up ordinary shares and 804,154 convertible preference shares. The ordinary A, B and preference shares have a par value of £1. The ordinary E shares have a par value of £150.

Both A & B ordinary shares have veto rights appropriate for a participant in a joint venture arrangement providing they retain a certain percentage of the ordinary shares of the Bank. The convertible preference share holders have preferential rights in relation to any dividends that may be declared by the board of the Bank. The ordinary E shares are non-voting and have no entitlement to a dividend.

The 1000 E shares issued on 14 September 2012 as consideration for the acquisition of the Prestige group (see note 14 Related parties and investments in group undertakings for more details) have had their value enhanced over and above their nominal value by a bilateral put/call agreement between the holders and OSB Holdco Ltd.

**Perpetual Subordinated Bonds**

In addition to the PSBs in note 24, the Bank has issued £22m 6.591% PSBs which are classified as equity, as full discretion can be exercised by the Directors over the payment of the coupon. The classification of these PSBs means that any coupon payments on them are now treated within equity rather than through the Income Statement.

**Transfer reserve**

The transfer reserve of £12.8m (Bank: £15.2m) represents the difference between the true value of net assets transferred as at the date of transfer and the value of shares issued to the A ordinary shareholders.

**AFS reserve**

The AFS reserve of £1.3m (2011: £1.8m) represents the cumulative net change in the fair value of investment securities measured at fair value through other comprehensive income net of deferred tax.

## 26. FSCS and other provisions

In common with all regulated UK deposit takers, OneSavings Bank plc pays levies to the Financial Services Compensation Scheme (FSCS) to enable the FSCS to meet claims against it. The FSCS levy consists of two parts: a management expenses levy and a compensation levy. The management expenses levy covers the costs of running the scheme and the compensation levy covers the amount of compensation the scheme pays, net of any recoveries it makes using the rights that have been assigned to it. During 2008 and 2009 claims were triggered against the FSCS in relation to Bradford & Bingley plc, Kaupthing Singer & Friedlander Ltd, Heritable Bank plc, Landsbanki Islands hf, London Scottish Bank plc and Dunfermline Building Society.

The FSCS meets these current claims by way of loans received from HMT. The terms of these loans were interest only for the first three years, and the FSCS seeks to recover the interest cost, together with ongoing management expenses, by way of annual management levies on members over this period. The Bank pays levies to the ('FSCS') to enable the FSCS to meet claims against it.

The Bank's FSCS provision reflects market participation up to the reporting date and relates to the estimated management expense levy for the scheme years 2010/11, 2011/12, 2012/13 and the estimated management expense levy and capital levy for scheme year 2013/14. These amounts were calculated on the basis of the Bank's share of protected deposits taking into account the FSA's estimate of total management expenses levies for each scheme year.

The management expenses levy for scheme year 2011/12, which formed part of the provision at 31 December 2012, was calculated using the agreed funding rate of 12 month LIBOR + 30bps. Following the expiry of the initial three year fixed interest term, extensive negotiations between HMT and FSCS resulted in an agreed funding rate of 12 month LIBOR + 100bps which is the rate that will be charged for the HMT loans for the period from 1 April 2012, on which the management expenses levy for scheme years 2012/13 and 2013/14 have been based. The Bank has therefore recognised a provision of £1.2m related to management expense levy for 2013/14 and an additional levy of £0.1m for the periods 2010/11 and 2011/12.

In addition to the management levies, from scheme year 2013/14, triggered by participation in the market at 31 December 2012, the FSCS is to levy over three years the current estimated shortfall on capital loans outstanding of £802m. In common with the management expenses levy, the capital loan repayment was calculated on the basis of the Bank's current share of UK protected deposits. The Bank has therefore recognised a provision of £1m related to the capital levy.

| Movement in provisions: | **Group and Bank**<br>**FSCS**<br>**31-Dec-12**<br>**£'000** | **Group and Bank**<br>**Regulatory provisions**<br>**31-Dec-12**<br>**£'000** | **Group and Bank**<br>**FSCS**<br>**31-Dec-11**<br>**£'000** | **Group and Bank**<br>**Regulatory provisions**<br>**31-Dec-11**<br>**£'000** |
|---|---|---|---|---|
| As at 1 January 2012 / date of incorporation | **2,387** | **150** | **-** | **-** |
| Transfer of business 1 February 2011 | **-** | **-** | **1,186** | **648** |
| Paid during the period | **-** | **(6)** | **-** | **-** |
| Net charge/(release) for the period | **2,325** | **6** | **1,201** | **(498)** |
| At 31 December 2012 / 2011 | **4,712** | **150** | **2,387** | **150** |

## 27. Financial commitments

a) There were no capital commitments for the Group contracted but not provided for as at 31 December 2012 (2011: Nil).

b) Operating leases

| Total commitments under operating leases | *Group and Bank*<br>**31-Dec-12**<br>**£'000** | *Group and Bank*<br>**31-Dec-11**<br>**£'000** |
|---|---|---|
| Land and buildings | | |
| Within one year | **130** | **68** |
| Within two to five years | **299** | **8** |
| | **429** | **76** |

| | Group<br>31-Dec-12<br>£'000 | Bank<br>31-Dec-12<br>£'000 | Group<br>31-Dec-11<br>£'000 | Bank<br>31-Dec-11<br>£'000 |
|---|---|---|---|---|
| c) Undrawn mortgage loan facilities | **132,704** | **81,368** | **26,326** | **17,358** |

## 28. Risk management and financial instruments

**Overview**

Financial instruments form the vast majority of the Group's and Bank's assets and liabilities. The Group manages risk on a consolidated basis, and risk disclosures are provided on this basis.

**Types of financial instrument**

A financial instrument is one which gives rise to a financial asset or a financial liability. The Group is a retailer of financial instruments, mainly in the form of mortgages and savings products. The Group also uses wholesale financial instruments to invest liquid asset balances, to raise wholesale funding and to manage the risks arising from its operations. The Group does not operate a trading book.

The Group uses derivative instruments to manage various aspects of market risk. Instruments used for risk management purposes include derivative financial instruments ("derivatives"), which are contracts whose value is derived from one or more underlying prices, rates or indices defined in the contract or agreement, such as interest rates. Derivatives are solely used by the Group to reduce the risk of loss arising from changes in market factors. Derivatives are not used for speculative purposes.

**Types of derivatives and uses**

The derivative instruments used by the Group in managing its balance sheet risk exposures are interest rate swaps. These are used to protect the Group from exposures arising principally from fixed rate mortgage lending, deposit funding and subscribed capital. An interest rate swap is a contract to exchange one set of interest rate cash flows for another. Such swaps result in the economic exchange of interest rates. No exchange of principal takes place. Instead, interest payments are based on notional principal amounts agreed at the inception of the swap.

The following table describes the significant activities undertaken by the Group and the risks associated with such activities: derivatives in the form of interest rate swaps are used by the Group in managing such risks. Such risks may alternatively be managed using existing Balance Sheet instruments as part of the Group's integrated approach to risk management.

| Activity | Risk |
|---|---|
| Fixed rate savings products and fixed rate funding | Decrease in interest rates |

| Fixed rate mortgage lending and fixed rate asset investments | Increase in interest rates |
|---|---|

**Financial risks**

The principal risks to which the Group is exposed are operational, credit, liquidity and market risk. Each of these is considered below.

**Credit risk**

Credit risk is the risk that unexpected losses may arise as a result of the Group's borrowers or market counterparties failing to meet their obligations to repay.

The Group has adopted the Standardised Approach for assessment of credit risk capital requirements. This approach considers risk weightings as defined under Basel II principles.

The classes of financial instruments to which the Group is most exposed are loans and advances to customers, loans and advances to credit institutions, and investment securities. The maximum exposure to credit risk is generally represented by the carrying amount of each financial asset plus any off-balance sheet credit commitments.

**Credit risk - loans and advances to customers**

Credit risk associated with mortgage lending is largely driven by the housing market and level of unemployment. A recession and/or high interest rates could cause pressure within the market, resulting in rising levels of arrears and repossessions.

All loan applications are assessed with reference to the Group's Lending Policy. Changes to policy are approved by the Board, with mandates set for the approval of loan applications.

Credit Committee and the ALCO regularly monitor lending activity, taking appropriate actions to re-price products and adjust lending criteria in order to control risk and manage exposure. Where necessary and appropriate, changes to Lending Policy are recommended to the Risk Committee and the Board.

The following table shows an analysis of the Group mortgage portfolio by borrower type at year-end:

| **Loans and advances to customers** | **Group 31 December 2012** | | **Bank 31 December 2012** | |
|---|---|---|---|---|
| | **£'000** | **%** | **£'000** | **%** |
| Owner occupied mortgages | **1,614,434** | **72%** | **1,130,945** | **74%** |
| Buy to let mortgages | **450,748** | **20%** | **304,210** | **20%** |
| Commercial mortgages | **161,840** | **8%** | **88,235** | **6%** |
| Total | **2,227,022** | **100%** | **1,523,390** | **100%** |

| **Loans and advances to customers** | **Group 31 December 2011** | | **Bank 31 December 2011** | |
|---|---|---|---|---|
| | **£'000** | **%** | **£'000** | **%** |
| Owner occupied mortgages | **1,257,452** | **75%** | **778,645** | **75%** |
| Buy to let mortgages | **288,489** | **17%** | **160,881** | **16%** |
| Commercial mortgages | **126,297** | **8%** | **94,974** | **9%** |
| Total | **1,672,238** | **100%** | **1,034,500** | **100%** |

Property values are updated to reflect changes in the house price index. A breakdown of the table above by indexed loan to value is as follows:

**Loan to value analysis by band:**

**Group**

**31 December 2012**

| Band | Owner occupied £'000 | Buy to let £'000 | Commercial £'000 | Total £'000 | |
|---|---|---|---|---|---|
| 0 – 50% | **807,057** | **54,992** | **27,732** | **889,781** | **39%** |
| 50% - 60% | **235,402** | **44,758** | **19,600** | **299,760** | **13%** |
| 60% - 70% | **241,151** | **87,064** | **30,230** | **358,445** | **15%** |
| 70% - 80% | **165,841** | **152,177** | **31,529** | **349,547** | **15%** |
| 80% - 90% | **117,221** | **65,966** | **8,252** | **191,439** | **9%** |
| >90% | **47,762** | **45,791** | **44,497** | **138,050** | **9%** |
| Total | **1,614,434** | **450,748** | **161,840** | **2,227,022** | **100%** |

**Bank**

**31 December 2012**

| Band | Owner occupied £'000 | Buy to let £'000 | Commercial £'000 | Total £'000 | |
|---|---|---|---|---|---|
| 0 - 50% | **693,882** | **24,964** | **12,295** | **731,141** | **48%** |
| 50% - 60% | **165,362** | **24,438** | **8,126** | **197,926** | **13%** |
| 60% - 70% | **159,741** | **57,540** | **14,318** | **231,599** | **15%** |
| 70% - 80% | **78,092** | **118,629** | **14,659** | **211,380** | **14%** |
| 80% - 90% | **28,788** | **40,979** | **1,128** | **70,895** | **5%** |
| >90% | **5,080** | **37,660** | **37,709** | **80,449** | **5%** |
| Total | **1,130,945** | **304,210** | **88,235** | **1,523,390** | **100%** |

**Group**

**31 December 2011**

| Band | Owner occupied £'000 | Buy to let £'000 | Commercial £'000 | Total £'000 | |
|---|---|---|---|---|---|
| 0 - 50% | **632,602** | **52,120** | **16,534** | **701,256** | **42%** |
| 50% - 60% | **183,100** | **36,041** | **16,711** | **235,852** | **14%** |
| 60% - 70% | **210,321** | **67,796** | **26,786** | **304,903** | **18%** |
| 70% - 80% | **130,692** | **59,822** | **22,353** | **212,867** | **13%** |
| 80% - 90% | **68,724** | **29,130** | **3,519** | **101,373** | **6%** |
| >90% | **32,013** | **43,580** | **40,394** | **115,987** | **7%** |
| Total | **1,257,452** | **288,489** | **126,297** | **1,672,238** | **100%** |

**Bank**

**31 December 2011**

| Band | Owner occupied £'000 | Buy to let £'000 | Commercial £'000 | Total £'000 | |
|---|---|---|---|---|---|
| 0 - 50% | **488,408** | **22,490** | **12,735** | **523,633** | **51%** |
| 50% - 60% | **104,428** | **13,646** | **8,227** | **126,301** | **12%** |
| 60% - 70% | **111,322** | **38,326** | **17,105** | **166,753** | **16%** |
| 70% - 80% | **56,132** | **33,048** | **17,554** | **106,734** | **10%** |

| | | | | | |
|---|---|---|---|---|---|
| 80% - 90% | **14,963** | **14,896** | **1,092** | **30,951** | **3%** |
| >90% | **3,392** | **38,475** | **38,261** | **80,128** | **8%** |
| Total | **778,645** | **160,881** | **94,974** | **1,034,500** | **100%** |

**Analysis of mortgage portfolio by arrears and collateral held**

The table below provides further information on the mortgage portfolio by payment due status:

**Not impaired:**

| **Status** | **Group 31 December 2012** | | **Bank 31 December 2012** | |
|---|---|---|---|---|
| | **Mortgage balance** | **Collateral** | **Mortgage balance** | **Collateral** |
| | **£'000** | **£'000** | **£'000** | **£'000** |
| Not past due | **1,823,147** | **1,819,576** | **1,225,392** | **1,224,053** |
| Past due up to 3 months | **250,543** | **250,543** | **182,445** | **181,975** |
| Past due 3 to 6 months | **33,055** | **33,055** | **25,699** | **25,400** |
| Past due 6 to 12 months | **26,769** | **26,570** | **16,816** | **16,471** |
| Past due over 12 months | **19,862** | **18,515** | **10,528** | **9,769** |
| Possessions | **7,560** | **7,543** | **5,268** | **5,250** |
| | **2,160,936** | **2,155,802** | **1,466,148** | **1,462,918** |

| **Status** | **Group 31 December 2011** | | **Bank 31 December 2011** | |
|---|---|---|---|---|
| | **Mortgage balance** | **Collateral** | **Mortgage balance** | **Collateral** |
| | **£'000** | **£'000** | **£'000** | **£'000** |
| Not past due | **1,398,316** | **1,398,117** | **849,561** | **849,369** |
| Past due up to 3 months | **140,910** | **140,910** | **89,558** | **89,558** |
| Past due 3 to 6 months | **19,171** | **19,069** | **10,038** | **9,936** |
| Past due 6 to 12 months | **13,342** | **13,166** | **7,584** | **7,423** |
| Past due over 12 months | **5,482** | **5,455** | **3,314** | **3,285** |
| Possessions | **1,217** | **1,217** | **1,217** | **1,217** |
| | **1,578,438** | **1,577,934** | **961,272** | **960,788** |

Note: For each exposure collateral value is capped at the mortgage balance to eliminate the effect of over-collateralisation.

**Impaired:**

| **Status** | **Group 31 December 2012** | | **Bank 31 December 2012** | |
|---|---|---|---|---|
| | **Mortgage balance** | **Collateral** | **Mortgage balance** | **Collateral** |
| | **£'000** | **£'000** | **£'000** | **£'000** |
| Not past due | **2,184** | **663** | **2,184** | **663** |
| Past due up to 3 months | **94** | **94** | **94** | **94** |
| Past due 3 to 6 months | **-** | **-** | **-** | **-** |

| | | | | |
|---|---|---|---|---|
| Past due 6 to 12 months | **1,776** | **1,410** | **918** | **910** |
| Past due over 12 months | **50,083** | **32,191** | **49,082** | **31,236** |
| Possessions | **11,949** | **10,241** | **4,964** | **3,770** |
| Total | **66,086** | **44,599** | **57,242** | **36,673** |

| **Status** | **Group 31 December 2011** | | **Bank 31 December 2011** | |
|---|---|---|---|---|
| | **Mortgage balance** | **Collateral** | **Mortgage balance** | **Collateral** |
| | **£'000** | **£'000** | **£'000** | **£'000** |
| Not past due | **15,178** | **12,596** | **5,609** | **4,811** |
| Past due up to 3 months | **17,334** | **14,504** | **16,151** | **13,542** |
| Past due 3 to 6 months | **3,822** | **3,822** | **-** | **-** |
| Past due 6 to 12 months | **14,987** | **11,497** | **11,222** | **7,773** |
| Past due over 12 months | **32,803** | **16,872** | **30,571** | **14,640** |
| Possessions | **9,676** | **8,062** | **9,676** | **8,022** |
| Total | **93,800** | **67,353** | **73,229** | **48,788** |

Note: For each exposure collateral value is capped at the mortgage balance to eliminate the effect of over-collateralisation.

| **Collateral held against mortgages** | **Group 31 December 2012** | | **Bank 31 December 2012** | |
|---|---|---|---|---|
| | **Mortgage balance** | **Collateral** | **Mortgage balance** | **Collateral** |
| | **£'000** | **£'000** | **£'000** | **£'000** |
| Past due but not impaired | **337,789** | **336,626** | **240,756** | **239,610** |
| Impaired | **66,086** | **44,599** | **57,242** | **36,673** |
| Total | **403,875** | **381,225** | **297,998** | **276,283** |

| **Collateral held against mortgages** | **Group 31 December 2011** | | **Bank 31 December 2011** | |
|---|---|---|---|---|
| | **Mortgage balance** | **Collateral** | **Mortgage balance** | **Collateral** |
| | **£'000** | **£'000** | **£'000** | **£'000** |
| Past due but not impaired | **180,122** | **179,817** | **111,711** | **111,419** |
| Impaired | **93,800** | **67,353** | **73,229** | **48,788** |
| Total | **273,922** | **247,170** | **184,940** | **160,207** |

Note: For each exposure collateral value is capped at the mortgage balance to eliminate the effect of over-collateralisation.

**Geographical analysis by region**

An analysis of mortgages by region is provided below:

| **Region** | **Group 31 December 2012** | | **Bank 31 December 2012** | |
|---|---|---|---|---|
| | **£'000** | **%** | **£'000** | **%** |

| | | | | |
|---|---|---|---|---|
| East Anglia | **48,092** | **2.2%** | **45,285** | **3.0%** |
| East Midlands | **79,239** | **3.6%** | **75,080** | **4.9%** |
| Greater London | **451,851** | **20.3%** | **441,273** | **29.0%** |
| Guernsey | **146,959** | **6.6%** | **-** | **0.0%** |
| Jersey | **501,259** | **22.5%** | **-** | **0.0%** |
| Northern Ireland | **7,442** | **0.3%** | **6,963** | **0.5%** |
| North | **7,515** | **0.3%** | **7,515** | **0.5%** |
| North East | **29,158** | **1.3%** | **27,063** | **1.8%** |
| North West | **113,275** | **5.1%** | **106,173** | **7.0%** |
| Scotland | **39,749** | **1.8%** | **37,490** | **2.5%** |
| South East | **493,492** | **22.2%** | **485,761** | **31.9%** |
| South West | **113,638** | **5.1%** | **109,045** | **7.2%** |
| Wales | **50,450** | **2.3%** | **45,402** | **3.0%** |
| West Midlands | **91,364** | **4.1%** | **86,675** | **5.4%** |
| Yorks & Humberside | **53,539** | **2.3%** | **49,665** | **3.3%** |
| Total | **2,227,022** | **100.0%** | **1,523,390** | **100.0%** |

| **Region** | **Group 31 December 2011** | | **Bank 31 December 2011** | |
|---|---|---|---|---|
| | **£'000** | **%** | **£'000** | **%** |
| East Anglia | **27,962** | **1.7%** | **27,487** | **2.7%** |
| East Midlands | **48,202** | **2.9%** | **47,936** | **4.6%** |
| Greater London | **328,965** | **19.7%** | **327,320** | **31.6%** |
| Guernsey | **119,507** | **7.1%** | **-** | **-** |
| Jersey | **512,072** | **30.6%** | **-** | **-** |
| Northern Ireland | **4,002** | **0.2%** | **4,002** | **0.4%** |
| North | **16,092** | **1.0%** | **15,671** | **1.5%** |
| North West | **70,748** | **4.3%** | **70,264** | **6.8%** |
| Scotland | **7,410** | **0.4%** | **7,409** | **0.7%** |
| South East | **376,805** | **22.5%** | **375,981** | **36.3%** |
| South West | **72,488** | **4.3%** | **72,013** | **7.0%** |
| Wales | **16,732** | **1.0%** | **16,613** | **1.6%** |
| West Midlands | **48,297** | **2.9%** | **47,821** | **4.6%** |
| Yorkshire & Humberside | **22,956** | **1.4%** | **21,983** | **2.2%** |
| Total | **1,672,238** | **100.0%** | **1,034,500** | **100.0%** |

**Credit risk - investment securities and loans and advances to credit institutions**

The Group holds treasury instruments in order to meet liquidity requirements and for general business purposes. The credit risk arising from these investments is closely monitored and managed by the Group's Treasury department within the guidelines laid down in the Treasury Policy approved by the Board and reported to the ALCO monthly.

As at 31 December 2012 one of the Group's treasury portfolio exposures - Glitnir: £1.6m against which impairment provision has been made of £1.1m - was both past due and impaired. There are no assets held as treasury instruments whose terms have been renegotiated.

The Group has limited exposure to emerging markets (Indian operations) and to non-investment-grade debt, including investments with building societies and local authorities. The ALCO is responsible for approving Treasury counterparties.

| **Ratings** | **Group 31 December 2012** |
|---|---|

| | AAA | AA | A | Less than A rating | Unrated building societies | Total |
|---|---|---|---|---|---|---|
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Certificate of deposit | - | 15,004 | - | - | - | 15,004 |
| Call accounts | 1,804 | - | 202,871 | 524 | - | 205,199 |
| Time deposits | - | - | 65,020 | 22,003 | - | 87,023 |
| Floating rate notes | 5,011 | - | - | - | - | 5,011 |
| Treasury bills | 261,464 | - | - | - | - | 261,464 |
| RMBS | 16,117 | - | 5,825 | - | - | 21,942 |
| Gilts | 106,396 | - | - | - | - | 106,396 |
| Total | 390,792 | 15,004 | 273,716 | 22,527 | - | 702,039 |
| Percentages | 55.7% | 2.1% | 39.0% | 3.2% | 0.0% | 100.0% |

| **Ratings** | **Bank<br>31 December 2012** | | | | | |
|---|---|---|---|---|---|---|
| | AAA | AA | A | Less than A rating | Unrated building societies and local authority | Total |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Certificate of deposit | - | 15,004 | - | - | - | 15,004 |
| Call accounts | 1,804 | - | 200,682 | 524 | - | 203,010 |
| Time deposits | - | - | 65,020 | 22,003 | - | 87,023 |
| Floating rate notes | 5,011 | - | - | - | - | 5,011 |
| Treasury bills | 261,464 | - | - | - | - | 261,464 |
| RMBS | 16,117 | - | 5,825 | - | - | 21,942 |
| Gilts | 106,396 | - | - | - | - | 106,396 |
| Total | 390,792 | 15,004 | 271,527 | 22,527 | - | 699,850 |
| Percentages | 55.9% | 2.1% | 38.8% | 3.2% | - | 100.0% |

| **Ratings** | **Group<br>31 December 2011** | | | | | |
|---|---|---|---|---|---|---|
| | AAA | AA | A | Less than A rating | Unrated building societies | Total |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Certificate of deposit | - | 47,238 | 91,516 | 4,553 | 10,035 | 153,342 |
| Call accounts | 1,213 | - | 194,511 | - | - | 195,724 |
| Time deposits | 8,146 | 1,276 | - | - | - | 9,422 |
| Floating rate notes | 5,011 | 2,509 | 3,246 | - | - | 10,766 |
| Treasury bills | 147,507 | - | - | - | - | 147,507 |
| Gilts | 84,237 | - | - | - | - | 84,237 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total | **246,114** | **51,023** | **289,273** | **4,553** | **10,035** | **600,998** |
| Percentages | **41.0%** | **8.5%** | **48.1%** | **0.8%** | **1.7%** | **100.0%** |

| **Ratings** | **Bank 31 December 2011** | | | | | |
|---|---|---|---|---|---|---|
| | **AAA** | **AA** | **A** | **Less than A rating** | **Unrated building societies and local authority** | **Total** |
| | **£'000** | **£'000** | **£'000** | **£'000** | **£'000** | **£'000** |
| Certificate of deposit | **-** | **47,238** | **91,516** | **4,553** | **10,035** | **153,342** |
| Call accounts | **1,213** | **-** | **192,779** | **-** | **-** | **193,992** |
| Time deposits | **8,146** | **1,276** | **-** | **-** | **-** | **9,422** |
| Floating rate notes | **5,011** | **2,509** | **3,246** | **-** | **-** | **10,766** |
| Treasury bills | **147,507** | **-** | **-** | **-** | **-** | **147,507** |
| Gilts | **84,237** | **-** | **-** | **-** | **-** | **84,237** |
| Total | **246,114** | **51,023** | **287,541** | **4,553** | **10,035** | **599,266** |
| Percentages | **41.2%** | **8.4%** | **48.0%** | **0.8%** | **1.7%** | **100.0%** |

| **Industry sector/asset class** | **Group 31 December 2012** | | **Bank 31 December 2012** | |
|---|---|---|---|---|
| | **£'000** | **%** | **£'000** | **%** |
| Financial institutions | | | | |
| Banks | **640,024** | **91.2%** | **637,835** | **91.1%** |
| Building societies | **62,015** | **8.8%** | **62,015** | **8.9%** |
| Total | **702,039** | **100.0%** | **699,850** | **100.0%** |

| **Industry sector/asset class** | **Group 31 December 2011** | | **Bank 31 December 2011** | |
|---|---|---|---|---|
| | **£'000** | **%** | **£'000** | **%** |
| Financial institutions | | | | |
| Banks | **536,156** | **89.2%** | **534,424** | **89.2%** |
| Building societies | **64,842** | **10.8%** | **64,842** | **10.8%** |
| Total | **600,998** | **100.0%** | **599,266** | **100.0%** |

| **Geographical exposure** | **Group 31 December 2012** | | **Bank 31 December 2012** | |
|---|---|---|---|---|
| | **£'000** | **%** | **£'000** | **%** |
| United Kingdom | **630,280** | **89.8%** | **628,091** | **89.8%** |
| Europe except United Kingdom | **56,754** | **8.1%** | **56,754** | **8.1%** |
| Australia | **15,005** | **2.1%** | **15,005** | **2.1%** |
| Total | **702,039** | **100.0%** | **699,850** | **100.0%** |

| **Geographical exposure** | **Group 31 December 2011** | | **Bank 31 December 2011** | |
|---|---|---|---|---|
| | **£'000** | **%** | **£'000** | **%** |

| | | | | |
|---|---|---|---|---|
| United Kingdom | **545,922** | **90.9%** | **545,923** | **91.2%** |
| Europe except United Kingdom | **47,587** | **7.9%** | **47,587** | **7.9%** |
| Australia | **2,509** | **0.4%** | **2,509** | **0.4%** |
| America | **3,247** | **0.5%** | **3,247** | **0.5%** |
| India | **1,733** | **0.3%** | | |
| Total | **600,998** | **100.0%** | **599,266** | **100.0%** |

The Group monitors exposure concentrations against a variety of criteria, including asset class, sector and geography. To avoid refinancing risks associated with any one counterparty, sector or geographical region, the Board has set appropriate limits. These are contained in the Treasury Policy.

**Liquidity risk**

Liquidity risk is the risk of having insufficient liquid assets to fulfil obligations as they become due or the cost of raising liquid funds becoming too expensive.

The Group's approach to managing liquidity risk is to maintain sufficient liquid resources to cover cash flow imbalances and fluctuations in funding in order to retain full public confidence in the solvency of the Group and to enable the Group to meet its financial obligations. This is achieved through maintaining a prudent level of liquid assets, through wholesale funding facilities and through control of the growth of the business.

Liquidity management is the responsibility of the ALCO, with day-to-day management delegated to Treasury as detailed in the Treasury Policy. The ALCO is responsible for setting limits over the level and maturity profile of wholesale funding and for monitoring the composition of the Group balance sheet.

For each material class of financial liability a contractual maturity analysis is provided in notes 19 to 21.

The following table provides an analysis of the Group's gross contractual cash flows payable under financial liabilities:

| **Group and Bank As at 31 December 2012** | **Up to 3 months** | **3 - 12 months** | **1 - 5 years** | **More than 5 years** | **Total** |
|---|---|---|---|---|---|
| | **£'000** | **£'000** | **£'000** | **£'000** | **£'000** |
| Amounts owed to retail depositors | **1,162,361** | **262,777** | **752,557** | **600,432** | **2,778,127** |
| Amounts owed to credit institutions and other customers | **10,185** | **14,005** | **537** | **-** | **24,727** |
| Derivative financial instruments | **(541)** | **1,219** | **20,555** | **43,398** | **64,631** |
| Other liabilities | **10,235** | **-** | **-** | **-** | **10,235** |
| Subordinated liabilities | **65** | **1,075** | **10,999** | **19,299** | **31,438** |
| Perpetual Subordinated Bonds | **595** | **1,181** | **1,184** | **15,000** | **17,960** |
| Total liabilities | **1,182,900** | **280,257** | **785,832** | **678,129** | **2,927,118** |

| **Group and Bank As at 31 December 2011** | **Up to 3 months** | **3 - 12 months** | **1 - 5 years** | **More than 5 years** | **Total** |
|---|---|---|---|---|---|
| | **£'000** | **£'000** | **£'000** | **£'000** | **£'000** |
| Amounts owed to retail depositors | **790,098** | **599,051** | **771,929** | **-** | **2,161,078** |
| Amounts owed to credit institutions and other customers | **18,965** | **18,963** | **1,090** | **-** | **39,018** |
| Derivative financial instruments | **431** | **2,838** | **17,252** | **81,019** | **101,540** |
| Other liabilities | **4,551** | **-** | **-** | **-** | **4,551** |

| | | | | | |
|---|---|---|---|---|---|
| Subordinated liabilities | **65** | **1,048** | **11,543** | **19,663** | **32,319** |
| Perpetual Subordinated Bonds | **599** | **1,188** | **2,366** | **15,000** | **19,153** |
| Total liabilities | **814,709** | **623,088** | **804,180** | **115,682** | **2,357,659** |

It has been assumed that Perpetual Subordinated Bonds will not mature at the first call date.

**Market risk**

Market risk is the risk of an adverse change in Group income or the Group's net worth arising from movement in interest rates, exchange rates or other market prices. Market risk exists, to some extent, in all the Group's businesses. The Group recognises that the effective management of market risk is essential to the maintenance of stable earnings and preservation of shareholder value.

**Interest rate risk**

The primary market risk faced by the Group is interest rate risk. Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. It is most prevalent in mortgage lending where fixed rate mortgages are not funded by fixed rate deposits of the same duration, or where the fixed rate risk is not hedged by a fully matching interest rate derivative.

The Group is exposed to movements in interest rates reflecting the mismatch between the dates on which interest receivable on assets and interest payable on liabilities are next reset to market rates or, if earlier, the dates on which the instruments mature. The Group manages this exposure on a continuous basis through the use of derivatives within limits set by the ALCO and the Board. After taking into account the derivatives entered into by the Group, the interest rate sensitivity at period end is assessed by considering a parallel shift in interest rates at that date, with a 2% parallel increase in rates leading to a sensitivity of (£557k) at December 2012 month end.

There is no material difference between the interest rate risk profile for the Group and that for the Bank.

**Fair value adjustments for hedged risk**

This represents the fair value adjustments to the carrying value of mortgage assets, amounts owed to credit institutions and other customers, subordinated debt, and subscribed capital as a result of portfolio hedging.

**Fair values of financial assets and financial liabilities**

The following table gives a comparison of book and fair values of the Group's financial assets and liabilities as at the period end. The Group does not undertake transactions for trading or speculative purposes. Market values have been used to determine fair values but where these are not available the financial instruments have been valued by discounting cash flows at prevailing interest rates.

| | ***Group 31 December 2012*** | | | | |
|---|---|---|---|---|---|
| | **Positive Book value £'000** | **Positive Fair value £'000** | **Negative Book value £'000** | **Negative Fair value £'000** | **Principal/ Notional £'000** |
| Cash and balances with the Bank of England | **282** | **282** | **-** | **-** | **282** |
| Loans and advances to credit institutions | **291,700** | **291,700** | **-** | **-** | **293,847** |
| Investment securities | **410,339** | **388,398** | **-** | **-** | **390,696** |
| Loans and advances to customers | **2,196,050** | **2,504,861** | **-** | **-** | **2,314,589** |
| Amounts owed to retail depositors | **-** | **-** | **(2,744,646)** | **(2,801,332)** | **(2,778,537)** |

| | | | | | |
|---|---|---|---|---|---|
| Amounts owed to credit institutions | **-** | **-** | **(3,190)** | **(3,190)** | **(3,180)** |
| Amounts owed to other customers | **-** | **-** | **(21,763)** | **(24,783)** | **21,651** |
| Subordinated liabilities | **-** | **-** | **(27,576)** | **(29,599)** | **27,353** |
| Perpetual Subordinated Bonds | **-** | **-** | **(15,189)** | **(16,799)** | **15,000** |
| Derivatives | **-** | **-** | **(63,949)** | **(63,948)** | **1,553,700** |
| **Total** | **2,898,371** | **3,185,241** | **(2,876,313)** | **(2,939,651)** | |

***Bank 31 December 2012***

| | Positive Book value £'000 | Positive Fair value £'000 | Negative Book value £'000 | Negative Fair value £'000 | Principal/ Notional £'000 |
|---|---|---|---|---|---|
| Cash and balances with the Bank of England | **282** | **282** | **-** | **-** | **282** |
| Loans and advances to credit institutions | **289,511** | **289,511** | **-** | **-** | **291,621** |
| Investment securities | **410,339** | **388,398** | **-** | **-** | **390,696** |
| Loans and advances to customers | **1,496,853** | **1,680,805** | **-** | **-** | **1,496,853** |
| Investments in group undertakings | **703,683** | **703,683** | **-** | **-** | **703,683** |
| Amounts owed to retail depositors | **-** | **-** | **(2,744,646)** | **(2,801,332)** | **(2,778,537)** |
| Amounts owed to credit institutions | **-** | **-** | **(3,190)** | **(3,190)** | **(3,180)** |
| Amounts owed to other customers | **-** | **-** | **(21,763)** | **(24,783)** | **21,651** |
| Subordinated liabilities | **-** | **-** | **(27,576)** | **(29,599)** | **27,353** |
| Perpetual Subordinated Bonds | **-** | **-** | **(15,189)** | **(16,799)** | **15,000** |
| Derivatives | **-** | **-** | **(63,949)** | **(63,948)** | **1,553,700** |
| **Total** | **2,900,668** | **3,062,679** | **(2,876,313)** | **(2,939,651)** | |

***Group 31 December 2011***

| | Positive Book value £'000 | Positive Fair value £'000 | Negative Book value £'000 | Negative Fair value £'000 | Principal/ Notional £'000 |
|---|---|---|---|---|---|
| Cash and balances with the Bank of England | **253** | **253** | **-** | **-** | **253** |
| Loans and advances to credit institutions | **239,661** | **239,661** | **-** | **-** | **241,358** |
| Investment securities | **361,337** | **361,341** | **-** | **-** | **343,651** |
| Loans and advances to customers | **1,639,946** | **1,758,635** | **-** | **-** | **1,699,946** |
| Amounts owed to retail depositors | **-** | **-** | **(2,081,590)** | **(2,107,399)** | **(2,057,974)** |
| Amounts owed to credit institutions | **-** | **-** | **(831)** | **(832)** | **830** |
| Amounts owed to other customers | **-** | **-** | **(38,394)** | **(39,092)** | **38,115** |
| Subordinated liabilities | **-** | **-** | **(26,842)** | **(29,011)** | **26,650** |
| Perpetual Subordinated Bonds | **-** | **-** | **(15,327)** | **(17,547)** | **15,000** |
| Derivatives | **683** | **683** | **(95,222)** | **(95,222)** | **1,677,050** |
| Total | **2,241,880** | **2,360,573** | **(2,258,206)** | **(2,289,103)** | |

***Bank 31 December 2011***

| | Positive Book value £'000 | Positive Fair value £'000 | Negative Book value £'000 | Negative Fair value £'000 | Principal/ Notional £'000 |
|---|---|---|---|---|---|
| Cash and balances with the Bank of | **253** | **253** | **-** | **-** | **253** |

| | | | | | |
|---|---|---|---|---|---|
| England | | | | | |
| Loans and advances to credit institutions | **237,929** | **237,929** | **-** | **-** | **239,625** |
| Investment securities | **361,337** | **361,341** | **-** | **-** | **343,651** |
| Loans and advances to customers | **1,007,054** | **1,089,105** | **-** | **-** | **1,067,054** |
| Investments in group undertakings | **640,920** | **640,920** | | | **640,920** |
| Amounts owed to retail depositors | **-** | **-** | **(2,081,590)** | **(2,107,399)** | **(2,057,974)** |
| Amounts owed to credit institutions | **-** | **-** | **(831)** | **(832)** | **830** |
| Amounts owed to other customers | **-** | **-** | **(38,394)** | **(39,092)** | **38,115** |
| Subordinated liabilities | **-** | **-** | **(26,842)** | **(29,011)** | **26,650** |
| Perpetual Subordinated Bonds | **-** | **-** | **(15,327)** | **(17,547)** | **15,000** |
| Derivatives | **683** | **683** | **(95,222)** | **(95,222)** | **1,677,050** |
| **Total** | **2,248,176** | **2,330,231** | **(2,258,206)** | **(2,289,103)** | |

**Effective interest rate**

The table below summarises the effective interest rate for monetary financial instruments not carried at fair value through the balance sheet.

| | Group 2012 | Bank 2012 | Group 2011 | Bank 2011 |
|---|---|---|---|---|
| **Assets** | | | | |
| Liquid assets | **0.91%** | **0.91%** | **1.09%** | **1.09%** |
| Loans and advances to customers | **4.81%** | **4.81%** | **3.75%** | **3.75%** |
| Investments in group undertakings | **-** | **2.99%** | **-** | **2.95%** |
| | | | | |
| **Liabilities** | | | | |
| Amounts owed to retail depositors | **3.09%** | **3.09%** | **2.96%** | **2.96%** |
| Amounts owed to credit institutions and other customers | **1.64%** | **1.64%** | **2.12%** | **2.12%** |
| Subordinated liabilities | **4.49%** | **4.49%** | **4.49%** | **4.49%** |
| Perpetual Subordinated Bonds | **7.88%** | **7.88%** | **7.88%** | **7.88%** |

The table below indicates the source of inputs used to derive the carrying value of the Group's assets and liabilities that are held at fair value:

| **Group and Bank** | **Level 1** | **Level 2** | **Level 3** | **Total** |
|---|---|---|---|---|
| | **£'000** | **£'000** | **£'000** | **£'000** |
| **31 December 2012** | | | | |
| **Financial assets** | | | | |
| Available for sale | | | | |
| Government investment securities | **367,870** | **-** | **-** | **367,870** |
| Transferable investment securities - unlisted | **-** | **20,528** | **-** | **20,528** |
| Transferable investment securities - listed | **-** | **21,941** | **-** | **21,941** |
| Derivative financial instruments | | | | |
| Interest rate swaps | **-** | **-** | **-** | **-** |
| | **367,870** | **42,469** | **-** | **410,339** |
| **Financial liabilities** | | | | |
| Derivative financial instruments | | | | |
| Interest rate swaps | **-** | **(63,949)** | **-** | **(63,949)** |

| | | | | |
|---|---|---|---|---|
| | **-** | **(63,949)** | **-** | **(63,949)** |

| **Group and Bank** | **Level 1** | **Level 2** | **Level 3** | **Total** |
|---|---|---|---|---|
| | **£'000** | **£'000** | **£'000** | **£'000** |
| **31 December 2011** | | | | |
| **Financial assets** | | | | |
| Available for sale | | | | |
| Government investment securities | **231,744** | **-** | **-** | **231,744** |
| Transferable investment securities - unlisted | **-** | **108,881** | **-** | **108,881** |
| Transferable investment securities - listed | **-** | **9,422** | **-** | **9,422** |
| Derivative financial instruments | | | | |
| Interest rate swaps | **-** | **683** | **-** | **683** |
| | **231,744** | **118,986** | **-** | **350,730** |
| **Financial liabilities** | | | | |
| Derivative financial instruments | | | | |
| Interest rate swaps | **-** | **(95,222)** | **-** | **(95,222)** |
| | **-** | **(95,222)** | **-** | **(95,222)** |

Fair values are determined using the following fair value hierarchy that reflects the significance of the inputs used in making the measurements:

**Level 1**

These are valuation techniques that are based entirely on quoted market prices in an actively traded market and are the most reliable.

**Level 2**

These are valuation techniques for which all significant inputs are taken from observable market data. These include valuation models used to calculate the present value of expected future cash flows and may be employed either when no active market exists or when there are quoted prices available for similar instruments in active markets.

Where discounting techniques are used in respect of derivatives, management have chosen to use LIBOR rather than the Overnight Index Swap ('OIS') rate. This will be reviewed when derivative clearing is introduced. No Credit ('CVA') or Debit ('DVA') value adjustments have been made in respect of credit risk in the fair value of the Group's derivative financial instruments.

In considering which similar instruments to use, management take into account the sensitivity of the instrument to changes in market rates and the credit quality of the instrument.

Basis risk derivatives are valued using discounted cash flow models and observable market data and will be sensitive to benchmark interest rate curves.

**Level 3**

These are valuation techniques for which any one or more significant input is not based on observable market data. None of the Group's financial assets or liabilities are valued using this technique.

Valuation techniques include net present value and discounted cashflow models, comparison to similar instruments for which market observable prices exist, Black-Scholes and other valuation models. Assumptions and market observable inputs used in valuation techniques include risk-free and benchmark interest rates, foreign currency exchange rates, equity index prices and expected price

volatilities. The objective of valuation techniques is to arrive at a fair value determination that reflects the price of the financial instrument at the reporting date that would have been determined by market participants acting at arm's length.

Observable prices are those that have been seen either from counterparties or from market pricing sources including Bloomberg. The use of these depends upon the liquidity of the relevant market.

## 29. Pension scheme

**Defined contribution scheme:**

The amount charged to the Income Statement in respect of contributions to the Group's defined contribution and stakeholder pension arrangements is the contribution payable in the period. The total pension cost charged to the Income Statement amounted to £499k (2011: £368k).

**Defined benefit scheme:**

KRBS operated a defined benefit pension scheme (the Scheme) funded by the payment of contributions to a separately administered fund for nine retired members. The Society's Board decided to close the Scheme with effect from 31 December 2001 and introduced a new defined contribution scheme to cover service of Scheme members from 1 January 2002.

The Scheme Trustees, having taken actuarial advice, decided to wind up the Scheme rather than continue to operate it on a "paid up" basis. The winding up is largely complete. As at 31 December 2012 the liability to remaining members is £1.6k matched by Scheme assets.

## 30. Capital Management

The Group is governed by its Capital Management Policy. The objectives of the Bank's Capital Management Policy are to efficiently manage the capital base to optimise shareholder returns whilst maintaining capital adequacy and satisfying key stakeholders such as customers and regulators.

The Bank's prime objectives in relation to the management of capital are to comply with the requirements set out by the Financial Services Authority (FSA), the Bank's primary prudential supervisor, to provide a sufficient capital base to cover business risks, maintain a targeted credit rating and support future business development.

The Bank has implemented Basel II requirements in measuring credit risks under the standardised approach and operational risk under the basic indicator approach. Under Pillar I of Basel II, the Bank calculates its minimum capital requirements based on 8% of risk weighted assets. The FSA then applies a multiplier to this amount to cover risks under Pillar II of Basel II and generate an Individual Capital Guidance (ICG). As instructed by the FSA, the Bank manages its capital on a consolidated basis and hence the Bank's capital position is not disclosed separately.

The ultimate responsibility for capital adequacy rests with the Board of Directors. The Bank's ALCO, which consists of the Chief Executive Officer, Finance Director and other senior executives, is responsible for the management of the capital process including approving policy, overseeing internal controls and setting internal limits over capital ratios.

The Bank actively manages its capital position and reports this on a regular basis to senior management via the ALCO and other governance committees. Capital requirements are included within budgets, reforecast and strategic plans with initiatives being executed against this plan.

During the period the Group complied with the capital requirements set out by the FSA.

| Capital and funding position | 2012 | 2011 |
|---|---|---|
| | £'000 | £'000 |
| **Tier 1 Capital** | | |
| Permanent share capital | **1,001** | **361** |
| Transfer reserve | **(12,818)** | **(12,818)** |
| Retained losses | **(3,921)** | **(12,562)** |
| Share premium account / Capital contribution | **106,421** | **90,639** |
| Deductions from tier 1 capital | **(910)** | **(495)** |
| **Total tier 1 capital after deductions** | **89,773** | **65,125** |
| | | |
| **Tier 2 Capital** | | |
| Perpetual subordinated bonds | **37,189** | **37,327** |
| Available for sale reserve | **1,285** | **1,822** |
| Collective provisions | **1,284** | **1,260** |
| Subordinated liabilities | **26,873** | **26,842** |
| Bonds | **703** | **-** |
| Deductions from tier 2 capital | **(4,145)** | **(797)** |
| **Total tier 2 capital after deductions** | **63,189** | **66,454** |
| | | |
| Excess of Tier 2 over Tier 1 | **-** | **(1,329)** |
| | | |
| **Total regulatory capital** | **152,962** | **130,250** |

The Bank does not have solo consolidation waivers for some of its subsidiaries. The impact of this has been included in the above table.

## 31. Adoption of new and revised International Financial Reporting Standards (IFRSs)

There have been no new standards or interpretations adopted during the year.

Disclosed below are the new IFRSs and amendments which as at 31 December 2012 have been endorsed by the EU but were not effective and have therefore not been applied in preparing these financial statements:

- Amendments to IAS 1, Presentation of items of Other Comprehensive Income. This amendment is effective from 1 January 2013 and requires entities to group items presented in the Statement of Other Comprehensive Income on the basis of whether they are potentially reclassifiable to profit or loss in subsequent periods. The impact of this amendment on the financial statements will be immaterial to the Group.

- IFRS 10, Consolidated Financial Statements. This new standard is effective from 1 January 2014 and replaces IAS 27, Consolidated and Separate Financial Statements and SIC 12, Consolidation - Special Purpose Entities. The new standard defines the principle of control and establishes control as the basis for determining which entities are consolidated in the consolidated financial statements. The IFRSs also set out the accounting requirements for the preparation of consolidated financial statements. With the exception of additional disclosure requirements, the new standard is not expected to have a significant impact for the Group.

- IFRS 11, Joint Arrangements. This new standard is effective from 1 January 2014 and replaces IAS 31, Interests in Joint Ventures and SIC 13, Jointly Controlled Entities - Non-Monetary Contributions by Venturers. The new standard removes the choice to apply the proportionate consolidation method, requiring all joint arrangements to be accounted for under the equity method. The new standard will have no impact on the financial statements of the Group.

- IFRS 12, Disclosure of Interests in Other Entities. This standard applies to entities that have an interest in a subsidiary, a joint arrangement, an associate or an unconsolidated structured entity, and

is effective from 1 January 2014. This standard will have an impact on the disclosure requirements of the Group but these are not expected to be extensive.

- IFRS 13, Fair Value Measurement. This new standard defines fair value and sets out in a single framework comprehensive guidance for measuring fair value. It will also require increased disclosure about fair value measurements. The standard does not change the requirements with regards to which financial and non-financial assets and liabilities will be measured at fair value. The standard is effective from 1 January 2013 and again, with the exception of some additional disclosure requirements, is expected to have minimal impact on the financial statements of the Group.

- IFRS 7, Financial Instruments – Disclosures. Amendments to IFRS 7 'Disclosures – Offsetting Financial Assets and Financial Liabilities' is effective from 1 January 2013 and requires new disclosures for all recognised financial instruments that are offset in the statement of financial position. The impact of the amendment to IFRS 7 is unlikely to be material to the Group.

The Group notes that there are also new accounting standards on the horizon, which are neither adopted by the EU nor effective at 31 December 2012 including IFRS 9: 'Financial Instruments' (IFRS 9). IFRS 9 is still subject to EU endorsement, the timing of which is uncertain, but is currently expected to be effective for annual periods beginning on or after 1 January 2015. As such the Group is monitoring developments and considering the associated impact on the Group financial statements.

## 32. Post balance sheet events

There were no post balance sheet events.