Results for the year ended 31 December 2014

A strong start in establishing TSB as Britain's challenger bank

Key highlights

Financial

	2014 £ million	2013[(1)] £ million	Change %
Franchise profit before tax	**62.0**	130.7	
Mortgage Enhancement profit before tax	**71.7**	–	
Management profit before tax	**133.7**	130.7	2.3
Statutory profit before tax	**170.2**	84.8	100.7
Franchise banking net interest margin[(2)] remains broadly stable	**3.62%**	3.59%	3bps
Group asset quality ratio[(3)] significantly better given the improving economic environment	**0.44%**	0.61%	17bps
Franchise customer lending fell by 6% as expected	**£18.8bn**	£20.1bn	(6)%
Franchise loan to deposit ratio continues to fall creating funding headroom for growth	**76.5%**	87.0%	(10.5)pp
TSB remains strongly capitalised ahead of lending growth in 2015 – CET 1 ratio (pro-forma)[(4)]	**19.7%**	–	

Strategic delivery

— 8.4% share of all new and switching bank accounts over the last 12 months[(5)] – almost 500,000 new bank accounts opened with TSB in 2014.

— Launch of TSB's mortgage broker service as planned – with over £300 million of applications received to date.

— More customers than ever, as measured by our net promoter score, would recommend TSB[(6)].

— The only high street bank rated in the top quartile for customer service across major UK brands by *Which?* Magazine[(7)].

2015 outlook

We expect:

— To consistently attract a greater than 6% share of gross flow of all switching and new personal bank accounts through 2015.

— The balance of Franchise net lending to increase by around £1.5 billion in 2015, with net growth from mid-way through the year.

— To meet these growth targets while controlling costs to no more than £720 million in 2015.

— The Franchise net interest margin to be broadly flat in 2015, with a positive start offset by subsequent compression.

— Franchise other income to fall by c. £15 million primarily driven by lower interchange income.

"2014 was a pivotal year for our business as we started to establish TSB as Britain's challenger bank.

In terms of financial performance, I'm pleased that, on balance, we've exceeded the expectations we set out at the time of our IPO in June last year. In addition, I'm delighted that we've made such a strong start in delivering TSB's growth strategy.

With 8.4% of all people switching or opening a bank account in 2014 choosing TSB; with the recent successful launch of our TSB mortgage broker service and with more people than ever before now recommending TSB to friends and family, it's great to have reached "base camp" on our mission to "bring more competition to UK banking"."

Paul Pester
Chief Executive Officer

(1) - (7) See explanatory notes on page 3.

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Basis of presentation

This statement presents the preliminary annual results of TSB Banking Group plc and its subsidiaries (the Group) for the year ended 31 December 2014.

Management basis

In order to present a more useful view of business performance, the Group's results are presented on a management basis which excludes volatility arising from derivatives and a non-recurring settlement gain arising from the Group's withdrawal from defined benefit pension schemes, details of which can be found on page 15.

Comparison periods

A number of factors have had a significant effect on the comparability of the Group's financial position and results with those of the prior periods. As a result, comparison of the results for the year to 31 December 2014 with the year to 31 December 2013 is of limited benefit. Therefore, income statement commentaries throughout this document include comparisons of H1 2014 against H2 2014.

Reporting segments

TSB is a provider of retail banking services in Britain and is organised, managed and reported across two business segments:

- Franchise, the Group's multi-channel retail banking business; and
- Mortgage Enhancement, a mortgage loan portfolio that was assigned to the Group by Lloyds Banking Group (LBG) with effect from 28 February 2014 in response to a review by the Office of Fair Trading of the effect on competition of the divestment of TSB which is designed to enhance the Group's profitability by over £230 million.

Forward looking statements

This announcement contains forward looking statements with respect to the business, strategy and plans of the TSB Banking Group, its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about the Group or the Group's management's beliefs and expectations are forward looking statements. By their nature, forward looking statements involve risk and uncertainty because they relate to future events and circumstances that will or may occur. The Group's actual future business, strategy, plans and/or results may differ materially from those expressed or implied in these forward looking statements as a result of a variety of factors, including, but not limited to, UK domestic and global economic and business conditions; the ability to access sufficient funding to meet the Group's liquidity needs; risks concerning borrower or counterparty credit quality; instability in the global financial markets, including Eurozone instability and the impact of any sovereign credit rating downgrade or other sovereign financial issues; market-related risks including in relation to interest rates and exchange rates; changing demographics and market-related trends; changes in customer preferences; changes to laws, regulation, accounting standards or taxation, including changes to regulatory capital or liquidity requirements; the policies and actions of governmental or regulatory authorities in the UK or the European Union or other jurisdictions in which the Group operates; the implementation of the Recovery and Resolution Directive and banking reform following the recommendations made by the Independent Commission on Banking; the ability to attract and retain senior management and other employees; the extent of any future impairment charges or write-downs caused by depressed asset valuations, market disruptions and illiquid markets; the effects of competition and the actions of competitors, including non-bank financial services and lending companies; exposure to regulatory scrutiny, legal proceedings, regulatory investigations or complaints and other factors. The forward looking statements contained in this announcement are made as at the date of this announcement and the Group undertakes no obligation to update any of its forward looking statements.

Summary results

Summary balance sheet

	2014 £ million	2013[1] £ million	Change %
Loans and advances to customers	**21,641.4**	20,099.1	**7.7**
Other assets	**5,530.0**	4,855.3	**13.9**
Total assets	**27,171.4**	24,954.4	**8.9**
Customer deposits	**24,624.9**	23,100.4	**6.6**
Other liabilities	**912.1**	547.3	**66.7**
Shareholders' equity	**1,634.4**	1,306.7	**25.1**
Total equity and liabilities	**27,171.4**	24,954.4	**8.9**
Franchise loan to deposit ratio	**76.5%**	87.0%	**(10.5)pp**
Net asset book value per share (pence)	**327p**	261p	**66p**
Common Equity Tier 1 Capital ratio (fully loaded)	**23.0%**	19.0%	**4.0pp**
Pro forma Common Equity Tier 1 Capital ratio[4]	**19.7%**		
Leverage ratio (fully loaded)	**5.8%**	4.7%	**1.1pp**

Summary income statement

	H1 2014 £ million	H2 2014 £ million	2014 £ million	2013[1] £ million	Change %
Net interest income	390.6	396.5	**787.1**	473.8	**66.1**
Other income	72.6	67.7	**140.3**	113.4	**23.7**
Total income	463.2	464.2	**927.4**	587.2	**57.9**
Operating expenses	(333.5)	(362.6)	**(696.1)**	(376.2)	**(85.0)**
Impairment	(51.1)	(46.5)	**(97.6)**	(80.3)	**(21.5)**
Profit before taxation (management basis)	78.6	55.1	**133.7**	130.7	**2.3**
Profit/(loss) on derivatives and hedge accounting	0.2	(3.3)	**(3.1)**	(39.3)	
Derivative fair value unwind	(14.0)	(10.1)	**(24.1)**	(6.6)	
Defined benefit pension scheme settlement gain	63.7	–	**63.7**	–	
Statutory profit before taxation	128.5	41.7	**170.2**	84.8	**100.7**
Taxation	(26.7)	(9.0)	**(35.7)**	100.2	
Statutory profit for the period	101.8	32.7	**134.5**	185.0	**(27.3)**
Group banking net interest margin[2]	3.58%	3.55%	**3.56%**	3.59%	**(3)bps**
Franchise banking net interest margin [2]	3.62%	3.63%	**3.62%**	3.59%	**3bps**
Group management basis cost:income ratio	72.0%	78.1%	**75.1%**	64.1%	**(11.0)pp**
Group asset quality ratio (AQR)[3]	0.47%	0.42%	**0.44%**	0.61%	**17bps**

Other key performance indicators

	Quarter to 30 Sept 2014 £ million	Quarter to 31 Dec 2014 £ million	Change
Mortgage gross new lending (£ million)	397.8	404.5	**1.7%**
Share of new personal bank account openings[5]	9.7%[9]	8.0%[8]	**(1.7)pp**
Customer advocacy – net promoter score (NPS)[6]	1	9	**8**

(1) Comparative figures have been restated to reflect: the insertion of the new parent company; and guidance provided in IFRIC 21 *Levies*.
(2) Management net interest income divided by average loans and advances to customers, gross of impairment provisions.
(3) Impairment charge on loans and advances to customers divided by average loans and advances to customers, gross of impairment allowance.
(4) Pro forma is calculated on a full Internal Ratings Based (IRB) basis – see page 25.
(5) Source: CACI Current and Savings Account Market Database (CSDB) which includes current, packaged, youth, student and basic bank accounts, and new account openings excluding account upgrades. Data presented on a 2 month lag. Membership of CSDB changed in January 2014.
(6) NPS is based on the question "On a scale of 0-10, where 0 is not at all likely and 10 is extremely likely, how likely is it that you would recommend TSB to a friend or colleague?" NPS is the percentage of TSB customers who score 9-10 after subtracting the percentage who score 0-6.
(7) *Which?* Magazine Oct 2014: 'Best and worst brands for customer service' survey article. TSB ranked joint 22nd with a customer service score of 76%.
(8) Data presented on a two month lag, i.e. covers the three months from August to October 2014.
(9) Data presented on a two month lag, i.e. covers the three months from May to July 2014.

Chief Executive Officer's statement

TSB made a strong start to life as an independent listed business in 2014. We delivered financial performance that, on balance, exceeded our expectations and we made a strong start in the delivery of TSB's growth strategy.

We delivered a profit of £133.7 million in 2014, of which just over half was generated by the Mortgage Enhancement portfolio.

Deposits increased to £24.6 billion, a strong testament to the strength of the TSB model and brand in attracting bank accounts and deposits. Meanwhile, as expected, our Franchise customer lending fell to £18.8 billion in 2014 as TSB mortgages had not been available through intermediaries who represent c.60% of the UK mortgage market.

We have clear headroom for future growth, with our Franchise loan to deposit ratio falling to 76.5% and our Pro forma Common Equity Tier 1 ratio at almost 20%, making us one of the strongest capitalised banks in the UK.

TSB's Franchise margin remained broadly flat at 3.62% despite lending margin and low interest rate pressures, while the benign economic environment resulted in the Group AQR falling to 44 basis points.

Our growth strategy

Our strategy is to grow by using our strong mobile and online banking facilities, our nationwide network of branches, our full range of retail banking products, the scalability of our IT platform, and an increasingly differentiated service delivered by our Partners. We want to provide great banking to more people.

Over the next five years, we expect TSB to be consistently chosen by at least 6% of all those moving their bank account or opening a new one. This will allow TSB to grow its share of all bank accounts from 4.3% today towards 6% with the pace of progression dependent on the number of accounts being opened and switched across the market.

Over the same period, we want to help more people to borrow well by lending to more people right across Britain. We expect the Group's Franchise lending balances to be 40% to 50% higher in 2019 than they were at the IPO in June 2014. A key step in achieving this growth will be TSB's re-entry into the intermediary mortgage market, giving people the option of acquiring a TSB mortgage through a mortgage broker. We continue to expect to provide around £4 billion of mortgages through brokers in 2017.

We will focus on using TSB's existing capability to support the growth of the business while also seeking opportunities for greater operational efficiency. Our focus on customer service and investments to enhance further our products and services, including our online and mobile banking services, will help TSB to continue to attract more customers and to grow.

We continue to focus on the delivery of our organic strategy but remain open to considering appropriate inorganic growth opportunities as they arise.

We expect the successful delivery of our strategy, supported by increasing UK interest rates, to enable TSB to reach 10% return on equity in 2019, with returns expected to increase further in the longer term.

Promising early progress

We have made a strong start with our strategy to grow TSB. We opened almost half a million new bank accounts in 2014, supported by the launch of 'Classic Plus' at the end of March and its associated media and advertising campaign. Consequently, TSB attracted 8.4% of all new and switching bank accounts over the last 12 months*. This is well above our long term target of 6%.

I believe that the development of TSB's intermediary mortgage market capability, successfully launched in January 2015, is an important step in enabling more people right across Britain to borrow well with TSB. Alongside this we continue to build UK consumers' consideration of TSB as a destination for mortgages through our increased profile as a lender, including our 'Borrow Well' marketing campaign.

While this is very much the start of the TSB journey, I am delighted with customers' reaction to our brand as much has been achieved in our drive to help TSB stand out when compared to other banks. Our investment in the business is already beginning to deliver on a number of programmes to further enhance the Group's digital channels, upgrade branches and reduce the cost for customers who call us. Most importantly, we are differentiating ourselves through the great service we offer as a result of our culture of personal ownership among our highly engaged team of Partners.

We believe TSB's Partners will be the single greatest difference between TSB and other banks. Our successes in 2014 are a direct result of their ability, commitment, collaboration and belief in what we are seeking to achieve at TSB.

* See explanatory note 5 on page 3.

Chief Executive Officer's statement (continued)

We provide further detailed information about our progress against our three strategic priorities in 2014.

1. Provide great banking to more people

Grow market share of bank accounts by consistently taking a greater than 6% share of gross flow over a five year period.

— Over the four most recent quarters, TSB has taken 8.4% share of flow, or 1 in 12 of all new and switching bank accounts.
— This strong performance was supported by the continued customer response to the 'Classic Plus' bank account and the associated media and advertising campaign.
— As the initial launch campaign has ended, we are intending that over time TSB's share of flow should normalise closer to the long-term target of 6%.

2. Help more people borrow well

Grow Franchise customer lending by 40% to 50% over a five year period from IPO.

— As expected, given the absence of a mortgage intermediary distribution channel, mortgage lending balances to TSB Franchise customers reduced by £1.1 billion to £16.6 billion over 2014.
— However, we successfully launched the mortgage intermediary channel in January 2015 receiving over £300 million of applications so far.
— In 2014 we launched our 'Borrow Well' marketing campaign and ran separate mortgage campaigns offering to pay customers' stamp duty on their house purchase and offering to pay customers' council tax bill for a year. Customer reaction to these campaigns has been positive, reflected in the brand's mortgage consideration score improving from 4% to 11%(1) over the 12 month period and the share of direct mortgages increasing from 1.6% in Q1 2014 to 2.2% in Q4 2014(2).
— However, unsecured lending remained relatively flat in a very congested, competitive environment.

3. Provide the kind of banking experience people want and deserve

Deploy TSB's strong digital capability. Build greater consideration of the TSB brand. Deliver a differentiated customer experience through our Partners.

— We further improved our online and mobile banking service, with the launch of the TSB.co.uk website which optimises itself on each user's device.
— The percentage of customers signing up to online banking when they open a bank account increased to 84% as we continue to support customers' use of digital services.
— Over 300 branches in 2014 were enhanced.
— We launched the TSB 'Truth and Banking' initiative, which clearly explains how TSB operates and makes money.
— '0345' telephone numbers were introduced, making it cheaper for customers to call us.
— Every employee was made a Partner in the business by awarding them TSB shares, and the incentive to deliver shareholder value through a differentiated customer experience.
— A new remuneration approach, aligned to and reinforcing TSB's values, was announced for the Group's executive which was further rolled out to all TSB Partners in early 2015.

TSB's efforts to differentiate its customer experience are now starting to be recognised. In a recent survey by *Which?* magazine on the customer service provided by UK brands, TSB was the only high street bank to be ranked in the top quartile.

Our progress is also evident from a 29 point increase in our customer net promoter score (NPS) since December 2013, which turned positive in the second half of the year.

Banking complaints have remained stable at 1.0 per 1,000 accounts(3) through 2014 as TSB works to improve customer service.

(1) © GfK NOP Ltd, Financial Research Survey (FRS) 6 months ending December 2013 and December 2014. Circa 440 adults considering taking out/switching a mortgage in the next 12 months were interviewed for each 6 month period. Results show percentage who would consider TSB.
(2) Market share has increased between Q1 and Q4 in 2014 using a market size based on Bank of England data for total flow and Council of Mortgage Lenders' data for a split of the Direct part of the market.
(3) Figures exclude reportable banking complaints relating to packaged bank accounts sold prior to TSB's separation from Lloyds Banking Group. Including reportable complaints relating to packaged bank accounts sold under TSB's banking licence, reportable banking complaints rose from 1.1 in the first half to 1.2 in the second half of 2014.

Chief Executive Officer's statement (continued)

Outlook in a competitive environment

In 2014, headwinds emerged that pose some challenges to TSB's profit growth. Competition amongst lenders stepped up markedly and expectations increased for a lower for longer base rate environment. While we expect to see a continuation of these headwinds, we expect to make further progress in line with our strategic plan in 2015. Growth remains our key strategic focus and we expect TSB to continue to consistently attract more than 6% of all new and switching bank accounts each quarter.

Following the promising launch of our intermediary channel, we expect net lending to grow from mid-way through the year. Franchise lending balances are expected to end 2015 around £1.5 billion higher than they started.

We expect the average Franchise margin to remain broadly flat in 2015 compared to 2014. We anticipate margin expansion in the early months of the year, reflecting the continued benefit from liability repricing and the mix effect of a reducing mortgage book. Subsequently, we expect margin compression pressure to build throughout the rest of the year as a result of competition for new loans, the lower interest rate environment and margin dilution from the growing proportion of mortgages on TSB's balance sheet.

A Europe-wide change in interchange fee structures will be fully introduced in 2016. However, an earlier than expected phased introduction from card scheme providers will reduce interchange fees in 2015 and is expected to be the primary driver in reducing Franchise other income by around £15 million in 2015.

We will, however, continue to invest in enhancing and differentiating the TSB proposition as we seek to provide the kind of banking experience people want and deserve. We expect to invest around £50 million in 2015 across our branches, digital channels, products and brand profile, whilst also ensuring that we continue to manage the efficiency of our operations.

In 2014 we began to demonstrate our focus on expenditure as we spent £696 million, around £25 million less than had been expected at the time of TSB's IPO. In 2015 we are expecting to spend no more than £720 million, a material reduction against previous guidance of £750 million as we aim to ensure that we are efficiently delivering our growth strategy for our customers and shareholders.

Conclusion

2014 has been a successful year for TSB. Strong delivery of bank account growth and our successful IPO provide us with excellent business foundations. With high levels of capital and liquidity, customer brand consideration and satisfaction continuing to grow and with our mortgage intermediary capability up and running, I remain confident in the ability of the business to deliver against our growth strategy.

Paul Pester
Chief Executive Officer

Business review

Significant developments

2014 has been a year of significant achievements and developments at TSB. The Group's financial position and, in particular its strong capital and funding position, provides a sound platform from which to deliver the growth strategy over the coming years.

During 2013, a significant number of customers and their accounts were added to the Group's existing business following their transfer from other LBG entities, in preparation for the Group's listing. In May 2013, 3.5 million customers transferred together with their deposit balances of £17.3 billion and loan balances of £2.1 billion. A further £13.0 billion of mortgage balances transferred to the Group in July 2013. This, along with the transfer of a number of branches and associated business infrastructure, transformed the Group's size and capabilities.

During 2014, the Group has continued to build on this transformation with the following key developments:

Corporate structuring and associated transactions

During the course of 2014, the Group made the necessary changes to its corporate structure establishing TSB as a strong, independent competitor in the UK banking market. These included:

— *Transferring colleagues to the Group* - On 31 March 2014, TSB Partners were transferred to TSB from LBG under the terms of the Transfer of Undertakings (Protection of Employment) Regulations 2006. At this point, those who were members of LBG defined benefit pension schemes became deferred members of those schemes and our defined benefit pension scheme deficit was transferred to Lloyds Bank plc. No settlement payment was required and consequently the Group recorded a one-off gain of £63.7 million.

— *Establishing a Group holding company* - On 25 April 2014, TSB Banking Group plc became the holding company of the TSB Group following a share for share exchange in which it acquired 100% of the issued share capital of TSB Bank plc from Lloyds Bank plc.

— *Capitalising the Group for growth* - On 1 May 2014, TSB Banking Group plc issued £385.0 million of Tier 2 dated subordinated debt (for proceeds of £383.0 million) and, on 19 May 2014, issued 445 million ordinary shares for proceeds of £200.0 million. Both issues of capital were wholly subscribed for by Lloyds Bank plc.

— *Listing the Group* - On 25 June 2014, TSB Banking Group plc achieved a premium listing on the London Stock Exchange, with a free-float of 38.5%. The free float increased to approximately 50% on 26 September 2014 following a further partial sell-down by LBG.

Formalising arrangements and agreements with LBG

As part of the listing process, a number of agreements were signed with LBG to ensure that the Group is able to operate effectively and independently. These agreements are outlined in more detail on page 49 within our related party disclosures.

Factors affecting the Group's medium term profitability

In establishing TSB as a strong competitor in the UK banking market, and in response to a review by the Office of Fair Trading of the effect on competition of the divestment of TSB from LBG, two significant developments took place in 2014 that were designed to enhance the Group's medium term profit earning capacity:

— *Mortgage Enhancement* - With effect from 28 February 2014, the economic benefit of a £3.4 billion portfolio of mortgage loans was assigned to the Group by LBG. This is designed to enhance the Group's profit before tax (PBT) by a cumulative £230 million over approximately five years and, during 2014, increased the Group's PBT by £71.7 million. This portfolio is subject to a call option exercisable by LBG, after the £230 million profit target has been achieved including at least £30 million in 2017.

— *Services arrangements with LBG* - On 1 January 2014, the Group transitioned from operating within the LBG shared service model to a standalone business cost structure. IT services and certain operational activities are however still being provided by LBG under a Transitional Services Agreement (TSA). The TSA runs until the end of 2016 when it will be replaced by the Long Term Services Agreement (LTSA) which is expected to increase the Group's cost base by more than £100 million p.a. from 2017.

Context for interpreting financial performance

These developments provide important context for understanding the current and future trends in the Group's financial performance. In particular:

— The ten months of earnings from the Mortgage Enhancement portfolio generated 53.6% of the Group's 2014 management basis PBT, a share that is expected to decline over the next three years; and

— The process to establish the Group's baseline standalone cost structure is now largely complete, but will see a significant step increase when the Group transitions to the LTSA from 2017.

Business review (continued)

The future impact of these two factors will be material. Adjusting the Group's 2014 management basis profit of £133.7 million to exclude the £71.7 million of earnings from the Mortgage Enhancement portfolio and taking into account the more than £100 million increase in costs from the future transition to the LTSA would have left the Group loss making. The growth strategy, combined with the normalisation of UK interest rates and the Group's continued focus on cost control, are together intended to deliver a 10% return on equity within five years following the Group's listing.

The net result of these developments during 2013 and 2014 is the formation of a UK bank with a very sound financial standing that is well positioned to deliver its growth strategy.

Review of financial performance

Balance sheet, funding and capital

Group customer deposits grew by 6.6%, driven in particular by the successful 'Classic Plus' bank account launch.

Group customer loans and advances increased by 7.7% following the £3.4 billion Mortgage Enhancement transaction. However, TSB Franchise lending continued to reduce, as expected, down 6.3% primarily due to lower mortgage balances. This reflected the effect of the Group's temporary inability to access the mortgage intermediary market for new business while the £7.2 billion back book of mortgages that was originally written through the intermediary market continued to repay and refinance. As a consequence, the Franchise loan to deposit ratio reduced from 87.0% to 76.5% during 2014.

In May 2014 the Group established a standalone liquid asset portfolio which at 31 December 2014 totalled £4.5 billion, of which £4.2 billion was held on deposit with the Bank of England and £0.3 billion was invested in a portfolio of UK gilts. Prior to the establishment of the standalone liquid asset portfolio, the Group was a member of the LBG UK Defined Liquidity Group and all liquid assets were held on deposit with LBG.

The Group's capital ratios strengthened in the year, with the CET 1 ratio increasing from 19.0% to 23.0%. This reflects the issue of equity and profits retained during the year, partially offset by higher risk weighted assets primarily driven by a change to the operational risk capital calculation and the transfer of the Mortgage Enhancement portfolio.

The strong funding, liquidity and capital positions are intended to accommodate delivery of the Group's growth strategy.

Income statement and profitability

The Group's income statement performance in 2014 reflects the significant developments noted on page 7.

As a consequence, comparison of the Group's 2014 performance with that of 2013 is of limited benefit. A more meaningful comparison of the second half of 2014 to the first half of 2014 is therefore also presented in the business review.

2014 compared to 2013

PBT on a management basis increased by £3.0 million to £133.7 million in 2014. Higher income, driven by a full year of earnings from customers and balances transferred during 2013 and the Mortgage Enhancement transaction was largely offset by the planned increase in operating costs as the Group established its standalone operating model.

H2 2014 compared to H1 2014

PBT on a management basis decreased in the second half by £23.5 million to £55.1 million compared to the £78.6 million earned in the first half of 2014. This was primarily driven by an increase in the Group's costs as investment spend was skewed to the second half of the year, with the IPO being the Group's focus during H1. Income remained broadly unchanged in H2 compared to H1 as lower income from declining Franchise lending balances was offset by the recognition of a full half year of income from the Mortgage Enhancement portfolio. Impairment losses decreased by £4.6 million from H1 to H2 given the continuing relatively benign UK economic environment.

Business review (continued)

Sources of funding

	2014 £ million	2013 £ million	Change %
Customer deposits	**24,624.9**	23,100.4	**6.6**
Non-customer funding:			
Debt securities in issue	**10.0**	1.4	
Subordinated liabilities	**405.5**	–	
Shareholders' equity	**1,634.4**	1,306.7	**25.1**
Total funding resources	**26,674.8**	24,408.5	**9.3**

A substantial proportion of the Group's funding is made up of customer bank accounts and savings balances, which although repayable on demand have historically provided a stable source of long term funding. During 2014, funding resources increased by 9.3% to £26,674.8 million. As shown in note 1 to the preliminary annual results, growth in bank account balances of £1,072.5 million is the largest contributor to customer deposit balance growth. This follows the successful launch of the 'Classic Plus' bank account in March 2014 which contributed to the Group opening 8.4% of all new and switching personal bank accounts in the UK over the last 12 months. Savings balances increased by 2.7% to £17,056.0 million reflecting the strength of the Group's deposit gathering capability. This growth was despite reductions in savings payable rates during the year.

In addition, during the year, the Group took initial steps to diversify further its funding sources. A securitisation funding programme (Cape Funding) was established in May 2014 under which the Group is able to borrow up to £2.5 billion from Lloyds Bank plc. The facility is capped at the lower of the balance of the Mortgage Enhancement portfolio and £2.5 billion and is therefore expected to decline as the Mortgage Enhancement portfolio reduces. As at 31 December 2014, only £10.0 million of this facility had been drawn. Further funding was raised from subordinated liabilities issued to LBG in May 2014.

Cost of funding

The cost of customer deposits decreased by 6bps in H2 2014 to 0.77% compared with 0.83% in H1 2014, reflecting the phased reduction in interest payable rates on the savings portfolio. Average savings deposit costs decreased from 0.93% to 0.82%. This decrease was partially offset by the increase in the average cost of bank accounts given the 5% rate offered on 'Classic Plus' accounts. The overall reduction in the average cost of customer deposits was partially offset by higher non-customer funding costs reflecting the issuance of subordinated debt as part of the Group's recapitalisation in May 2014. Average bank account deposit rates increased from 0.57% to 0.65%.

Business review (continued)

Loans

	2014 £ million	2013 £ million	Change %
Loans and advances to customers:			
Franchise	**18,839.3**	20,099.1	**(6.3)**
Mortgage Enhancement	**2,802.1**	–	
Total loans and advances to customers	**21,641.4**	20,099.1	**7.7**
Primary liquidity assets:			
Balances at central banks[1]	**4,169.3**	–	
Debt securities – available-for-sale	**339.7**	–	
Deposits with LBG	**–**	4,124.7	
Total liquidity portfolio	**4,509.0**	4,124.7	**9.3**

(1) Balances at central banks are combined with other cash balances of £227.0 million when shown on the group's consolidated balance sheet on page 32.

Loans and advances to customers

Loans and advances to customers increased by 7.7% compared to December 2013, primarily reflecting the transfer to the Group of the Mortgage Enhancement portfolio on 28 February 2014. Excluding this, Franchise loan balances, net of impairment provisions, decreased by £1,259.8 million or 6.3%. This reflects a continuation of the trend in 2013 where repayments on the mortgage portfolio, originated through both direct and intermediary channels, continued to exceed new loan origination which was limited to sales from direct channels only. Despite the overall reduction in the intermediary balance, the direct balance remained stable and we saw our market share of direct new business grow from 1.6% to 2.2% during the year.

Unsecured retail lending and business banking loan balances, net of impairments, reduced by 4.9%. This was primarily due to the redirection of approximately 2,000 business banking customers to LBG as the Group was unable to provide the more complex products and services those customers required. Retail unsecured balances, net of impairment provisions, decreased by 0.9%, remaining broadly stable in spite of increased competition within this product segment.

Liquidity portfolio

As previously mentioned, in May 2014, the Group exited the LBG UK Defined Liquidity Group and established a standalone liquid asset portfolio. At 31 December 2014, this was primarily held on deposit with the Bank of England with the portfolio being diversified from October 2014 through the purchase of a tranche of gilts.

Interest rates earned on loans

In H2 2014, the average rate earned on Franchise loans reduced from 3.90% to 3.87% as competition continued to weigh on new business and refinance rates. The average rate earned on Franchise mortgages reduced from 2.75% to 2.72%. Lower rates were earned on the non-SVR portion of the portfolio reflecting lower funding costs and increased competition in the market. Yields on unsecured retail lending decreased from 13.04% to 12.72% reflecting pressure on unsecured margins in a highly competitive market.

Business review (continued)

Income

Total income (management basis)

	H1 2014 £ million	H2 2014 £ million	2014 £ million	2013 £ million	Change %
Franchise	356.5	350.8	**707.3**	473.8	**49.3**
Mortgage Enhancement	34.1	45.7	**79.8**	–	
Net interest income	390.6	396.5	**787.1**	473.8	**66.1**
Other income	72.6	67.7	**140.3**	113.4	**23.7**
Total income (management basis)	463.2	464.2	**927.4**	587.2	**57.9**
Group banking net interest margin	3.58%	3.55%	**3.56%**	3.59%	**(3)bps**
Franchise banking net interest margin	3.62%	3.63%	**3.62%**	3.59%	**3bps**
Mortgage Enhancement banking net interest margin	3.16%	3.07%	**3.11%**	–	

2014 compared to 2013

Net interest income in 2014 increased by 66.1% to £787.1 million, primarily reflecting the full year effects of the 2013 customer transfers as outlined on page 7 and net interest income earned on the Mortgage Enhancement portfolio since its transfer to the Group on 28 February 2014. Franchise banking net interest margin remained broadly stable at 3.62% for the year to 31 December 2014.

Other income increased by 23.7% to £140.3 million and reflects earnings for the full year on the 3.5 million customers transferred to the Group in May 2013.

H2 2014 compared to H1 2014

Net interest income in the second half of 2014 increased by 1.5% to £396.5 million compared to the first half, primarily as the second half included a full six months of earnings on the Mortgage Enhancement portfolio. Franchise net interest income was marginally lower in the second half reflecting lower loan balances. Franchise banking net interest margin remained broadly stable as lower lending rates and the cost of subordinated debt issued in May 2014 were offset by lower funding rates and the mix effect of a proportionately smaller mortgage book. Lower interest rates, and particularly lower five year swap rates, only had a marginal impact on net interest income during H2 2014. However, as the Group continues to re-invest maturing five year swaps at prevailing rates, this will become a more significant factor through 2015 if current low interest rate expectations persist.

Other income in the second half of 2014 was £67.7 million, 6.7% lower than the first half. While other income in the Franchise segment was broadly stable, the Mortgage Enhancement segment reflected the recognition of a full half year of servicing fees and fees in respect of the Group's Cape Funding securitisation funding programme which commenced in June 2014.

Business review (continued)

Charges

(i) Operating expenses

	H1 2014 £ million	H2 2014 £ million	2014 £ million	2013[1] £ million	Change %
Direct costs:					
Staff costs	163.0	178.8	**341.8**	138.6	**(146.6)**
Premises and equipment expenses	36.7	37.8	**74.5**	44.3	**(68.2)**
Advertising and promotion	26.7	41.8	**68.5**	0.8	
FSCS levy	17.3	(1.3)	**16.0**	3.9	
Other	36.7	60.8	**97.5**	29.0	
	280.4	317.9	**598.3**	216.6	**(176.2)**
Transitional Services Agreement costs	53.1	44.7	**97.8**	–	
Recharges from Lloyds Banking Group companies	–	–	**–**	159.6	
Total operating expenses (management basis)	333.5	362.6	**696.1**	376.2	**(85.0)**
Cost:income ratio (management basis)	72.0%	78.1%	**75.1%**	64.1%	**(11.0)pp**

(1) Comparative figures have been restated to reflect guidance provided in IFRIC 21 *Levies.*

2014 compared to 2013

Operating expenses increased by 85.0% to £696.1 million and reflect the transition on 1 January 2014 from operating within the LBG shared service model (with associated economies of scale) to our standalone operating model. Consequently, recharges from LBG ceased and were replaced with charges under the TSA for IT services and increased direct costs. These were reflected in higher employment costs, up £203.2 million from a full year of the Group's enlarged branch and operational infrastructure, the establishment of the Group's support functions and directly incurred marketing spend, up £67.7 million. The annual Financial Services Compensation Scheme (FSCS) levy increased by £12.1 million reflecting our larger balance sheet.

H2 2014 compared to H1 2014

Operating expenses in the second half of 2014 increased by 8.7% compared to the first half. However, excluding the cost of the full year FSCS levy recognised in April 2014, the increase was 15.1%. This primarily reflects investment spend that was disproportionately weighted to the fourth quarter of 2014 (as we focused in H1 2014 on completing the Group's listing) and increased headcount as the Group continued to develop its intermediary mortgage distribution capability and completed the formation of the central functions required of an independent listed Group. TSA costs reduced in the second half of 2014 as the Group exited a number of the underlying TSA arrangements after establishing standalone capability in these areas and benefited from a £5 million discount.

Business review (continued)

Charges (continued)

(ii) Impairment charge

	H1 2014 £ million	H2 2014 £ million	2014 £ million	2013 £ million	Change %
Mortgages	(0.6)	(0.2)	**(0.8)**	2.9	
Personal unsecured	48.2	46.8	**95.0**	72.7	
Business banking	2.9	(0.1)	**2.8**	4.7	
Total Franchise	50.5	46.5	**97.0**	80.3	**(20.8)**
Mortgage Enhancement	0.6	–	**0.6**	–	
Total impairment charge	51.1	46.5	**97.6**	80.3	**(21.5)**

Asset quality ratio:	H1 2014 %	H2 2014 %	2014 %	2013 %	
Mortgages	(0.01)	–	**–**	0.03	**3bps**
Personal unsecured	4.50	4.31	**4.40**	4.63	**23bps**
Business banking	1.88	(0.07)	**1.02**	1.65	**63bps**
Total Franchise	0.51	0.48	**0.50**	0.61	**11bps**
Mortgage Enhancement	0.05	–	**0.02**	–	**(2)bps**
Total	0.47	0.42	**0.44**	0.61	**17bps**

2014 compared to 2013

The impairment charge increased by 21.5% to £97.6 million. The year on year comparison is of limited benefit given the significant balance of loans transferred to the Group during 2013. The asset quality ratio however decreased reflecting the improved economic conditions during 2014.

H2 2014 compared to H1 2014

The impairment charge in the second half of 2014 decreased by 9.0% to £46.5 million compared to the first half, primarily driven by a lower charge for the business banking and unsecured portfolios. The decrease in the business banking charge reflects the reduced size of the portfolio combined with lower arrears and write-offs. Within the unsecured portfolio, continued improvement in new lending quality and the positive effects of a stronger macroeconomic environment (particularly lower unemployment) helped to lower the charge in the second half of 2014 to £46.8 million from £48.2 million in the first half. During the second half the loss emergence period on unsecured lending was extended from two to three months to reflect changes in the time it takes customers to reach impairment, which increased the impairment charge by £5.5 million.

(iii) Taxation

The tax charge of £35.7 million (2013: tax credit £100.2 million) represents an effective tax rate of 21.0% which is broadly consistent with the average UK corporation tax rate of 21.5% in 2014. The tax credit in 2013 was due to the recognition of £121.6 million of deferred tax assets arising from the transfer of business to the Group.

Business review (continued)

Profits and returns to shareholders

(i) Segmental analysis

The Group's Executive Committee and Board review the results of the Group and consider performance across two segments: TSB Franchise segment; and the Mortgage Enhancement segment.

The Mortgage Enhancement segment was created to reflect the transfer of the economic benefit of a £3.4 billion portfolio of mortgages to the Group from LBG with effect from 28 February 2014. During 2014, the Mortgage Enhancement segment generated PBT of £71.7 million representing 53.6% of the Group's total PBT.

Year ended 31 December 2014	Franchise £ million	Mortgage Enhancement £ million	Total £ million
Net interest income	**707.3**	**79.8**	**787.1**
Other income/(expense)	**147.8**	**(7.5)**	**140.3**
Total income	**855.1**	**72.3**	**927.4**
Operating expenses	**(696.1)**	**–**	**(696.1)**
Impairment	**(97.0)**	**(0.6)**	**(97.6)**
Profit before taxation (management basis)	**62.0**	**71.7**	**133.7**
H2 2014			
Net interest income	350.8	45.7	396.5
Other income/(expense)	73.3	(5.6)	67.7
Total income	424.1	40.1	464.2
Operating expenses	(362.6)	–	(362.6)
Impairment	(46.5)	–	(46.5)
Profit before taxation (management basis)	15.0	40.1	55.1
H1 2014			
Net interest income	356.5	34.1	390.6
Other income/(expense)	74.5	(1.9)	72.6
Total income	431.0	32.2	463.2
Operating expenses	(333.5)	–	(333.5)
Impairment	(50.5)	(0.6)	(51.1)
Profit before taxation (management basis)	47.0	31.6	78.6

Key balance sheet items at 31 December 2014	£ million	£ million	£ million
Loans and advances to customers	**18,839.3**	**2,802.1**	**21,641.4**
Customer deposits	**24,624.9**	**–**	**24,624.9**
Key balance sheet items at 30 June 2014			
Loans and advances to customers	19,381.8	3,111.6	22,493.4
Customer deposits	23,700.4	–	23,700.4
Key balance sheet items at 31 December 2013			
Loans and advances to customers	20,099.1	–	20,099.1
Customer deposits	23,100.4	–	23,100.4

H2 2014 compared to H1 2014

Franchise PBT decreased by 68.1% to £15.0 million in H2 2014 compared to H1 2014. This was primarily due to higher costs, reflecting the build of the corporate support functions and mortgage intermediary capability, and lower income earned on the lower Franchise loan balances.

Mortgage Enhancement PBT increased by 26.9% to £40.1 million as the second half of 2014 included a full six months of earnings on the transferred mortgage portfolio, partially offset by lower mortgage balances.

Business review (continued)

Profits and returns to shareholders (continued)

(ii) Management basis

In order to present a more useful basis of the Group's underlying business performance the Group excludes certain one-off and volatile items from its management results. The key adjustments are as follows:

	2014 £ million	2013[1] £ million	Change %
Management profit before taxation	**133.7**	130.7	**2.3**
Loss on derivatives and hedge accounting	**(3.1)**	(39.3)	
Derivative fair value unwind	**(24.1)**	(6.6)	
Defined benefit pension scheme settlement gain	**63.7**	–	
Statutory profit before taxation	**170.2**	84.8	**100.7**

(1) Comparative figures have been restated to reflect guidance provided in IFRIC 21 *Levies.*

Loss on derivatives and hedge accounting

From 1 January 2014, the Group established qualifying hedge accounting relationships designed to minimise accounting volatility. These are available as the Group adopts the accounting policy treatment available in the EU endorsed version of International Accounting Standards (IAS) 39 *Financial Instruments: Recognition and Measurement*, which is not available in the version issued by the International Accounting Standards Board (IASB). The loss on derivatives and hedge accounting of £3.1 million primarily reflects the volatility arising from certain derivatives not designated in hedge accounting relationships including a portfolio of swaps with LBG used to economically hedge the basis risk of the Mortgage Enhancement portfolio. Prior to 1 January 2014, the Group did not designate any of its derivatives in hedge relationships for accounting purposes and therefore changes in their fair values of £39.3 million were reflected in the Group's income statement in 2013.

Derivative fair value unwind

As the interest rate swaps entered into with LBG on 1 November 2013 were designed to reflect the continuity of LBG's economic hedging approach within the Group, the terms differed from market rates at that date. Consequently, the interest rate swaps had a net positive fair value of £53.0 million on the date they were established. This amount, net of the amount recognised in 2013, unwinds through the Group's income statement over the remaining life of the interest rate swaps. During 2014, £24.1 million (2013: £6.6 million) of the fair value movement in the Group's derivatives was attributable to this factor. For statutory reporting purposes this amount is part of the change in fair value of derivatives presented in other income and is excluded from management profit as it does not appropriately reflect the Group's economic hedging approach.

Defined benefit pension scheme settlement gain

As explained in note 14, the Group recorded a gain on settlement of £63.7 million reflecting the derecognition of the defined benefit pension scheme deficit. From 1 April 2014, the Group has no further liabilities in respect of defined benefit pension schemes.

Business review (continued)

Profits and returns to shareholders (continued)

Reconciliation of the management basis profit to the statutory results:

Year ended 31 December 2014	Management basis £ million	Gain/(loss) on derivatives and hedge accounting £ million	Derivative fair value unwind £ million	Defined benefit pension scheme settlement gain £ million	Statutory results £ million
Net interest income	**787.1**	**(28.9)**	**–**	**–**	**758.2**
Other income/(expense)	**140.3**	**25.8**	**(24.1)**	**–**	**142.0**
Total income	**927.4**	**(3.1)**	**(24.1)**	**–**	**900.2**
Operating expenses	**(696.1)**	**–**	**–**	**63.7**	**(632.4)**
Impairment	**(97.6)**	**–**	**–**	**–**	**(97.6)**
Profit before taxation	**133.7**	**(3.1)**	**(24.1)**	**63.7**	**170.2**
Taxation	**(28.6)**	**0.7**	**5.2**	**(13.0)**	**(35.7)**
Profit after taxation	**105.1**	**(2.4)**	**(18.9)**	**50.7**	**134.5**

Year ended 31 December 2013[1]	Management basis £ million	Gain/(loss) on derivatives and hedge accounting £ million	Derivative fair value unwind £ million	Defined benefit pension scheme settlement gain £ million	Statutory results £ million
Net interest income	473.8	(10.0)	–	–	463.8
Other income/(expense)	113.4	(29.3)	(6.6)	–	77.5
Total income	587.2	(39.3)	(6.6)	–	541.3
Operating expenses	(376.2)	–	–	–	(376.2)
Impairment	(80.3)	–	–	–	(80.3)
Profit before taxation	130.7	(39.3)	(6.6)	–	84.8
Taxation	(32.0)	9.1	1.5	121.6	100.2
Profit after taxation	98.7	(30.2)	(5.1)	121.6	185.0

(1) Comparative figures have been restated to reflect guidance provided in IFRIC 21 *Levies.*

Business review (continued)

Funding and liquidity management

The Group's liquidity is actively monitored and managed through a series of Board approved limits and triggers. These short and long-term liquidity measures are reported on a regular basis both internally and externally to the regulators.

The Group's funding and liquidity position is underpinned by a significant customer deposit base. A substantial proportion of the deposit base is made up of customer bank accounts and savings accounts which, although repayable on demand, have historically provided a stable source of funding and help to reduce the amount of liquidity that the Group is required to hold to comply with its regulatory obligations.

The Group currently has a minimal requirement for wholesale funding and holds surplus liquidity.

Group funding position

	2014 £ million	2013 £ million	Change %
Availability of funding			
Customer deposits	**24,624.9**	23,100.4	**6.6**
Wholesale funding:			
Debt securities in issue	**10.0**	1.4	
Subordinated liabilities	**405.5**	–	
Total shareholders' equity	**1,634.4**	1,306.7	**25.1**
Total funding resources	**26,674.8**	24,408.5	**9.3**
Funding on demand			
Loans and advances to customers	**21,641.4**	20,099.1	**7.7**
Loans and advances to banks[1]	**134.5**	–	
Cash balances	**227.0**	200.2	**13.4**
Funded assets	**22,002.9**	20,299.3	**8.4**
Balances at central banks	**4,169.3**	–	
Gilts – available-for-sale	**339.7**	–	
Loans and advances to banks	**–**	4,124.7	
Primary liquidity assets	**4,509.0**	4,124.7	**9.3**
Other assets[2]	**659.5**	530.4	**24.3**
Total assets	**27,171.4**	24,954.4	**8.9**
Other liabilities[3]	**(496.6)**	(545.9)	**(9.0)**
Funding requirement	**26,674.8**	24,408.5	**9.3**

Funding and liquidity key performance indicators	%	%	Change
Group loan to deposit ratio	**87.9**	87.0	0.9pp
Franchise loan to deposit ratio	**76.5**	87.0	(10.5)pp

(1) Loans and advances to banks at 31 December 2014 primarily comprise balances required by Cape Funding No.1 plc.
(2) Other assets comprise derivative assets, items in course of collection, property, plant and equipment, deferred tax assets and other assets.
(3) Other liabilities comprise derivative liabilities, items in the course of transmission to other banks, deposits from banks, current tax liabilities and other liabilities.

Wholesale funding

During 2014, the structure of the Group's balance sheet continued to develop to reflect the Group operating on a standalone liquidity basis. The Group sought to ensure its funding base was appropriately diversified and established access to alternative forms of funding through its first secured funding transaction, Cape Funding, a secured facility of £2,500 million established with LBG in May 2014. This facility has only been partially utilised in 2014 with an outstanding drawn balance of £10.0 million at 31 December 2014. The Group also issued subordinated liabilities in May 2014 for net proceeds of £383.0 million.

Business review (continued)

Funding and liquidity risk (continued)

Analysis of 31 December 2014 total wholesale funding by residual maturity

	Less than one year £ million	One to two years £ million	Two to five years £ million	More than five years £ million	Total 31 Dec 2014 £ million	Total 31 Dec 2013 £ million
Securitisations	–	–	–	10.0	10.0	–
Subordinated liabilities[(1)]	–	–	–	405.5	405.5	–
Total wholesale funding[(2)]	–	–	–	415.5	415.5	–

(1) Subordinated liabilities include accrued interest and fair value hedge accounting adjustments (see note 3 to the Group's preliminary annual results).
(2) All wholesale funding is denominated in sterling.

Encumbered assets

The Board monitors and manages total balance sheet encumbrance under a Board approved risk appetite measure. As referred to above, the Group established a securitisation funding structure (Cape Funding) which resulted in the encumbrance of certain loans and advances to customers in support of the transaction as follows.

Securitisations

	Assets encumbered £ million	Notes in issue £ million
Cape Funding No. 1 plc	11.7	10.0
At 31 December 2014	**11.7**	**10.0**
At 31 December 2013	–	–

In addition the Group has the following assets that are considered to be encumbered:
— Cash collateral placed with counterparties of £53.6 million;
— Available-for-sale financial assets in the form of gilts sold subject to repurchase agreements of £32.9 million; and
— Loans and advances to banks of £132.6 million recognised by Cape Funding No.1 plc.

Liquidity portfolio

In May 2014, the Group established a standalone liquid asset portfolio as part of its exit from the LBG UK Defined Liquidity Group. As at 31 December 2014, the portfolio comprised cash held on deposit with the Bank of England and a portfolio of UK gilts. Prior to this, all liquidity was held on deposit with LBG and was reported on the Group's balance sheet within loans and advances to banks.

The Group's liquidity portfolio comprises highly liquid unencumbered assets available and immediately accessible to meet potential cash outflows. The Group's liquidity position is managed centrally as a single pool by the Group's Treasury function and is available for deployment at immediate notice, subject to complying with regulatory requirements, and is a key component of the Group's liquidity management process.

The Group also tracks performance against the upcoming Capital Requirements Directive (CRD) IV requirements to report a Liquidity Coverage Ratio (LCR) and a Net Stable Funding Ratio (NSFR). The Group is well positioned to meet both requirements when they become effective, currently expected to be October 2015 for LCR and 1 January 2018 for the NSFR.

Primary liquidity

	2014 £ million	2013 £ million
Central bank cash deposits	4,169.3	–
UK gilts	339.7	–
Loans and advances to banks	–	4,124.7
Total	**4,509.0**	4,124.7

Business review (continued)

Credit risk

Impaired loans and advances

Impaired loans decreased to £205.0 million, a 15.0% reduction since December 2013 and as a percentage of closing advances, reduced to 0.9% (2013: 1.2%). The reductions followed a sustained improvement in UK economic conditions during the year.

Impairment provisions as a percentage of impaired loans increased slightly to 42.0% as at 31 December 2014. The increased level of provision coverage for unsecured lending results from an extension to the loss emergence period in the second half of the year.

At 31 December 2014	Loans and advances to customers £ million	Impaired loans £ million	Impaired loans as a % of closing advances %	Impairment provisions[1] £ million	Impairment provisions as a % of impaired loans %
Mortgages:					
Franchise	**16,580.7**	**127.3**	**0.8**	**19.3**	**15.2**
Mortgage Enhancement	**2,802.7**	**0.5**	**–**	**0.6**	**120.0**
Total mortgages	**19,383.4**	**127.8**	**0.7**	**19.9**	**15.6**
Personal unsecured	**2,120.1**	**71.5**	**3.4**	**63.2**	**88.4**
Business banking	**224.0**	**5.7**	**2.5**	**3.0**	**52.6**
Total gross lending	**21,727.5**	**205.0**	**0.9**	**86.1**	**42.0**
Impairment provisions	**(86.1)**				
Total	**21,641.4**				

At 31 December 2013	Loans and advances to customers £ million	Impaired loans £ million	Impaired loans as a % of closing advances %	Impairment provisions[1] £ million	Impairment provisions as a % of impaired loans %
Mortgages:					
Franchise	17,728.7	138.7	0.8	24.0	17.3
Mortgage Enhancement	–	–	–	–	–
Total mortgages	17,728.7	138.7	0.8	24.0	17.3
Personal unsecured	2,143.3	87.7	4.1	67.7	77.2
Business banking	323.9	14.9	4.6	5.1	34.2
Total gross lending	20,195.9	241.3	1.2	96.8	40.1
Impairment provisions	(96.8)				
Total	20,099.1				

(1) Impairment provisions include collective unimpaired provisions.

Business review (continued)

Credit risk (continued)

Mortgages portfolio

The Group's mortgage portfolio consists of Franchise mainstream home-owner mortgages, Franchise buy-to-let mortgages and the Mortgage Enhancement portfolio; it does not include specialist or sub-prime mortgage products. Loans and advances as at 31 December 2014 total £19,383.4 million (31 December 2013: £17,728.7 million), of which 85.5%, £16,580.7 million, are Franchise mortgages.

The Group is committed to helping local people find the right mortgage for their needs. During 2014, the Group advanced gross new mortgage lending of £1,474.1 million, of which £296.3 million was to first time buyers. The Group also lent £625.9 million to a mixture of new and existing customers moving to a new home. The percentage of Franchise mainstream new lending agreed on an interest only basis is less than 7% of total new lending.

The composition of the Franchise mortgage portfolio has remained stable during 2014, with buy-to-let mortgages representing 13.4% (2013: 13.3%) of the total Franchise loans and advances.

To allow the Group to reach more customers and help them to borrow well, it invested in its mortgage business through the successful implementation of the Mortgage Market Review (MMR) in the first half of 2014, and more recently with the launch of a new intermediary channel that will support its core growth aspirations.

Mortgages - composition by rate type

The composition of the Franchise portfolio by rate type has changed modestly during 2014. The Group ceased offering standard variable rate mortgages (SVR) as the standard reversionary rate from June 2010, replacing this product with the home-owner variable rate (HVR) mortgage. Consequently, the SVR book continues to decrease as customers repay or remortgage from this product. SVR mortgages now represent 61.4% of total Franchise mortgages, down from 65.9% at December 2013 with HVR increasing to 8.1% (2013: 5.2%).

The continuing low interest rate environment has resulted in an increase in the portfolio share of fixed rate mortgages to 19.3% (2013: 16.4%). The proportion of the portfolio represented by tracker mortgages has reduced as a result of lower demand in the current economic environment, and as customers revert to the HVR product at the end of their initial tracker term.

	Franchise		Mortgage Enhancement		Total	
	At 31 Dec 2014 £ million	At 31 Dec 2013 £ million	At 31 Dec 2014 £ million	At 31 Dec 2013 £ million	At 31 Dec 2014 £ million	At 31 Dec 2013 £ million
SVR	**10,186.3**	11,683.7	**–**	–	**10,186.3**	11,683.7
HVR	**1,347.9**	930.7	**1,630.5**	–	**2,978.4**	930.7
Fixed	**3,199.0**	2,899.2	**359.9**	–	**3,558.9**	2,899.2
Tracker	**1,847.5**	2,215.1	**812.3**	–	**2,659.8**	2,215.1
Total	**16,580.7**	17,728.7	**2,802.7**	–	**19,383.4**	17,728.7

Business review (continued)

Credit risk (continued)

Mortgages - composition by repayment type

Franchise mortgages on interest only decreased to 44.0% of total mortgages (31 December 2013: 45.8%) reflecting the Group's approach to new lending in this area. All applicants for new interest only lending are fully assessed to ensure that a suitable method of repayment is in place to repay their mortgage at maturity. For existing interest only customers, the Group has a contact programme in place designed to ensure they have a suitable mortgage repayment vehicle already in place, or have the opportunity to take steps to avoid a potential repayment shortfall.

	Franchise		Mortgage Enhancement		Total	
	At 31 Dec 2014 £ million	At 31 Dec 2013 £ million	At 31 Dec 2014 £ million	At 31 Dec 2013 £ million	At 31 Dec 2014 £ million	At 31 Dec 2013 £ million
Repayment	**9,292.1**	9,614.2	**1,503.5**	–	**10,795.6**	9,614.2
Interest only	**7,288.6**	8,114.5	**1,299.2**	–	**8,587.8**	8,114.5
Total	**16,580.7**	17,728.7	**2,802.7**	–	**19,383.4**	17,728.7

Mortgages – Franchise maturity profile

As at 31 December 2014, 9.0% of the Group's Franchise mortgages are due to mature within five years. 16.9% of interest only mortgages are due to mature within the next five years.

At 31 December 2014	Due within one year £ million	Due within one to five years £ million	Due after more than five years £ million	Total £ million
Repayment	**8.9**	**261.5**	**9,021.7**	**9,292.1**
Interest only	**222.3**	**1,007.3**	**6,059.0**	**7,288.6**
Total	**231.2**	**1,268.8**	**15,080.7**	**16,580.7**

At 31 December 2013	Due within one year £ million	Due within one to five years £ million	Due after more than five years £ million	Total £ million
Repayment	7.8	253.1	9,353.3	9,614.2
Interest only	242.5	1,003.5	6,868.5	8,114.5
Total	250.3	1,256.6	16,221.8	17,728.7

Mortgage loan to value analysis

Increasing house prices have led to improvement in the Group's loan to value (LTV) composition during 2014. Of the Group's Franchise portfolio, 76.9% of mortgages have a LTV of less than 70% (31 December 2013: 65.9%). The increase in house prices also benefitted the percentage of Franchise mortgage accounts with a LTV of more than 100%, which has reduced to 1.0% (31 December 2013: 2.7%).

The average LTV for new mortgage accounts has increased slightly to 55.9%, from 55.3% in 2013. Stock LTV on the Franchise portfolio decreased to 41.7% (31 December 2013: 46.3%), as a result of the improvements to house prices. The Group employs several LTV criteria on its mortgage products and these limits also apply to the new intermediary business launched in January 2015.

Business review (continued)

Credit risk (continued)

Mortgage loan to value analysis

At 31 December 2014	Franchise mainstream %	Franchise buy-to-let %	Franchise interest only %	Franchise total %	Mortgage Enhancement %	Total %
Less than 70%	**75.8**	**83.6**	**75.1**	**76.9**	**94.5**	**79.4**
70% to 80%	**13.8**	**9.9**	**11.4**	**13.3**	**5.4**	**12.2**
80% to 90%	**6.6**	**3.6**	**6.5**	**6.2**	**0.1**	**5.3**
90% to 100%	**2.6**	**2.6**	**4.8**	**2.6**	**–**	**2.2**
Greater than 100%	**1.2**	**0.3**	**2.2**	**1.0**	**–**	**0.9**
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Average loan to value:(1)						
Stock	**41.0**	**46.3**	**43.7**	**41.7**	**40.3**	**41.5**
New mortgages	**55.7**	**57.7**	**49.9**	**55.9**	**–**	**55.9**
Impaired mortgages(2)	**53.1**	**53.4**	**56.1**	**53.1**	**47.5**	**53.0**

At 31 December 2013	Franchise mainstream %	Franchise buy-to-let %	Franchise interest only %	Franchise total %	Mortgage Enhancement %	Total %
Less than 70%	64.8	72.5	64.7	65.9	–	65.9
70% to 80%	17.7	16.5	15.5	17.5	–	17.5
80% to 90%	10.4	5.3	8.2	9.7	–	9.7
90% to 100%	4.2	4.1	6.5	4.2	–	4.2
Greater than 100%	2.9	1.6	5.1	2.7	–	2.7
Total	100.0	100.0	100.0	100.0	–	100.0
Average loan to value:(1)						
Stock	45.4	53.4	48.2	46.3	–	46.3
New mortgages	55.2	57.0	49.1	55.3	–	55.3
Impaired mortgages(2)	55.8	69.1	59.2	56.3	–	56.3

(1) Average LTV is calculated as total loans and advances as a percentage of the total collateral of these loans and advances.
(2) Impaired mortgages are defined as more than six months in arrears including mortgages in possessions.

Business review (continued)

Credit risk (continued)

Mortgages greater than three months in arrears (excluding repossessions)

To assist with peer and industry benchmarking, the Group monitors the performance of mortgage accounts that are greater than three months in arrears as it is an indicator to the quality of secured portfolios.

	Number of cases		Total mortgage accounts %		Value of debt[1]		Total mortgage balances %	
	At 31 Dec 2014 Cases	At 31 Dec 2013 Cases	At 31 Dec 2014 %	At 31 Dec 2013 %	At 31 Dec 2014 £ million	At 31 Dec 2013 £ million	At 31 Dec 2014 %	At 31 Dec 2013 %
Repayment	**1,321**	1,411	**1.1**	1.2	**92.3**	98.2	**1.0**	1.0
Interest only	**778**	927	**1.6**	1.6	**115.1**	127.1	**1.6**	1.6
Franchise	**2,099**	2,338	**1.2**	1.3	**207.4**	225.3	**1.3**	1.3
Mortgage Enhancement	**26**	–	**0.1**	–	**3.7**	–	**0.1**	–
Total	**2,125**	2,338	**1.1**	1.3	**211.1**	225.3	**1.1**	1.3

(1) Value of debt represents total book value of mortgages in arrears.

Personal unsecured portfolio

The unsecured portfolio consists of bank account overdrafts, credit cards and fixed term personal loans up to £25,000. Total balances on the unsecured portfolio have remained broadly stable at £2,120.1 million as at 31 December 2014 (31 December 2013: £2,143.3 million).

Impaired loans on the unsecured portfolio have reduced during 2014 to £71.5 million from £87.7 million as at 31 December 2013. These improvements have been driven by lower levels of arrears, reflecting an improvement in the economic environment.

	At 31 Dec 2014 £ million	At 31 Dec 2013 £ million
Loans and advances to customers		
Personal loans	**1,286.1**	1,313.3
Personal current accounts	**273.8**	281.9
Credit cards	**560.2**	548.1
Total	**2,120.1**	2,143.3

Business banking portfolio

During 2014, the Group completed the planned transfer to LBG of certain customers who have banking requirements not currently met by the Group's business banking proposition. This has led to a reduction in loans and advances to £224.0 million as at 31 December 2014 (31 December 2013: £323.9 million).

Impaired loans have reduced by 61.7% to £5.7 million as at 31 December 2014 (31 December 2013: £14.9 million). This is due to a number of factors including the reduction in the size of the portfolio, improved arrears rates, and a change to the impairment definition.

Business review (continued)

Credit risk (continued)

Forbearance

The Group operates a number of schemes to assist borrowers who are experiencing financial difficulties. Forbearance solutions may offer temporary relief in the form of reductions to contractual payments, and for customers who have longer term financial difficulties, term extensions and 'repair' approaches such as capitalisation of arrears.

Franchise mortgages

Mortgage accounts which are currently or recently forborne continue to reduce. As at 31 December 2014, balances that are forborne reduced by £76.8 million to £134.9 million.

	Total loans and advances which are currently or recently forborne		Total current and recently forborne loans and advances which are impaired		Impairment provision as a % of loans and advances which are currently or recently forborne	
	At 31 Dec 2014 £ million	At 31 Dec 2013 £ million	At 31 Dec 2014 £ million	At 31 Dec 2013 £ million	At 31 Dec 2014 %	At 31 Dec 2013 %
Temporary forbearance arrangements						
Reduced contractual monthly payments(1)	**4.3**	33.7	**2.2**	5.0	**0.8**	2.7
Reduced payment arrangements(2)	**30.0**	36.0	**5.9**	3.4	**1.1**	2.1
	34.3	69.7	**8.1**	8.4	**1.1**	2.4
Permanent treatments						
Repair and term extensions(3)	**100.6**	142.0	**10.9**	9.6	**2.2**	1.8
Total	**134.9**	211.7	**19.0**	18.0	**1.9**	2.0

Personal unsecured

Unsecured balances which are forborne reduced by 18.6% to £39.4 million as at 31 December 2014. This is influenced by the improving economy and, in particular, the reduction in unemployment rates.

	Total loans and advances which are currently or recently forborne		Total current and recently forborne loans and advances which are impaired		Impairment provision as a % of loans and advances which are currently or recently forborne	
	At 31 Dec 2014 £ million	At 31 Dec 2013 £ million	At 31 Dec 2014 £ million	At 31 Dec 2013 £ million	At 31 Dec 2014 %	At 31 Dec 2013 %
Temporary forbearance arrangements						
Reduced contractual monthly payments(4)	**15.7**	19.4	**15.5**	19.2	**41.6**	38.1
Reduced payment arrangements(5)	**13.4**	13.9	**12.8**	13.2	**46.0**	54.3
	29.1	33.3	**28.3**	32.4	**43.6**	44.9
Permanent treatments						
Repair and term extensions(6)	**10.3**	15.1	**3.5**	6.3	**11.3**	12.7
Total	**39.4**	48.4	**31.8**	38.7	**35.2**	34.8

(1) Includes temporary interest only arrangements and short-term payment holidays granted in collections and where the concession has ended within the previous six months (temporary interest only) and previous 12 months (short-term payment holidays).

(2) Includes customers who had an arrangement to pay less than the contractual amount at 31 December or where an arrangement ended within the previous three months.

(3) Includes capitalisation of arrears and term extensions which commenced during the previous 24 months and remaining as customers at 31 December 2014.

(4) Includes repayment plans and short-term payment holidays granted in collections and where the concession has ended within the last six months.

(5) Includes customers who had an arrangement to pay less than the contractual amount at 31 December or where an arrangement ended within the last six months.

(6) December 2013 numbers have been re-stated from the first half 2014 reporting to include customers who had exited forbearance within the probationary periods as defined in (3) to (5)

Counterparty credit risk

A counterparty to a transaction which fails to honour its obligations under a contract as they fall due is considered to be a counterparty credit risk. This typically relates to contracts for financial instruments including derivative contracts and repurchase agreements. As a consequence of hedging market risk with other financial counterparties and placing surplus liquidity with appropriate counterparties, including the Bank of England, the Group has credit exposures to these counterparties.

Business review (continued)

Capital management

The capital strength of the Group further improved during the year ended 31 December 2014 with the fully loaded CET 1 ratio improving to 23.0% (December 2013: 19.0%) and the Total Capital ratio improving to 28.5% (December 2013: 19.0%).

The improvement in the CET 1 ratio primarily relates to the issue of 445 million ordinary shares to Lloyds Bank plc for £200.0 million in May 2014, £134.5 million of retained profits and a reduction in the excess expected losses over impairment allowances. The improvement in CET 1 capital has also led to a significant improvement in the leverage ratio to 5.8% at 31 December 2014 (31 December 2013: 4.7%). In addition to this, the Total Capital ratio also benefitted from the issuance of subordinated debt to Lloyds Bank plc in May 2014.

At 31 December 2013, the Group's risk weighted assets (RWAs) were calculated under LBG's Internal Ratings Based (IRB) approach. While the Group received permission to use its own IRB models as a standalone business, it has currently only moved its Franchise mortgages and personal loan book to an IRB approach. The remainder of the Franchise book transferred to and has remained on the standardised basis approach, thereby reducing RWAs and excess expected loss. At 31 December 2014, this reduction in RWAs was offset by the inclusion of the Mortgage Enhancement portfolio and the change in methodology for calculating operational risk RWAs to use a steady state income basis which is more reflective of the scale of the Group's business than the historic three year method.

The Group plans to migrate, subject to PRA approval, all remaining Franchise personal unsecured customer asset portfolios to an IRB basis by June 2015. For illustrative purposes a pro forma CET 1 ratio, on a full IRB basis (for the Franchise business), has been calculated which reflects the consequential increase in credit risk RWAs and excess expected loss. This pro forma ratio of 19.7% remains strong.

From 1 January 2014, capital adequacy is measured in accordance with CRD IV. Prior to this, capital adequacy was measured under the Basel II framework. Therefore, in order to aid comparison, comparatives for December 2013 have also been presented on a CRD IV basis.

Capital resources

	At 31 Dec 2014 CRD IV £ million	At 31 Dec 2013 CRD IV £ million	At 31 Dec 2013 Basel II[1] £ million
Shareholders' equity per balance sheet	**1,634.4**	1,306.7	1,306.7
Excess of expected losses over impairment provisions	**(41.0)**	(110.6)	(110.6)
Deferred tax assets	**–**	(14.1)	–
Intangible assets	**(0.4)**	–	–
Common Equity Tier 1/Total Tier 1 capital	**1,593.0**	1,182.0	1,196.1
Tier 2 capital	**384.3**	–	–
Total capital resources	**1,977.3**	1,182.0	1,196.1
CRD IV basis:			
Risk-weighted assets	**6,930.2**	6,214.5	
Common Equity Tier 1/Total Tier 1 capital ratio (fully loaded)	**23.0%**	19.0%	
Pro forma Common Equity Tier 1/Total Tier 1 capital ratio (fully loaded)	**19.7%**		
Total Capital ratio (fully loaded)	**28.5%**	19.0%	
Basel II basis:			
Risk-weighted assets			6,123.5
Tier 1/Total Tier 1 capital ratio			19.5%
Total Capital ratio			19.5%

(1) Shareholders' equity has been restated to reflect: the insertion of the new parent company; and guidance provided in IFRIC 21 *Levies*.

Business review (continued)

Capital management (continued)

The movements in CET 1, Tier 2 and Total Capital in the year are shown below:

	CET 1/ Total Tier 1 £ million	Tier 2 £ million	Total capital resources £ million
At 31 December 2013 (CRD IV basis)	1,182.0	–	1,182.0
Profit attributable to ordinary shareholders	134.5	–	134.5
Share issuance	200.0	–	200.0
Change in excess of expected losses over impairment provisions	69.6	–	69.6
Issuance of subordinated debt	–	383.2	383.2
Change in excess of default provision over default expected loss	–	1.1	1.1
Change in deferred tax asset deduction	14.1	–	14.1
Movement in shares held by trusts	(9.1)	–	(9.1)
Change in intangible assets	(0.4)	–	(0.4)
Share-based compensation reserve	1.9	–	1.9
Movement in AFS reserve	0.4	–	0.4
At 31 December 2014	**1,593.0**	**384.3**	**1,977.3**

Risk-weighted assets

	At 31 Dec 2014 CRD IV £ million	At 31 Dec 2013 CRD IV £ million
Risk type analysis of risk-weighted assets:		
Credit risk:		
Franchise standardised approach	**1,300.6**	547.4
Franchise IRB approach	**3,187.3**	5,233.5
Total Franchise	**4,487.9**	5,780.9
Mortgage Enhancement standardised approach	**984.8**	–
Total credit risk	**5,472.7**	5,780.9
Operational risk	**1,451.5**	433.6
Market and counterparty risk	**6.0**	–
Total risk-weighted assets	**6,930.2**	6,214.5

Business review (continued)

Capital management (continued)

Leverage ratio

The leverage ratio measure is defined as the ratio of Tier 1 capital to total exposure. This is intended to complement the risk based capital requirements with a simple, non-risk based 'backstop' measure.

The Group calculates its leverage ratio based on the exposure measure in the revised Basel III leverage ratio framework published in January 2014, and the CRR definition of Tier 1.

The Basel Committee has proposed that final adjustments to the definition and calibration of the leverage ratio are carried out in 2017, with a view to migrating to a Pillar 1 treatment in 2018. The Group continues to monitor Basel III developments and their adoption in the CRD IV framework.

In order to aid comparison, comparatives for December 2013 have also been presented in accordance with this definition.

Leverage ratio

	At 31 Dec 2014 £ million	At 31 Dec 2013 £ million
Total Tier 1 Capital for leverage ratio		
Shareholders' equity per balance sheet	**1,634.4**	1,306.7
Less: regulatory adjustments	**(41.4)**	(124.7)
	1,593.0	1,182.0
Exposures for leverage ratio		
Total statutory balance sheet assets	**27,171.4**	24,954.4
Removal of accounting value for derivatives	**(123.1)**	(99.4)
Exposure value for derivatives and securities financing transactions	**28.5**	46.1
Off-balance sheet	**405.0**	375.0
Other regulatory adjustments	**(41.4)**	(124.7)
Total exposures	**27,440.4**	25,151.4
Leverage ratio	**5.8%**	4.7%

The Group's leverage ratio is 5.8% which comfortably exceeds the Basel Committee's proposed minimum of 3%, applicable from 2018. The Group will continue to monitor closely the leverage ratio against the emerging rules and minimum calibration.

Other regulatory adjustments consist of adjustments that are required under CRD IV to be deducted from Tier 1 capital. The removal of these from the exposure measure ensures consistency is maintained between the capital and exposure components of the ratio.

Darren Pope
Chief Financial Officer

Risk report

Risk framework and culture

Effective risk management is a key component of the Group's strategy to deliver local banking for Britain, and is at the heart of everything the Group does for customers and communities.

The Group's straightforward business model is supported by a risk culture grounded in ensuring a sustainable appetite for risk.

The Group's risk culture is designed to ensure that all Partners deliver the right outcomes for customers and other stakeholders through their approach to their work and the decisions and actions they take. Risks are owned and managed by all Partners, not just by specialist risk teams. The risk culture encourages all Partners to focus on identifying, assessing and managing risk within their areas of responsibility and supports clear escalation and reporting of risks to senior management and the Board. The Group's risk management culture is reinforced by its approach to remuneration throughout the business.

The Board and senior management set risk appetite. This is achieved through clear and consistent communication of the approach to risk and cascading accountability to appropriately qualified individuals throughout the Group. The Board ensures that senior management implements risk policies and risk appetite that either limit or, where appropriate, prohibit activities, relationships and situations that could be detrimental to the Group's risk profile.

The Group maintains a sustainable appetite for risk which supports the delivery of its growth strategy, whilst protecting customers, shareholders and Partners.

The Group's risk framework is built upon three key principles:

— **Straightfoward** - A consistent risk management approach across its business, with simple reporting requirements to provide a holistic view of risk throughout the Group's operations.
— **Transparent** - A clear risk management approach which is understood across the business. By working collaboratively, all Partners are able to share findings and approaches to help ensure adequate controls and processes are in place.
— **Responsible** - Clear ownership of risks within the Group and empowerment of Partners to manage risk exposures in line with expected values and behaviours.

Governance of risk

The Group's committees monitor and challenge risk exposures against approved risk appetite. Each committee within the governance structure is responsible for ensuring the risk and control environment is established within its area of authority. This enables day-to-day decisions to be made, with clear reporting lines established through the Executive and Board Risk committees, and ultimately to the Board.

Risk report (continued)

Summary of principal risks and uncertainties

The Group is exposed to a number of principal risks and strategic uncertainties that arise from the business activities that underpin its business model and strategy. The principal risks faced by the Group are summarised below:

Conduct risk
The risk that the Group fails to deliver fair customer outcomes and achieve a positive experience for its customers.

Mitigating actions:
— Ensuring customers' best interests are at the heart of everything the Group does.
— Enhancing how its customer propositions are reviewed and assessed.
— Refining how customer outcomes are understood.
— Developing clear customer accountabilities for Partners including rewards with customer-centric metrics.
— Identifying and understanding the root cause of where the Group falls short and putting it right.

Funding and liquidity risk
Funding risk is the risk that the Group does not have sufficiently stable and diverse sources of funding or its funding structure is not efficient. Liquidity risk is the risk that the Group has insufficient financial resources to meet commitments as they fall due, or can only secure them at an excessive cost.

Mitigating actions:
— Maintaining a prudent liquid asset buffer of high quality unencumbered assets in excess of regulatory requirements.
— Demonstrating an ability to meet prudent liquidity risk appetite metrics throughout the Group's planning horizon.
— Stress testing of the Group's liquidity positions, conducted against a range of scenarios, to meet all UK liquidity regulatory requirements.
— Maintaining a contingency funding plan to address possible liquidity shortfalls in emergency situations.

Credit risk
The risk that borrowers with the Group fail to repay their loans or any other lending product on time.

Mitigating actions:
— The Group's credit policy incorporates prudent lending criteria aligned with Board approved risk appetite.
— Clearly defined levels of authority to ensure the Group lends appropriately and responsibly with a separation of origination and sanctioning activities.
— Robust credit processes and controls, including well-established committees and independent credit risk assurance, to ensure distressed and impaired loans are identified, considered and controlled.
— Stress tests undertaken as part of the business planning cycle with the aim of ensuring the Group is able to operate within its risk appetite, throughout the period of the plan.

Capital risk
The risk of the Group having insufficient capital, by quantity or quality, to meet current or future requirements.

Mitigating actions:
— Monitoring of capital ratios to ensure they exceed regulatory capital requirements and internal Board approved risk appetite measures over the plan period.
— Stress tests undertaken as part of the business planning cycle with the aim of ensuring the Group is able to operate within its risk appetite, throughout the period of the plan.

Market risk
The risk of a reduction in earnings, value or reserves caused by changes in the prices of financial instruments.

Mitigating actions:
— Board approved risk appetite and governance framework.
— Regular reporting of market risk exposure to the Group's Asset and Liabilities Committee and Risk Committee.

Risk report (continued)

Summary of principal risks and uncertainties (continued)

Operational risk
The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Mitigating actions:
- The Group employs a framework for managing its operational risk which includes preventative, detective and mitigating controls.
- Under a detailed arm's length TSA, LBG continues to support the Group following its admission to the London Stock Exchange. This agreement provides for the supply of IT and associated banking services to the Group and its customers. Benefits include LBG continually updating and improving its IT system architecture and systems' resilience.

Statutory information

Basis of preparation

On 31 January 2014, TSB Banking Group plc was incorporated and on 25 April 2014 became the new holding company for the TSB Group. This took place by way of a share for share exchange whereby TSB Banking Group plc issued shares to Lloyds Bank plc in return for obtaining 100% ownership of the issued share capital of TSB Bank plc. TSB Banking Group plc was subsequently listed on the London Stock Exchange on 25 June 2014.

These preliminary annual results of TSB Banking Group plc (the Group) comprise the results of TSB Banking Group plc consolidated with those of its subsidiaries, including TSB Bank plc. Comparative figures, as at and for the year ended 31 December 2013, are those of TSB Bank plc, except for the presentation of share capital, share premium and capital reorganisation reserve balances, which are presented as if TSB Banking Group plc had been the parent company during both years presented (see note 19).

These preliminary annual results have been prepared in accordance with the Companies Act 2006 and with International Financial Reporting Standards (IFRS), as adopted by the European Union (EU). IFRS comprises accounting standards prefixed IFRS, issued by the IASB and those prefixed IAS, issued by the IASB's predecessor body, as well as interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) and its predecessor body. The Group has taken advantage of relaxations in hedge accounting requirements in the EU endorsed version of IAS 39, *Financial Instruments: Recognition and Measurement* adopted by the EU which are not available in the version issued by the IASB.

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

Accounting policies

The accounting policies are consistent with those applied by TSB Bank plc in its December 2013 Annual Report and Accounts with the exception of the treatment of the FSCS levy.

From 1 January 2014 the Group changed its accounting policy for recognising the costs of the UK's FSCS levy to reflect guidance provided in IFRIC 21 *Levies*, an interpretation of IAS 37 *Provisions, contingent liabilities and contingent assets*. IFRIC 21 clarifies that the obligating event that gives rise to a liability to pay the FSCS levy is the activity that triggers the payment of the levy, which for the FSCS levy, is being a deposit gathering financial institution at the start of the levy year each April, and an entity does not have a constructive obligation to pay a levy that will be triggered by operating in a future period. Prior to 1 January 2014, the Group's policy was to recognise a liability on the basis of a constructive obligation at 31 December in the previous year. This change in accounting policy has been applied retrospectively with comparative periods restated.

Critical accounting estimates and judgements

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

There have been no significant changes in the basis upon which estimates have been determined compared to that applied at 31 December 2013.

Consolidated balance sheet

as at 31 December 2014

	Note	2014 £ million	2013[1] £ million
Assets			
Cash and balances at central banks		**4,396.3**	200.2
Loans and receivables:			
Loans and advances to customers	6	**21,641.4**	20,099.1
Loans and advances to banks		**134.5**	4,124.7
Available-for-sale financial assets	8	**339.7**	–
Items in course of collection from banks		**135.7**	116.2
Deferred tax assets	16	**108.1**	138.0
Property, plant and equipment		**149.2**	122.6
Other assets		**143.4**	54.2
Derivative financial assets	20	**123.1**	99.4
Total assets		**27,171.4**	24,954.4
Liabilities			
Customer deposits	1	**24,624.9**	23,100.4
Deposits from banks		**32.5**	234.7
Debt securities in issue	2	**10.0**	1.4
Subordinated liabilities	3	**405.5**	–
Items in course of transmission to banks		**144.6**	63.6
Other liabilities		**202.8**	97.7
Retirement benefit obligations		**–**	64.3
Derivative financial liabilities	20	**116.7**	85.6
Total liabilities		**25,537.0**	23,647.7
Equity			
Share capital	19	**5.0**	0.1
Share premium	19	**965.1**	–
Merger reserve	19	**616.5**	–
Available-for-sale reserve	19	**0.4**	–
Capital reorganisation reserve	19	**(1,311.6)**	74.9
Capital reserve	19	**410.0**	410.0
Retained profits	19	**949.0**	821.7
Shareholders' equity		**1,634.4**	1,306.7
Total equity and liabilities		**27,171.4**	24,954.4

(1) Comparative figures have been restated to reflect: the insertion of the new parent company; and guidance provided in IFRIC 21 *Levies.*

Consolidated statement of comprehensive income

for the year ended 31 December 2014

	Note	2014 £ million	2013[1] £ million
Income statement:			
Interest and similar income	10	**979.1**	697.0
Interest and similar expense	10	**(220.9)**	(233.2)
Net interest income	10	**758.2**	463.8
Fee and commission income	11	**208.6**	159.2
Fee and commission expense	11	**(70.4)**	(49.3)
Net fee and commission income	11	**138.2**	109.9
Other operating income/(expense)	12	**3.8**	(32.4)
Other income		**142.0**	77.5
Total income		**900.2**	541.3
Operating expenses:			
Other operating expenses		**(696.1)**	(376.2)
Defined benefit pension scheme settlement gain	14	**63.7**	–
Total operating expenses	13	**(632.4)**	(376.2)
Operating profit before impairment losses and taxation		**267.8**	165.1
Impairment losses on loans and advances to customers	7	**(97.6)**	(80.3)
Profit before taxation		**170.2**	84.8
Taxation	15	**(35.7)**	100.2
Profit for the year	19	**134.5**	185.0
Other comprehensive income:			
Items that will not be subsequently reclassified to profit or loss:			
Post-retirement defined benefit scheme re-measurement before taxation		**–**	1.1
Taxation	16	**–**	(1.9)
Items that may be subsequently reclassified to profit or loss:			
Movements in revaluation reserve in respect of available-for-sale financial assets		**0.5**	–
Taxation	16	**(0.1)**	–
Other comprehensive income/(expense) for the year, net of taxation		**0.4**	(0.8)
Total comprehensive income for the year		**134.9**	184.2

(1) Comparative figures have been restated to reflect guidance provided in IFRIC 21 *Levies*.

Consolidated statement of changes in equity

for the year ended 31 December 2014

	Share capital[1] £ million	Share premium £ million	Merger reserve £ million	Capital reorg-anisation reserve[1] £ million	Capital reserve £ million	Available-for-sale reserve £ million	Retained profits[1] £ million	Total £ million
Balance at 1 January 2013	0.1	–	–	74.9	–	–	637.5	712.5
Comprehensive income:								
Profit for the year	–	–	–	–	–	–	185.0	185.0
Other comprehensive income	–	–	–	–	–	–	(0.8)	(0.8)
Total comprehensive income	–	–	–	–	–	–	184.2	184.2
Transactions with owners:								
Capital contribution	–	–	–	–	410.0	–	–	410.0
Balance at 31 December 2013	0.1	–	–	74.9	410.0	–	821.7	1,306.7
Balance at 1 January 2014	**0.1**	–	**–**	**74.9**	**410.0**	**–**	**821.7**	**1,306.7**
Comprehensive income:								
Profit for the year	**–**	**–**	**–**	**–**	**–**	**–**	**134.5**	**134.5**
Other comprehensive income	**–**	**–**	**–**	**–**	**–**	**0.4**	**–**	**0.4**
Total comprehensive income	**–**	**–**	**–**	**–**	**–**	**0.4**	**134.5**	**134.9**
Transactions with owners:								
Insertion of new parent	**0.5**	**769.5**	**616.5**	**(1,386.5)**	**–**	**–**	**–**	**–**
Issue of new shares	**4.4**	**195.6**	**–**	**–**	**–**	**–**	**–**	**200.0**
Movement in shares held by trusts	**–**	**–**	**–**	**–**	**–**	**–**	**(9.1)**	**(9.1)**
Value of Partner services	**–**	**–**	**–**	**–**	**–**	**–**	**1.9**	**1.9**
Total transactions with owners	**4.9**	**965.1**	**616.5**	**(1,386.5)**	**–**	**–**	**(7.2)**	**192.8**
Balance at 31 December 2014	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**0.4**	**949.0**	**1,634.4**

(1) Comparative figures have been restated to reflect: the insertion of the new parent company; and guidance provided in IFRIC 21 *Levies*.

Consolidated cash flow statement

for the year ended 31 December 2014

	Note	2014 £ million	2013[1] £ million
Profit before taxation		**170.2**	84.8
Adjustments for:			
Change in operating assets	23	**5,697.6**	4,408.6
Change in operating liabilities	23	**1,568.5**	(7,490.9)
Non-cash and other items	23	**41.1**	213.5
Taxation paid		**(3.7)**	(68.7)
Net cash provided by/(used in) operating activities		**7,473.7**	(2,852.7)
Cash flows from investing activities			
Purchase of property, plant and equipment		**(85.8)**	(37.5)
Purchase of financial assets		**(3,682.1)**	(15,148.4)
Purchase of financial liabilities		**–**	17,383.8
Purchase of shares held by trusts		**(9.1)**	**–**
Proceeds from disposal of financial assets and liabilities		**–**	374.7
Net cash (used in)/provided by investing activities		**(3,777.0)**	2,572.6
Cash flows from financing activities			
Proceeds from debt securities issued		**10.0**	–
Interest paid on debt securities		**(0.6)**	–
Repurchase of debt securities	2	**(0.8)**	–
Proceeds from subordinated liabilities issued	3	**383.0**	–
Interest paid on subordinated liabilities		**(11.4)**	–
Proceeds from shares issued	19	**200.0**	–
Proceeds from repurchase agreements	4	**32.5**	–
Capital contribution received		**–**	410.0
Net cash provided by financing activities		**612.7**	410.0
Change in cash and cash equivalents		**4,309.4**	129.9
Cash and cash equivalents at beginning of year		**174.4**	44.5
Cash and cash equivalents at end of year	23	**4,483.8**	174.4

(1) Comparative figures have been restated to reflect guidance provided in IFRIC 21 *Levies.*

Notes to the preliminary annual results

Sources of funding

1. Customer deposits

	2014 £ million	2013[(1)] £ million
Non-interest bearing current accounts	**4,777.3**	4,373.6
Interest bearing current accounts	**2,791.6**	2,122.8
Savings accounts	**17,056.0**	16,604.0
Total customer deposits	**24,624.9**	23,100.4

(1) Amounts have been reclassified to provide consistency with current year presentation.

At 31 December 2014 £1,937.1 million (2013: £1,115.5 million) of customer deposits had a residual maturity of greater than one year. There are no amounts due to LBG companies included in customer deposits above (2013: £nil).

2. Debt securities in issue

	2014 £ million	2013 £ million
Preference shares	**–**	1.4
Securitisation notes (note 6)	**10.0**	–
Total debt securities in issue	**10.0**	1.4

On 21 January 2014, the Group repurchased all of the issued preference share capital of £1.4 million from its then immediate parent company, TSB Intermediate Company 2 Limited. The preference shares were immediately cancelled. The Group paid a consideration of £0.8 million, being the fair value of the preference shares at the date of repurchase, and recognised a gain on the extinguishment of this liability of £0.6 million. The balance at 31 December 2014 represents the balance of debt securities issued by Cape Funding No. 1 plc (see note 6).

3. Subordinated liabilities

	2014 £ million	2013 £ million
Fixed/floating rate reset callable subordinated Tier 2 notes due May 2026	**383.2**	–
Accrued interest	**3.5**	–
Fair value hedge accounting adjustments	**18.8**	–
Total subordinated liabilities	**405.5**	–

On 1 May 2014, TSB Banking Group plc issued £385.0 million of fixed/floating rate reset callable subordinated Tier 2 notes at an issue price of 99.493% of the principal amount to Lloyds Bank plc. The notes pay interest at a rate of 5.75% per annum, payable semi-annually in arrears until 6 May 2021 at which time the interest rate becomes 3 month LIBOR plus 3.43% per annum payable quarterly in arrears. The Company has the option to redeem these notes on 6 May 2021 and quarterly thereafter, subject to approval of the Prudential Regulatory Authority.

Notes to the preliminary annual results

Sources of funding (continued)

4. Repurchase agreements

During the year, the Group established capability to undertake repurchase agreements in order to provide additional flexibility to raise short term cash from the financial markets. At 31 December 2014, the Group had entered into repurchase agreements which transferred the legal title of certain gilts, in return for cash, together with an agreement to repurchase the gilts at a later date and at a predetermined price. The gilts were not derecognised from the Group's balance sheet as substantially all of the rewards, including interest income on the gilts, and risks, including credit and interest rate risks, are retained by the Group. In all cases, the transferee has the right to sell or repledge the gilts concerned, subject to delivering equivalent securities at the repurchase date.

The table below presents the carrying values of the transferred gilts and the associated repurchase agreement liabilities. The associated liabilities represent the Group's obligation to repurchase the transferred assets.

At 31 December 2014	Carrying amount of transferred assets £ million	Carrying amount of associated liabilities £ million
Repurchase agreements:		
Available-for-sale financial assets (note 8)	**32.9**	**(32.5)**

5. Fair value of financial liabilities

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

		2014		2013	
	Note	Carrying value £ million	Fair value £ million	Carrying value £ million	Fair value £ million
Financial liabilities					
Customer deposits	1	**24,624.9**	**24,679.7**	23,100.4	23,142.1
Debt securities in issue	2	**10.0**	**10.0**	1.4	0.8
Subordinated liabilities	3	**405.5**	**404.9**	–	–
Derivative financial liabilities	20	**116.7**	**116.7**	85.6	85.6

The carrying amount of deposits from banks and items in course of transmission to banks is a reasonable approximation of fair value. Fair value is the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. As quoted market prices are not available for the Group's financial instruments, fair values have been determined using valuation techniques which, to the extent possible, use market observable inputs, but in some cases use non-market observable inputs. Valuation techniques used include discounted cash flow analysis and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by the Group.

Notes to the preliminary annual results

Sources of funding (continued)

5. Fair value of financial liabilities (continued)

Valuation hierarchy of financial liabilities

The table below analyses the fair values of financial liabilities of the Group which are carried at fair value or for which fair value is disclosed above.

	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2014					
Customer deposits	**–**	**24,679.7**	**–**	**24,679.7**	**24,624.9**
Debt securities in issue	**–**	**10.0**	**–**	**10.0**	**10.0**
Subordinated liabilities	**–**	**404.9**	**–**	**404.9**	**405.5**
Derivative financial liabilities	**–**	**116.7**	**–**	**116.7**	**116.7**
At 31 December 2013					
Customer deposits	–	23,142.1	–	23,142.1	23,100.4
Debt securities in issue	–	0.8	–	0.8	1.4
Derivative financial liabilities	–	85.6	–	85.6	85.6

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

Liabilities carried at fair value, or for which fair values are disclosed, have been classified into three levels according to the quality and reliability of information used to determine the fair values. Derivative financial instruments are the only liabilities of the Group that are carried at fair value.

Level 1

Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2

Level 2 valuations are those where quoted market prices are not available, for example where the instrument is traded in a market that is not considered to be active or valuation techniques are used to determine fair value and where these techniques use inputs that are based significantly on observable market data.

Level 3

Level 3 portfolios are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data.

Notes to the preliminary annual results

Loans

6. Loans and advances to customers

	2014 £ million	2013 £ million
Mortgages – Franchise	**16,580.7**	17,728.7
Mortgages – Mortgage Enhancement	**2,802.7**	–
Unsecured lending and business banking	**2,344.1**	2,467.2
Gross lending	**21,727.5**	20,195.9
Allowance for impairment losses on loans and receivables (note 7)	**(86.1)**	(96.8)
Total loans and advances to customers	**21,641.4**	20,099.1

At 31 December 2014 £19,422.2 million of loans and advances to customers (2013: £17,835.7 million) had a contractual residual maturity of greater than one year.

Loans and advances to customers include loans securitised under the Group's securitisation programme, which have been sold by TSB Bank plc to a special purpose entity (Cape Funding No. 1 plc). As Cape Funding No. 1 plc is funded by the issue of debt on terms whereby the majority of the risks and rewards of the portfolio are retained, it is consolidated fully and all of these loans are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue.

The balance of the loans subject to the Group's securitisation programme and the carrying value of the notes in issue are listed in the table below.

	31 December 2014		31 December 2013	
	Loans and advances securitised £ million	Notes in issue £ million	Loans and advances securitised £ million	Notes in issue £ million
Cape Funding No. 1 plc	**2,876.3**	**2,925.0**	**–**	**–**
Less: held by the Group		**2,915.0**		**–**
Total securitisation notes (note 2)		**10.0**		**–**

7. Allowance for impairment losses on loans and receivables

	Mortgages £ million	Unsecured retail and small business £ million	Total £ million
At 1 January 2013	11.5	24.4	35.9
Advances written off	(3.2)	(96.5)	(99.7)
Recoveries of advances written off in previous years	–	13.5	13.5
Transfer of business	12.8	54.0	66.8
Charge to the income statement	2.9	77.4	80.3
At 31 December 2013	**24.0**	**72.8**	**96.8**
Advances written off	**(3.9)**	**(118.2)**	**(122.1)**
Recoveries of advances written off in previous years	**–**	**13.8**	**13.8**
Charge/(credit) to the income statement	**(0.2)**	**97.8**	**97.6**
At 31 December 2014	**19.9**	**66.2**	**86.1**

Included in the Group's total allowance for loans and receivables is £63.0 million (2013: £75.2 million) related to lending that was determined to be impaired at 31 December 2014.

Notes to the preliminary annual results

Loans (continued)

8. Available-for-sale financial assets

	2014 £ million	2013 £ million
Gilts	**339.7**	–

At 31 December 2014, gilts with a carrying value of £32.9 million were subject to repurchase agreements (note 4). At 31 December 2014, all of the Group's available-for-sale financial assets had a contractual maturity of greater than one year.

9. Fair value of financial assets

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

		2014		2013	
	Note	Carrying value £ million	Fair value £ million	Carrying value £ million	Fair value(1) £ million
Financial assets					
Loans and advances to customers	6	**21,641.4**	**21,451.6**	20,099.1	19,888.4
Available-for-sale financial assets	8	**339.7**	**339.7**	–	–
Derivative financial instruments	20	**123.1**	**123.1**	99.4	99.4

(1) Amounts have been represented on a basis consistent with 2014.

The carrying amount of cash and balances at central banks, items in course of collection from banks and loans and advances to banks is a reasonable approximation of fair value.

Fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. As quoted market prices are not available for the Group's financial instruments, fair values have been determined using valuation techniques which, to the extent possible, use market observable inputs, but in some cases use non-market observable inputs. Valuation techniques used include discounted cash flow analysis and pricing models and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by the Group.

Valuation hierarchy of financial assets

The table below analyses the fair values of the financial assets of the Group which are carried at fair value or for which fair value is disclosed above.

	Level 1 £ million	Level 2 £ million	Level 3 £ million	Total fair value £ million	Total carrying value £ million
At 31 December 2014					
Loans and advances to customers	**–**	**–**	**21,451.6**	**21,451.6**	**21,641.4**
Available-for-sale financial assets	**339.7**	**–**	**–**	**339.7**	**339.7**
Derivative financial assets	**–**	**123.1**	**–**	**123.1**	**123.1**
At 31 December 2013					
Loans and advances to customers	–	–	19,888.4	19,888.4	20,099.1
Derivative financial assets	–	99.4	–	99.4	99.4

The Group provides loans and advances at both fixed and variable rates. Fair value is principally estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period. Available-for-sale financial assets are valued using quoted market prices. The Group's derivative financial assets are all interest rate swaps and are valued using a discounted cash flow model where the most significant input is interest yield curves which are developed from publicly quoted rates.

Notes to the preliminary annual results

Income

10. Net interest income

	2014 £ million	2013 £ million
Interest and similar income:		
Loans and advances to banks	**6.9**	109.4
Loans and advances to customers	**972.2**	587.6
Total interest and similar income	**979.1**	697.0
Interest and similar expense:		
Deposits from banks	**(1.9)**	(46.1)
Customer deposits	**(219.0)**	(187.1)
Total interest and similar expense	**(220.9)**	(233.2)
Net interest income	**758.2**	463.8

Included within interest and similar income is £10.4 million (2013: £8.3 million) in respect of impaired financial assets. Included in net interest income above is £6.9 million (2013: £109.4 million) receivable from LBG companies and £17.6 million (2013: £46.1 million) payable to LBG companies.

11. Net fee and commission income

	2014 £ million	2013 £ million
Fee and commission income:		
Bank accounts	**98.6**	82.0
Credit and debit card fees	**65.6**	45.3
Insurance commission income	**22.9**	23.0
Other	**21.5**	8.9
Total fee and commission income	**208.6**	159.2
Fee and commission expense:		
Bank accounts	**(55.4)**	(42.7)
Credit and debit card fees	**(6.0)**	(6.2)
Other	**(9.0)**	(0.4)
Total fee and commission expense	**(70.4)**	(49.3)
Net fee and commission income	**138.2**	109.9

Fees and commissions which are an integral part of the effective interest rate (EIR) are recognised in net interest income. Included in net fee and commission income above is £22.9 million (2013: £23.0 million) receivable from LBG companies and £7.3 million (2013: £1.4 million) payable to LBG companies.

12. Other operating income/(expense)

	2014 £ million	2013 £ million
Fair value movement on instruments held at fair value through profit or loss	**1.7**	(35.9)
Gain on repurchase of preference shares	**0.6**	–
Rent receivable	**1.3**	1.3
Other income	**0.2**	2.2
Total other operating income/(expense)	**3.8**	(32.4)

Notes to the preliminary annual results

Charges

13. Operating expenses

	2014 £ million	2013[1] £ million
Staff costs:		
Wages and salaries	**231.7**	96.6
Social security costs	**25.6**	8.5
Defined benefit pension scheme settlement gain	**(63.7)**	–
Other pension costs	**31.8**	25.3
Share-based payments	**9.3**	3.1
Other staff costs	**43.4**	5.1
Total staff costs	**278.1**	138.6
Premises and equipment expenses:		
Rent	**31.0**	18.9
Rates	**14.5**	10.0
Other	**29.0**	15.4
Total premises and equipment expenses	**74.5**	44.3
Other expenses:		
Recharges from Lloyds Banking Group companies	**–**	159.6
Transitional Service Agreement costs	**97.8**	–
Professional fees	**34.2**	0.6
Advertising and promotion	**68.5**	0.8
Financial Services Compensation Scheme levy	**16.0**	3.9
Other	**46.1**	14.6
Total other expenses	**262.6**	179.5
Depreciation	**17.2**	13.8
Total operating expenses	**632.4**	376.2

(1) Comparative figures have been restated to reflect guidance provided in IFRIC 21 *Levies.*

The average monthly number of persons on a headcount basis employed by the Group during the year was 8,427 (2013: 4,721), all of whom were employed in the UK.

Included in other expenses are fees paid to the Group's auditors in respect of work carried out for the Group of £1.2 million (2013: £0.6 million). Of this amount, £1.0 million (2013: £0.6 million) was in respect of the audit of the Group's financial statements and £0.2 million (2013: nil) was in respect of non-audit services primarily related to the Group's listing. Also included in other expenses are £0.2 million (2013: nil) paid to LBG in respect of a review by their auditors, PwC, of controls undertaken on the Group's behalf by LBG under the TSA.

Notes to the preliminary annual results

Charges (continued)

14. Retirement benefit obligations

On 31 March 2014, TSB Partners were transferred to the Group from LBG under the terms of the Transfer of Undertakings (Protection of Employment) Regulations 2006. At this point, those that were members of LBG defined benefit pension schemes became deferred members of those schemes. No settlement payment was required and the Group has no further liability to these schemes. Consequently, a gain of £63.7m was recognised in operating expenses in the income statement reflecting the economic substance of the transaction.

The expense recognised in operating expenses in the income statement is as follows:

	2014 £ million	2013 £ million
Current service cost	**4.6**	15.0
Settlement gain	**(63.7)**	–
Past service cost	**–**	0.6
Interest cost	**0.7**	2.9
Plan administration costs	**0.2**	1.0
Total net (gain)/expense	**(58.2)**	19.5

The amounts recognised on the balance sheet were as follows:

	2014 £ million	2013 £ million
Share of present value of funded obligations	**–**	578.2
Share of fair value of scheme assets	**–**	(513.9)
Retirement benefit obligations liability	**–**	64.3

The movements in the liability previously recognised on the balance sheet are as follows:

	£ million
At 31 December 2013	64.3
Net gain recognised in the income statement	(58.2)
Re-measurement	–
Contributions paid	(6.1)
At 31 December 2014	**–**

15. Taxation (charge)/credit for the year

	2014 £ million	2013[(1)] £ million
UK corporation tax:		
Current tax on profit for the year	**(7.6)**	(20.0)
Adjustments in respect of prior years	**1.7**	2.1
Current tax charge	**(5.9)**	(17.9)
Deferred tax (note 16):		
Origination and reversal of temporary differences:		
Deferred tax on business transfers	**(16.3)**	141.4
Deferred tax on pension	**(14.0)**	0.1
Accelerated capital allowances	**(1.1)**	–
Other temporary differences	**(0.6)**	(0.5)
Reduction in UK corporation tax rate	**2.2**	(20.6)
Adjustment in respect of prior years	**–**	(2.3)
Deferred tax (charge)/credit	**(29.8)**	118.1
Taxation (charge)/credit	**(35.7)**	100.2

(1) Comparative figures have been restated to reflect guidance provided in IFRIC 21 *Levies.*

Charges (continued)

15. Taxation (charge)/credit (continued)

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

	2014 £ million	2013[1] £ million
Profit before taxation	**170.2**	84.8
Taxation charge at average UK corporation tax rate of 21.5% (2013: 23.25%)	**(36.6)**	(19.7)
Factors affectting (charge)/credit		
Deferred tax asset arising from business transfers	**–**	141.4
UK corporation tax rate change	**2.2**	(20.6)
Disallowed and non-taxable items	**(3.0)**	(0.7)
Adjustment in respect of prior years	**1.7**	(0.2)
Tax (charge)/credit	**(35.7)**	100.2

(1) Comparative figures have been restated to reflect guidance provided in IFRIC 21 *Levies.*

16. Deferred tax assets

The movement in net deferred tax is as follows:

	2014 £ million	2013 £ million
At 1 January	**138.0**	21.8
Income statement (charge)/credit (note 15):	**(29.8)**	118.1
Amount charged to shareholders' equity:		
Movements in available-for-sale reserve	**(0.1)**	–
Post retirement benefit scheme re-measurements	**–**	(1.9)
At 31 December	**108.1**	138.0

The deferred tax movement in the income statement comprises the following temporary differences:

	2014 £ million	2013 £ million
Temporary differences arising from business transfers	**15.2**	(121.6)
Pension and other post-retirement benefits	**13.0**	2.5
Accelerated capital allowances	**1.0**	0.2
Other temporary differences	**0.6**	0.8
	29.8	(118.1)

Deferred tax assets are comprised as follows:

	2014 £ million	2013 £ million
Deferred tax assets:		
Deferred tax impact of business transfers	**106.4**	121.6
Pension and other post-retirement benefits	**0.1**	13.1
Revaluations of available-for-sale financial assets	**(0.1)**	–
Other temporary differences	**1.7**	3.3
Total deferred tax assets	**108.1**	138.0

Notes to the preliminary annual results

Profits and returns to shareholders

17. Segmental analysis

The segmental results are presented in a manner which is consistent with internal reporting provided to the Executive Committee which is considered to be the chief operating decision maker. The segmental results are presented on a management basis, which excludes certain volatile and non-recurring items and is the basis reviewed by the Executive Committee. The Group's reportable segments have been identified as 'Franchise' and 'Mortgage Enhancement' reflecting its organisational and management structures.

Franchise comprises the retail banking business carried out in the UK which offers a broad range of retail financial services including bank accounts, savings products, personal loans, credit cards and mortgages.

Mortgage Enhancement is a separate portfolio of mortgage assets which was assigned to the Group by LBG with effect from 28 February 2014. This segment was established in response to a review by the Office of Fair Trading of the effect on competition of the divestment of TSB and is designed to enhance the Group's profitability by over £230 million.

The Executive Committee's review includes a consideration of each segment's net interest income and consequently the interest income and expense for each reportable segment is presented on a net basis.

Year ended 31 December 2014	Franchise £ million	Mortgage Enhancement £ million	Total £ million
Net interest income	**707.3**	**79.8**	**787.1**
Other income	**147.8**	**(7.5)**	**140.3**
Total income	**855.1**	**72.3**	**927.4**
Operating expenses	**(696.1)**	**–**	**(696.1)**
Impairment	**(97.0)**	**(0.6)**	**(97.6)**
Profit before tax (management basis)	**62.0**	**71.7**	**133.7**
Losses on derivatives and hedge accounting			**(3.1)**
Derivative fair value unwind			**(24.1)**
Defined benefit pension scheme settlement gain			**63.7**
Statutory profit before taxation			**170.2**
At 31 December 2014			
Segment loans and advances to customers	**18,839.3**	**2,802.1**	**21,641.4**
Segment customer deposits	**24,624.9**	**–**	**24,624.9**

Year ended 31 December 2013	Franchise £ million	Mortgage Enhancement £ million	Total £ million
Net interest income	473.8	–	473.8
Other income	113.4	–	113.4
Total income	587.2	–	587.2
Operating expenses	(376.2)	–	(376.2)
Impairment	(80.3)	–	(80.3)
Profit before tax (management basis)	130.7	–	130.7
Losses on derivatives and hedge accounting			(39.3)
Derivative fair value unwind			(6.6)
Statutory profit before taxation			84.8
At 31 December 2013			
Segment loans and advance to customers	20,099.1	–	20,099.1
Segment customer deposits	23,100.4	–	23,100.4

Notes to the preliminary annual results

Profits and returns to shareholders (continued)

17. Segmental analysis (continued)

The table below provides a reconciliation from the management basis to the statutory results.

Year ended 31 December 2014	Management basis £ million	Loss on derivatives and hedge accounting £ million	Derivative fair value unwind £ million	Defined benefit pension scheme settlement gain £ million	Statutory basis £ million
Net interest income	**787.1**	**(28.9)**	**–**	**–**	**758.2**
Other income	**140.3**	**25.8**	**(24.1)**	**–**	**142.0**
Total income	**927.4**	**(3.1)**	**(24.1)**	**–**	**900.2**
Operating expenses	**(696.1)**	**–**	**–**	**63.7**	**(632.4)**
Impairment	**(97.6)**	**–**	**–**	**–**	**(97.6)**
Profit before taxation	**133.7**	**(3.1)**	**(24.1)**	**63.7**	**170.2**
Year ended 31 December 2013					
Net interest income	473.8	(10.0)	–	–	463.8
Other income	113.4	(29.3)	(6.6)	–	77.5
Total income	587.2	(39.3)	(6.6)	–	541.3
Operating expenses	(376.2)	–	–	–	(376.2)
Impairment	(80.3)	–	–	–	(80.3)
Profit before taxation	130.7	(39.3)	(6.6)	–	84.8

18. Earnings per share

	2014 £ million	2013 £ million
Profit attributable to shareholders	**134.5**	185.0

	Shares million	Shares million
Weighted average number of shares in issue - basic	**331.1**	55.0
Adjustment for share options and awards	**0.4**	–
Weighted average number of shares in issue - diluted	**331.5**	55.0

	Pence	Pence
Basic earnings per share	**40.6**	336.4
Diluted earnings per share	**40.6**	336.4

Basic earnings per share is calculated by dividing the profit attributable to shareholders by the weighted average number of ordinary shares in issue during the year excluding ordinary shares purchased and held by trusts.

On 25 April 2014, the Group issued 50 million ordinary shares in exchange for the acquisition of the entire share capital of TSB Bank plc increasing the total ordinary shares in issue at that date to 55 million. The weighted average number of ordinary shares in issue has been adjusted as if the share exchange had occurred at the beginning of the comparative period. The weighted average number of shares in issue also reflects the issue of a further 445 million shares on 19 May 2014 which are included in the calculation of weighted average from this date. Had these shares been in issue from the beginning of the comparative period, basic and diluted earnings per share would have been 26.9 pence (2013: 37.0 pence).

Profits and returns to shareholders (continued)

19. Shareholders' equity

	Share capital £ million	Share premium £ million	Merger reserve £ million	Capital reorg-anisation reserve £ million	Capital Reserve £ million	Available-for-sale reserve £ million	Retained profits £ million
Balance at 1 January 2014	**75.0**	**–**	**–**	**–**	**410.0**	**–**	**810.2**
Restatements:						**–**	
Insertion of new parent company	**(74.9)**	**–**	**–**	**74.9**	**–**	**–**	**–**
Change in accounting policy	**–**	**–**	**–**	**–**	**–**	**–**	**11.5**
At 1 January 2014 - restated	**0.1**	**–**	**–**	**74.9**	**410.0**	**–**	**821.7**
Share for share exchange	**0.5**	**769.5**	**616.5**	**(1,386.5)**	**–**	**–**	**–**
Issue of new shares	**4.4**	**195.6**	**–**	**–**	**–**	**–**	**–**
Movement in shares held by trusts	**–**	**–**	**–**	**–**	**–**	**–**	**(9.1)**
Value of Partner services	**–**	**–**	**–**	**–**	**–**	**–**	**1.9**
Net movement in available-for-sale reserve	**–**	**–**	**–**	**–**	**–**	**0.4**	**–**
Profit for the year	**–**	**–**	**–**	**–**	**–**	**–**	**134.5**
Balance at 31 December 2014	**5.0**	**965.1**	**616.5**	**(1,311.6)**	**410.0**	**0.4**	**949.0**

Restatements

On 31 January 2014 LBG established a newly incorporated public limited company, TSB Banking Group plc, with 50,000 ordinary £1 shares, which increased to 5.0 million one pence ordinary shares following a 100 for 1 share split on 4 April 2014. TSB Banking Group plc became the new holding company for the Group by way of a share for share exchange with Lloyds Bank plc on 25 April 2014. As a consequence of the insertion of the new holding company, share capital, share premium and the capital reorganisation reserve have been restated from those of TSB Bank plc, as if TSB Banking Group plc had been the holding company of the TSB Group during all periods presented.

Share for share exchange

On 25 April 2014, TSB Banking Group plc issued 50 million one pence ordinary shares in exchange for the acquisition of the entire share capital of TSB Bank plc, which following a 100 for one share split on 4 April 2014, comprised of 7,500,000,100 one pence ordinary shares.

The issuance of TSB Banking Group plc shares was recorded at the carrying amount of the net assets of TSB Bank plc at the date of acquisition of £1,386.5 million. The nominal value of the shares issued was £0.5 million and the minimum premium amount required by the Companies Act 2006 of £769.5 million was transferred to share premium. The balance of £616.5 million was transferred to the Merger Reserve.

Issue of new shares

On 19 May 2014, TSB Banking Group plc issued 445.0 million one pence ordinary shares at a premium of £0.4394 per share to its immediate parent company, Lloyds Bank plc, for cash proceeds of £200.0 million. At 31 December 2014, TSB Banking Group plc had in issue 500.0 million one pence ordinary shares allotted and fully paid up.

Notes to the preliminary annual results

Managing financial risk

20. Derivative financial instruments

The Group holds derivative financial instruments in the normal course of its banking business for interest rate risk management and margin stabilisation purposes. Derivatives are held at fair value on the Group's balance sheet. The fair values and notional amounts of derivative instruments are presented in the following table:

	31 December 2014			31 December 2013		
	Contract/ notional amount £ million	Fair value of assets £ million	Fair value of liabilities £ million	Contract/ notional amount £ million	Fair value of assets £ million	Fair value of liabilities £ million
Interest rate swaps	**10,874.0**	**56.8**	**(42.8)**	13,491.0	99.4	(85.6)
Designated as fair value hedges	**5,246.8**	**66.3**	**(73.9)**	–	–	–
Total	**16,120.8**	**123.1**	**(116.7)**	13,491.0	99.4	(85.6)

From 1 January 2014, the Group has established fair value hedge accounting relationships for interest rate risk. The Group designates certain of its fixed rate customer loans, debt securities available for sale, bank accounts, savings accounts and subordinated debt in fair value hedge accounting relationships. Gains of £74.2 million (2013: nil) were recognised on the derivatives in hedge accounting relationships. Losses of £74.6 million (2013: nil) were recognised on the hedged items attributable to the hedged interest rate risk.

Derivative assets of £108.9 million (2013: £76.5 million) are expected to be recovered after more than one year. Derivative liabilities of £112.3 million (2013: £74.2 million) are expected to be settled after more than one year.

Other important disclosures

21. Contingent liabilities

(a) The Financial Services Compensation Scheme

The FSCS is the UK's independent statutory compensation fund of last resort for customers of authorised financial services firms and pays compensation if a firm is unable or likely to be unable to pay claims against it. The FSCS is funded by levies on the authorised financial services industry. Each deposit-taking institution contributes towards the FSCS levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year, which runs from 1 April to 31 March.

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. Although the substantial majority of this loan, which totalled approximately £15.8 billion at 31 December 2014, will be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets of the firms that defaulted, any shortfall and interest cost will be funded by deposit-taking participants of the FSCS. In January 2015, the FSCS forecast that it expects to require to levy a capital shortfall of £1.1 billion on all deposit-taking participants to enable it to repay the balance of the HM Treasury loan. During 2014, the Group has paid, as required, its share of the 2013/14 interest and the 2014/15 capital elements of the levy and provided for its share of the 2014/15 interest element, payable September 2015. The amount of future compensation costs levies payable by the Group depends on a number of factors including participation in the market at 31 December, the level of protected deposits and the population of deposit-taking participants.

(b) Legal and regulatory matters

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

Notes to the preliminary annual results

Other important disclosures (continued)

22. Related party transactions

The Group's related parties include its parent, other LBG companies and key management personnel.

Balances with Lloyds Banking Group companies

The Group enters into banking transactions with LBG companies in the normal course of its business. These include loans, deposits and investment related transactions and are carried out on commercial terms and at market rates. These are included in the Group's consolidated balance sheet as follows:

	2014 £ million	2013 £ million
Assets included within:		
Items in course of collection from banks	**2.4**	–
Loans and advances to banks	**134.5**	4,124.7
Derivative financial assets	**–**	99.4
Other assets	**43.1**	3.7
	180.0	4,227.8
Liabilities included within:		
Deposits from banks	**32.5**	234.7
Items in course of transmission to banks	**3.4**	–
Derivative financial liabilities	**0.9**	85.6
Debt securities in issue	**10.0**	1.4
Subordinated liabilities	**405.5**	–
Other liabilities	**17.2**	0.5
	469.5	322.2

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. In respect of transactions with LBG companies during 2014, the Group recognised net interest expense of £10.7 million (2013: net interest income £63.3 million), net fee and commission income of £15.6 million (2013: £21.6 million), income of £9.7 million in respect of derivative financial instruments (2013: expense of £35.9 million) and incurred expenses of £97.8 million under the TSA. In 2013, the Group incurred net recharges of £159.6 million from LBG companies in respect of various services provided between the Group and LBG companies.

On 1 May 2014, the Group exited the LBG UK Defined Liquidity Group and established a standalone liquid asset portfolio which at 31 December 2014 was held on deposit with the Bank of England. Prior to this all liquidity was held on deposit with LBG and was recognised in loans and advances to banks.

The Group and Lloyds Bank plc entered into the Tier 2 Subscription Agreement relating to the subscription by Lloyds Bank plc of Tier 2 securities that were issued for net proceeds of £383.0 million on 1 May 2014.

On 20 May 2014, the Group entered into the £2.5 billion RMBS Funding Facility arrangement with LBG and others (including Cape Funding No. 1 plc, established by the Group) to part fund the transfer of the economic benefit of a £3.4 billion portfolio of mortgage loans by LBG to the Group. Debt securities in issue of £10.0 million reflect the drawdown of funding from this securitisation programme. The balance at 31 December 2013 of £1.4 million reflects preference shares which were repurchased on 21 January 2014 from TSB Bank's then immediate parent company.

Transactions with Lloyds Banking Group companies

A number of transactions were undertaken with LBG companies to prepare the Group for its admission to the London Stock Exchange, to improve its medium term profitability and to formalise arrangements over the provision of IT and certain operational services which are explained as follows:

Notes to the preliminary annual results

Other important disclosures (continued)

Corporate structuring and associated transactions

— *Transferring colleagues to the Group* - On 31 March 2014, TSB employees (now known as TSB Partners) were transferred to TSB from LBG under the terms of the Transfer of Undertakings (Protection of Employment) Regulations 2006. At this point, those who were members of LBG defined benefit pension schemes became deferred members of those schemes and the Group's defined benefit pension scheme deficit was derecognised. No settlement payment was required and consequently the Group recorded a one-off gain of £63.7 million reflecting the transfer of the defined benefit pension scheme deficit.

— *Establishing a Group holding company* - On 25 April 2014, TSB Banking Group plc became the holding company of the Group following a share for share exchange in which it acquired 100% of the issued share capital of TSB Bank plc from Lloyds Bank plc.

— *Capitalising the Group for growth* - On 1 May 2014, TSB Banking Group plc issued £385.0 million of Tier 2 dated subordinated debt and, on 19 May 2014, issued 445 million ordinary shares for proceeds of £200.0 million. Both issues of capital were wholly subscribed for by Lloyds Bank plc. On 13 October 2014, the Tier 2 dated subordinated debt was admitted to listing on the Official List of the UK Listing Authority and to trading on the London Stock Exchange's Regulated Market.

— *Listing the Group* - On 25 June 2014, TSB Banking Group plc achieved a premium listing on the London Stock Exchange, with a free-float of 38.5%. The free float increased to approximately 50% on 26 September 2014 following a further partial sell-down by LBG.

Formalising arrangements and agreements with LBG

— *Transitional Services Agreement* - From 1 January 2014, the Group transitioned from operating within the LBG shared service model. On 9 June 2014, TSB and LBG formally entered into the TSA and LTSA for the provision of IT services and certain operational activities.

— *Mortgage Valuation Services* - On 30 May 2014, the Group and LBG entered into an agreement for the provision of mortgage valuation and associated panel management services to the Group by Colleys.

— *Separation Agreement* - On 9 June 2014, the Group and LBG entered into the Separation Agreement. This governs (amongst other things) the allocation of certain pre-IPO liabilities, including liability for breach of law and regulation and of customer terms and conditions and also governs certain aspects of the relationship between the Group and LBG following IPO.

— *Relationship Agreement and Tax Separation Deed* - On 9 June 2014, the Group and LBG entered into the Relationship Agreement and Tax Separation Deed. The principal purpose of the Relationship Agreement is to ensure that the Group is capable at all times of carrying on its business independently of LBG and its associates. The Tax Separation Deed regulates certain aspects of the separation of the Group from any LBG tax groups.

— *General Insurance Distribution Agreement* - On 9 June 2014, the Group and Lloyds Bank Insurance Services Limited (LBIS) entered into the General Insurance Distribution Agreement. Pursuant to the General Insurance Distribution Agreement, the Group agreed to promote and sell to TSB Bank customers certain home insurance products that are underwritten by LBIS.

— *Mortgage Intermediary Platform Build Agreement* - On 9 June 2014, the Group and LBG entered into the Mortgage Intermediary Platform Build Agreement under which LBG agreed to complete the build of a mortgage intermediary platform for TSB. The build of this channel has now completed and it commenced trading in January 2015.

Enhancing the Group's medium term profitability

— *Services Arrangements with LBG* - On 1 January 2014, the Group transitioned from operating within the LBG shared service model to a standalone business cost structure. IT services and certain operational activities are however still being provided by LBG under a TSA. The TSA runs until the end of 2016 when it will be replaced by the LTSA, which is expected to increase the Group's cost base by over £100 million p.a. from 2017.

— *Mortgage Enhancement* - With effect from 28 February 2014, in response to a review by the Office of Fair Trading of the effect on competition of the divestment of TSB from LBG, the economic benefit of a £3.4 billion portfolio of mortgage loans was assigned to the Group by LBG. This was designed to enhance the Group's PBT by a cumulative £230 million and, during 2014, increased PBT by £71.7 million. This portfolio is subject to a call option exercisable by LBG after the £230 million profit target has been achieved.

Notes to the preliminary annual results

Other important disclosures (continued)

UK Government

In January 2009, the UK government through HM Treasury became a related party of LBG following its subscription for ordinary shares issued under a placing and open offer. As at 31 December 2014, HM Treasury held a 24.8% interest in LBG's ordinary share capital and consequently HM Treasury remained a related party of the Group. During the year ended 31 December 2014, this percentage holding reduced from 32.7% at 31 December 2013 following the UK government's sale of 5,555 million shares on 31 March 2014 and 46 million shares in December 2014.

In accordance with IAS 24 Related Party Disclosures, UK government-controlled entities are related parties of the Group. The Group regards the Bank of England and entities controlled by the UK government, including The Royal Bank of Scotland Group plc, Northern Rock (Asset Management) plc and Bradford & Bingley plc, as related parties.

In the ordinary course of business, the Group may from time to time access market-wide facilities provided by central banks. There were no significant transactions with other UK Government-controlled entities (including UK Government-controlled banks) during the year that were not made in the ordinary course of business or that were unusual in their nature or conditions.

Indemnity for customer remediation costs

The Group has been indemnified by its intermediate parent company, Lloyds Bank plc, in respect of redress costs arising from past misconduct. At 31 December 2014 the Group recognised a recoverable under the indemnity of £22.2 million (2013: £3.7 million).

Notes to the preliminary annual results

Other important disclosures (continued)

23. Notes to the cash flow statement

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

	2014 £ million	2013 £ million
Change in loans and receivables:		
Change in loans and advances to banks	**4,084.0**	3,558.6
Change in loans and advances to customers	**1,726.4**	879.2
Change in derivative assets	**(23.7)**	–
Change in other operating assets	**(89.1)**	(29.2)
Change in operating assets	**5,697.6**	4,408.6
Change in deposits from banks	**(105.8)**	(7,931.0)
Change in customer deposits	**1,540.3**	394.3
Change in derivative liabilities	**31.1**	–
Change in other operating liabilities	**102.9**	45.8
Change in operating liabilities	**1,568.5**	(7,490.9)
Depreciation and amortisation	**17.2**	13.8
Allowance for loan losses	**97.6**	80.3
Other non-cash items	**(73.7)**	119.4
Non cash and other items	**41.1**	213.5
Analysis of cash and cash equivalents as shown in the balance sheet		
Cash and balances with central banks	**4,396.3**	200.2
Less: Mandatory reserve deposits(1)	**(47.0)**	(25.8)
	4,349.3	174.4
Loans and advances to banks with maturity less than three months	**134.5**	–
Total cash and cash equivalents	**4,483.8**	174.4

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

24. Other information

In accordance with the Listing Rules of the UK Listing Authority, these preliminary annual results have been agreed with the Company's auditors, PricewaterhouseCoopers LLP, and the Directors have not been made aware of any likely modification to the auditors' report to be included with the annual report and accounts for the year ended 31 December 2014.

The preliminary annual results, which were approved by the Directors on 24 February 2015, do not constitute statutory accounts within the meaning of section 434 of the Companies Act 2006.

Statutory accounts for TSB Bank plc for the year ended 31 December 2013 have been delivered to the Registrar of Companies. The auditors' report on those accounts was unqualified, did not include an emphasis of matter paragraph and did not include a statement under section 498 of the Companies Act 2006.

Appendix

Quarterly results summary by segment (unaudited)

Group

	Q4 2014 £ million	Q3 2014 £ million	Q2 2014 £ million	Q1 2014 £ million
Net interest income	197.2	199.3	201.6	189.0
Other income	34.5	33.2	34.5	38.1
Total income	231.7	232.5	236.1	227.1
Operating expenses	(194.7)	(167.9)	(180.7)	(152.8)
Impairment	(23.5)	(23.0)	(23.8)	(27.3)
Profit before taxation (management basis)	13.5	41.6	31.6	47.0
Losses on derivatives and hedge accounting	(0.4)	(2.9)	0.8	(0.6)
Derivative fair value unwind	(4.5)	(5.6)	(6.7)	(7.3)
Defined benefit pension scheme settlement gain	–	–	–	63.7
Statutory profit before taxation	8.6	33.1	25.7	102.8
Loans and advances to customers	21,641.4	22,016.2	22,493.4	23,039.3
Customer deposits	24,624.9	24,157.6	23,700.4	23,259.7
Group banking net interest margin(2)	3.57%	3.54%	3.54%	3.62%
Management basis cost:income ratio	84.0%	72.2%	76.5%	67.3%
Group asset quality ratio(3)	0.43%	0.41%	0.42%	0.52%

Franchise

	Q4 2014 £ million	Q3 2014 £ million	Q2 2014 £ million	Q1 2014 £ million
Net interest income	175.2	175.6	176.7	179.8
Other income	37.3	36.0	36.0	38.5
Total income	212.5	211.6	212.7	218.3
Operating expenses	(194.7)	(167.9)	(180.7)	(152.8)
Impairment	(23.5)	(23.0)	(23.7)	(26.8)
Profit before taxation (management basis)	(5.7)	20.7	8.3	38.7
Loans and advances to customers	18,839.3	19,063.1	19,381.8	19,749.4
Customer deposits	24,624.9	24,157.6	23,700.4	23,259.7
Franchise banking net interest margin(2)	3.65%	3.61%	3.60%	3.64%

Mortgage Enhancement

	Q4 2014 £ million	Q3 2014 £ million	Q2 2014 £ million	Q1 2014 £ million
Net interest income	22.0	23.7	24.9	9.2
Other income	(2.8)	(2.8)	(1.5)	(0.4)
Total income	19.2	20.9	23.4	8.8
Operating expenses	–	–	–	–
Impairment	–	–	(0.1)	(0.5)
Profit before taxation (management basis)	19.2	20.9	23.3	8.3
Loans and advances to customers	2,802.1	2,953.1	3,111.6	3,289.9
Mortgage Enhancement banking net interest margin(2)	3.03%	3.10%	3.13%	3.25%

(2) and (3) See notes on page 3.

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