# Annual report & consolidated financial statements

## Clydesdale Bank PLC

For the year ended 30 September 2019

Company Number: SC001111

# Clydesdale Bank PLC

## Annual report & consolidated financial statements
## For the year ended 30 September 2019

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### Overview

Clydesdale Bank PLC ('the Bank'), together with its subsidiary undertakings (which together comprise 'the Group'), operate under the Clydesdale Bank, Yorkshire Bank, B and Virgin Money brands. It offers a range of banking services for both retail and business customers through retail branches, Business Banking centres, direct and online banking, and brokers. It is the main operating subsidiary of its immediate parent, Virgin Money UK PLC. The results referred to in this annual report and accounts relate to the 12 months up to 30 September 2019, which reflect the acquisition of Virgin Money Holdings (UK) plc on 15 October 2018.

Certain figures contained in this document, including financial information, may have been subject to rounding adjustments and foreign exchange conversions. Accordingly, in certain instances, the sum or percentage change of the numbers contained in this document may not conform exactly to the total figure given.

The forward-looking statements disclaimer can be found on page 196.

# Officers and professional advisers

| | |
|---|---|
| **Directors** | David Duffy<br>Ian Smith<br>Clive Adamson<br>David Bennett<br>Paul Coby<br>Geeta Gopalan<br>Adrian Grace<br>Fiona MacLeod<br>Jim Pettigrew<br>Darren Pope<br>Dr Teresa Robson-Capps<br>Amy Stirling<br>Tim Wade |
| **Secretary** | Lorna McMillan<br>James Peirson |
| **Registered office** | 30 St Vincent Place<br>Glasgow<br>G1 2HL |
| **Independent auditors** | Ernst & Young LLP<br>Bridgewater Place<br>1 Water Lane<br>Leeds<br>LS11 5QR |

# Strategic report

The Directors of the Bank and its subsidiary undertakings (which together comprise 'the Group') present their Strategic report for the year ended 30 September 2019.

### Principal activities

The Group operates a full service UK-focused retail and commercial banking business under the brand names 'Clydesdale Bank', 'Yorkshire Bank', 'B' and 'Virgin Money' across its core regional markets (Scotland, North East England, North West England, Yorkshire and the Humber) and selected national markets. The banks are strong, low risk retail-only banks focused on providing residential mortgages, personal and business current accounts, savings, personal loans and credit cards, loans for small and medium businesses, and payment and transaction services.

### Business review

| Summary balance sheet as at 30 September | 2019 £m | 2018 £m |
|---|---|---|
| Customer loans | **72,971** | 33,281 |
| Other financial assets | **16,391** | 9,233 |
| Other non-financial assets | **1,739** | 1,069 |
| **Total assets** | **91,101** | 43,583 |
| Customer deposits | **(63,787)** | (28,854) |
| Wholesale funding | **(18,497)** | (8,116) |
| Other liabilities | **(3,676)** | (3,322) |
| **Total liabilities** | **(85,960)** | (40,292) |
| Ordinary shareholders' equity | **(4,469)** | (2,866) |
| Additional Tier 1 (AT1) equity | **(672)** | (425) |
| **Equity** | **(5,141)** | (3,291) |
| **Total liabilities and equity** | **(91,101)** | (43,583) |

| Summary income statement – underlying and statutory basis[(1)] for the year ended 30 September | 2019 £m | 2018 £m |
|---|---|---|
| Net interest income | **1,413** | 855 |
| Non-interest income | **196** | 156 |
| **Total operating income** | **1,609** | 1,011 |
| Total operating and administrative expenses | **(937)** | (633) |
| Bank levy | **(5)** | - |
| **Operating profit before impairment losses** | **667** | 378 |
| Impairment losses on credit exposures[(2)] | **(147)** | (41) |
| **Underlying profit on ordinary activities before tax** | **520** | 337 |
| Restructuring costs | **(149)** | - |
| Acquisition costs | **(134)** | (7) |
| Legacy conduct | **(433)** | (544) |
| Other items | **14** | (62) |
| **Statutory loss on ordinary activities before tax** | **(182)** | (276) |
| Tax credit | **43** | 37 |
| **Statutory loss attributable to equity holders** | **(139)** | (239) |

(1) The summary income statement is presented on a statutory and underlying basis. The underlying basis excludes certain items that are included in the statutory results, as management believe that these items are not reflective of the underlying business and do not aid meaningful year-on-year comparison. Full details on the adjusted items are included in the Glossary on page 188.

(2) Impairment losses on credit exposures relate solely to loans and advances to customers (refer to note 3.2 to the financial statements).

# Strategic report (continued)

### Business review (continued)

2019 has been a year of unprecedented change for the Group, following the acquisition of Virgin Money Holdings (UK) PLC on 15 October 2018, and the subsequent integration of the two banks. We delivered a resilient operating performance as a newly enlarged group in a challenging environment, while executing on key integration milestones that now enable us to commence the customer and platform integration programme. We have also made good initial progress in the delivery of our refreshed strategy and targets. The Group experienced an unwelcome and unexpected surge in payment protection insurance (PPI) claims ahead of August's complaint deadline, but we have been able to absorb the additional cost impact and remain focused on implementing our strategy.

### Balance sheet progress

Our strategy to re-shape the balance sheet is off to a good start with asset growth of 2.9%. This was achieved through above market growth in Business and Personal lending, with more muted growth in Mortgages as we optimised for value. We delivered strong growth of 7.1% in our relationship deposits as we look to rebalance our funding away from less sticky and more expensive non-linked savings and term deposits.

### Resilient underlying operating performance

The Group delivered a resilient operating performance with underlying profit before tax (PBT) of £520m (2018: £337m). The Group delivered income of £1,609m (2018: £1,011m) and underlying operating profit of £667m (2018: £378m) in a challenging environment. Impairments rose from £41m to £147m, reflecting the effects of the acquisition, portfolio maturation and the adoption of IFRS9, but underlying asset quality remains strong.

### Statutory loss impacted by legacy conduct

In line with the rest of the industry, we received an unprecedented volume of PPI information requests and complaints during August, which required us to take additional PPI provisions of £415m during the year.

The scale of the PPI provision coupled with the anticipated acquisition and restructuring costs incurred this year (£290m) meant that the Group has reported a statutory loss after tax of £139m (2018: £239m loss after tax).

### Robust capital position supports strategy

While the PPI provision clearly had a significant impact on the Group's capital position, thanks to the significant buffer the Group was prudently holding we have been able to absorb the impact and remain robustly capitalised.

Our Common Equity Tier 1 (CET1) ratio of 14.4% as at 30 September 2019 retains a significant buffer to our Capital Requirements Directive IV (CRD IV) regulatory requirement of 11.0% and provides sufficient capacity to deliver our strategy.

### Funding and liquidity

The Group's liquidity surplus continues to comfortably exceed our regulatory minimum and internal risk appetite, with a Liquidity Coverage Ratio (LCR) of 152% as at 30 September 2019 (2018: 137%). Net stable funding ratio (NSFR) was 128% at 30 September 2019 (2018: 125%).

### Conclusion

2019 has been a year of building foundations for the future, while seeking to close out legacy issues. Our refreshed strategy is predicated on actions within our own control and leverages the key strategic advantages available to us. We look forward to another year of strong delivery and progress in 2020.

### Key performance indicators

The Directors do not rely on key performance indicators at the individual subsidiary level. The performance of the Group is included in the Annual Report and Accounts of Virgin Money UK PLC, formerly known as CYBG PLC ('CYBG'). The business is managed within the Virgin Money UK PLC Group and the results are consistent with the Group's status as a fully integrated and wholly owned subsidiary of the Virgin Money UK PLC Group. For this reason, the Company's Directors believe that providing further indicators for the Group itself would not enhance an understanding of the development, performance or position of the Group.

# Strategic report (continued)

**Business review (continued)**

**Reconciliation of statutory to underlying results**

The underlying results presented within this Business review reflect the Group's results prepared on an underlying basis. These exclude certain items that are included in the statutory results, as management believes that these items are not reflective of the underlying business and do not aid meaningful year-on-year comparison. The table below reconciles the statutory results to the underlying basis, and full details on the adjusted items are included in the Glossary on page 188:

| **2019 income statement** | **Statutory results £m** | **Restructuring costs £m** | **Acquisition costs £m** | **Legacy conduct £m** | **Other £m** | **Underlying basis £m** |
|---|---|---|---|---|---|---|
| Net interest income | 1,516 | - | (103) | - | - | 1,413 |
| Non-interest income | 257 | - | - | - | (61) | 196 |
| **Total operating income** | 1,773 | - | (103) | - | (61) | 1,609 |
| Total operating and administrative expenses before impairment losses | (1,698) | 149 | 132 | 433 | 47 | (937) |
| Bank levy | (5) | - | - | - | - | (5) |
| **Operating profit/(loss) before impairment losses** | 70 | 149 | 29 | 433 | (14) | 667 |
| Impairment losses on credit exposures | (252) | - | 105 | - | - | (147) |
| **(Loss)/profit on ordinary activities before tax** | (182) | 149 | 134 | 433 | (14) | 520 |

| 2018 income statement | Statutory results £m | Acquisition costs £m | Legacy conduct £m | Other £m | Underlying basis £m |
|---|---|---|---|---|---|
| Net interest income | 855 | - | - | - | 855 |
| Non-interest income | 156 | - | - | - | 156 |
| Total operating income | 1,011 | - | - | - | 1,011 |
| Total operating and administrative expenses before impairment losses | (1,246) | 7 | 544 | 62 | (633) |
| Operating (loss)/profit before impairment losses | (235) | 7 | 544 | 62 | 378 |
| Impairment losses on credit exposures | (41) | - | - | - | (41) |
| (Loss)/profit on ordinary activities before tax | (276) | 7 | 544 | 62 | 337 |

# Strategic report (continued)

### Principal risks and mitigating actions

The Group's principal risk categories include those risks that could result in events or circumstances that might threaten the Group's business model, future performance, solvency, liquidity and reputation. In the 2019 refresh of the Group's Risk Management Framework (RMF), technology risk was classified as a standalone principal risk, separate from operational risk, to align with the Group's strategy for digitisation and current industry focus on business resilience and cyber risk.

| Principal risks | Key mitigating actions |
|---|---|
| **Credit risk** is the risk of loss of principal or interest stemming from a borrower's failure to meet contracted obligations to the Group in accordance with their agreed terms. Credit risk manifests at both a portfolio and transactional level. | • Ongoing monitoring and approval of individual transactions, regular asset quality reviews and independent oversight of credit decisions and portfolios.<br>• The Group applies detailed lending policies and standards which outline the approach to lending, underwriting, concentration limits and product terms.<br>• Portfolio monitoring techniques cover such areas as product, industry, geographical concentrations and delinquency trends.<br>• Stress test scenarios are regularly prepared with the outcomes reviewed and relevant actions taken. Outputs will typically include impairment charges, risk-weighted assets (RWAs) and write-offs. |
| **Financial risk** includes capital risk, funding risk, liquidity risk, market risk, model risk, pension risk, and financial risks arising from climate change, all of which have the ability to impact the financial performance of the Group if managed improperly. | • Funding and liquidity risk is managed in accordance with Board approved standards, including the annual Internal Liquidity Adequacy Assessment Process (ILAAP), strategic, funding and liquidity funding plans.<br>• The Group completes an annual Internal Capital Adequacy Assessment Process (ICAAP) which formally assesses the impact of severe, yet plausible, stress events to ensure that appropriate level and type of capital underpins the strength of the balance sheet in both normal and stressed conditions. Furthermore, the Group will be participating in the Bank of England (BoE) ACS from 2020.<br>• The Group has implemented a range of pension reforms to reduce exposure to pension risk.<br>• The Group has policies and standards for managing the risks that arise during the change, development, validation, implementation and usage of its models. |
| **Regulatory and compliance risk** is the risk of failing to comply with relevant laws and regulatory requirements, not keeping regulators informed of relevant issues, not responding effectively to information requests, not meeting regulatory deadlines or obstructing the regulator. | • Clearly defined regulatory and compliance policy statements and standards are in place, supporting both regulatory and customer expectations.<br>• There is ongoing proactive and co-ordinated engagement with key regulators.<br>• Formal monitoring of compliance is managed through oversight by the Regulatory Management team, regular reporting to the Risk Committee and regular dialogue with the regulators. |

# Strategic report (continued)

### Principal risks and mitigating actions (continued)

| Principal risks | Key mitigating actions |
|---|---|
| **Conduct risk** is the risk of undertaking business in a way which is contrary to the interests of our customers, resulting in the delivery of inappropriate customer outcomes or detriment, regulatory censure, redress costs and/or reputational damage. | • The Group has an overarching Conduct Risk Framework, with clearly defined policy statements and standards.<br>• There is ongoing reporting and development of conduct risk appetite measures to the Executive Risk Committee and the Board.<br>• Continual assessment of evolving conduct regulations, customer expectations and proposition development.<br>• A risk-based assurance framework has been designed to monitor compliance with regulation and assess customer outcomes. |
| **Operational risk** is the risk of loss resulting from inadequate or failed internal processes, people or systems or from external events. | • The Group has an established Operational Risk Framework to identify, manage and mitigate operational risks.<br>• Internal and external loss events are categorised using Basel II risk categories to ensure consistent assessment, monitoring and reporting of risks and events.<br>• The Group undertakes regular, forward-looking scenario analysis to gain insight into the stresses the business could be subject to in the event of operational risk events materialising. |
| **Financial crime risk** is the risk that the Group's products and services will be used to facilitate financial crime against the Group, its customers or third parties. | • The Group has an established Financial Crime Framework to support the management, monitoring and mitigation of financial crime risk.<br>• The Group continues to monitor industry, fraudster and customer dynamics within an evolving and volatile risk environment.<br>• The Group implements a framework of risk-based systems and controls to minimise the extent to which its products and services can be used to commit or be subject to fraud.<br>• The Group performs regular reviews of fraud mitigation strategies to ensure they remain effective and in line with Board approved risk appetite. |
| **Strategic and enterprise risk** is the risk of significant loss of earnings or damage arising from decisions or actions that impact the long-term interests of the Group's stakeholders or from an inability to adapt to external developments, including potential execution risk as a result of integration and transformation activity. | • Strategic and enterprise risk is addressed through the Board approved five-year Strategic and Financial Plan.<br>• The Group considers strategic and enterprise risk as part of ongoing risk reporting and the management of identified strategic risks is allocated to members of the Group's Leadership Team by the CEO.<br>• The Group has a defined sustainability strategy that takes account of both the risks and opportunities in relation to environmental factors, including analysis and management of risks associated with climate change.<br>• Regular oversight activity with workstreams focussed solely on the execution risk of delivering integration, placing customers' interests at the centre of all aspects of change. |

# Strategic report (continued)

### Principal risks and mitigating actions (continued)

| Principal risks | Key mitigating actions |
|---|---|
| **People risk** is the risk of not having sufficiently skilled and motivated colleagues who are clear on their responsibilities and accountabilities and behaving in an ethical way. | • Roles, responsibilities and performance expectations are defined in role profiles and expanded through objective setting and ongoing performance management.<br>• The Group's cultural framework has a clearly defined Purpose, with Values and Behaviours that form the foundation of the performance management framework.<br>• The quality and continuity of the Group's leadership is reviewed and assessed through succession planning and talent management activity. |
| **Technology risk** is the risk of loss resulting from inadequate or failed information technology processes. It includes cybersecurity, IT resilience, information security, data privacy and payment risk. | • The Group continues to invest significantly in the protection and resilience of its systems, processes, information and data across all three lines of defence, recognising the changing cyber landscape, and increased focus on digital capabilities, as well as the changing risk profile of the business.<br>• The Board approved security strategy focusses on the management of cyber risk, exposure and manipulation of confidential data and identity and access management.<br>• These risks are managed by a number of controls that align to the industry recognised National Institute of Standards & Technology (NIST) framework.<br>• The Group has a Data Management Framework governing the creation, storage, distribution, usage and retirement of data.<br>• The Group continues to enhance its Privacy Framework to ensure data subject rights are managed in line with GDPR.<br>• The Payment Risk Framework outlines key scheme rules, regulations and compliance requirements to ensure that payment risk is managed within appetite. |

### Operational resilience

Operational resilience underpins all nine principal risks and is defined as the ability of the Group to protect and sustain its most critical functions, and underlying assets, whilst adapting to expected or unexpected occurrences of operational stress or disruption, and having the capacity to recover from issues as and when they arise. The Group assesses its operational resilience in relation to people, technology, third parties and premises ensuring it aims to provide a superior level of support and services to customers and stakeholders on a consistent and uninterrupted basis.

# Strategic report (continued)

### Emerging risks

The Group's risks are continually reassessed and reviewed through a horizon scanning process, with escalation and reporting to the Board. The horizon scanning process fully considers all relevant internal and external factors, and is designed to consider and capture those risks which are current but have not yet fully crystallised, as well as those which are expected to crystallise in future periods. These risks are allocated a status based on their expected impact and time to fully crystallise, in line with the definitions outlined in the RMF.

| Emerging risks | Description | Mitigating actions |
|---|---|---|
| **Geopolitical and macroeconomic environment** | As a UK focussed bank, the Group is exposed to a variety of risks resulting from a downturn in the UK's economic environment, namely macro-economic growth outlook, credit performance and margin pressure. Economic risks remain heightened as a result of the uncertainty surrounding the UK vote to leave the European Union (Brexit), and the upcoming General Election. | • The Group actively monitors its credit portfolios and undertakes robust internal stress testing to identify sectors that may come under stress as a result of an economic slowdown in the UK.<br>• The Group continues to monitor economic and political developments, in light of the ongoing uncertainty, considering potential consequences for its customers, products and operating model, including its sources of funding. |
| **Competition** | Competition within the financial services sector has increased as a result of newly ring-fenced banks re-establishing their focus on the UK retail sector. In addition, regulatory initiatives, such as Open Banking, may lead to material changes in the future provision of financial products and services and the way in which our customers access them. | • The Group recognises both the risks and opportunities resulting from the changes and continues to develop strategies, products and technologies to ensure it can take strategic advantage where possible and mitigate any corresponding risks. |
| **Regulatory change** | The Group continues to face a significant and evolving agenda of regulatory and legislative change. | • The Group continues to monitor emerging regulatory initiatives to identify any potential impact on or change to its business model and ensure it is well placed to respond with effective regulatory change management.<br>• The Group continues to work with regulators and the industry to ensure it meets all regulatory obligations, with identified implications of upcoming regulatory activity incorporated into the strategic planning cycle. |

# Strategic report (continued)

**Emerging risks (continued)**

| Emerging risks | Description | Mitigating actions |
|---|---|---|
| **Climate change** | The Group is exposed to physical, transition and reputation risks arising from climate change. | • The Group has developed a plan to fully consider the impacts of climate change in line with the Prudential Regulation Authority's (PRA's) Supervisory Statement SS3/19, the Group's Strategy for Sustainability and its broader responsibilities to society.<br>• The plan aims to deepen the Group's understanding of the financial risks from climate change, agree a Board level firm-wide strategic response, and consider how decisions today affect future financial risks. A governance framework has been put in place to ensure appropriate visibility of risks arising from climate change. |

**Outlook**

Over the next 12 months the Group will continue to support Virgin Money UK PLC, the Group's ultimate parent, in delivering its targets and executing its strategy.

The Strategic report was approved by the Board of Directors on 27 November 2019 and was signed on its behalf by:

David Duffy

**Chief Executive Officer**

Clydesdale Bank PLC

# Risk report

Effective risk management is critical to realising the Group's strategy of pioneering growth, with delighted customers and colleagues, while operating with super straightforward efficiency, discipline and sustainability. The safety and soundness of the Group is aligned to Our Purpose and is a fundamental requirement to enable our customers and stakeholders to be "happier about money".

### Risk Culture

Personal accountability is at the heart of the Group's risk culture. This is enabled through the risk management accountability model and a formal delegation framework through which colleagues are able to make risk-based decisions. Culture is shaped by many aspects including Purpose, Values and Behaviours that set a "Tone from the Top", the Group's and Regulatory Codes of Conduct, operating principles, Policy Statements and Standards, the risk management operating model and an approved articulation of risk appetite that aligns to, and supports, strategic objectives.

The Group strives to instil a culture that enables colleagues to meet the requirements of all relevant rules, regulations, laws, codes and policies and build constructive regulatory relationships. All colleagues are recruited with the core skills, abilities and attitude required to competently carry out their role. They are provided with sufficient training and development, during their time with the Group, to ensure they maintain the required levels of competence underpinned by the Group's Purpose, Values and Behaviours.

Management encourage an environment of effective challenge in which decision-making processes promote a range of views. Transparency and open dialogue are encouraged, including enabling colleagues to raise concerns when they feel uncomfortable about actions, practices or behaviours.

The Group is customer centric and values open and honest feedback from its customers. This feedback allows the Group to rectify problems, learn from them and consistently create products and services that meet customer needs in alignment with Purpose. The Board and senior management are responsible for taking leadership of risk culture through their actions and words, and proactively overseeing and addressing any identified areas of weakness or concern. Internal Audit (IA) provides an independent view of risk culture to the Board's Audit Committee through a risk and control related management awareness assessment assigned to the majority of audits. Following the launch of Our Purpose in 2019, IA is piloting independent deep dives in specific areas of the business, to complement existing reporting and measure alignment between actual and intended culture.

### Risk Strategy

The Group has a clearly defined risk strategy to manage and mitigate risk in the daily course of its business. The strategy:

- ensures all principal and emerging risks are identified and assessed;
- ensures risk appetite is clearly articulated and influences the Group's strategic plan;
- promotes a clearly defined risk culture which emphasises risk management across all areas of the business while maintaining independent oversight;
- undertakes ongoing analysis of the environment in which the Group operates to proactively address potential risk issues as they arise; and
- supports commercial decisions and people with appropriate risk processes, systems and controls.

### Risk Appetite Statement (RAS)

Risk appetite is defined as "the level and types of risk the Group is willing to assume within the boundaries of its risk capacity, to achieve its strategic objectives". The RAS articulates the Group's risk appetite to stakeholders and provides a view on the risk-taking activities the Board is comfortable with, guiding decision-makers in their strategic and business decisions.

The Risk Appetite Framework sets out the mandatory governance requirements for the creation, management and oversight of the RAS.

# Risk report (continued)

### Risk Appetite Statement (RAS) (continued)

The RAS conveys the balance required between risk taking and the commercial and reputational implications of doing so, promoting good customer outcomes and protecting the Group from excessive exposure. The RAS includes qualitative and quantitative limits which inform strategies, targets, policies, procedures and other controls that collectively ensure the Group remains within the Board's approved appetite.

The Group's RAS is prepared by the Group Chief Risk Officer with consideration of the strategic objectives and business model, as well as the environment in which the Group operates. Reporting to Executive Committees and Board includes details of performance against relevant RAS settings, breaches and trends.

### Risk Policies and Procedures

The policy framework is a key component of the Group's RMF providing structure and governance for the consistent and effective management of policies. In developing the policy framework the Group sets the tone that demonstrates the risk culture expected across the organisation. This aligns with the behavioural expectations for all colleagues which form a core part of our performance management approach. Policy statements and supporting policy standards define the minimum control requirements which must be observed across the Group to manage material sources of risk within risk appetite.

### Principal and Emerging Risk Categories

See page 5 in the Strategic Report for details on the Group's principal and emerging risk categories.

### RMF

The RMF aligns to Our Purpose by establishing an overarching framework for the identification, measurement and management of risk in a clear and transparent way. The Group identifies and manages risk using the RMF, which is the totality of systems, structures, policies, processes and people that identify, measure, evaluate, control, mitigate, monitor and report all internal and external sources of material risk.

### Risk Governance and Oversight

The Group has a structured risk governance framework to support the Board of Directors' aim of achieving long-term and sustainable growth through the Group's purpose of "making you happier about money". This includes a number of Committees with a specific risk management focus, although all Committees consider risk matters in accordance with the Group RMF.

During the year, the Group continuously considered the effectiveness of the executive committee governance framework in order to ensure it remains fit for purpose.

### Three Lines of Defence

Effective operation of a Three Lines of Defence model is integral to the Group's approach to risk management and is based on the overriding principle that risk capability must be embedded within the first line of defence teams to be effective. This principle embodies the following concepts:

- risk management responsibilities are clearly understood and adhered to by all colleagues when carrying out their day-to-day activities;
- decisions are made with proactive consideration of the potential risk and impact on customers;
- business areas must self-identify and report management issues, which are captured centrally, showing good levels of risk awareness, management remediation, and promoting a strong risk culture; and
- regular control assessments are undertaken to confirm the effectiveness of the control environment, based on control monitoring and testing, in relation to both the current and emerging risk profile.

Control is exercised through a clearly defined delegation of authority, with communication and escalation channels throughout the Group.

# Risk report (continued)

### Stress testing

Stress testing is an important and widely recognised risk management tool, used to assess the vulnerability of financial institutions and identify risks under adverse economic scenarios. The Group uses stress testing in strategic and capital planning, liquidity plans and to inform risk appetite, risk mitigation and contingency planning.

The Group undertakes stress testing following the Basel Committee principles which utilise, where appropriate, scenarios provided by the BoE.

The Board and senior management are actively involved in the consideration of stress testing. This involvement works through all aspects of stress testing from the consideration of scenarios or events to be tested to the outcomes and mitigating actions. The involvement of the Board and senior management is considered to be essential for the effective operation of stress testing and the manner in which the results can then inform strategic planning and risk appetite. Reverse stress testing is also undertaken to assess the types of risks that would pose fundamental threats to the viability of the Group's business model.

Recognising our enlarged size, from 2020, the Group will take part in the BoE's concurrent stress test.

### Risk Management and Internal Controls

The Board actively monitors the Group's risk management and internal control systems. A review of the effectiveness of those systems has been performed incorporating all material controls, including financial, operational and compliance controls.

*CREDIT RISK*

Credit risk is the risk that a borrower or counterparty fails to pay the interest or capital due on a loan or other financial instrument.

Credit risk manifests itself in the financial instruments and / or products that the Group offers, and those in which the Group invests (including, among others, loans, guarantees, credit related commitments, letters of credit, acceptances, inter-bank transactions, foreign exchange transactions, swaps and bonds). Credit risk can be found both on and off balance sheet.

### Risk appetite

The Group controls its levels of credit risk by placing limits on the amount of risk it is willing to take in order to achieve its strategic objectives. This involves a defined set of qualitative and quantitative limits in relation to its credit risk concentrations to one borrower, or group of borrowers, and to geographical, product and industry segments. The management of credit risk within the Group is achieved through ongoing approval and monitoring of individual transactions, regular asset quality reviews and the independent oversight of credit decisions and portfolios.

### Credit strategies and policies

Credit risks associated with lending are managed through the application of detailed lending policies and standards which outline the approach to lending, underwriting criteria, credit mandates, concentration limits and product terms. Credit risk is managed and monitored using the credit models that underpin the internal ratings based (IRB) approval for the mortgage and business portfolios and the standardised approach for the personal portfolios. The Group maintains a dynamic approach to credit management and will take necessary steps if individual issues are identified or if credit performance deteriorates, or is expected to deteriorate, due to borrower, economic or sector-specific weaknesses.

Roles and responsibilities for the management, monitoring and mitigation of credit risk within the Group are clearly defined in line with the Group's RMF.

Significant credit risk strategies and policies are approved, and reviewed annually, by the Credit Risk Committee. For complex credit products and services, the Head of Business Risk, Head of Retail Risk and Credit Risk Committee provide a policy framework which identifies and quantifies risks and establishes the means of mitigating such risks. These policies and frameworks are delegated to and disseminated under the guidance and control of, the Board and senior management, with appropriate oversight through governance committees.

# Risk report (continued)

*CREDIT RISK (continued)*

### Exposures

Credit risk exposures are categorised as mortgages, personal and business. In terms of loans and advances, credit risk arises both from amounts loaned and commitments to extend credit to customers. To ensure appropriate credit limits exist, especially for business lending, a single large exposure policy is in place and forms part of the risk appetite measures that are monitored and reported on a monthly basis. The overall composition and quality of credit portfolio exposures are monitored and periodically reported to the Board and, where required, to the relevant supervisory authorities.

Exposures are also managed in accordance with the large exposure reporting requirements of the Capital Requirements Regulation (CRR).

Unless otherwise noted, the amount that best represents the maximum credit exposure at the reporting date is the carrying value of the financial asset.

### Measurement

The Group uses a combination of strategies and statistical models that utilise internal and external data to measure the exposure to credit risk within the portfolios

Portfolios are assessed using segmentation for measurement, reporting and monitoring purposes.

For the year ended 30 September 2019, the Group applied the IRB methodology to mortgage and business exposures for regulatory capital. All other exposures are measured under the standardised approach.

Note 3.2 of the consolidated financial statements provides details of the Group's approach to the impairment of financial assets and the calculation of the Group impairment charge.

In the year to 30 September 2019, the following changes have had a material impact on the Group's credit risk methodology and calculation, and how this is presented within this report:

1. The adoption of IFRS 9 'Financial Instruments' with effect from 1 October 2018; and
2. The acquisition of Virgin Money Holdings (UK) PLC on 15 October 2018.

The Group has elected not to restate comparative figures on an IFRS 9 basis as permitted by the standard. Where a comparative has been presented in the credit risk report, the basis of preparation is either:

- as at 30 September 2018 (audited): representing the audited position under International Accounting Standard (IAS) 39 as originally disclosed in the 2018 Annual Report and Accounts; or
- as at 1 October 2018 (unaudited): representing the position as at 30 September 2018 (excluding Virgin Money Holdings (UK) PLC) as amended for the adoption of IFRS 9.

While the overall policies and methodologies developed by the Group in preparing for its adoption of IFRS 9 on 1 October 2018 have many similarities to those used by Virgin Money, there are differences in the detail relating to the inputs and processes supporting the expected credit loss (ECL) calculations. The complexity of the underlying data, model-related methodology and inputs means that a single methodology in providing a combined Group ECL view, while under development, is not possible at this time, with each subsidiary retaining its own distinct set of IFRS 9 compliant models.

The Group's statutory impairment charge for the year is £252m, which includes the effect of the acquired assets that are required to be assessed under the staging criteria introduced by IFRS 9, irrespective of the fact that the fair value of the acquired assets incorporated an adjustment for credit risk. The underlying impairment charge of £148m excludes the acquisition accounting impairment impact to aid meaningful period to period comparison.

# Risk report (continued)

*CREDIT RISK (continued)*

A number of the Group's key credit metrics are no longer applicable as a result of the change to an IFRS 9 basis of calculating expected ECLs and have been replaced with metrics appropriate to the revised basis. These are shown in the table below.

**Key credit metrics**

| | **30 Sep 2019** | 1 Oct 2018[1] | 30 Sep 2018[1] |
|---|---|---|---|
| | **(audited)** | (unaudited) | (audited) |
| As at: | **£m** | £m | £m |
| **Impairment provisions held on credit exposures** | | | |
| Business lending | **147** | 150 | 136 |
| Mortgage and personal lending | **215** | 74 | 59 |
| | **362** | 224 | 195 |
| **Underlying impairment charge on credit exposures** | | | |
| Business lending | **25** | N/a | 15 |
| Mortgage and personal lending | **123** | N/a | 26 |
| | **148** | N/a | 41 |
| **Asset quality measures:** | | | |
| Underlying impairment charge[2] to average customer loans (cost of risk) | **0.21%** | N/a[3] | 0.12% |
| 90+ days past due (DPD) plus impaired assets to customer loans | **N/a** | N/a | 0.91% |
| Stage 3 assets to customer loans | **1.09%** | 1.77% | N/a |
| Total provision to customer loans | **0.50%** | 0.68% | 0.61% |
| Specific provision to impaired assets | **N/a** | N/a | 35.50% |
| Stage 3 provision to Stage 3 loans | **14.32%** | 14.55% | N/a |

(1) These exclude the impact of the acquisition of Virgin Money Holdings (UK) PLC with 30 September and 1 October 2018 ratios presented on an IAS 39 basis.
(2) Inclusive of gains/losses on assets held at fair value and elements of fraud loss but excludes the acquisition accounting impact on impairment losses shown on page 4.
(3) An underlying impairment charge was not calculated as at 1 October 2018 and therefore this metric cannot be calculated for that date.

The increase in underlying impairment charge from £41m to £148m primarily reflects a higher charge on our personal exposures which includes the charge relative to the acquired credit cards portfolio. The charge relative to business and mortgage exposures has also increased. The cost of risk, at 21 basis points (bps), is reflective of a return to normalisation however remains below our expectation of a long term loss rate of 30bps.

# Risk report (continued)

## *CREDIT RISK (continued)*

Asset quality measures remain resilient, reflective of the focus on responsible credit decisions and controlled risk appetite. The level of Stage 3 assets remains modest against a growing book. This reflects the credit quality of the portfolios, supported by the low interest rate environment. The ratio of total provisions to customer loans at 0.50% is reflective of a well-collateralised portfolio, supported by the increase in the size of the mortgage portfolio which proportionately requires a lower provision coverage and is a key driver of the overall reduction.

### Reconciliation of the impairment loss allowance from IAS 39 to IFRS 9

The movement in the Group's opening impairment provision as a result of adopting an ECL impairment methodology as required by IFRS 9 from 1 October 2018 is illustrated below:

| | £m |
|---|---|
| Closing IAS 39 impairment provision as at 30 September 2018 | 195 |
| Less: removal of IAS 39 collective provision | (152) |
| Add: introduction of a 12-month ECL calculation (Stage 1) | 53 |
| Add: introduction of a lifetime ECL calculation (Stage 2 and 3) | 121 |
| Add: undrawn balances | 5 |
| Add: multiple economic scenarios | 2 |
| **Opening IFRS 9 impairment provision as at 1 October 2018** | 224 |

*Removal of IAS 39 collective provision*

The IAS 39 concept of a collective impairment provision to cover losses that have been incurred but not yet identified on loans subject to an individual assessment is no longer an acceptable basis for impairment provisioning under IFRS 9.

*Introduction of a 12-month ECL calculation*

IFRS 9 requires a 12-month ECL calculation on all assets which have not undergone a significant increase in credit risk (SICR) since origination. These are classed as Stage 1 under IFRS 9, with the calculation on loans and advances allocating the ECL at an individual account level. The 12-month ECL calculation is based on the possibility of default occurring within 12 months of the reporting date.

*Introduction of a lifetime ECL calculation*

IFRS 9 requires a lifetime ECL calculation where a financial asset has been assessed as experiencing a SICR based on the Group's staging criteria. These can be classed as either Stage 2 or Stage 3 under IFRS 9, with the calculation on loans and advances allocating the ECL at an individual account level. Not all of these accounts would have been included in the IAS 39 collective provision, with the quantum of the ECL calculation also higher due to the requirement for lifetime losses to be included. The lifetime ECL calculation is based on the possibility of credit losses occurring over the lifetime of the asset.

*Undrawn balances*

IFRS 9 requires that impairment allowances be held on an expected loss basis rather than the incurred loss basis under IAS39. This change has brought into scope products (such as pipeline exposures) where an irrevocable commitment has been made to a customer but where no drawdown had occurred at the IFRS 9 adoption date, and for which no impairment allowance was held previously.

*Multiple economic scenarios*

This represents the difference, at adoption of IFRS 9, between calculated provisions under the Group's base scenario and the final aggregate position over the three scenarios (base, mild upside and severe downside).

# Risk report (continued)

*CREDIT RISK (continued)*

### Maximum exposure to credit risk (audited)

The table below shows the maximum exposure to credit risk including derivatives. The maximum exposure is shown gross, before the effect of mitigation through use of master netting and collateral agreements. The table also shows the maximum amount of commitments from the Group's and Bank's banking operations.

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018[1] | **2019** | 2018[1] |
| | **£m** | £m | **£m** | £m |
| Loans and advances to customers (note 3.1) | **73,093** | 32,748 | **32,389** | 31,635 |
| Cash and balances with central banks (note 3.4) | **10,296** | 6,573 | **6,621** | 6,573 |
| Due from other banks | **1,018** | 693 | **225** | 233 |
| Due from related entities | **18** | 35 | **2,476** | 1,238 |
| Financial instruments at fair value through other comprehensive income (FVOCI) (note 3.7) | **4,328** | - | **2,350** | - |
| Financial assets available for sale | **-** | 1,562 | **-** | 1,556 |
| Derivative financial assets (note 3.6) | **366** | 262 | **442** | 151 |
| Other financial assets at fair value (note 3.5) | **261** | 362 | **254** | 362 |
| | **89,380** | 42,235 | **44,757** | 41,748 |
| Contingent liabilities (note 5.1) | **113** | 119 | **113** | 119 |
| Other credit commitments (note 5.1) | **15,158** | 7,016 | **6,677** | 6,887 |
| **Maximum credit risk exposure** | **104,651** | 49,370 | **51,547** | 48,754 |

(1) The comparative year has been restated in line with the current year presentation. £34m of derivative collateral in relation to clearing houses has been reclassified between other liabilities and due to other banks and £143m has been reclassified between other assets and due from other banks.

All Treasury-related financial assets are classed as Stage 1 financial assets under IFRS 9.

£8.4bn of cash is held with the BoE (2018: £4.8bn, excluding Virgin Money Holdings (UK) PLC). Due from other banks is all with senior investment grade counterparties. Financial instruments at FVOCI and the credit rating of counterparties are discussed in note 3.7.

### Mitigation

The management and mitigation of credit risk within the Group is achieved through both approval and monitoring of individual transactions and asset quality, analysis of the performance of the various credit risk portfolios, and the independent oversight of credit portfolios across the Group. Portfolio monitoring techniques cover such areas as product, industry or geographic concentrations and delinquency trends.

There is regular analysis of the borrower's ability to meet their interest and capital repayment obligations with early support and mitigation steps taken where required. Credit risk mitigation (CRM) is also supported, in part, by obtaining collateral, and corporate and personal guarantees where appropriate.

# Risk report (continued)

***CREDIT RISK (continued)***

**Mitigation (continued)**

Other mitigating measures are described below:

*Specialist expertise*

Credit quality is managed and monitored by skilled teams including, where required, specialists who provide dedicated support for customers experiencing financial difficulty. Credit decisions utilise credit scoring techniques and manual underwriting, as appropriate. These tasks are performed by skilled and competent specialists acting within agreed delegated authority levels set in accordance with their experience and capabilities.

*Credit policy and adherence to Policy Standards*

Specialist teams oversee credit portfolio performance as well as adherence to credit risk policies and standards. Activities include targeted risk based reviews, providing an assessment of the effectiveness of internal controls and risk management practices. Bespoke assignments are also undertaken in response to emerging risks and regulatory requirements. Independent assurance reviews are also regularly undertaken by Internal Audit.

*Portfolio oversight*

Portfolios of credit and related risk exposures and the key benchmarks, behaviours and characteristics by which those portfolios are managed in terms of credit risk exposures are regularly reviewed. This entails the production and analysis of regular portfolio monitoring reports for review by senior management.

*Controls over rating systems*

The Group has an Independent Model Validation Unit that sets common minimum standards. The standards are designed to ensure risk models and associated rating systems are developed consistently and are of sufficient quality to support business decisions and meet regulatory requirements. The Group performs an annual self-assessment exercise of its ratings systems to ensure ongoing CRR compliance supported by all three lines of defence.

*Stress testing*

Stress test scenarios are regularly prepared with the outcomes reviewed and relevant actions taken. Outputs will typically include impairment charges, RWA, and write-offs. Management will consider how each stress scenario may impact on different components of the credit portfolio. The primary method applied uses migration matrices, modelling the impact of probability of default (PD) rating migrations and changes in portfolio default rates to changes in macroeconomic factors, to obtain a stressed position for the credit portfolios. Loss given default (LGD) is stressed based on a range of factors, including property price movements.

The Group also utilises other instruments and techniques across its wider balance sheet. These are summarised below:

*Derivatives*

The Group maintains control limits on net open derivative positions. At any one time, the amount subject to credit risk is limited to the current fair value of instruments that are favourable to the Group (i.e. assets where their fair value is positive), which in relation to derivatives may only be a small fraction of the contract, or notional values used to express the volume of instruments outstanding. This credit risk is managed as part of the customers' overall exposure together with potential exposures from market movements.

*Master netting agreements*

The Group further restricts its exposure to credit losses by entering into master netting arrangements with counterparties with whom it undertakes a significant volume of transactions. Master netting arrangements do not generally result in an offset of balance sheet assets and liabilities, as transactions are usually settled on a gross basis. However, credit risk associated with the favourable contracts is reduced by a master netting arrangement to the extent that, if any counterparty failed to meet its obligations in accordance with the agreed terms, all amounts with the counterparty are terminated and settled on a net basis. Derivative financial instrument contracts are typically subject to the International Swaps and Derivatives Association (ISDA) master netting agreements, as well as Credit Support Annexes (CSA), where relevant, around collateral arrangements attached to those ISDA agreements. Derivative exchange or clearing counterparty agreements exist where contracts are settled via an exchange or clearing house.

# Risk report (continued)

*CREDIT RISK (continued)*

### Credit assessment and mitigation

Credit risk is managed in accordance with lending policies, the Group's risk appetite and the RMF. Lending policies and performance against risk appetite are reviewed regularly.

The Group uses a variety of lending criteria when assessing applications for mortgage and personal customers. The approval process uses credit scorecards, as well as manual underwriting, and involves a review of an applicant's previous credit history using information held by credit reference agencies.

The Group also assesses the affordability of the borrower under stressed scenarios including increased interest rates. In addition, the Group has in place quantitative thresholds, such as maximum limits on the level of borrowing to income and the ratio of borrowing to collateral. Some of these limits relate to internal approval levels and others are hard limits above which the Group will reject the application.

For residential mortgages, the Group's policy is to accept only standard applications with a loan to value ratio (LTV) less than 95%. The Group has maximum percentage LTV limits which depend upon the loan size. Product types such as BTL and residential interest- only mortgages are controlled by transactional limits covering both LTV and value.

For business customers, credit risk is further mitigated by focusing on business sectors where the Group has specific expertise and through limiting exposures on higher value loans and to certain sectors. When making credit decisions for business customers the Group will routinely assess the primary source of repayment, most typically the cash generated by the customer through its normal trading cycle. Secondary sources of repayment are also considered and while not the focus of the lending decision, collateral will be taken when appropriate. The Group seeks to obtain security cover, and where relevant, personal guarantees from borrowers.

### Monitoring

Credit policies and procedures, which are subject to ongoing review, are documented and disseminated in a form that supports the credit operations of the Group.

- Credit Risk Committee (CRC): The CRC ensures that the credit RMF and associated policies remain effective. The Committee has oversight of the quality, composition and concentrations of the credit risk portfolio and considers strategies to adjust the portfolio to react to changes in market conditions.
- RAS measures: Measures are monitored monthly and reviewed bi-annually, at a minimum, to ensure that the measures accurately reflect the Group's risk appetite, strategy and concerns relative to the wider macro environment. All measures are subject to extensive engagement with the Executive Leadership Team and the Board and are subject to endorsement from Executive Governance Committees prior to Board approval. Regulatory engagement is also scheduled as appropriate.
- Risk concentration: Concentration of risk is managed by counterparty, by product, by geographical region and by industry sector. In addition, single name exposure limits exist to control exposures to a single counterparty. Concentrations are also considered through the RAS process focussing particularly on comparing the portfolio against market benchmarks.
- Single large exposure excesses: All excesses are reported to the Transactional Credit Committee (TCC) and the Head of Business Risk. Any exposure which continues or is expected to continue beyond 30 days will also be submitted to the TCC with proposals to correct the exposure within an agreed period, not to exceed 12 months.

# Risk report (continued)

*CREDIT RISK (continued)*

### Concentration of lending assets

The following audited tables show the levels of concentration of the Group's loans and advances.

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018[(2)] | **2019** | 2018[(2)] |
| | **£m** | £m | **£m** | £m |
| Property - mortgage | **60,391** | 24,540 | **23,693** | 23,461 |
| Agriculture, forestry, fishing and mining | **1,494** | 1,676 | **1,495** | 1,676 |
| Instalment loans to individuals and other personal lending (including credit cards) | **5,280** | 1,239 | **1,406** | 1,238 |
| Manufacturing | **793** | 853 | **758** | 836 |
| Wholesale and retail | **766** | 779 | **767** | 779 |
| Property - construction | **165** | 246 | **165** | 246 |
| Financial, investment and insurance | **104** | 116 | **104** | 116 |
| Government and public authorities | **30** | 41 | **30** | 40 |
| Other commercial and industrial | **4,221** | 3,791 | **4,195** | 3,775 |
| Gross loans and advances to customers[(1)] | **73,244** | 33,281 | **32,613** | 32,167 |

(1) The Group has a portfolio of fair valued business loans of £253m (2018: £362m) which are classified separately as financial assets at fair value through profit or loss on the balance sheet. At 30 September 2019 the most significant concentrations of exposure were in agriculture, forestry, fishing and mining (29%), real estate (25%), health and social work (15%) and government and public authorities (7%).

(2) The comparative year has not been restated to align with the current year presentation.

| **Contingent liabilities and related commitments (audited)** | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| Property - mortgage | **2,642** | 1,937 | **1,394** | 1,808 |
| Agriculture, forestry, fishing and mining | **302** | 294 | **302** | 294 |
| Instalment loans to individuals and other personal lending (including credit cards) | **9,069** | 1,800 | **1,789** | 1,800 |
| Manufacturing | **582** | 587 | **582** | 587 |
| Wholesale and retail | **472** | 477 | **472** | 477 |
| Property - construction | **118** | - | **118** | - |
| Financial, investment and insurance | **103** | 84 | **150** | 84 |
| Government and public authorities | **350** | 276 | **350** | 276 |
| Other commercial and industrial | **1,633** | 1,680 | **1,633** | 1,680 |
| | **15,271** | 7,135 | **6,790** | 7,006 |

# Risk report (continued)

*CREDIT RISK (continued)*

### Gross loans and advances by IFRS 9 stage allocation

The distribution of the Group's gross loans and advances by IFRS 9 stage allocation is analysed below.

| **Gross loans and advances to customers as at 30 September 2019** | **Stage 1 £m** | **Stage 2 <30 DPD £m** | **Stage 2 >30 DPD £m** | **Stage 2 Total £m** | **Stage 3 £m** | **Stage 3 POCI £m** | **Total £m** |
|---|---|---|---|---|---|---|---|
| Mortgages | 58,120 | 1,637 | 168 | 1,805 | 363 | 103 | 60,391 |
| Personal of which: | 4,787 | 392 | 32 | 424 | 61 | 8 | 5,280 |
| - credit cards | 3,806 | 353 | 25 | 378 | 46 | 8 | 4,238 |
| - personal overdrafts | 53 | - | 1 | 1 | 4 | - | 58 |
| - other personal lending | 928 | 39 | 6 | 45 | 11 | - | 984 |
| Business | 5,016 | 2,280 | 5 | 2,285 | 272 | - | 7,573 |
| **Closing balance** | 67,923 | 4,309 | 205 | 4,514 | 696 | 111 | 73,244 |

| **Gross loans and advances to customers** as at 1 October 2018 (excluding Virgin Money)[1] | **Stage 1 £m** | **Stage 2 <30 DPD £m** | **Stage 2 >30 DPD £m** | **Stage 2 Total £m** | **Stage 3 £m** | **Stage 3 POCI £m** | **Total £m** |
|---|---|---|---|---|---|---|---|
| Mortgages | 23,572 | 605 | 84 | 689 | 279 | - | 24,540 |
| Personal of which: | 1,143 | 28 | 10 | 38 | 22 | - | 1,203 |
| - credit cards | 370 | 1 | 3 | 4 | 7 | - | 381 |
| - personal overdrafts | 50 | - | 1 | 1 | 4 | - | 55 |
| - other personal lending | 723 | 27 | 6 | 33 | 11 | - | 767 |
| Business | 4,741 | 2,161 | 9 | 2,170 | 263 | - | 7,174 |
| **Closing balance** | 29,456 | 2,794 | 103 | 2,897 | 564 | - | 32,917 |

(1) Excludes loans designated at fair value through profit and loss, balances due from customers on acceptances, accrued interest and deferred and unamortised fee income.

Overall, the lending portfolio increased by £40.3bn between 1 October 2018 and 30 September 2019. In addition to underlying growth, the increase reflects the acquisition of Virgin Money Holdings (UK) PLC on 15 October 2018, with the acquired portfolio totalling £39.5bn as at 30 September 2019. Of this, £111m is Stage 3 POCI, representing the acquired assets that were classed as credit impaired at date of acquisition.

#### Mortgages

With total gross loans and advances of £60.4bn as at 30 September 2019, there has been underlying growth in the portfolio year-on-year, although the increase in lending balance results mainly from the Virgin Money acquisition. The majority are classed as Stage 1. Stage 3 POCI for mortgages reduced from £137m on acquisition to £103m as at 30 September 2019 as a result of customer redemptions and balance paydowns.

#### Personal

Of the £5.3bn total personal portfolio, the majority is credit cards, at £4.2bn. The year-on-year growth results mainly from the acquired credit cards portfolio, however, underlying growth is evident on both the credit card and other personal lending portfolios. The personal portfolio evidences stable performance with 91% of balances classed as stage 1. Stage 3 POCI for retail unsecured has reduced from £34m on acquisition to £8m as at 30 September 2019 due to write offs and customer balance paydowns.

# Risk report (continued)

*CREDIT RISK (continued)*

**Business**

At £7.6bn, business lending continues to evidence core underlying growth. The proportion of lending in Stage 2 has remained stable at 30% year-on-year, reflective of the Group's controlled and cautious approach to identifying customers experiencing financial difficulty and, where appropriate, providing early intervention assistance such as forbearance to support customers in meeting their financial commitments to the Group.

**Credit quality of loans and advances**

The following tables highlight the significant exposure to credit risk in respect of which the ECL model is applied for the Group's mortgage, personal and business loans and advances, including loan commitments and financial guarantee contracts, based on the following risk gradings:

**Credit risk exposure, by internal PD rating, by IFRS 9 stage allocation**

The distribution of the Group's credit exposures by internal PD rating is analysed below:

| As at 30 September 2019 | Gross carrying amount | | | | |
|---|---|---|---|---|---|
| Mortgages | Stage 1 12-month ECLs £m | Stage 2 (not credit impaired) Lifetime ECLs £m | Stage 3 (credit impaired) Lifetime ECLs £m | Stage 3 (POCI) Lifetime ECLs £m | Total £m |
| <0.15 | 38,816 | 389 | - | - | 39,205 |
| 0.15 to <0.25 | 5,836 | 103 | - | - | 5,939 |
| 0.25 to <0.50 | 7,983 | 245 | - | - | 8,228 |
| 0.50 to <0.75 | 2,422 | 96 | - | - | 2,518 |
| 0.75 to <2.50 | 2,648 | 455 | - | - | 3,103 |
| 2.50 to <10.00 | 376 | 274 | - | - | 650 |
| 10.00 to <100.00 | 39 | 243 | - | - | 282 |
| 100.00 (Default) | - | - | 363 | 103 | 466 |
| **Total** | 58,120 | 1,805 | 363 | 103 | 60,391 |

| | Gross carrying amount | | | | |
|---|---|---|---|---|---|
| Personal | Stage 1 12-month ECLs £m | Stage 2 (not credit impaired) Lifetime ECLs £m | Stage 3 (credit impaired) Lifetime ECLs £m | Stage 3 (POCI) Lifetime ECLs £m | Total £m |
| <0.15 | 93 | - | - | - | 93 |
| 0.15 to <0.25 | 68 | - | - | - | 68 |
| 0.25 to <0.50 | 1,326 | 6 | - | - | 1,332 |
| 0.50 to <0.75 | 967 | 8 | - | - | 975 |
| 0.75 to <2.50 | 1,743 | 36 | - | - | 1,779 |
| 2.50 to <10.00 | 553 | 231 | - | - | 784 |
| 10.00 to <100.00 | 37 | 143 | - | - | 180 |
| 100.00 (Default) | - | - | 61 | 8 | 69 |
| **Total** | 4,787 | 424 | 61 | 8 | 5,280 |

# Risk report (continued)

*CREDIT RISK (continued)*

**Credit quality of loans and advances (continued)**

| | Gross carrying amount | | | | |
|---|---|---|---|---|---|
| | Stage 1 12-month ECLs | Stage 2 (not credit impaired) Lifetime ECLs | Stage 3 (credit impaired) Lifetime ECLs | Stage 3 (POCI) Lifetime ECLs | Total |
| **Business** | £m | £m | £m | £m | £m |
| <0.15 | 530 | 5 | - | - | 535 |
| 0.15 to <0.25 | 440 | 17 | - | - | 457 |
| 0.25 to <0.50 | 718 | 52 | - | - | 770 |
| 0.50 to <0.75 | 535 | 101 | - | - | 636 |
| 0.75 to <2.50 | 2,199 | 1,019 | - | - | 3,218 |
| 2.50 to <10.00 | 592 | 919 | - | - | 1,511 |
| 10.00 to <100.00 | 2 | 172 | - | - | 174 |
| 100.00 (Default) | - | - | 272 | - | 272 |
| **Total** | 5,016 | 2,285 | 272 | - | 7,573 |

| As at 1 October 2018 (excluding Virgin Money) | Gross carrying amount | | | | |
|---|---|---|---|---|---|
| | Stage 1 12-month ECLs | Stage 2 (not credit impaired) Lifetime ECLs | Stage 3 (credit impaired) Lifetime ECLs | Stage 3 (POCI) Lifetime ECLs | Total |
| **Mortgages** | £m | £m | £m | £m | £m |
| <0.15 | 8,085 | 13 | - | - | 8,098 |
| 0.15 to <0.25 | 4,292 | 27 | - | - | 4,319 |
| 0.25 to <0.50 | 6,199 | 77 | - | - | 6,276 |
| 0.50 to <0.75 | 1,791 | 49 | - | - | 1,840 |
| 0.75 to <2.50 | 2,813 | 205 | - | - | 3,018 |
| 2.50 to <10.00 | 370 | 194 | - | - | 564 |
| 10.00 to <100.00 | 22 | 124 | - | - | 146 |
| 100.00 (Default) | - | - | 279 | - | 279 |
| **Total** | 23,572 | 689 | 279 | - | 24,540 |

# Risk report (continued)

*CREDIT RISK (continued)*

Credit quality of loans and advances (continued)

| | Gross carrying amount | | | | |
|---|---|---|---|---|---|
| **Personal** | **Stage 1 12-month ECLs £m** | **Stage 2 (not credit impaired) Lifetime ECLs £m** | **Stage 3 (credit impaired) Lifetime ECLs £m** | **Stage 3 (POCI) Lifetime ECLs £m** | **Total £m** |
| <0.15 | 113 | - | - | - | 113 |
| 0.15 to <0.25 | 97 | - | - | - | 97 |
| 0.25 to <0.50 | 249 | - | - | - | 249 |
| 0.50 to <0.75 | 153 | - | - | - | 153 |
| 0.75 to <2.50 | 354 | 2 | - | - | 356 |
| 2.50 to <10.00 | 166 | 15 | - | - | 181 |
| 10.00 to <100.00 | 11 | 21 | - | - | 32 |
| 100.00 (Default) | - | - | 22 | - | 22 |
| **Total** | 1,143 | 38 | 22 | - | 1,203 |

| | Gross carrying amount | | | | |
|---|---|---|---|---|---|
| **Business** | **Stage 1 12-month ECLs £m** | **Stage 2 (not credit impaired) Lifetime ECLs £m** | **Stage 3 (credit impaired) Lifetime ECLs £m** | **Stage 3 (POCI) Lifetime ECLs £m** | **Total £m** |
| <0.15 | 571 | 8 | - | - | 579 |
| 0.15 to <0.25 | 371 | 13 | - | - | 384 |
| 0.25 to <0.50 | 549 | 34 | - | - | 583 |
| 0.50 to <0.75 | 700 | 157 | - | - | 857 |
| 0.75 to <2.50 | 1,930 | 917 | - | - | 2,847 |
| 2.50 to <10.00 | 594 | 943 | - | - | 1,537 |
| 10.00 to <100.00 | 26 | 98 | - | - | 124 |
| 100.00 (Default) | - | - | 263 | - | 263 |
| **Total** | 4,741 | 2,170 | 263 | - | 7,174 |

# Risk report (continued)

*CREDIT RISK (continued)*

**ECL impairment allowance by IFRS 9 stage allocation**

The following tables disclose the impairment allowance by portfolio:

| As at 30 September 2019 | Stage 1 £m | Stage 2 <30 DPD £m | Stage 2 >30 DPD £m | Stage 2 Total £m | Stage 3 £m | Stage 3 POCI £m | Total £m |
|---|---|---|---|---|---|---|---|
| Mortgages | 6 | 5 | 4 | 9 | 26 | (1) | 40 |
| Personal of which: | 53 | 71 | 16 | 87 | 37 | (2) | 175 |
| - credit cards | 42 | 65 | 12 | 77 | 28 | (2) | 145 |
| - personal overdrafts | 2 | - | 1 | 1 | 3 | - | 6 |
| - other personal lending | 9 | 6 | 3 | 9 | 6 | - | 24 |
| Business | 20 | 72 | - | 72 | 55 | - | 147 |
| **Closing balance** | 79 | 148 | 20 | 168 | 118 | (3) | 362 |

| As at 1 October 2018 (excluding Virgin Money) | Stage 1 £m | Stage 2 <30 DPD £m | Stage 2 >30 DPD £m | Stage 2 Total £m | Stage 3 £m | Stage 3 POCI £m | Total £m |
|---|---|---|---|---|---|---|---|
| Mortgages | 3 | 2 | 1 | 3 | 23 | - | 29 |
| Personal of which: | 15 | 5 | 7 | 12 | 18 | - | 45 |
| - credit cards | 6 | - | 1 | 1 | 7 | - | 14 |
| - personal overdrafts | 2 | - | 1 | 1 | 3 | - | 6 |
| - other personal lending | 7 | 5 | 5 | 10 | 8 | - | 25 |
| Business | 35 | 71 | - | 71 | 44 | - | 150 |
| **Closing balance** | 53 | 78 | 8 | 86 | 85 | - | 224 |

The Group's impairment allowance has increased by £138m in the period from 1 October 2018 to 30 September 2019, which is primarily due to the impact of the acquisition of Virgin Money Holdings (UK) PLC. Acquisition accounting requires that the acquired loans and advances balance is fair valued on acquisition, resulting in a nil ECL allowance on acquisition. The loans and advances balance is then subject to the IFRS 9 ECL methodology with a full ECL allowance calculated, which resulted in a charge of £67m being recognised in the Group income statement immediately following the acquisition date. The ECL allowance for the acquired portfolio subsequently increased to £136m as at 30 September 2019.

**Mortgages**

The mortgage impairment allowance of £40m is reflective of the level of collateral held and the low ECL for this portfolio. The increase of £11m from 2018 is due to the impact of the acquisition of the acquired mortgage portfolio.

**Personal**

The total impairment allowance for the personal portfolio of £175m has increased by £130m in the period. This is primarily due to the level of impairment allowance relative to the acquired credit cards portfolio, where the ECL at point of acquisition was £60m and subsequently increased to £125m as at 30 September 2019. The underlying impairment allowance for the personal exposures increased over the period as a result of the combined effect of portfolio growth, higher default rates due to seasoning and maturation of the portfolio and routine recalibration of underlying provisioning models.

# Risk report (continued)

*CREDIT RISK (continued)*

**ECL impairment allowance by IFRS 9 stage allocation (continued)**

**Business**

The overall impairment allowance for the business portfolio decreased by £3m to £147m. This is the result of a £15m reduction in Stage 1 ECL, primarily due to IFRS 9 modelling adjustments, partially offset by an £11m increase in Stage 3 due to a higher level of single name, individually assessed provisions.

**ECL impairment allowance coverage ratios**

**As at 30 September 2019**

| | Stage 1 | Stage 2 <30 DPD | Stage 2 >30 DPD | Stage 2 Total | Stage 3 | Stage 3 POCI | Total |
|---|---|---|---|---|---|---|---|
| | % | % | % | % | % | % | % |
| Mortgages | 0.01% | 0.29% | 2.26% | 0.47% | 7.13% | -0.80% | 0.07% |
| Personal of which: | 1.15% | 18.22% | 51.18% | 20.64% | 62.14% | -22.61% | 3.39% |
| - credit cards | 1.11% | 18.49% | 46.91% | 20.35% | 60.39% | -22.61% | 3.42% |
| - personal overdrafts | 5.00% | 14.17% | 66.02% | 56.00% | 91.21% | - | 11.41% |
| - other personal lending | 1.09% | 15.56% | 68.29% | 22.35% | 60.64% | - | 2.75% |
| Business | 0.40% | 3.13% | 2.27% | 3.13% | 19.99% | - | 1.93% |
| **Closing balance** | 0.12% | 3.41% | 9.68% | 3.69% | 16.89% | -2.30% | 0.50% |

As at 1 October 2018
(excluding Virgin Money)

| | Stage 1 | Stage 2 <30 DPD | Stage 2 >30 DPD | Stage 2 Total | Stage 3 | Stage 3 POCI | Total |
|---|---|---|---|---|---|---|---|
| | % | % | % | % | % | % | % |
| Mortgages | 0.01% | 0.32% | 1.61% | 0.48% | 8.19% | - | 0.12% |
| Personal of which: | 1.38% | 18.17% | 65.20% | 30.04% | 80.36% | - | 3.78% |
| - credit cards | 1.78% | 9.52% | 53.16% | 39.89% | 94.32% | - | 3.94% |
| - personal overdrafts | 3.66% | 10.02% | 59.21% | 51.07% | 78.12% | - | 10.06% |
| - other personal lending | 1.03% | 18.61% | 71.71% | 28.05% | 72.56% | - | 3.24% |
| Business | 0.73% | 3.25% | 5.13% | 3.26% | 16.79% | - | 2.08% |
| **Closing balance** | 0.18% | 2.77% | 7.86% | 2.95% | 15.05% | - | 0.68% |

The impact of the Virgin Money Holdings (UK) PLC acquisition results in a proportionately higher volume of the total portfolio being mortgage lending which requires a lower proportionate impairment allowance, consequently the total portfolio coverage has reduced by 18bps in line with the revised portfolio profile.

*CREDIT RISK (continued)*

### ECL impairment allowance coverage ratios (continued)

#### Mortgages

The coverage rate reduced by 5bps in the period as a result of the composition, quality and value of the acquired mortgage portfolio.

#### Personal

The total coverage ratio reduced by 39bps, primarily in the credit card portfolio where the quality of the acquired portfolios, in particular, the growing Virgin Atlantic credit card portfolio, is stronger than the pre-existing portfolios,

#### Business

Coverage for the business lending portfolio decreased by 15bps, reflective of portfolio growth in Stage 1 where proportionately less provision coverage is required and a small number of significant write offs from Stage 3.

### Reconciliation of movement in gross balances and impairment loss allowance

The following tables explain the changes in the loss allowance and gross carrying value of the portfolios between 30 September 2018 and 30 September 2019. Values are calculated using the individual customer account balances, and the stage allocation is taken as at the end of each month. Balance movements across the stages can vary between months as a result of repayments and other account activity between stage movements. The monthly position of each account is aggregated to report a net closing position, thereby incorporating all movements an account has made during the year.

| **As at 30 September 2019** | Non-Credit Impaired | | | | Credit Impaired | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| (audited) | **Stage 1** | | **Stage 2** | | **Stage 3** | | **Gross Loans** | | **Total provision** | **Total Gross Loans** | **Total provisions** |
| Mortgages | **Gross Loans** | **ECL** | **Gross Loans** | | **Gross Loans** | **ECL** | **Gross Loans** | **ECL** | **(IAS 39)** | | |
| | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** |
| Opening balance at 30 September 2018 | - | - | - | - | - | - | - | - | 32 | - | 32 |
| IFRS 9 restatements | - | - | - | - | - | - | - | - | (32) | - | (32) |
| **Opening balance at 1 October 2018** | 23,572 | 3 | 689 | 3 | 279 | 23 | - | - | - | 24,540 | 29 |
| Acquisition of Virgin Money | 34,641 | 7 | - | - | - | - | 137 | - | - | 34,778 | 7 |
| New assets originated or purchased | 10,089 | 1 | 3 | - | 1 | - | - | - | - | 10,093 | 1 |
| ***Opening balance movements:*** | - | - | - | - | - | - | - | - | - | - | - |
| Transfer to lifetime ECL (non-credit impaired) | (3,851) | (4) | 3,835 | 22 | - | - | - | - | - | (16) | 18 |
| Transfer to credit impaired | (92) | (1) | (185) | (4) | 276 | 11 | - | - | - | (1) | 6 |
| Transfer to 12-month ECL | 2,393 | 1 | (2,401) | (9) | - | - | - | - | - | (8) | (8) |
| Transfer from credit impaired | 29 | - | 72 | 1 | (105) | (4) | - | - | - | (4) | (3) |
| Repayments and other movements | (2,412) | - | (48) | (3) | (17) | - | (14) | (1) | - | (2,491) | (4) |
| Changes to model methodology | - | - | - | - | - | - | - | - | - | - | - |
| Repaid or derecognised (exc write-offs) | (6,249) | (1) | (160) | (1) | (63) | (2) | (20) | - | - | (6,492) | (4) |
| Decrease due to write-offs | - | - | - | - | (8) | (3) | - | - | - | (8) | (3) |
| Cash recoveries | - | - | - | - | - | - | - | - | - | - | - |
| Individually assessed impairment P&L charge | - | - | - | - | - | 1 | - | - | - | - | 1 |
| **Closing balance at 30 September 2019** | 58,120 | 6 | 1,805 | 9 | 363 | 26 | 103 | (1) | - | 60,391 | 40 |

# Risk report (continued)

*CREDIT RISK (continued)*

### Reconciliation of Movement in Gross Balances and Impairment Loss Allowance (continued)

| **As at 30 September 2019** | Non-Credit Impaired | | | | Credit Impaired | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| (audited) | **Stage 1** | | **Stage 2** | | **Stage 3** | | **Stage 3 POCI** | | **Total provision** | **Total Gross Loans** | **Total provisions** |
| Personal | **Gross Loans** | **ECL** | **Gross Loans** | **ECL** | **Gross Loans** | **ECL** | **Gross Loans** | **ECL** | **(IAS 39)** | | |
| | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** |
| Opening balance at 30 September 2018 | - | - | - | - | - | - | - | - | 27 | - | 27 |
| IFRS 9 restatements | - | - | - | - | - | - | - | - | (27) | - | (27) |
| **Opening balance at 1 October 2018** | 1,143 | 15 | 38 | 12 | 22 | 18 | - | - | - | 1,203 | 45 |
| Acquisition of Virgin Money | 3,042 | 60 | - | - | - | - | 34 | - | - | 3,076 | 60 |
| New assets originated or purchased | 1,387 | 25 | 2 | - | 1 | 1 | - | - | - | 1,390 | 26 |
| ***Opening balance movements:*** | - | - | - | - | - | - | - | - | - | - | - |
| Transfer to lifetime ECL (non-credit impaired) | (931) | (48) | 970 | 194 | - | - | - | - | - | 39 | 146 |
| Transfer to credit impaired | (28) | (1) | (95) | (56) | 125 | 91 | - | - | - | 2 | 34 |
| Transfer to 12-month ECL | 403 | 12 | (422) | (70) | - | - | - | - | - | (19) | (58) |
| Transfer from credit impaired | 3 | - | 2 | 1 | (7) | (6) | - | - | - | (2) | (5) |
| Repayments and other movements | (20) | (5) | (24) | 17 | 5 | (2) | (3) | (2) | - | (42) | 8 |
| Changes to model methodology | 32 | (1) | (32) | (6) | - | - | - | - | - | - | (7) |
| Repaid or derecognised (exc write-offs) | (244) | (4) | (15) | (5) | (7) | (6) | (1) | - | - | (267) | (15) |
| Decrease due to write-offs | - | - | - | - | (78) | (165) | (22) | - | - | (100) | (165) |
| Cash recoveries | - | - | - | - | - | 27 | - | - | - | - | 27 |
| Individually assessed impairment P&L charge | - | - | - | - | - | 79 | - | - | - | - | 79 |
| **Closing balance at 30 September 2019** | 4,787 | 53 | 424 | 87 | 61 | 37 | 8 | (2) | - | 5,280 | 175 |

# Risk report (continued)

*CREDIT RISK (continued)*

### Reconciliation of Movement in Gross Balances and Impairment Loss Allowance (continued)

| **As at 30 September 2019** | Non-Credit Impaired | | | | Credit Impaired | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| (audited) | **Stage 1** | | **Stage 2** | | **Stage 3** | | **Stage 3 POCI** | | **Total provision** | **Total Gross Loans** | **Total provisions** |
| Business | **Gross Loans £m** | **ECL £m** | **Gross Loans £m** | **ECL £m** | **Gross Loans £m** | **ECL £m** | **Gross Loans £m** | **ECL £m** | **(IAS 39) £m** | **£m** | **£m** |
| Opening balance at 30 September 2018 | - | - | - | - | - | - | - | - | 136 | - | 136 |
| IFRS 9 restatements | - | - | - | - | - | - | - | - | (136) | - | (136) |
| **Opening balance at 1 October 2018** | 4,741 | 35 | 2,170 | 71 | 263 | 44 | - | - | - | 7,174 | 150 |
| Acquisition of Virgin Money | - | - | - | - | - | - | - | - | - | - | - |
| New assets originated or purchased | 8,075 | 59 | 999 | 65 | 44 | 6 | - | - | - | 9,118 | 130 |
| ***Opening balance movements:*** | - | - | - | - | - | - | - | - | - | - | - |
| Transfer to lifetime ECL (non-credit impaired) | (1,770) | (8) | 1,765 | 41 | - | - | - | - | - | (5) | 33 |
| Transfer to credit impaired | (33) | - | (216) | (22) | 249 | 23 | - | - | - | - | 1 |
| Transfer to 12-month ECL | 823 | 4 | (827) | (19) | - | - | - | - | - | (4) | (15) |
| Transfer from credit impaired | 9 | - | 54 | 4 | (63) | (8) | - | - | - | - | (4) |
| Repayments and other movements | 1,448 | (18) | (196) | 3 | (50) | (7) | - | - | - | 1,202 | (22) |
| Changes to model methodology | (1,784) | (4) | - | - | - | - | - | - | - | (1,784) | (4) |
| Repaid or derecognised (exc write-offs) | (6,493) | (48) | (1,464) | (71) | (142) | (7) | - | - | - | (8,099) | (126) |
| Decrease due to write-offs | - | - | - | - | (29) | (31) | - | - | - | (29) | (31) |
| Cash Recoveries | - | - | - | - | - | 1 | - | - | - | - | 1 |
| Individually assessed impairment P&L charge | - | - | - | - | - | 34 | - | - | - | - | 34 |
| **Closing balance at 30 September 2019** | 5,016 | 20 | 2,285 | 72 | 272 | 55 | - | - | - | 7,573 | 147 |

# Risk report (continued)

## *CREDIT RISK (continued)*

### Reconciliation of Movement in Gross Balances and Impairment Loss Allowance (continued)

The contractual amount outstanding on loans and advances that were written off during the reporting period, and still subject to enforcement activity was £3.7m.

*IFRS 9 restatements*

At adoption of IFRS 9 the provision balances previously calculated under IAS 39 methodology are reversed out.

*Opening balance at 1 October 2018*

The day 1 balance sheet positions calculated under the IFRS 9 methodology which applies a 12-month ECL for assets in stage 1 and a lifetime ECL for assets in stage 2 and stage 3.

*Acquisition of Virgin Money*

The opening value of the acquired assets; purchased at fair value. All assets classed as stage 1 at point of acquisition, with the exception of those assets assessed as credit impaired that are classed as stage 3 POCI.

*New assets originated or purchased*

The balance and ECL calculated on newly opened or originated assets. Assets where the term has ended, and a new facility has been provided are reported as new assets.

*Transfer to lifetime ECL (non-credit impaired)*

IFRS 9 requires a lifetime ECL calculation where an asset has been assessed as experiencing a SICR, as determined by the Group's staging criteria. The non-credit impaired movements are classed as stage 2.

*Transfer to credit impaired*

IFRS 9 requires a lifetime ECL calculation where an asset has been assessed as experiencing a SICR, as determined by the Group's staging criteria. The credit impaired movements are classed as stage 3.

*Transfer to 12-month ECL*

IFRS 9 requires a 12-month ECL calculation where an asset, that had previously been classed as stage 2, has reverted back to the conditions observed at the initial credit assessment.

*Transfer from credit impaired*

IFRS 9 requires that where an asset, that had previously been classed at stage 3, has reverted back to the conditions observed at the initial credit assessment, a 12-month ECL should be calculated.

*Repayments and other movements*

Movements due to customer repayment and other minor movements not captured under any other category.

*Changes in model methodology*

ECL value changes resulting from a change to an underlying model methodology.

*Repaid or derecognised (exc write-offs)*

ECL impact from customer repayment or derecognition of all or part of an asset, other than that resulting from a write-off.

*Decrease due to write-offs*

ECL impact due to the reduction of all, or part, of an asset balance due to a write-off approved by the Group. ECL release may appear higher than the asset balance on some occasions as a result of the initial ECL lifetime being released, in addition to the individually assessed provision applied for the asset balance write-off.

# Risk report (continued)

## *CREDIT RISK (continued)*

**Reconciliation of Movement in Gross Balances and Impairment Loss Allowance (continued)**

*Cash recoveries*

ECL impact of payments received on assets that had previously been written off.

*Individually assessed P&L charge*

The charge taken to profit or loss where an individually assessed provision has been recognised or a direct write-off has been applied to an asset balance and reported separately from IFRS 9 stage 3 provision.

**Collateral**

*Collateral held as security and other credit enhancements*

The Group evaluates each customer's creditworthiness on a case by case basis. The amount of collateral obtained, if deemed necessary by the Group upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held can vary, but may include:

- specific charges over defined assets of the counterparty;
- a floating charge over all assets and undertakings of an entity;
- specific or interlocking guarantees; and
- loan agreements which include affirmative and negative covenants and, in some instances, guarantees of counterparty obligations.

Generally, the Group does not take possession of collateral it holds as security or call on other credit enhancements that would result in recognition of an asset on its balance sheet.

It is the Group's policy to dispose of repossessed properties with the proceeds used to reduce or repay the outstanding balance. In general, the Group does not occupy repossessed properties for its own business use.

*Mortgage lending by average LTV*

The LTV ratio of mortgage lending, coupled with the relationship of the debt to customers' income, is integral to the credit quality of these loans. The table below sets out the indexed LTV analysis of the Group's mortgage stock.

| LTV ratio (audited)[2] | 2019<br>% | 2018[1]<br>% |
|---|---|---|
| Less than 50% | **35** | 31 |
| 50% to 75% | **48** | 51 |
| 76% to 80% | **6** | 6 |
| 81% to 85% | **5** | 5 |
| 86% to 90% | **4** | 4 |
| 91% to 95% | **2** | 2 |
| 96% to 100% | **-** | - |
| Greater than 100% | **-** | - |
| Unknown | **-** | 1 |
| | **100** | 100 |

(1) 30 September 2018 shown as Reported, excluding Virgin Money.

(2) LTV of the mortgage portfolio is defined as mortgage portfolio weighted by balance. Currently the Clydesdale Bank PLC portfolio is indexed using the MIAC Acadametrics indices at a given date, while the Virgin Money Holdings (UK) PLC portfolio is indexed using the Markit indices. The Group view is a combined summary of the two portfolios. 'Unknown' in the prior period represented loans where data was not available due to front book data matching and a de minimis amount due to weaknesses in historic data capture processes.

# Risk report (continued)

***CREDIT RISK (continued)***

### Collateral (continued)

*Residential mortgages*

Residential property is the Group's main source of collateral and means of mitigating loss in the event of the default credit risk inherent in its residential mortgage portfolios. All lending activities are supported by an appropriate form of valuation using either professional or indexed (subject to policy rules and confidence levels) valuations.

*Commercial property*

Commercial property is the Group's main source of collateral on business lending and means of mitigating loss in the event of default. Collateral for the majority of commercial loans comprises first legal charges over freehold or long leasehold property (including formal Companies House registration where appropriate). All commercial property collateral is subject to an independent, professional valuation when taken and thereafter subject to periodic review in accordance with policy requirements.

*Non-property related collateral*

In addition to residential and commercial property based security, the Group also takes other forms of collateral when lending. This can involve obtaining security against the underlying loan through the use of cash collateral and / or netting agreements, both of which reduce the original exposure by the amount of collateral held, subject to volatility and maturity adjustments where applicable.

The Group also operates a policy of obtaining security against the underlying loan via the use of guarantees, which can be either limited or unlimited, making the guarantor liable for only a portion or all of the debt.

The following table shows the total non-property collateral held by sector at 30 September in terms of cash, guarantees (these guarantors are predominantly other financial institutions who are considered to be of a high credit quality) and netting. The exposure amount shown below is the total gross exposure (before any CRM and after Credit Conversion Factors (CCFs) have been applied where applicable) for arrangements which have some form of associated collateral held against it and is not the total exposure for each asset class, as disclosed elsewhere in this section.

| Group (audited)<br>2019 | Cash | Guarantees | Netting | Debt Securities | Total | Exposure |
|---|---|---|---|---|---|---|
| Exposure classes | £m | £m | £m | £m | £m | £m |
| Corporates | 12 | - | 69 | - | 81 | 203 |
| Total IRB approach | 12 | - | 69 | - | 81 | 203 |
| Central governments or central banks | 3,809 | - | - | - | 3,809 | 5,695 |
| Regional governments or local authorities | - | - | 110 | - | 110 | 110 |
| Institutions | - | - | - | 304 | 304 | 360 |
| Corporates | 4 | 6 | - | - | 10 | 10 |
| Secured by mortgages on residential real estate | - | - | - | - | - | 2 |
| Secured by mortgages on commercial real estate | - | - | - | - | - | 1 |
| Exposures in default | - | - | - | - | - | - |
| Total Standardised approach | 3,813 | 6 | 110 | 304 | 4,233 | 6,178 |
| Total | 3,825 | 6 | 179 | 304 | 4,314 | 6,381 |

# Risk report (continued)

*CREDIT RISK (continued)*

### Collateral (continued)

| Group (audited)[1]<br>2018 | Cash<br>£m | Guarantee<br>£m | Netting<br>£m | Total<br>£m | Exposure<br>£m |
|---|---|---|---|---|---|
| Central Government or Central Bank | 3,057 | - | - | 3,057 | 4,525 |
| Corporates | 28 | 15 | 75 | 118 | 180 |
| Financial institutions | - | - | - | - | - |
| Exposures at default | - | - | - | - | 1 |
| Regional Government or local authorities | - | - | 83 | 83 | 83 |
| Secured by mortgages on commercial real estate | - | - | - | - | 38 |
| Secured by mortgages on residential property | - | - | - | - | 4 |
| | 3,085 | 15 | 158 | 3,258 | 4,831 |

(1) All exposures were measured under the standardised approach as at 30 September 2018.

The increase in cash collateral held and corresponding exposure is due to increased repurchase (repo) and similar transactions outstanding at 30 September 2019 (including Term Funding Scheme (TFS) drawings), reflected within central governments or central banks. The new debt securities collateral held and corresponding exposure in financial institutions is due to a new repo where UK Gilts were placed as security.

Corporates is the largest sector utilising other risk mitigation techniques, with three methods utilised dependent on credit quality. The extent to which these will be used is dependent on the specific circumstances of the customer.

### Forbearance

Forbearance is considered to take place when the Group grants concessions to assist customers who are experiencing, or who are about to experience, difficulties in meeting their financial commitments to the Group. The Group's forbearance policies and definitions comply with the guidance established by the European Banking Authority (EBA) for FINREP reporting. Forbearance concessions include the granting of more favourable terms and conditions than those provided either at drawdown of the facility or which would not ordinarily be available to other customers with a similar risk profile. Forbearance parameters are regularly reviewed and refined as necessary to ensure they are consistent with the latest industry guidance and prevailing practice as well as ensuring that they adequately capture and reflect the most recent customer behaviours and market conditions. The Group makes every effort to treat customers fairly and aligns its forbearance practices to that principle.

Whilst forbearance alone is not necessarily an indicator of impaired status, it is a trigger for a review of the customer's credit profile and forbearance is only granted when there is a realistic prospect of the customer repaying all facilities in full. If there is any concern over future cash flows and the Group incurring a loss, then forborne loans will also be classified as impaired in accordance with the Group's impairment policy.

Exposures classified as forborne and performing at the date forbearance measures are granted, continue to be reported as subject to forbearance for a minimum period of two years from that date (the 'probation period'). Exposures classified as forborne and which are non-performing when customers were granted forbearance cannot exit non-performing status for a minimum of 12 months from the date forbearance was granted and cannot exit forbearance status for a further two years from the date of returning to performing status (three years in total). Forbearance activity is reviewed on a regular basis to ensure the operational processes remain appropriate and, where required, system changes are made to enhance forbearance data capture.

# Risk report (continued)

## *CREDIT RISK (continued)*

### Forbearance (continued)

The Group has identified a number of situations that in isolation are not considered to be forbearance:

- Facilities that have been temporarily extended pending review and no concession has been granted for reasons relating to the actual or apparent financial stress of a customer.
- A reduction in asset quality to a level where actual, or apparent, financial stress is not evident.
- Where changes are made to the terms of a borrower's interest structure or repayment arrangement on a commercial basis.
- Late provision of financial information, in the absence of other indicators of financial difficulty, is not in all cases considered a 'non-commercial' breach of non-financial covenants.

Where the Group has made a demand for repayment, the customer's facilities have been withdrawn or where a debt repayment process has been initiated, the exposure is classified as forborne if the debt is subject to any of the mentioned forbearance concessions.

### Mortgage and personal forbearance

The Group utilises various forbearance measures for mortgage and personal customers, specific to the individual customer and their circumstances. Customers may potentially be subject to more than one forbearance strategy at any one time where this is considered to be the most appropriate course of action.

*Debt management for mortgage customers in financial difficulty*

To support customers who are encountering financial difficulties, cases are managed on an individual basis, with the circumstances of each customer considered separately and the action taken judged as being affordable and sustainable for the customer. Operationally, the provision and review of such assistance is controlled by various methods. These include the application of an appropriate policy framework, controls around the execution of policy, regular review of the different treatments to confirm that they remain appropriate, monitoring of customers' performance including the level of payments received, and management visibility of the nature and extent of assistance provided and the associated risk.

Help is provided through specialist teams such as the Financial Care Team where tailored repayment programmes can be agreed. Customers are actively supported and referred to free money advice agencies when they have multiple credit facilities, including those at other lenders that require restructuring.

One component of the Group's approach is to contact customers showing signs of financial difficulty to discuss their circumstances and offer solutions to prevent their accounts falling into arrears.

# Risk report (continued)

*CREDIT RISK (continued)*

### Mortgage and personal forbearance (continued)

The tables below summarise the level of forbearance in respect of the Group's mortgage and credit card portfolios at each balance sheet date. All balances subject to forbearance are classed as either Stage 2 or Stage 3 for ECL purposes:

| **Group (audited)<br>As at 30 September 2019** | **Total loans and advances subject to forbearance measures** | | | **Impairment allowance on loans and advances subject to forbearance measures** | |
|---|---|---|---|---|---|
| | **Number of loans** | **Gross carrying amount £m** | **% of total portfolio** | **Impairment allowance £m** | **Coverage %** |
| **Mortgages** | | | | | |
| Formal arrangements | 1,352 | 157 | 0.26 | 4.4 | 2.83 |
| Temporary arrangements | 913 | 119 | 0.20 | 3.1 | 2.62 |
| Payment arrangement[1] | 1,118 | 113 | 0.19 | 1.6 | 1.41 |
| Payment holiday[1] | 981 | 114 | 0.19 | 0.7 | 0.58 |
| Interest only conversion | 358 | 54 | 0.09 | 0.3 | 0.57 |
| Term extension | 174 | 16 | 0.03 | 0.1 | 0.64 |
| Other | 35 | 3 | 0.00 | - | 0.50 |
| Legal | 130 | 13 | 0.02 | 0.3 | 2.46 |
| **Total mortgage forbearance** | 5,061 | 589 | 0.98 | 10.5 | 1.79 |
| Personal forbearance – credit cards | 5,522 | 24 | 0.53 | 9.5 | 41.30 |
| **Total** | **10,583** | **613** | **0.95** | **20.0** | **3.31** |

(1) Payment arrangement and payment holiday have been introduced as additional concession types within the Group's mortgage forbearance policy.

| Group (audited)<br>As at 30 September 2018 | Total loans and advances subject to forbearance measures | | | Impairment allowance on loans and advances subject to forbearance measures | |
|---|---|---|---|---|---|
| | Number of loans | Gross carrying amount £m | % of total portfolio | Impairment allowance £m | Coverage % |
| Mortgages | | | | | |
| Formal arrangements | 1,497 | 168 | 0.68 | 3.3 | 2.00 |
| Temporary arrangements | 1,275 | 161 | 0.66 | 2.3 | 1.45 |
| Interest only conversion | 231 | 32 | 0.13 | 0.1 | 0.18 |
| Term extension | 150 | 12 | 0.05 | 0.1 | 0.48 |
| Other | 41 | 4 | 0.02 | - | 0.36 |
| Legal | 148 | 15 | 0.06 | 0.5 | 3.34 |
| Total mortgage forbearance | 3,342 | 392 | 1.60 | 6.3 | 1.61 |
| Personal forbearance – credit cards | 787 | 2 | 0.18 | 0.9 | 40.68 |
| Total | 4,129 | 394 | 1.58 | 7.2 | 1.83 |

The increase in mortgage and credit card forbearance is attributable to the acquisition of the Virgin Money Holdings (UK) PLC portfolios.

# Risk report (continued)

*CREDIT RISK (continued)*

When all other avenues of resolution including forbearance have been explored, the Group will take steps to repossess and sell underlying collateral. In the 12-month period to 30 September 2019, there were 66 repossessions of which 14 were voluntary (12 months to 30 September 2018 (excluding Virgin Money): 38 including 16 voluntary).

*Forbearance – other personal lending*

Excluding credit cards, the Group currently exercises limited forbearance strategies in relation to other types of personal lending, namely current accounts and personal loans. The Group has assessed the total loan balances subject to forbearance on other types of personal lending to be £11.5m as at 30 September 2019 (30 September 2018 (excluding Virgin Money): £10.1m), representing 1.10% of the personal lending portfolio (30 September 2018: 1.22%).

Impairment provisions on forborne balances totalled £3.6m as at 30 September 2019 (30 September 2018 (excluding Virgin Money): £2.8m) providing overall coverage of 31.58% (30 September 2018: 28.30%).

**Business forbearance**

Forbearance is considered to exist for business customers where one or more concessions are granted on a non-commercial basis. The Group reports business forbearance at a customer level and at a value which incorporates all facilities and the related impairment allowance irrespective of whether each individual facility is subject to forbearance. Authority to grant forbearance measures for business customers is held by the Group's Strategic Business Services unit and is exercised, where appropriate, on the basis of detailed consideration of the customer's financial position and prospects.

Where a customer is part of a larger group, forbearance is exercised and reported across the Group at the individual entity level. Where modification of the terms and conditions of an exposure meeting the criteria for classification as forbearance results in derecognition of loans and advances from the balance sheet and the recognition of a new exposure, the new exposure shall be treated as forborne.

The tables below summarise the total number of arrangements in place and the loan balances and impairment provisions associated with those arrangements. All balances subject to forbearance are classed as either Stage 2 or Stage 3 for ECL purposes.

| Group (audited)<br>As at 30 September 2019 | Total loans and advances subject to forbearance measures | | | Impairment allowance on loans and advances subject to forbearance measures | |
|---|---|---|---|---|---|
| | Number of customers | Gross carrying amount £m | % of total portfolio | Impairment allowance £m | Coverage % |
| Term extension | 187 | 153 | 1.93 | 14.9 | 9.70 |
| Deferral of contracted capital repayments | 98 | 134 | 1.68 | 15.0 | 11.16 |
| Reduction in contracted interest rate | 3 | 1 | 0.02 | - | 3.37 |
| Alternative forms of payment | 2 | 7 | 0.08 | 0.4 | 5.37 |
| Debt forgiveness | 2 | 4 | 0.05 | - | 1.06 |
| Refinancing | 16 | 10 | 0.12 | 1.5 | 15.03 |
| Covenant breach/reset/waiver | 60 | 200 | 2.50 | 23.6 | 11.82 |
| Total business forbearance | 368 | 509 | 6.38 | 55.4 | 10.87 |

# Risk report (continued)

*CREDIT RISK (continued)*

**Business forbearance (continued)**

| Group (audited)<br>As at 30 September 2018 | Total loans and advances subject to forbearance measures | | | Impairment allowance on loans and advances subject to forbearance measures | |
|---|---|---|---|---|---|
| | Number of customers | Gross carrying amount £m | % of total portfolio | Impairment allowance £m | Coverage % |
| Term extension | 179 | 162 | 2.15 | 10.5 | 6.48 |
| Deferral of contracted capital repayments | 103 | 129 | 1.73 | 15.6 | 12.02 |
| Reduction in contracted interest rate | 2 | 1 | 0.01 | - | 4.05 |
| Alternative forms of payment | 4 | 25 | 0.33 | 7.5 | 30.46 |
| Debt forgiveness | 4 | 11 | 0.14 | 0.6 | 5.64 |
| Refinancing | 17 | 10 | 0.13 | 1.0 | 9.87 |
| Covenant breach/reset/waiver | 61 | 207 | 2.75 | 9.2 | 4.43 |
| Total business forbearance | 370 | 545 | 7.24 | 44.4 | 8.14 |

Included in other financial assets at fair value is a portfolio of loans that is included in the above table. The gross value of fair value loans subject to forbearance as at 30 September 2019 is £8m (30 September 2018: £15m), representing 0.11% of the total business portfolio (30 September 2018: 0.19%). The credit risk adjustment on these amounts totalled £0.6m (30 September 2018: £2m), a coverage of 6.94% (30 September 2018: 11.66%).

**Other credit risks**

The Group is exposed to credit risk on its other banking and Treasury-related activities, which are subject to mitigation and monitoring. No ECL provisions are currently held for these exposures.

*Offsetting of financial assets and liabilities*

The Group reduces exposure to credit risk through central clearing for eligible derivatives and daily posting of cash collateral on such transactions as detailed in note 3.6 to the financial statements. The amounts off set on the balance sheet, as shown below, represent derivatives and variation margin collateral with central clearing houses which meet the criteria for offsetting under IAS 32. The table excludes financial instruments not subject to offset and that are only subject to collateral arrangements (e.g. loans and advances).

The Group enters into derivatives with various counterparties which are governed by industry standard master netting agreements. The Group holds and provides collateral in respect of derivatives transactions covered by these agreements. The right to off set balances under these master netting agreements only arises in the event of non-payment or default and, as a result, these arrangements do not qualify for offsetting under IAS 32.

The net amounts presented in the table are not intended to represent the Group's exposure to credit risk, as the Group will use a wide range of strategies to mitigate credit risk in addition to netting and collateral.

# Risk report (continued)

*CREDIT RISK (continued)*

### Other credit risks (continued)

**Group**

**2019 (audited)**

| | Gross Amounts | Gross amounts offset in the balance sheet[1] | Net amounts presented on balance sheet[1] | Net amounts not offset in the balance sheet: Subject to master netting agreements instruments | Net amounts not offset in the balance sheet: Cash collateral pledged/ received | Net Amount |
|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m |
| **Assets** | | | | | | |
| Derivative financial instruments[2] | 478 | (112) | 366 | (70) | (8) | 288 |
| **Liabilities** | | | | | | |
| Derivative financial instruments[2] | 739 | (466) | 273 | (70) | (190) | 13 |
| Securities sold under repurchase agreement | 1,554 | - | 1,554 | (1,554) | - | - |

Group

2018 (audited)

| | Gross Amounts | Gross amounts offset in the balance sheet[1] | Net amounts presented on balance sheet[1] | Net amounts not offset in the balance sheet: Subject to master netting agreements instruments | Net amounts not offset in the balance sheet: Cash collateral pledged/ received | Net Amount |
|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m |
| Assets | | | | | | |
| Derivative financial instruments[2] | 262 | - | 262 | (99) | (26) | 137 |
| Liabilities | | | | | | |
| Derivative financial instruments[2] | 361 | - | 361 | (99) | (234) | 28 |
| Securities sold under repurchase agreement | 802 | - | 802 | (802) | - | - |

(1) Cash collateral amounts are limited to the net balance sheet exposure in order to exclude any over collateralisation. In addition to cash collateral, the Group holds securities collateral in respect of derivative transactions subject to master netting agreements of £57m (2018: £Nil), which is not recognised on the balance sheet.

(2) Derivative financial instruments comprise both trading and hedging derivative assets and liabilities.

# Risk report (continued)

*CREDIT RISK (continued)*

### Other Credit Risks (continued)

**Bank**

**2019 (audited)**

| | Gross Amounts £m | Gross amounts offset in the balance sheet [1] £m | Net amounts presented on balance sheet [1] £m | Net amounts not offset in the balance sheet: Subject to master netting agreements instruments £m | Net amounts not offset in the balance sheet: Cash Collateral Pledged/ Received £m | Net Amount £m |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| Derivative financial instruments[2] | 554 | (112) | 442 | (87) | (302) | 53 |
| **Liabilities** | | | | | | |
| Derivative financial instruments[2] | 757 | (465) | 292 | (87) | (180) | 25 |
| Securities sold under repurchase agreement | 1,554 | - | 1,554 | (1,554) | - | - |

Bank

2018 (audited)

| | Gross Amounts £m | Gross amounts offset in the balance sheet [1] £m | Net amounts presented on balance sheet [1] £m | Net amounts not offset in the balance sheet: Subject to master netting agreements instruments £m | Net amounts not offset in the balance sheet: Cash Collateral Pledged/ Received £m | Net Amount £m |
|---|---|---|---|---|---|---|
| Assets | | | | | | |
| Derivative financial instruments[2] | 151 | - | 151 | (99) | (26) | 26 |
| Liabilities | | | | | | |
| Derivative financial instruments[2] | 361 | - | 361 | (99) | (234) | 28 |
| Securities sold under repurchase agreement | 802 | - | 802 | (802) | - | - |

[1] Collateral amounts (cash and non-cash financial collateral) are reflected at their fair value; however, this amount is limited to the net balance sheet exposure in order to exclude any over collateralisation.
[2] Derivative financial instruments comprise of both trading and hedging derivative assets and liabilities.

# Risk report (continued)

*FINANCIAL RISK*

Financial risk covers several categories of risk which impact the manner in which the Group can support its customers in a safe and sound manner. They include capital, funding risk, liquidity risk, market risk, model risk, pension risk, tax risk and financial risks from climate change.

| 14.4% | 114% | 152% |
|---|---|---|
| CET1 | Loan to deposit ratio (LDR) | LCR |

**Risk appetite**

The primary objective for the management of financial risks is to control the risk profile within approved risk limits, to maintain the confidence of the Group's customers and other stakeholders. Financial risks are also managed to protect current and future earnings from the impact of market volatility. The Group applies a prudent approach to financial risks in order to safeguard the ongoing strength and resilience of the balance sheet.

Financial risk appetite is approved by the Board, with authority delegated to the Assets and Liability Committee (ALCO) for subsequent implementation and monitoring. The Board has established a range of capital risk appetite measures including CET1, leverage and minimum holdings of capital. Measures for funding and liquidity risks consider the structure of the balance sheet, the Group's overall funding profile and compliance with Overall Liquidity Adequacy Rule (OLAR).

The Group's participation in wholesale markets, along with its use of financial instruments, is to fund its banking activities and to manage the liquidity and interest rate risks arising from these activities. The Group establishes an appetite for these risks based on an overriding principle that the Group will not engage in proprietary risk taking.

The Group's pension risk appetite is a component of the Group wide RAS framework for the management of balance sheet risks and is considered in the context of potential capital impacts as a result of volatility in the Scheme's valuations.

In delivering its strategic objectives, the Group accepts a level of loss may arise from model error. Implementing key controls ensures that model errors remain within acceptable limits. The explicit consideration of an appetite for model risk is defined and articulated in the Group RAS. Specifically, in the case of model risk, the Board establishes the extent of its willingness, or otherwise, to accept results from using models. Model risk appetite is reported regularly to both the Board and the Model Governance Committee (MGC).

**Capital risk**

Capital is held by the Group to protect its depositors, to cover inherent risks in a normal and stressed operating environment and to support the Group's strategy of pioneering growth. Capital risk is the risk that the Group has insufficient quantity or quality of capital to support its operations.

**Exposures**

Capital risk exposures arise when the Group has insufficient capital resources to support its business activities and to meet regulatory capital requirements under normal operating conditions or stressed scenarios.

**Measurement**

The Group manages capital in accordance with prudential rules issued by the PRA and Financial Conduct Authority (FCA), which are implemented the CRD IV CRR regulatory framework. Pillar 1 capital requirements for the year ended 30 September 2019 are calculated in respect of credit risk, operational risk, market risk and credit valuation adjustments. The capital requirements for mortgages are calculated using an advanced internal ratings based (AIRB) approach while the business portfolios are calculated using a foundation internal ratings based (FIRB) approach. All other requirements are calculated using the standardised approach.

# Risk report (continued)

*FINANCIAL RISK (continued)*

A rigorous approach is taken to assess risks that are not adequately covered by Pillar 1, including interest rate risk and pension risk. The Group also undertakes analysis of a range of stress scenarios in order to test the impact on capital arising from severe yet plausible scenarios. These approaches to capital are thoroughly documented in the Group's ICAAP which is subject to review, challenge and approval by the Board.

### Capital Buffers

The regulatory capital buffer framework is intended to ensure firms maintain a sufficient amount of capital above their regulatory minimum in order to withstand periods of stress. The UK has implemented the provisions on capital buffers outlined in the CRD to create combined capital buffers including a Capital Conservation Buffer (CCB), a Countercyclical Capital Buffer (CCyB), a Global Systemically Important Institution Buffer, and a Systemic Risk Buffer (SRB) for ring-fenced banks. In the UK, the transitional period for the CCB has ended and it is set at 2.50%, effective from 1 January 2019.

The CCyB has been effective from 1 May 2014 and is dependent upon the BoE's view of credit conditions in the economy. The CCyB at 30 September 2019 is 1.00% of RWA's, increasing from 0.5% at 30 September 2018.

The Group's capital planning considers the impact of all relevant capital buffers.

The PRA's final rules on the approach to identifying other systemically important institutions (O-SII) were published in February 2016. In line with expectations the Group was not designated an O-SII. Similarly the Financial Policy Committee (FPC) issued its final framework for setting the SRB in May 2016. This confirmed that banks with total assets of less than £175bn (which includes the Group) will be subject to a 0% SRB.

### Mitigation

The Group's capital risk policy standard provides the framework for the manner in which capital is managed within the Group. The objectives of the policy standard are to efficiently manage the capital base to optimise shareholder returns while maintaining robust capital adequacy, meeting regulators' requirements, managing the rating agencies' assessment of the Group and ensuring that excessive leverage is not taken.

The Group is able to accumulate additional capital through the retention of profit over time, by cutting costs, by raising new equity via, for example, a rights issue or debt exchange, by reducing or cancelling distributions on capital instruments, and by raising AT1 and Tier 2 capital. The availability and cost of additional capital is dependent upon market conditions and perceptions at the time. The Group is also able to manage the demands for capital through management actions including adjusting lending strategy.

Capital optimisation remains a key strategic priority of the Group and approval for the use of IRB models for the retail mortgage and business portfolios was obtained in October 2018. Work is ongoing to consider the transition to the IRB approach for other portfolios.

### Monitoring

The capital plan is approved by the Board on an annual basis. The Group's ALCO monitors the capital plan and forecast positions on a monthly basis. This ensures that performance trends are appropriately reviewed and that there is transparency on the impact on capital ratios, risk appetite and the future outlook.

# Risk report (continued)

*FINANCIAL RISKS (continued)*

### Capital position

The Group's capital position as at 30 September 2019 is summarised below.

| Regulatory capital (unaudited)[1] | 2019 £m | 2018 £m |
|---|---|---|
| **Statutory total equity** | **5,141** | 3,291 |
| **CET1 capital: regulatory adjustments[2]** | | |
| External note reserve | **(672)** | (425) |
| Defined benefit pension fund assets | **(257)** | (138) |
| Prudent valuation adjustment | **(5)** | (3) |
| Intangible assets | **(501)** | (412) |
| Goodwill | **(11)** | - |
| Deferred tax asset relying on future profitability | **(250)** | (192) |
| Cash flow hedge reserve | **25** | 37 |
| Excess expected losses | **(88)** | - |
| AT1 coupon accrual | **(20)** | (10) |
| IFRS 9 transitional adjustments | **100** | - |
| **Total regulatory adjustments to CET1** | **(1,679)** | (1,143) |
| **Total CET1 capital** | **3,462** | 2,148 |
| **AT1 capital** | | |
| AT1 capital instruments | **672** | 425 |
| **Total AT1 capital** | **672** | 425 |
| **Total Tier 1 capital** | **4,134** | 2,573 |
| **Tier 2 capital: Instruments and provisions** | | |
| Subordinated debt | **723** | 477 |
| Credit risk adjustments[3] | **-** | 152 |
| **Total Tier 2 capital** | **723** | 629 |
| **Total capital** | **4,857** | 3,202 |

(1) This table shows the capital position on a CRD IV 'fully loaded' basis and transitional IFRS 9 basis.
(2) A number of regulatory adjustments to CET1 capital are required under CRD IV regulatory capital rules.
(3) The current period does not include Tier 2 credit risk adjustments due to the transition to IFRS 9 reporting.

# Risk report (continued)

*FINANCIAL RISKS (continued)*

## Capital position (continued)

| Regulatory capital flow of funds (unaudited)[1] | CRD IV 2019 £m | CRD IV 2018 £m |
|---|---|---|
| **CET1 capital[2]** | | |
| CET1 capital at 1 October | 2,148 | 2,440 |
| Share capital: ordinary share new issuance | 1,779 | 511 |
| Retained earnings and other reserves (including structured entities) | (186) | (684) |
| Prudent valuation adjustment | (2) | 1 |
| Intangible assets | (89) | (73) |
| Goodwill | (11) | - |
| Deferred tax asset relying on future profitability | (58) | (82) |
| Defined benefit pension fund assets | (119) | (3) |
| Cash flow hedge reserve | (12) | 38 |
| IRB shortfall of credit risk adjustments to expected losses | (88) | - |
| IFRS transitional relief | 100 | - |
| **CET1 capital at 30 September** | 3,462 | 2,148 |
| **AT1 capital** | | |
| AT1 capital at 1 October | 425 | 425 |
| Share capital issued: AT1 Capital issued | 247 | - |
| **Total AT1 capital at 30 September** | 672 | 425 |
| **Total Tier 1 capital at 30 September** | 4,134 | 2,573 |
| **Tier 2 capital** | | |
| Tier 2 capital at 1 October | 629 | 630 |
| Credit risk adjustments[3] | (152) | (2) |
| Other movements | (1) | 1 |
| Capital instruments issued: subordinated debt | 247 | - |
| **Total Tier 2 capital at 30 September** | 723 | 629 |
| **Total capital** | 4,857 | 3,202 |

[1] The table shows the capital position on a CRD IV 'fully loaded' basis and transitional IFRS 9 basis.
[2] CET1 capital is comprised of shares issued and related share premium, retained earnings and other reserves less specified regulatory adjustments.
[3] The transition to IFRS 9 reporting has removed the requirement for Tier 2 credit risk adjustments.

# Risk report (continued)

## *FINANCIAL RISKS (continued)*

### Capital position (continued)

| **Minimum Pillar 1 capital requirements (unaudited)** | **2019** | 2018 |
|---|---|---|
| | **£m** | £m |
| Credit Risk | **1,685** | 1,449 |
| Operational risk | **209** | 134 |
| Counterparty risk | **15** | 10 |
| Credit valuation adjustment | **15** | 17 |
| **Tier 1 regulatory capital requirements** | **1,924** | 1,610 |

| **IFRS 9 Transitional arrangements (unaudited)** [1] | **30 September 2019 (£m)** | |
|---|---|---|
| **Available capital (amounts)** | **As reported** | **Excluding impact of IFRS 9** |
| CET1 capital | **3,462** | **3,362** |
| Tier 1 capital | **4,134** | **4,034** |
| Total capital | **4,857** | **4,757** |
| **RWA (amounts)** | | |
| Total RWAs | **24,046** | **23,983** |
| **Capital ratios** | | |
| CET1 (as a percentage of risk exposure amount) | **14.4%** | **14.0%** |
| Tier 1 (as a percentage of risk exposure amount) | **17.2%** | **16.8%** |
| Total capital (as a percentage of risk exposure amount) | **20.2%** | **19.8%** |
| **Leverage ratio** | | |
| Leverage ratio total exposure measure | **94,742** | **94,642** |
| Leverage ratio | **4.4%** | **4.3%** |

[1] The table shows a comparison of capital resources, requirements and ratios with and without the application of transitional arrangements for IFRS 9

# Risk report (continued)

*FINANCIAL RISKS (continued)*

### RWA movements

| RWA flow statement (unaudited) [1] | 12 months to 30 Sep 2019 | | | | | 12 months to 30 Sep 2018 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | IRB RWA | STD RWA | Other RWA[2] | Total | Capital required | IRB RWA | STD RWA | Other RWA[2] | Total | Capital required |
| | £m | £m | £m | £m | £m | £m | £m | £m | £m | £m |
| RWA at 1 October | - | 18,103 | 2,014 | 20,117 | 1,610 | - | 18,116 | 1,939 | 20,055 | 1,604 |
| Asset size | 958 | 464 | 12 | 1,434 | 115 | - | (17) | 75 | 58 | 5 |
| Asset quality | (291) | (8) | - | (299) | (24) | - | 4 | - | 4 | 1 |
| Model updates[3] | (396) | - | - | (396) | (32) | - | - | - | - | - |
| Methodology and policy | 250 | - | - | 250 | 20 | - | - | - | - | - |
| Acquisitions and disposals | 4,330 | 2,870 | 960 | 8,160 | 653 | - | - | - | - | - |
| IRB accreditation | 10,247 | (15,592) | - | (5,345) | (428) | - | - | - | - | - |
| Other | 6 | 101 | 18 | 125 | 10 | - | - | - | - | - |
| **RWAs at 30 September** | 15,104 | 5,938 | 3,004 | 24,046 | 1,924 | - | 18,103 | 2,014 | 20,117 | 1,610 |

(1) While the Group has obtained IRB accreditation, the PRA has now released a final policy statement outlining its approach to implementing definition of default in line with EBA guidelines. Further to this, there are recommended changes to both PD and LGD model components relating directly to the calculation of risk-weighted capital requirements for residential mortgage portfolios. These changes are required to be implemented by 31 December 2020, subject to PRA approval.

(2) Other RWA includes operational risk, CVA and counterparty credit risk.

(3) Formal FIRB accreditation for the business portfolios was received in October 2018 for a suite of re-calibrated models which were implemented during November and which resulted in a £170m model impacts, included within the 'Model updates' row above. The differential is predominantly in relation to the mortgage quarterly PD model calibrations. Since this implementation, no additional model changes have occurred.

# Risk report (continued)

*FINANCIAL RISKS (continued)*

**Pillar 1 RWAs and Capital requirements by business line (unaudited)**

| Capital requirements for calculating RWAs | At 30 September 2019 Capital required £m | RWA £m | Exposure £m | At 30 September 2018 Capital required £m | RWA £m | Exposure £m |
|---|---|---|---|---|---|---|
| Corporates | 501 | 6,258 | 8,587 | - | - | - |
| Retail | 708 | 8,846 | 64,067 | - | - | - |
| **Total IRB Approach** | 1,209 | 15,104 | 72,654 | - | - | - |
| Central governments or central banks | 1 | 9 | 11,660 | - | 1 | 11,361 |
| Regional governments or local authorities | 1 | 13 | 175 | 1 | 12 | 143 |
| Public sector entities | - | 5 | 335 | - | 2 | 155 |
| Multilateral development banks | - | - | 1,034 | - | - | 155 |
| Financial institutions | 16 | 206 | 959 | 11 | 136 | 630 |
| Corporates | 28 | 349 | 378 | 316 | 3,956 | 4,311 |
| Retail | 319 | 3,993 | 5,324 | 90 | 1,124 | 1,499 |
| Secured by mortgages on immovable property | 40 | 496 | 873 | 938 | 11,708 | 28,423 |
| Exposures in default | 5 | 59 | 55 | 45 | 562 | 465 |
| Collective investments undertakings | - | - | - | - | 1 | 1 |
| Equity exposures | - | 5 | 3 | - | 5 | 4 |
| Items associated with particularly high risk | 1 | 11 | 7 | 4 | 49 | 33 |
| Covered bonds | 11 | 141 | 1,415 | 5 | 61 | 615 |
| Other items | 54 | 651 | 743 | 39 | 487 | 715 |
| **Total Standardised approach** | 476 | 5,938 | 22,961 | 1,449 | 18,104 | 48,510 |
| **Total credit risk** | 1,685 | 21,042 | 95,615 | 1,449 | 18,104 | 48,510 |
| Operational risk | 209 | 2,621 | | 134 | 1,670 | |
| Counterparty risk | 15 | 191 | | 10 | 125 | |
| Credit valuation adjustment | 15 | 192 | | 17 | 218 | |
| | 1,924 | 24,046 | | 1,610 | 20,117 | |

The exposure amounts disclosed above are post CCF and pre-credit mitigation.

Additional breakdown analysis of the IRB portfolios can be seen within the 'EU CR6 -IRB Approach – Credit risk by exposure class and PD range' table within the Group's Pillar 3 disclosures.

Prior period comparatives are reported under the standardised approach to credit risk as IRB accreditation was received in October 2018.

# Risk report (continued)

*FINANCIAL RISKS (continued)*

### Pillar 1 RWAs and Capital requirements by business line (unaudited) (continued)

| Capital position and CET1 (unaudited) | 2019 £m | 2018 £m |
|---|---|---|
| **RWAs** [1] | | |
| Retail mortgages | 8,845 | 9,002 |
| Business lending | 7,122 | 7,407 |
| Other retail lending | 4,042 | 981 |
| Other lending | 485 | 109 |
| Other [2] | 548 | 605 |
| Credit risk | 21,042 | 18,104 |
| Operational risk | 2,621 | 1,670 |
| Counterparty risk | 191 | 125 |
| Credit valuation adjustment | 192 | 218 |
| **Total RWAs** | **24,046** | 20,117 |
| **Capital ratios** | | |
| CET1 ratio | 14.4% | 10.7% |
| Tier 1 ratio | 17.2% | 12.8% |
| **Total capital ratio** | 20.2% | 15.9% |

(1) RWAs are calculated under the AIRB approach for both the mortgage and FIRB for the business portfolios with all other portfolios being calculated under the standardised approach, via either Sequential IRB implementation of Permanent Partial Use (PPU).
(2) The items included in the Other exposure class that attract a capital charge include items in the course of collection, cash in hand, fixed assets, other debtors, prepayments and deferred tax assets that are not deducted.

The Group measures the amount of capital it requires to hold by applying the CRD IV as implemented in the UK by the PRA and supplemented through additional regulation under the PRA Rulebook. The table below summarises the amount of capital in relation to RWAs the Group is currently required to hold, excluding any PRA Buffer. These ratios apply at the consolidated Group level.

| | As at 30 Sep 2019 | |
|---|---|---|
| **Minimum Requirements** | **CET1** | **Total Capital** |
| Pillar 1 [1] | 4.5% | 8.0% |
| Pillar 2A [2] | 3.0% | 5.3% |
| **Total Capital Requirement** | **7.5%** | **13.3%** |
| CCB [3] | 2.5% | 2.5% |
| UK CCyB [4] | 1.0% | 1.0% |
| **Total (excluding PRA buffer)** [5] | **11.0%** | **16.8%** |

(1) The minimum amount of total capital under Pillar 1 of the regulatory framework is determined as 8% of RWAs, of which at least 4.5% of RWAs is required to be covered by CET1 capital.
(2) The UK CCyB may be set between 0% and 2.5%. On 28 November 2018, the UK CCyB increased from 0.5% to 1.0%. At its October 2019 meeting, the FPC maintained the UK CCyB rate at 1%, noting the underlying vulnerabilities (excluding Brexit) that can amplify economic shocks have not changed materially since the November 2018 Financial Stability Report and remain at a standard level overall in the UK.
(3) The Group may be subject to a PRA buffer as set by the PRA but is not permitted to disclose the level of any buffer. A PRA buffer can consist of two components:

- A risk management and governance buffer that is set as a scalar of the Pillar 1 and Pillar 2A requirements.
- A buffer relating to the results of the BoE stress tests.

# Risk report (continued)

*FINANCIAL RISKS (continued)*

**Pillar 1 RWAs and Capital requirements by business line (unaudited) (continued)**

**Dividend**

On 11 November 2019 the Company paid an Ordinary Dividend of £10m to its holding company Virgin Money UK PLC. This Ordinary Dividend was equal in amount to an AT1 distribution made by Virgin Money UK PLC to investors on the same date. This follows the successful completion of an investor consent exercise in August 2019 to transfer the obligations of Virgin Money Holdings (UK) plc on its outstanding AT1 instrument (£230m) to Virgin Money UK PLC. The proceeds of the transfer were used by Virgin Money UK PLC to subscribe for £230m of Ordinary Shares in Clydesdale Bank.

**Leverage**

| Leverage ratio (unaudited) | 2019<br>£m | 2018<br>£m |
|---|---|---|
| **Total Tier 1 capital for the leverage ratio** | | |
| Total CET1 capital | **3,462** | 2,148 |
| AT1 capital | **672** | 425 |
| **Total Tier 1** | **4,134** | 2,573 |
| **Exposures for the leverage ratio** | | |
| Total statutory assets | **91,101** | 43,583 |
| Adjustment for off-balance sheet items | **2,728** | 1,763 |
| Adjustment for derivative financial instruments | **(35)** | (134) |
| Adjustment for securities financing transactions (SFTs) | **1,934** | 1,468 |
| Other adjustments | **(986)** | (708) |
| **Leverage ratio exposure** | **94,742** | 45,972 |
| **CRD IV Leverage Ratio[(1)]** | **4.4%** | 5.6% |
| **UK leverage ratio[(2)]** | **4.9%** | 6.5% |

(1) IFRS 9 transitional capital arrangements have been applied to the leverage ratio calculation as at 30 September 2019.

(2) The Group's leverage ratio on a UK basis, excluding qualifying central bank claims from the exposure measure in accordance with the policy statement issued by the PRA in October 2017. The Group is currently excluded from the full reporting requirements of the UK leverage ratio framework.

The leverage ratio is monitored against a Board set RAS with the responsibility for managing the ratio delegated to ALCO, which monitors it on a monthly basis.

The leverage ratio is the ratio of Tier 1 capital to total exposure, defined as:

- capital: Tier 1 capital defined according to CRD IV on an end point basis (assuming the full impact of CRD IV requirements on Tier 1 capital were in force with no transitional provisions); and
- exposures: total on and off balance sheet exposures (subject to CCFs) as defined in the Delegated Act amending CRR article 429 (Calculation of the Leverage Ratio), which includes deductions applied to Tier 1 capital.

# Risk report (continued)

*FINANCIAL RISKS (continued)*

### Leverage

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.

The UK leverage ratio framework, which came into force on 1 January 2016, is relevant to PRA regulated banks and building societies with consolidated retail deposits equal to or greater than £50bn. The Group is currently excluded from the full reporting requirements of the framework but will be required to comply in the first reporting period following the date at which this threshold is breached.

### Funding and liquidity risk

Funding risk occurs where the Group is unable to raise or maintain funds of sufficient quantity and quality to support the delivery of the business plan or sustain lending commitments. Prudent funding risk management reduces the likelihood of liquidity risks occurring, increases the stability of funding sources, minimises concentration risks and controls future balance sheet growth. Liquidity risk occurs when the Group is unable to meet its current and future financial obligations as they fall due or at acceptable cost, or reduces liquidity resources below internal or regulatory stress requirements.

### Exposures

The Group is predominantly funded by personal and business customers. Customer funding is supported by the Group's ongoing wholesale funding programmes, medium-term secured funding issuance (e.g. the Group's Lanark securitisation programme), the Regulated Covered Bond platform and unsecured medium- term notes. Funding risk exposures arise from an unsustainable or undiversified funding base, for example, a reliance on short-term wholesale deposits. The risk may result in deviation from funding strategy; requiring funding to be originated rapidly at excessive cost, or require a reduction in lending growth, which are outcomes that may adversely affect customers or shareholders.

The Group's primary liquidity risk exposure arises through the redemption of retail deposits where customers have the ability to withdraw funds with limited or no notice. Exposure also arises from the refinancing of customer and wholesale funding at maturity and the ability to fund new and existing committed lending obligations including mortgage pipeline and credit card facilities.

### Measurement

Funding and liquidity risks are subject to a range of measures contained within the Group's RAS and a series of limits agreed by ALCO. These measures provide a short and long-term view of risks under both normal and stressed conditions. The measures focus on: cash outflows and inflows under stress; concentration risks; refinancing risks and readiness of mitigating actions.

The Group funding plan establishes an acceptable level of funding risk which is approved by the Board and is consistent with risk appetite and the Group's strategic objectives. The development of the Group's funding plan is informed by the requirements of the Group's financial risk policy standards. A series of metrics is used across the Group to measure risk exposures, including funding ratios, limits to concentration risk and maximum levels of encumbrance.

Liquidity risk exposures are subject to assessment under both regulatory and internal requirements. The volume and quality of the Group's liquid asset portfolio is defined through a series of stress tests across a range of time horizons and stress conditions. The high-quality liquid asset requirement is quantified as the outflow of funds under a series of stress scenarios less the impact of inflows from assets. The Group ensures a liquidity surplus is held during normal market conditions above liquidity stress outflow requirements. Stress cash outflow assumptions have been established for individual liquidity risk drivers across idiosyncratic and market wide stresses. Liquidity within the Group is managed in accordance with the ILAAP, which is approved by the Board

The Treasury function is responsible for the development and execution of strategy subject to oversight from the Risk function. In relation to funding and liquidity risk, the primary management committee is ALCO. The Group continues to maintain its strong funding and liquidity position and seeks to achieve an appropriate balance between profitability, liquidity risk and capital optimisation.

# Risk report (continued)

*FINANCIAL RISKS (continued)*

### Monitoring

Liquidity is actively monitored by the Group. Reporting is conducted through ALCO and the Executive Risk Committee. In a stress situation, the level of monitoring and reporting is increased commensurate with the nature of the stress event.

Monitoring and control processes are in place against internal and regulatory liquidity requirements. The Group monitors a range of market and internal early warning indicators on a routine basis for early signs of liquidity risk in the market or specific to the Group. These are a mixture of quantitative and qualitative measures including daily variation of customer balances, measurement against stress requirements and monitoring of the macro-economic environment.

### Mitigation

The Group holds a portfolio of High Quality Liquid Assets (HQLA) that can be utilised to raise funding in times of stress. The size of the HQLA portfolio is calibrated based on a view of potential outflows under both systemic and idiosyncratic stress events. In addition, the Group can use the repo market to generate funds and can also participate in BoE operations through the Sterling Monetary Framework.

The Group has several sources of funding which are well diversified in terms of the type of instrument and product, counterparty, term structure and market. In addition to customer funding, wholesale funding is used to support balance sheet growth, lengthen the contractual tenor of funding and diversify sources of funding. These funding programmes are a source of strength for the Group and leverage the Group’s high-quality mortgage book as a source of collateral for secured funding. The funding plan includes an assessment of the Group's capacity for raising funds from its primary sources, mitigating funding risk. Refinancing risks are carefully managed and are subject to controls overseen by ALCO. The Group's funding plan includes an embedded TFS repayment profile designed to manage refinancing risk.

The Group operates a Funds Transfer Pricing (FTP) system. A key purpose of FTP is to ensure that liquidity risk is a factor in the pricing of loans and deposits. An early warning framework is also operated to ensure quick escalation of any issues.

A Liquidity Contingency Plan has been established for management of an escalated liquidity requirement if the Group experiences either restricted access to wholesale funding or a significant increase in the withdrawal of funds. The plan identifies triggers for escalation, details the action required, allocates the key tasks to individuals, provides a timeframe and defines a management committee to manage the action plan.

# Risk report (continued)

*FINANCIAL RISKS (continued)*

### External credit ratings

The Group's long-term credit ratings are summarised below:

| | Outlook as at | As at | |
|---|---|---|---|
| | 30 Sep 2019[1] | 30 Sep 2019 | 30 Sep 2018 |
| **Virgin Money UK PLC** | | | |
| Moody's | Positive | Baa3 | Not rated |
| Fitch | Rating Watch Negative | BBB+ | BBB+ |
| Standard & Poor's | Stable | BBB- | BBB- |
| **Clydesdale Bank PLC** | | | |
| Moody's[2] | Positive | Baa1 | Baa1 |
| Fitch | Rating Watch Negative | A- | BBB+ |
| Standard & Poor's | Stable | BBB+ | BBB+ |
| **Virgin Money Holdings (UK) plc** | | | |
| Moody's | Stable | Baa3 | Baa3 |
| Fitch | Rating Watch Negative | BBB+ | BBB+ |
| **Virgin Money plc** | | | |
| Moody's | Positive | Baa1 | Baa2 |
| Fitch | Rating Watch Negative | A- | BBB+ |

(1) For detailed background on the latest credit opinions, please refer to the respective rating agency websites.
(2) Long-term deposit rating.

On 1 March 2019, due to a reassessment of the probability of a no-deal/disruptive Brexit scenario, Fitch placed all of the Group's long-term Issuer Default Ratings (IDR) on Rating Watch Negative (along with 19 UK banks in total). None of the Group's other ratings or its "anchor" Viability Rating have been impacted.

On 3 June 2019, Fitch upgraded the long-term ratings of Clydesdale Bank PLC and Virgin Money plc to A-. The upgrades followed an increase in the junior debt buffer at Clydesdale Bank PLC.

On 21 October 2019, Fitch and Moody's withdrew the long- and short-term ratings of Virgin Money Holdings (UK) plc and Virgin Money UK plc following the completion of the Financial Services and Markets Act 2000 (FSMA) Part VII transfer. None of the Group's other ratings were impacted by the FSMA Part VII transfer.

As at 27 November 2019, there have been no other changes to the Group's long-term credit ratings or outlooks since the report date, with the exception of the outlook on the Virgin Money UK PLC and Clydesdale Bank PLC Moody's ratings, which were moved from 'positive' to 'stable' on 12 November 2019. This followed a revision in Moody's outlook for the UK sovereign from 'stable' to 'negative'. This was as a result of Moody's view that UK institutions have weakened and the UK's economic and fiscal strength are likely to be weaker going forward. Subsequently, Moody's adjusted the ratings Outlook for 15 UK banks, including the Group.

# Risk report (continued)

*FINANCIAL RISK (continued)*

### Assets and liabilities by maturity

The following tables represent a breakdown of the Clydesdale Bank PLC balance sheet, according to the contractual maturity of the assets and liabilities. Many of the longer-term monetary assets are variable rate products, with behavioural maturities shorter than the contractual terms. Accordingly, this information is not relied upon by Clydesdale Bank PLC in its management of interest rate risk.

The Group has disclosed certain term facilities within loans and advances to customers with a revolving element at the maturity of the facility as this best reflects their contractual maturity.

**Group**

**2019 (audited)**

| | Call | 3 months or less | 3 to 12 months | 1 to 5 years | Over 5 years | No specified maturity | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| **Assets** | | | | | | | |
| *Financial assets at amortised cost* | | | | | | | |
| Loans and advances to customers | 1,097 | 1,804 | 1,738 | 9,775 | 54,462 | 4,217 | 73,093 |
| Cash and balances with central banks | 8,722 | - | - | - | - | 1,574 | 10,296 |
| Due from other banks | 225 | 793 | - | - | - | - | 1,018 |
| *Financial assets at fair value through profit or loss* | | | | | | | |
| Loans and advances to customers | - | 6 | 26 | 96 | 125 | - | 253 |
| Derivative financial instruments | - | 8 | 34 | 226 | 98 | - | 366 |
| Other financial assets at fair value | - | - | - | - | - | 8 | 8 |
| Due from related entities | 11 | 7 | - | - | - | - | 18 |
| Financial assets at FVOCI | - | 125 | 784 | 1,735 | 1,684 | - | 4,328 |
| All other assets | - | 66 | 173 | - | - | 1,482 | 1,721 |
| **Total assets** | 10,055 | 2,809 | 2,755 | 11,832 | 56,369 | 7,281 | 91,101 |
| **Liabilities** | | | | | | | |
| *Financial liabilities at amortised cost* | | | | | | | |
| Customer deposits | 40,512 | 5,558 | 10,168 | 7,762 | - | - | 64,000 |
| Debt securities in issue | - | 574 | 1,241 | 4,148 | 1,303 | - | 7,267 |
| Due to other banks | 45 | 1,361 | 181 | 7,329 | - | - | 8,916 |
| *Financial liabilities at fair value through profit or loss* | | | | | | | |
| Customer deposits | - | 2 | 2 | - | - | - | 4 |
| Derivative financial instruments | - | 7 | 14 | 64 | 188 | - | 273 |
| Due to related entities | 4 | - | 19 | 1,020 | 1,272 | - | 2,315 |
| All other liabilities | 2,277 | 78 | 93 | - | - | 737 | 3,185 |
| **Total liabilities** | 42,838 | 7,580 | 11,718 | 20,323 | 2,763 | 737 | 85,960 |
| **Off balance sheet items** | | | | | | | |
| Contingent liabilities | - | 23 | 24 | 18 | 48 | - | 113 |
| Other credit commitments | 15,158 | - | - | - | - | - | 15,158 |
| **Total off balance sheet items** | 15,158 | 23 | 24 | 18 | 48 | - | 15,271 |

# Risk report (continued)

*FINANCIAL RISK (continued)*

**Assets and liabilities by maturity (continued)**

Group

2018 (audited)

| | Call | 3 months or less | 3 to 12 months | 1 to 5 years | Over 5 years | No specified maturity | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| Assets | | | | | | | |
| *Financial assets at amortised cost* | | | | | | | |
| Loans and advances to customers | 1,093 | 1,200 | 983 | 4,623 | 24,468 | 381 | 32,748 |
| Cash and balances with central banks | 4,917 | - | - | - | - | 1,656 | 6,573 |
| Due from other banks | 164 | 529 | - | - | - | - | 693 |
| *Financial assets at fair value through profit or loss* | | | | | | | |
| Loans and advances to customers | - | 8 | 36 | 144 | 174 | - | 362 |
| Derivative financial instruments | - | 13 | 26 | 164 | 59 | - | 262 |
| Due from related entities | - | 35 | - | - | - | - | 35 |
| Financial assets available for sale | - | 5 | 79 | 658 | 810 | 10 | 1,562 |
| All other assets | 143 | 128 | 62 | - | - | 1,015 | 1,348 |
| Total assets | 6,317 | 1,918 | 1,186 | 5,589 | 25,511 | 3,062 | 43,583 |
| | | | | | | | |
| Liabilities | | | | | | | |
| *Financial liabilities at amortised cost* | | | | | | | |
| Customer deposits | 23,142 | 981 | 1,787 | 2,994 | - | - | 28,904 |
| Debt securities in issue | - | 359 | 625 | 1,989 | 725 | - | 3,698 |
| Due to other banks | 19 | 502 | 300 | 2,250 | - | - | 3,071 |
| Financial liabilities at fair value through profit or loss | | | | | | | |
| Customer deposits | - | 2 | 6 | 7 | - | - | 15 |
| Derivative financial instruments | - | 10 | 19 | 133 | 199 | - | 361 |
| Due to related entities | 36 | 1 | 6 | 474 | 796 | - | 1,313 |
| All other liabilities | 2,288 | 94 | 110 | - | - | 438 | 2,892 |
| Total liabilities | 25,485 | 1,949 | 2,853 | 7,847 | 1,720 | 438 | 40,292 |
| | | | | | | | |
| Off balance sheet items | | | | | | | |
| Contingent liabilities | - | 26 | 36 | 12 | 45 | - | 119 |
| Other credit commitments | 7,016 | - | - | - | - | - | 7,016 |
| Total off balance sheet items | 7,016 | 26 | 36 | 12 | 45 | - | 7,135 |

# Risk report (continued)

*FINANCIAL RISK (continued)*

### Assets and liabilities by maturity (continued)

Bank
2019 (audited)

| | Call £m | 3 months or less £m | 3 to 12 months £m | 1 to 5 years £m | Over 5 years £m | No specified maturity £m | Total £m |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| *Financial assets at amortised cost* | | | | | | | |
| Loans and advances to customers | 1,097 | 1,468 | 873 | 4,987 | 23,598 | 366 | 32,389 |
| Cash and balances with central banks | 5,050 | - | - | - | - | 1,571 | 6,621 |
| Due from other banks | 225 | - | - | - | - | - | 225 |
| *Financial assets at fair value through profit or loss* | | | | | | | |
| Loans and advances to customers | - | 6 | 26 | 96 | 125 | - | 253 |
| Derivative financial instruments | - | 8 | 17 | 269 | 148 | - | 442 |
| Other financial assets at fair value | - | - | - | - | - | 1 | 1 |
| Due from related entities | 2,340 | 21 | 9 | - | - | 106 | 2,476 |
| Financial assets at FVOCI | - | - | 537 | 826 | 987 | - | 2,350 |
| All other assets | - | 47 | 151 | - | - | 3,005 | 3,203 |
| **Total assets** | 8,712 | 1,550 | 1,613 | 6,178 | 24,858 | 5,049 | 47,960 |
| **Liabilities** | | | | | | | |
| *Financial liabilities at amortised cost* | | | | | | | |
| Customer deposits | 22,058 | 2,032 | 3,925 | 1,756 | - | - | 29,771 |
| Debt securities in issue | - | - | 10 | - | 699 | - | 709 |
| Due to other banks | 43 | 1,363 | 204 | 2,250 | - | - | 3,860 |
| *Financial liabilities at fair value through profit or loss* | | | | | | | |
| Customer deposits | - | 2 | 2 | - | - | - | 4 |
| Derivative financial instruments | - | 8 | 16 | 86 | 182 | - | 292 |
| Due to related entities | 546 | 293 | 499 | 2,814 | 1,179 | 5 | 5,336 |
| All other liabilities | 2,277 | 46 | 85 | - | - | 624 | 3,032 |
| **Total liabilities** | 24,924 | 3,744 | 4,741 | 6,906 | 2,060 | 629 | 43,004 |
| **Off balance sheet items** | | | | | | | |
| Contingent liabilities | - | 23 | 24 | 18 | 48 | - | 113 |
| Other credit commitments | 6,677 | - | - | - | - | - | 6,677 |
| **Total off balance sheet items** | 6,677 | 23 | 24 | 18 | 48 | - | 6,790 |

# Risk report (continued)

*FINANCIAL RISK (continued)*

### Assets and liabilities by maturity (continued)

Bank
2018 (audited)

| | Call | 3 months or less | 3 to 12 months | 1 to 5 years | Over 5 years | No specified maturity | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| Assets | | | | | | | |
| *Financial assets at amortised cost* | | | | | | | |
| Loans and advances to customers | 1,093 | 1,193 | 977 | 4,564 | 23,427 | 381 | 31,635 |
| Cash and balances with central banks | 4,917 | - | - | - | - | 1,656 | 6,573 |
| Due from other banks | 164 | 69 | - | - | - | - | 233 |
| *Financial assets at fair value through profit or loss* | | | | | | | |
| Loans and advances to customers | - | 8 | 36 | 144 | 174 | - | 362 |
| Derivative financial instruments | - | 12 | 26 | 94 | 19 | - | 151 |
| Due from related entities | 1,093 | 17 | 45 | - | - | 83 | 1,238 |
| Financial assets available for sale | - | 5 | 79 | 658 | 810 | 4 | 1,556 |
| All other assets | 143 | 132 | 62 | - | - | 1,021 | 1,358 |
| Total assets | 7,410 | 1,436 | 1,225 | 5,460 | 24,430 | 3,145 | 43,106 |
| | | | | | | | |
| Liabilities | | | | | | | |
| *Financial liabilities at amortised cost* | | | | | | | |
| Customer deposits | 23,142 | 981 | 1,787 | 2,994 | - | - | 28,904 |
| Debt securities in issue | - | - | 10 | - | 698 | - | 708 |
| Due to other banks | 19 | 502 | 300 | 2,250 | - | - | 3,071 |
| *Financial liabilities at fair value through profit or loss* | | | | | | | |
| Customer deposits | - | 2 | 6 | 7 | - | - | 15 |
| Derivative financial instruments | - | 10 | 19 | 133 | 199 | - | 361 |
| Due to related entities | 220 | 150 | 387 | 2,475 | 648 | 5 | 3,885 |
| All other liabilities | 2,288 | 93 | 107 | - | - | 439 | 2,927 |
| Total liabilities | 25,669 | 1,738 | 2,616 | 7,859 | 1,545 | 444 | 39,871 |
| | | | | | | | |
| Off balance sheet items | | | | | | | |
| Contingent liabilities | - | 26 | 36 | 12 | 45 | - | 119 |
| Other credit commitments | 6,887 | - | - | - | - | - | 6,887 |
| Total off balance sheet items | 6,887 | 26 | 36 | 12 | 45 | - | 7,006 |

# Risk report (continued)

*FINANCIAL RISK (continued)*

### Cash flows payable under financial liabilities by contractual maturity

Group
2019 (audited)

| | Call | 3 months or less | 3 to 12 months | 1 to 5 years | Over 5 years | No specified maturity | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| **Liabilities** | | | | | | | |
| *Financial liabilities at amortised cost* | | | | | | | |
| Customer deposits | 40,512 | 5,590 | 10,321 | 8,014 | - | - | 64,437 |
| Debt securities in issue | - | 589 | 1,316 | 4,369 | 1,297 | - | 7,571 |
| Due to other banks | 45 | 1,375 | 240 | 7,380 | - | - | 9,040 |
| *Financial liabilities at fair value through profit or loss* | | | | | | | |
| Customer deposits | - | 2 | 2 | - | - | - | 4 |
| Trading derivative liabilities | - | 15 | 14 | 36 | 28 | - | 93 |
| Hedging derivative liabilities | | | | | | | |
| *Contractual amounts payable* | - | 7 | 36 | 197 | 619 | - | 859 |
| *Contractual amounts receivable* | - | - | (1) | (81) | (532) | - | (614) |
| Due to related entities | 4 | - | 87 | 1,338 | 1,315 | - | 2,744 |
| All other financial liabilities | 2,277 | 78 | 93 | - | - | 737 | 3,185 |
| **Total liabilities** | 42,838 | 7,656 | 12,108 | 21,253 | 2,727 | 737 | 87,319 |

Group
2018 (audited)

| | Call | 3 months or less | 3 to 12 months | 1 to 5 years | Over 5 years | No specified maturity | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| Liabilities | | | | | | | |
| *Financial liabilities at amortised cost* | | | | | | | |
| Customer deposits | 23,143 | 981 | 1,788 | 2,995 | - | - | 28,907 |
| Debt securities in issue | - | 359 | 647 | 2,119 | 822 | - | 3,947 |
| Due to other banks | 19 | 502 | 314 | 2,282 | - | - | 3,117 |
| *Financial liabilities at fair value through profit or loss* | | | | | | | |
| Customer deposits | - | 3 | 6 | 8 | - | - | 17 |
| Trading derivative financial instruments | - | 13 | 31 | 40 | 17 | - | 101 |
| Hedging derivative liabilities | | | | | | | |
| *Contractual amounts payable* | - | 8 | 42 | 253 | 235 | - | 538 |
| Due to related entities | 36 | 6 | 49 | 627 | 843 | - | 1,563 |
| All other liabilities | 2,288 | 94 | 110 | - | - | 438 | 2,930 |
| Total liabilities | 25,486 | 1,966 | 2,987 | 8,324 | 1,919 | 438 | 41,120 |

# Risk report (continued)

*FINANCIAL RISK (continued)*

### Cash flows payable under financial liabilities by contractual maturity (continued)

**Bank**
**2019 (audited)**

| | Call £m | 3 months or less £m | 3 to 12 months £m | 1 to 5 years £m | Over 5 years £m | No specified maturity £m | Total £m |
|---|---|---|---|---|---|---|---|
| **Liabilities** | | | | | | | |
| *Financial liabilities at amortised cost* | | | | | | | |
| Customer deposits | 22,058 | 2,035 | 3,964 | 1,815 | - | - | 29,872 |
| Debt securities in issue | - | 2 | 37 | 752 | 1,297 | - | 2,088 |
| Due to other banks | 43 | 1,365 | 216 | 2,260 | - | - | 3,884 |
| *Financial liabilities at fair value through profit or loss* | | | | | | | |
| Customer deposits | - | 2 | 2 | - | - | - | 4 |
| Trading derivative liabilities | - | 11 | 21 | 36 | 28 | - | 96 |
| Hedging derivative liabilities | | | | | | | |
| *Contractual amounts payable* | - | 8 | 38 | 186 | 69 | - | 301 |
| *Contractual amounts receivable* | - | - | (1) | (81) | - | - | (82) |
| Due to related entities | 546 | 148 | 754 | 3,675 | 1,315 | 5 | 6,443 |
| All other financial liabilities | 2,277 | 46 | 85 | - | - | 624 | 3,032 |
| **Total liabilities** | 24,924 | 3,617 | 5,116 | 8,643 | 2,709 | 629 | 45,638 |

Bank
2018 (audited)

| | Call £m | 3 months or less £m | 3 to 12 months £m | 1 to 5 years £m | Over 5 years £m | No specified maturity £m | Total £m |
|---|---|---|---|---|---|---|---|
| Liabilities | | | | | | | |
| *Financial liabilities at amortised cost* | | | | | | | |
| Customer deposits | 23,143 | 981 | 1,788 | 2,995 | - | - | 28,907 |
| Debt securities in issue | - | - | 32 | 130 | 795 | - | 957 |
| Due to other banks | 19 | 502 | 314 | 2,282 | - | - | 3,117 |
| *Financial liabilities at fair value through profit or loss* | | | | | | | |
| Customer deposits | - | 3 | 6 | 8 | - | - | 17 |
| Trading derivative financial instruments | - | 13 | 31 | 40 | 17 | - | 101 |
| Hedging derivative liabilities | | | | | | | |
| *Contractual amounts payable* | - | 8 | 42 | 253 | 235 | - | 538 |
| Due to related entities | 220 | 375 | 688 | 2,695 | 845 | 5 | 4,828 |
| All other liabilities | 2,292 | 89 | 107 | - | - | 439 | 2,927 |
| Total liabilities | 25,674 | 1,971 | 3,008 | 8,403 | 1,892 | 444 | 41,392 |

The balances in the cash flow tables above will not agree directly to the balances in the consolidated balance sheet as the table incorporates all cash flows, on an undiscounted basis, related to both principal as well as those associated with all future coupon payments.

# Risk report (continued)

## *FINANCIAL RISK (continued)*

### Market risk

Market risk is the risk associated with adverse changes in the fair economic value, or accrual net interest income and expense, of assets and liabilities held by the Group as a result of movements in market factors such as exchange rates, interest rates (duration risk), customer behaviour (optionality risk) and the movement in rate spreads across types of assets or liabilities (basis risk and credit spread risk). The Group's balance sheet is predominantly UK based and is denominated in GBP, therefore foreign exchange risk is not a major part of the Group's risk profile.

### Exposure

The Group's principal exposure comes from structural interest rate risk. It comprises the sensitivity of the Group's current and future net interest income and economic value to movements in market interest rates. The major contributors to interest rate risk are:

- the investment of non-interest bearing deposits and equity into interest-bearing assets;
- the mismatch, or duration, between repricing dates of interest-bearing assets and liabilities;
- basis risk, for example, the inability of the pricing 'basis' for customer asset and liability products to be replicated in the financial markets or the risk arising from changing relationships between different interest rate yield curves; and
- customer optionality, e.g. the right to repay borrowing in advance of contract maturity dates.

The focus of the Group's activity is to provide high quality banking services to its customers. These services include the provision of foreign exchange products and derivative products to enable customers to manage risks within their businesses. As a result of these activities, the Group may be exposed to forms of market risk that would arise from movements in price on these products, however these risks are not a major part of the Groups' risk profile. Controls include the hedging of these products as and when they arise.

### Measurement

Interest rate risk in the banking book (IRRBB) is measured, monitored, and managed from both an internal management and regulatory perspective. The RMF incorporates both market valuation and earnings-based approaches. In accordance with the Group IRRBB policy standard, risk measurement techniques include: basis point sensitivity; Value at Risk (VaR), earnings at risk (EaR), interest rate risk stress testing, repricing analysis, cash flow analysis.

The key features of the internal interest rate risk management model are:

- the use of basis point sensitivity analysis;
- historical simulation approach utilising instantaneous interest rate shocks including parallel rate movements and twists in the yield curve to explore risks around exposures to movements in short or long term interest rates;
- static balance sheet (i.e. any new business is assumed to be matched, hedged or subject to immediate repricing);
- VaR and EaR are measured on a statistical basis: 99% confidence level with appropriate holding periods depending on varying risk types;
- investment term for capital is modelled with a benchmark term agreed by the ALCO;
- investment term for core non-interest bearing assets and liabilities is modelled on a behavioural basis with a benchmark term agreed by the ALCO; and
- assumptions covering the behavioural life of products and customer behaviour for optionality are reviewed and approved by ALCO.

  Credit spread risk in the banking book (CSRBB) is assessed through a credit VaR applied on our Liquid Asset Buffer portfolio.

Foreign exchange risk is assessed based on the absolute exposure to each currency.

# Risk report (continued)

*FINANCIAL RISK (continued)*

### Mitigation measures

Market risks are overseen by the ALCO with delegation for day-to-day management given to Treasury. Treasury use a number of techniques and products to manage market risks including interest rate swaps, cash flow netting and foreign exchange. Basis risk is managed through a combination of wholesale market basis risk management products, pricing strategies and product innovation.

Fair value hedges - the Group hedges part of its existing interest rate risk, resulting from potential movements in the fair value of fixed rate assets and liabilities, using interest rate swaps. The fair value of these swaps is disclosed in note 3.4. There were no transactions for which fair value hedge accounting had to be discontinued in the year.

Cash flow hedges - the Group hedges a portion of the variability in future cash flows attributable to interest rate and foreign currency risk. The interest and foreign currency risk arise from variable interest rate assets and liabilities which are hedged using cross currency and interest rate swaps, and material non-GBP denominated transactions which are hedged using FX forward contracts. There were no transactions for which cash flow hedge accounting had to be discontinued in the period as a result of the highly probable cash flows no longer being expected to occur. The fair value of derivatives is disclosed in note 3.6.

### Monitoring

Model parameters and assumptions are reviewed and updated on at least an annual basis. Material changes require the approval of ALCO. Oversight of market risk is conducted by the Group's Financial Risk team which is independent of the Treasury function. The Board and Executive Risk Committee, through ALCO's oversight, monitors risk to ensure it remains within approved policy limits and Board requirements.

| *Market risk (audited)* | Group | | | |
|---|---|---|---|---|
| | Value at risk[1] | | EaR | |
| | **2019** | 2018[2] | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| **12 months to 30 September** | | | | |
| As at 30 September | **33** | 16 | **6** | 4 |
| Average value during the year | **35** | 11 | **6** | 4 |
| Minimum value during the year | **25** | 9 | **2** | 3 |
| Maximum value during the year | **42** | 16 | **9** | 5 |

| *Market risk (audited)* | Bank | | | |
|---|---|---|---|---|
| | Value at risk[1] | | EaR | |
| | **2019** | 2018[2] | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| **12 months to 30 September** | | | | |
| As at 30 September | **19** | 16 | **6** | 4 |
| Average value during the year | **21** | 11 | **5** | 4 |
| Minimum value during the year | **14** | 9 | **1** | 3 |
| Maximum value during the year | **30** | 16 | **10** | 5 |

(1) VaR is a combination of interest rate and credit spread VaR.

(2) Seven months to September. VaR calculation parameters were changed effective from 31 March 2018 onwards. The changes improved the modelling and measurement and did not represent a change in the Group's risk appetite for interest rate risk.

# Risk report (continued)

## *FINANCIAL RISK (continued)*

### Market risk (continued)

*Market risk linkage to the balance sheet (audited)*

The following table shows the Group's principal market risks, linked to the balance sheet assets and liabilities:

| | 2019 £m | 2018 £m | Interest rate Duration risk | Optionality risk | Basis risk | Credit Spread risk | Foreign Exchange risk |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| *Financial assets at amortised cost* | | | | | | | |
| Loans and advances to customers | **73,093** | 32,748 | ● | ● | ● | | ● |
| Cash and balances with central banks | **10,296** | 6,573 | ● | | ● | | |
| Due from other banks | **1,018** | 693 | ● | | ● | | ● |
| *Financial assets at fair value through profit or loss* | | | | | | | |
| Loans and advances to customers | **253** | 362 | ● | ● | ● | | ● |
| Derivative financial instruments | **366** | 262 | ● | | ● | | ● |
| Other financial assets | **8** | - | ● | | | | ● |
| Financial instruments at FVOCI | **4,328** | - | ● | | ● | ● | ● |
| Financial assets available for sale | **-** | 1,562 | ● | | ● | ● | ● |
| Other assets | **1,739** | 1,385 | ● | | | | ● |
| **Total assets** | **91,101** | 43,583 | | | | | |
| | | | | | | | |
| **Liabilities** | | | | | | | |
| *Financial liabilities at amortised cost* | | | | | | | |
| Customer deposits | **64,000** | 28,904 | ● | ● | ● | | ● |
| Debt securities in issue | **7,267** | 3,698 | ● | | ● | | ● |
| Due to other banks | **8,916** | 3,071 | ● | | ● | | ● |
| *Financial liabilities at fair value through profit or loss* | | | | | | | |
| Customer deposits | **4** | 15 | ● | ● | ● | | ● |
| Derivative financial instruments | **273** | 361 | ● | | ● | | ● |
| Other liabilities | **5,500** | 4,243 | ● | | | | ● |
| **Total liabilities** | **85,960** | 40,292 | | | | | |

(1) The comparative year has been restated in line with the current year presentation. Derivative collateral in relation to clearing houses has been reclassified between other assets/liabilities and due from / to other banks.

# Risk report (continued)

## *FINANCIAL RISK (continued)*

### Market risk (continued)

*Repricing periods of assets and liabilities by asset/liability category*

The following table shows the repricing periods of the Group's assets and liabilities as assessed by the Group. This repricing takes account of behavioural assumptions where material and the Group's policy to hedge capital in accordance with a benchmark term agreed by ALCO in order to reduce variability in net interest income.

| Group | Overnight | 3 months or less | 3 to 12 months | 1 to 5 years | Over 5 years | Non-interest bearing | Total |
|---|---|---|---|---|---|---|---|
| **2019** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** |
| **Assets** | | | | | | | |
| *Financial assets at amortised cost* | | | | | | | |
| Loans and advances to customers | 7,473 | 10,245 | 13,884 | 40,122 | 1,241 | 128 | 73,093 |
| Cash and balances with central banks | 8,254 | 1,968 | 12 | 62 | - | - | 10,296 |
| Due from other banks | 333 | 685 | - | - | - | - | 1,018 |
| *Financial assets at fair value through profit or loss* | | | | | | | |
| Loans and advances to customers | - | 21 | 87 | 145 | | | 253 |
| Derivative financial instruments | - | 366 | - | - | - | - | 366 |
| Due from related entities | 18 | - | - | - | - | - | 18 |
| Financial instruments at FVOCI | 684 | 1,099 | 410 | 836 | 1,299 | - | 4,328 |
| Other assets | - | 107 | 80 | 426 | - | 1,116 | 1,729 |
| **Total assets** | **16,762** | **14,491** | **14,473** | **41,591** | **2,540** | **1,244** | **91,101** |
| **Liabilities** | | | | | | | |
| *Financial liabilities at amortised cost* | | | | | | | |
| Customer deposits | 10,353 | 17,371 | 12,873 | 23,401 | 2 | - | 64,000 |
| Debt securities in issue | 300 | 5,600 | 300 | 203 | 864 | - | 7,267 |
| Due to other banks | 2,844 | 5,922 | 150 | - | - | - | 8,916 |
| *Financial liabilities at fair value through profit or loss* | | | | | | | |
| Customer deposits | 4 | | | | | | 4 |
| Derivative financial instruments | - | 273 | - | - | - | - | 273 |
| Due to related entities | - | 40 | - | 1,025 | 1,250 | - | 2,315 |
| Other liabilities | 1,167 | 48 | 143 | 760 | - | 1,067 | 3,185 |
| Equity | 350 | 240 | 719 | 3,832 | - | - | 5,141 |
| **Total liabilities and equity** | **15,018** | **29,494** | **14,185** | **29,221** | **2,116** | **1,067** | **91,101** |
| **Off balance sheet items** | | | | | | | |
| Notional value of derivatives managing interest rate | (2,253) | 16,185 | (800) | (13,149) | 17 | - | - |
| Total interest rate gap | (509) | 1,182 | (512) | (779) | 441 | 177 | - |
| **Cumulative interest rate gap** | **(509)** | **673** | **161** | **(618)** | **(177)** | **-** | **-** |

# Risk report (continued)

*FINANCIAL RISK (continued)*

### Market risk (continued)

| Group<br>2018 | Overnight<br>£m | 3 months or less<br>£m | 3 to 12 months<br>£m | 1 to 5 years<br>£m | Over 5 years<br>£m | Non-interest bearing<br>£m | Total<br>£m |
|---|---|---|---|---|---|---|---|
| Assets | | | | | | | |
| *Financial assets at amortised cost* | | | | | | | |
| Loans and advances to customers | 8,393 | 4,778 | 6,299 | 12,997 | 433 | (152) | 32,748 |
| Cash and balances with central banks | 6,374 | 10 | 30 | 159 | - | - | 6,573 |
| Due from other banks | 692 | 1 | - | - | - | - | 693 |
| *Financial assets at fair value through profit or loss* | | | | | | | |
| Loans and advances to customers | 362 | - | - | - | - | - | 362 |
| Derivative financial instruments | 262 | - | - | - | - | - | 262 |
| Due from related entities | 35 | - | - | - | - | - | 35 |
| Financial assets available for sale | 189 | 393 | - | 300 | 680 | - | 1,562 |
| Other assets | - | - | - | - | - | 1,348 | 1,348 |
| Total assets | 16,307 | 5,182 | 6,329 | 13,456 | 1,113 | 1,196 | 43,583 |
| Liabilities | | | | | | | |
| *Financial liabilities at amortised cost* | | | | | | | |
| Customer deposits | 11,495 | 1,281 | 3,465 | 12,662 | 1 | - | 28,904 |
| Debt securities in issue | - | 3,698 | - | - | - | - | 3,698 |
| Due to other banks | 3,070 | - | 1 | - | - | - | 3,071 |
| *Financial liabilities at fair value through profit or loss* | | | | | | | |
| Derivative financial instruments | 361 | - | - | - | - | - | 361 |
| Other financial liabilities at fair value | 15 | - | - | - | - | - | 15 |
| Due to related entities | 38 | - | - | 475 | 800 | - | 1,313 |
| Other liabilities | 677 | 47 | 142 | 760 | - | 1,304 | 2,930 |
| Equity | 191 | 155 | 466 | 2,479 | - | - | 3,291 |
| Total liabilities and equity | 15,847 | 5,181 | 4,074 | 16,376 | 801 | 1,304 | 43,583 |
| Off balance sheet items | | | | | | | |
| Notional value of derivatives managing interest rate | 206 | (2,203) | (596) | 2,572 | 21 | - | - |
| Total interest rate gap | 543 | (2,202) | 1,659 | (348) | 333 | 15 | - |
| Cumulative interest rate gap | 543 | (1,659) | - | (348) | (15) | - | - |

# Risk report (continued)

*FINANCIAL RISK (continued)*

## Market risk (continued)

| Bank | Overnight | 3 months or less | 3 to 12 months | 1 to 5 years | Over 5 years | Non-interest bearing | Total |
|---|---|---|---|---|---|---|---|
| 2019 | £m | £m | £m | £m | £m | £m | £m |
| **Assets** | | | | | | | |
| *Financial assets at amortised cost* | | | | | | | |
| Loans and advances to customers | 5,870 | 7,368 | 5,507 | 13,355 | 161 | 128 | 32,389 |
| Cash and balances with central banks | 4,579 | 1,968 | 12 | 62 | - | - | 6,621 |
| Due from other banks | - | 225 | - | - | - | - | 225 |
| *Financial assets at fair value through profit or loss* | | | | | | | |
| Loans and advances to customers | - | 21 | 87 | 145 | - | - | 253 |
| Derivative financial instruments | - | 442 | - | - | - | - | 442 |
| Due from related entities | 500 | 1,606 | 370 | - | - | - | 2,476 |
| Financial assets instruments at FVOCI | 557 | 298 | 410 | 345 | 740 | - | 2,350 |
| Other assets | | 107 | 80 | 426 | - | 815 | 1,428 |
| Investment in related entities | 1,776 | - | - | - | - | - | 1,776 |
| **Total assets** | 13,282 | 12,035 | 6,466 | 14,333 | 901 | 943 | 47,960 |
| **Liabilities** | | | | | | | |
| *Financial liabilities at amortised cost* | | | | | | | |
| Customer deposits | 10,355 | 2,887 | 4,970 | 11,557 | 2 | - | 29,771 |
| Debt securities in issue | - | - | - | - | 709 | - | 709 |
| Due to other banks | 3,829 | 31 | - | - | - | - | 3,860 |
| *Financial liabilities at fair value through profit or loss* | | | | | | | |
| Customer deposits | 4 | - | - | - | - | - | 4 |
| Derivative financial instruments | - | 292 | - | - | - | - | 292 |
| Due to related entities | 300 | 2,558 | - | 1,228 | 1,250 | - | 5,336 |
| Other liabilities | 1,014 | 48 | 143 | 760 | - | 1,067 | 3,032 |
| Equity | 1,765 | 160 | 479 | 2,552 | - | - | 4,956 |
| **Total liabilities and equity** | 17,267 | 5,976 | 5,592 | 16,097 | 1,961 | 1,067 | 47,960 |
| **Off balance sheet items** | | | | | | | |
| Notional value of derivatives managing interest rate | (2,254) | 1,296 | (782) | 129 | 1,611 | - | - |
| Total interest rate gap | (6,239) | 7,355 | 92 | (1,635) | 551 | (124) | - |
| **Cumulative interest rate gap** | (6,239) | 1,116 | 1,208 | (427) | 124 | - | - |

# Risk report (continued)

*FINANCIAL RISK (continued)*

### Market risk (continued)

| Bank | Overnight | 3 months or less | 3 to 12 months | 1 to 5 years | Over 5 years | Non-interest bearing | Total |
|---|---|---|---|---|---|---|---|
| 2018 | £m | £m | £m | £m | £m | £m | £m |
| Assets | | | | | | | |
| *Financial assets at amortised cost* | | | | | | | |
| Loans and advances to customers | 7,280 | 4,778 | 6,299 | 12,997 | 433 | (152) | 31,635 |
| Cash and balances with central banks | 6,374 | 10 | 30 | 159 | - | - | 6,573 |
| Due from other banks | 233 | - | - | - | - | - | 233 |
| *Financial assets at fair value through profit or loss* | | | | | | | |
| Derivative financial instruments | 151 | - | - | - | - | - | 151 |
| Other financial assets at fair value | 362 | - | - | - | - | - | 362 |
| Due from related entities | 1,238 | 1 | - | - | - | 3 | 1,242 |
| Financial assets available for sale | 183 | 393 | - | 300 | 680 | - | 1,556 |
| Other assets | - | - | - | - | - | 1,354 | 1,354 |
| Total assets | 15,821 | 5,182 | 6,329 | 13,456 | 1,113 | 1,205 | 43,106 |
| Liabilities | | | | | | | |
| *Financial liabilities at amortised cost* | | | | | | | |
| Customer deposits | 11,495 | 1,281 | 3,465 | 12,662 | 1 | - | 28,904 |
| Debt securities in issue | - | - | - | - | 708 | - | 708 |
| Due to other banks | 3,070 | - | 1 | - | - | - | 3,071 |
| *Financial liabilities at fair value through profit or loss* | | | | | | | |
| Derivative financial instruments | 361 | - | - | - | - | - | 361 |
| Due to related entities | 297 | 3,588 | - | - | - | - | 3,885 |
| Other financial liabilities at FVOCI | 15 | - | - | - | - | - | 15 |
| Other liabilities | 674 | 47 | 143 | 760 | - | 1,303 | 2,927 |
| Equity | 135 | 155 | 466 | 2,479 | - | - | 3,235 |
| Total liabilities and equity | 16,047 | 5,071 | 4,075 | 15,901 | 709 | 1,303 | 43,106 |
| Off balance sheet items | | | | | | | |
| Notional value of derivatives managing interest rate | 206 | (2,203) | (596) | 2,572 | 21 | - | - |
| Total interest rate gap | (36) | (2,092) | 1,659 | 127 | 425 | (83) | - |
| Cumulative interest rate gap | (36) | (2,128) | (469) | (342) | 83 | - | - |

# Risk report (continued)

*FINANCIAL RISK (continued)*

**Model risk**

The Group's definition of a model is a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates.

This extends to calculation methods or systems, calculation mechanisms and frameworks or systems where qualitative judgement is applied to generate quantitative results (e.g. where adjustments are made to address known model limitations).

A model meeting this definition might be used for analysing business strategies, informing business decisions, identifying and measuring risks, valuing exposures, conducting stress testing, assessing adequacy of capital, measuring compliance with internal limits, maintaining the formal control apparatus of the Group, or meeting financial or regulatory reporting requirements and issuing public disclosures.

The use of models invariably presents model risk, which is the potential for adverse consequences from decisions based on incorrect or misused model outputs and reports. Model risk increases with greater model complexity, higher uncertainty about inputs and assumptions, broader use, and larger potential impact. If left unmitigated, model risk can lead to poor decision making, misreporting or a failure to identify risks, which in turn could result in financial and reputational losses, as well as having a detrimental impact on customers.

*Exposures*

To determine the level of model risk exposure, all models are classified according to materiality. Model materiality assessments are required to enable Senior Management to prioritise and understand model risk.

The Group's model materiality criteria utilises a risk-based approach and sets quantitative and qualitative thresholds focusing on coverage and impact, with clear consideration given to the risks associated with the models, i.e. criteria such as purpose or strategic importance. Model risk increases with greater model complexity, volatility, higher uncertainty about inputs and assumptions, broader use, and larger potential impact. As such, a model complexity overlay is applied based on the complexity of the model to give a final model materiality rating. A model's assessed materiality level determines its approval path through governance and the degree, frequency and depth of review and validation expected.

Within the combined Group model inventory, there are 339 live and to be implemented models, covering a range of model risk disciplines. As a result of the wide scope and breadth of coverage, there is exposure to model risk across a number of the Group's principal risk categories.

# Risk report (continued)

## *FINANCIAL RISK (continued)*

### Model risk (continued)

*Measurement*

Model RAS is reported regularly to both the Board and the Model Governance Committee (MGC).

*Mitigation*

The Group has a model risk policy framework in place to manage and mitigate model risk, which encompasses the end to end model lifecycle.

The model risk policy standard defines roles and responsibilities in terms of model risk management. Specifically, it sets out the model owner has the responsibility of attesting to the compliance to the Model Risk Policy Standard requirements on an annual basis or advise exemptions, including that the model is implemented correctly in an appropriate system.

The Independent Validation function conducts model validations prior to model implementation, when a model is changed and on a periodic basis. The function assists with identifying model deficiency and raises mitigating actions and additional risk control.

Furthermore, Internal Audit assesses the overall effectiveness of the model RMF.

*Monitoring*

MGC is the primary model approval authority and body responsible for overseeing model risk of the Group's most material models. The Model Risk Policy dictates that model risk must be reported at least annually to the MGC. This extends to model monitoring and analysis on work to mitigate previously identified deficiencies, including regular updates on action management.

### Pensions risk

The Group operates a defined benefit pension scheme, the Yorkshire and Clydesdale Bank Pension Scheme (the Scheme). Clydesdale Bank PLC (the Bank) is the Scheme's principal employer and there are no other participating employers. The Scheme was closed to future accrual on 1 August 2017 for most members (a small number of members remain on a defined benefit accruals basis subject to certain conditions).

Defined benefit pension schemes provide a promise to pay members a pre-determined level of income at retirement which is independent of the contributions, investments and returns (the Scheme assets) used to fund these benefit promises (the Scheme liabilities). The operation of a pension scheme gives rise to several risks, e.g. movements in equity valuations, changes in bond yields, life expectancy of scheme members, movements in interest and inflation rates and changes in legislation.

Pension risk is the risk that, at any point in time, the value of the scheme assets is not enough to meet the current or expected future value of the scheme liabilities. This risk will continue to exist until the Scheme is formally wound up, either if all the liabilities are transferred to a third party (for example an insurer) or once all individual member benefits have been honoured.

# Risk report (continued)

## *FINANCIAL RISK (continued)*

### Pensions risk (continued)

*Risk appetite*

The Group's pension risk appetite is a component of the Group wide RAS framework for the management of balance sheet risks and is considered in the context of potential capital impacts because of volatility in the Scheme's valuations.

*Assets*

The Trustee governs investments according to a Statement of Investment Principles. This is reviewed and agreed by the Trustee Board on a regular basis, with the Bank consulted on any proposed changes. The Statement of Investment Principles is drafted in accordance with the requirements of Section 35 of the Pensions Act 1995 (as amended by the Pensions Act 2004 and regulations made under it). This sets out the Scheme objectives and the Journey Plan to meet these objectives.

This results in an appropriate mix of return seeking assets as well as liability matching assets to better match future pension obligations. The main market risks within the asset portfolio are interest rates and equities. The split of Scheme assets is shown within Note 3.12 of the Group's consolidated financial statements. The fair value of the assets was £3.96bn as at 30 September 2019 (2018: £2.12bn).

*Liabilities*

The retirement benefit obligations are a series of future cash flows with relatively long duration and are responsive to movements on many of the inputs including interest rates. On an IAS 19 basis these cash flows are primarily sensitive to changes in the expected long-term price inflation rates (Retail Price Index (RPI)/ Consumer Prices Index (CPI)), the life expectancy of members and the discount rate (linked to yields on AA corporate bonds):

- an increase in long-term expected inflation corresponds to an increase in liabilities;
- an increase in life expectancy corresponds to an increase in liabilities; and
- a decrease in the discount rate corresponds to an increase in liabilities.

*Exposure*

The Group's defined benefit pension scheme affects its regulatory capital in two ways:

- CET1 capital – an IAS 19 deficit is treated as a liability on the Group's balance sheet. Movement in a deficit due to remeasurements, including actuarial losses, are recognised immediately through Other Comprehensive Income and as such reduce shareholders' equity and CET1 capital. An IAS 19 surplus is treated as an asset on the balance sheet and increases shareholders' equity; however, it is deducted for the purposes of determining CET1 capital.
- Pillar 2A capital – the Group is also required to determine the level of capital required to be held under Pillar 2A for pension obligation risk as part of the annual ICAAP process. This requirement forms part of the Group's regulatory Total Capital Requirement (TCR).

Within the Scheme itself, risk arises because the assets are exposed to market valuation movements, within and between asset classes, while the liabilities are more sensitive to interest rate and inflation rate changes, and changes in other actuarial assumptions which may not be borne out in experience, for example life expectancy.

*Mitigation*

The Trustee and Group have a common view of the Scheme's long-term strategic aims, encapsulated by an agreed de-risking Journey Plan. Within the Journey Plan, several core principles have been established, including a long-term self-sufficiency funding target (i.e. the point in time when the Scheme would no longer need to call on the Bank for additional funding) with assumptions as to how this target is expected to be managed, monitored and met. Potential actions to address deviations in the actual funding level relative to the Journey Plan have also been considered.

# Risk report (continued)

## *FINANCIAL RISK (continued)*

### Pensions risk (continued)

Several other activities have been implemented by the Group and Trustee since 2003 with the specific aim of reducing risk in the Scheme, including equity options which reduce the downside risk of a fall in equity values, increasing the levels of inflation and interest rate hedging and several member benefit reforms, culminating in closure to future accrual for most members.

In addition, the Group has signed a contingent security arrangement to give the Trustee a degree of protection against the risk of the Group defaulting on its obligations under the Recovery Plan and to provide an additional amount to partially mitigate adverse changes impacting the Scheme's assets or liabilities.

The Bank and the Trustee continue to explore other cost-effective options to further reduce risk within the Scheme.

*Monitoring*

Information on the Scheme's current valuations, asset holdings and discount and inflation rate assumptions are presented monthly to ALCO. The impact of the Scheme on the Group is also subject to risk oversight from Financial Risk who subsequently report to the Executive Risk Committee. In addition, semi-annual Pension Risk updates are provided to the Executive and Board Risk Committees.

Performance of the Scheme's asset portfolio against the various risk metrics is independently monitored by the Scheme investment adviser, Willis Towers Watson, and reported to the Investment Sub Committee (ISC), which includes Bank representation, and Trustee Board on a quarterly basis.

### Financial risks arising from climate change

The Group has established targets relating to CO2 emissions that arise from its own operations. Progress will be monitored through the Group's annual CO2 disclosures. We have also signed up to the United Nations Environment Programme's Principles for Responsible Banking. 2019 has seen an unprecedented focus on climate change with progress at governmental and regulatory levels along with a broad range of publications and, importantly, increasing demands from society for governments, firms and individuals to all play their part in addressing the longer-term risks from climate change.

The financial risks from climate change can be categorised as:

- Physical risks arising from climate and weather-related events, such as heatwaves, droughts, floods, storms and sea level rise. They can potentially result in large financial losses, impairing asset values and the creditworthiness of borrowers; and
- Transition risks that can arise from the process of adjustment towards a low-carbon economy. Changes in policy, technology and sentiment could prompt a reassessment of the value of a large range of assets and create credit exposures for banks and other lenders as costs and opportunities become apparent.

The Group has an established process to apply Environmental, Social and Governance (ESG) criteria to lending decisions. This includes sectors that are not within our risk appetite and those where additional scrutiny is required before a credit decision can be made. The policy framework has also been enhanced to reflect the need for more forward thinking relating to transition risks. The Group recognises the need to enhance capability for assessing and modelling the impact of physical risks over the long-term horizon over which increased risks may arise. The Group's governance framework has been amended to ensure specific reference to climate related risks is provided at the Group's Credit Risk and Executive Risk Committees. The Board will oversee this work.

# Risk report (continued)

## *REGULATORY AND COMPLIANCE RISK*

Regulatory and compliance risk is the risk of failing to understand and comply with relevant laws and regulatory requirements; failing to identify, monitor and respond to changes in the regulatory environment; non-compliance or not keeping regulators informed of relevant issues; not responding effectively to the information requests, regulator review findings or not meeting regulatory deadlines or obstructing the regulator. It is also the risk of failure to comply with the wider set of rules, regulations, codes of practice and laws relevant to the Group.

### Risk appetite

The Group has no appetite for actions which result in breaches of regulation or for inaction to address systemic process and control failures leading to material non-compliance. Notwithstanding the complexity and volume of the regulatory agenda, the Group will ensure that all mandatory requirements are prioritised with sufficient resources to implement within required timescales in a customer focused manner. The Group will have an open dialogue with colleagues and regulators escalating all issues they would reasonably expect to be made aware of.

### Exposures

The Group remains exposed to regulatory and compliance risk as a result of significant ongoing and new regulatory change.

### Measurement

Regulatory and compliance risks are measured against a defined set of Board approved risk appetite metrics relating to regulatory breaches, and past due regulatory implementations and actions. Thresholds are set and form part of the Board approved RAS.

### Mitigation

The following controls and procedures help to mitigate regulatory and compliance risk:

- A clearly defined Regulatory & Compliance Policy Statement (with supporting Policy Standards) and RAS signed off by the Board;
- Ongoing development, maintenance and reporting of risk appetite measures for regulatory & compliance risk to the Executive Risk Committee and the Board;
- Maintenance of proactive and co-ordinated engagement with the Group's key regulators;
- Continual assessment of evolving regulatory requirements, including regulatory business plans and thematic reviews;
- Consideration of regulatory requirements in the context of product and proposition development and associated appropriate governance;
- Oversight of regulatory & compliance risks and issues in relevant governance bodies;
- Ongoing review and tracking of known regulatory & compliance issues and remediation actions being taken; and
- A risk-based assurance framework designed to monitor compliance with regulation and assess customer outcomes.

### Monitoring

Regulatory and compliance risk is considered by all three lines of defence as part of their oversight and assurance activities. A risk assurance plan, approved by the Board's Risk Committee on an annual basis, independently assesses the control framework underpinning compliance with laws and regulations.

# Risk report (continued)

## *CONDUCT RISK*

Conduct risk is the risk of undertaking business in a way which is contrary to the interests of our customers, resulting in the delivery of inappropriate customer outcomes, customer detriment, regulatory censure, redress costs and/or reputational damage.

### Risk appetite

The Group is committed to acting in the interests of its customers, and has no appetite for conduct risk.

### Exposures

With the FCA's deadline on PPI complaints now passed, there is a significant reduction in uncertainty in determining the quantum of conduct risk-related liabilities with note 3.16 reflecting the Group's current position in relation to redress provisions for PPI, interest rate hedging products (IRHPs) tailored business loans (TBLs), and other smaller historic conduct matters. Nonetheless a degree of uncertainty remains in the final amount required to settle the Group's potential liabilities for these matters. The Group will continue to reassess the adequacy of provisions for these matters and the assumptions underlying the calculations at each reporting date based upon experience and other relevant factors at that time.

### Measurement

Conduct risks are measured against a defined set of Board approved risk appetite metrics, including measures of the quality of advised and non-advised sales, the volume of complaints and the quality of complaint handling. Thresholds are set and form part of the Board approved RAS.

### Mitigation

The following controls and procedures help to mitigate conduct risk:

- Clearly defined Conduct Policy Statement (with supporting Policy Standards) and RAS signed off by the Board;
- Ongoing development, maintenance and reporting of risk appetite measures for Conduct to the Executive Risk Committee and the Board;
- Continual assessment of evolving Conduct regulations and customer expectations;
- Consideration of Conduct Risk in the context of product and proposition development and associated appropriate governance;
- Regular management review of end-to-end Conduct reporting, centered on core product areas and aligned to relevant businesses;
- Oversight of Conduct risks and issues in relevant governance bodies;
- Analysis of customer experience oriented data, complaints quality and volumes and root causes of complaints discussed in the relevant governance bodies, with actions agreed and tracked by senior stakeholders;
- Ongoing review and tracking of known Conduct issues and remediation actions being taken; and
- A risk-based assurance framework has been designed to monitor compliance with regulation and assess customer outcomes.

### Monitoring

All three lines of defence consider conduct risk as part of their oversight and assurance activities. A risk assurance plan, approved by the Board's Risk Committee on an annual basis, independently assesses the control framework underpinning the Group's conduct risk management to ensure customers are treated fairly and products are designed and sold to meet their needs. The Group also works to ensure that customer expectations are met and complaints are dealt with effectively and fairly.

# Risk report (continued)

## *OPERATIONAL RISK*

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people strategies and systems or from external events. It is a core component of the RMF and is embedded in day-to-day business activities focused on enabling operational efficiencies. Requirements and responsibilities are set out in the operational risk policy statement and supporting operational risk framework policy standard that seeks to identify, assess, mitigate, monitor, and report the operational risks, events and issues that could impact the achievement of business objectives or impact core business processes.

Business units are responsible for the day-to-day management of operational risk, with oversight from the risk management function, and independent assurance activities undertaken by internal audit.

### Risk Appetite

The Group is prepared to tolerate a level of operational risk exposure within agreed thresholds and limits. A level of resilience risk from internal and external events is tolerated, however, immediate steps are taken to minimise customer disruption through recovery within defined timelines. Operational risks arise from day-to-day business activities, which may result in direct or indirect losses and could adversely impact the Group's financial performance, levels of customer care or reputation. In achieving its strategic objectives, the Group strives to deliver operational efficiency and accepts that a level of loss may arise from operational failure. Implementing key controls and monitoring ensures that operational risks are managed, and losses remain within acceptable limits.

### Exposures

The Group's exposure to operational risk is impacted through the need to engage with innovative, dynamic third parties; deliver new products and services; and make effective use of reliable data in a changing external environment to deliver on the Group's strategic objectives. Operational risk oversight is focused on the following key areas:

| Risk Category | |
|---|---|
| **Change risk**[1] | The risks associated with a failure to execute and deliver change that could result in an inability to meet our strategic objectives, including failing to meet our customer, regulator, colleague or shareholder expectations at a Group level and local management level.<br><br>**How this risk is managed** - the Group maintains a centralised view of change to ensure that the risks of individual changes are managed effectively, and that change is prioritised to minimise the overall risks to the organisation in line with risk appetite. |
| **Third Party risk** | The risks associated with ensuring the Group's outsourced and offshoring arrangements are controlled effectively, including the risk of failure to service existing and new customers, and the potential cessation of specific activities, or the risk of personally identifiable information or Group sensitive data being exposed or exploited, or the risk of financial, reputational and regulatory censure if the third party enters into any illegal or unethical activities.<br><br>**How this risk is managed** - the Group continues to strengthen its third party management framework and oversight, and ensures that the procurement of service providers adheres to these requirements. |

(1) Execution risk, as a result of integration and transformation activity, is captured within strategic and enterprise risk, further information on which can be found on page 76.

# Risk report (continued)

## *OPERATIONAL RISK (continued)*

### Measurement

Material operational risk events are identified, reviewed and escalated in line with criteria set out in the RMF. Root cause analysis is undertaken and action plans are implemented.

Losses may result from both internal and external events, and are categorised using risk categories aligned to Basel II. The Basel II categories are used to ensure that data can be reported externally and compared with other industry data. Due to the nature of risk events, losses can take time to crystallise and therefore may be restated for prior or subsequent financial years.

### Operational risk losses by Basel category

The majority of losses are recorded against two Basel categories, 'External Fraud' and 'Execution, Delivery and Process Management'. External Fraud accounts for the highest volume of losses at 76.1%. The higher volume of low value events in this category is in line with industry experience and relates mainly to card and online fraud. 'Execution, Delivery and Process Management' volumes are typical and reflect the daily volume of transactions and customer interactions.

| | % of total volume | | % of total losses | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| Business disruption and system failures | 0.5% | 1.5% | 2.2% | 0.4% |
| Clients, products and business practices | 2.8% | 15.6% | 6.4% | 52.1% |
| Damage to physical assets | 0.3% | 1.9% | 1.0% | 0.8% |
| Employee practices and workplace safety | 0.0% | 0.8% | 0.0% | 0.2% |
| Execution, delivery and process management | 13.0% | 26.6% | 14.4% | 12.4% |
| External fraud | 83.0% | 52.9% | 76.1% | 34.0% |
| Internal fraud | 0.0% | 0.0% | 0.0% | 0.0% |

### Mitigation

In delivering to its strategic objectives, the Group strives to deliver operational efficiency and accepts that a level of loss may arise from operational failure. Implementing key controls and monitoring ensures that Operational Risks are managed, and losses remain within acceptable limits.

### Monitoring

The Group has identified, assessed and is currently monitoring all key operational risks across the above noted categories, including undertaking an assessment of control effectiveness, monitoring trends in key risk indicators and escalating events, in accordance with policy requirements. Risk management performs oversight of the Group's business planning process, including analysis of industry trends or forward-looking threats that could lead to material impact on our ability to deliver on the strategic objectives or result in a significant impact on assessment of Operational Risk Capital. It also performs ongoing oversight of the Groups' management of operational risk, including Risk & Control Assessment, Issues and Risk Events.

# Risk report (continued)

*OPERATIONAL RISK (continued)*

### Stress testing

The Group develops and maintains a suite of operational risk scenarios using internal and external data. These scenarios provide insights into the stresses the business could be subject to given extreme circumstances. Scenarios cover all material operational risks including execution of change, failures to core processes or contagion risk from a third party. Scenarios are owned by senior management custodians with review and challenge provided by Risk Management, Executive Risk Committee and Board Risk Committee, as part of the ICAAP process. Management actions are agreed and monitored and linked with business resilience and continuity testing where appropriate.

*TECHNOLOGY RISK*

Technology risk is defined as the risk of loss resulting from inadequate or failed information technology processes through strategy, design, build or run components and internally or externally provisioned services. Through organisational design and management focus considerable investment has been made within these areas by the Group.

### Risk appetite

Technology risks are measured against a set of defined risk appetite metrics and reported to Executive and Board Committees.

### Exposures

The Group's exposure to Technology Risk is materially impacted through the need to embrace new technology. Technology risk is comprised of the following risk categories:

| *Risk category* | |
|---|---|
| Cyber and information security risk | The risks arising from inadequate internal and external information and cyber security, where failures impact the confidentiality, integrity and availability of electronic data through our systems and processes. This more broadly considers the risks and controls associated with cyber security where the group has recognised significant escalation of external cyber threats, regulatory penalty and resilience need.<br><br>**How this risk is managed** – The Group continues to enhance and invest in the control environment, recognising the changing cyber landscape and the increased focus on digital capabilities, as well as the changing risk profile of the business. All three lines of defence possess skilled resource in this discipline to protect the Group. |

# Risk report (continued)

*TECHNOLOGY RISK (continued)*

| | |
|---|---|
| Physical security risk | The risk to the safety and protection of colleagues, customers and physical assets arising from unauthorised access to buildings, theft, robbery, intimidation, blackmail, sabotage, terrorism and other physical security risks.<br><br>**How this risk is managed** – Physical and personal security standards are managed by the Group's Chief Information Security and Resilience Officer (CISRO). Controls are in place to protect the Group's physical assets, as well as the security of colleagues and customers. |
| IT resilience risk | IT resilience is the ability of the Group to quickly adapt to disruptions while maintaining continuous operations on key and critical processes, safeguarding technology and all associated assets in the face of adverse events, shocks and chronic or incremental changes. IT resilience risk includes the risks associated with technology, suppliers, property and staff. The Group recognise the significant regulatory focus on resilience as the market becomes more reliant on mobile and online banking and developments in cloud solutions, AI and machine learning.<br><br>**How this risk is managed –** IT resilience sits within the resilience framework with underlying risk metrics reported to Board. The Group is well placed to respond to new regulations and standards in resilience and develops technology with resilience inbuilt as a principle. A programme of continuous ongoing monitoring and disaster recovery testing helps to minimise the likelihood of system failure, however, in preparation for an outage, the Group also maintains and tests critical end-to-end business recovery and contingency plans. |
| Data risk | Data underpins decision making at all levels of the organisation. Poor quality data can lead to loss, customer disruption, non-compliance with GDPR (for example, in relation to data minimisation, data accuracy and the Group's ability to respond adequately when data subject rights are exercised) and unnecessary rework. Data therefore needs to be controlled to the appropriate standards throughout its lifecycle and be made available for re-use where appropriate.<br><br>**How this risk is managed** – The Group has a data management framework governing the creation, storage, distribution, usage and retirement of data, which is aligned with GDPR requirements. Quality is attested to by each division against three attributes: completeness, accuracy and appropriateness. Oversight is well established within Technology, Risk and Audit. |
| Privacy risk | Privacy risk may result from non-compliance with Data Privacy legal and regulatory obligations, either through lack of awareness, incorrect assessment, or inadequate compliance. The risk is crystallised when personal data is put at risk, or individuals' data rights are compromised, due to process or cultural failure in the Group's role as data controller. When crystallised, Privacy Risk can result in harm to customers, significant financial impacts, operational disruption, litigation, damage to reputation, loss of trust and/or regulatory censure.<br><br>**How this risk is managed -** The Group continues to enhance its Privacy Risk Framework to ensure privacy by design and by default and ensure data subject rights are managed efficiently and in line with GDPR. The Group has created a Data Protection Office within Risk to independently oversee compliance reporting to the Board Risk Committee and relevant governance forums. A culture of compliance is encouraged through a robust Data Privacy Policy and enhanced staff training to those areas handling and processing data on the Group's behalf. |

# Risk report (continued)

*TECHNOLOGY RISK (continued)*

| | |
|---|---|
| Payment risk | Significant development has occurred within open banking and payment services regulation which will continue to increase over the next 12-18 months. There is the risk that financial transactions are not conducted per the instructions and parameters of our customers, payment / trading / clearing / settlement schemes or business requirements. This includes payment delays, inaccuracies, duplicates, failures or rejections as well as system-based restrictions and errors.<br><br>**How this risk is managed –** The payment risk framework outlines key scheme rules, regulations and compliance requirements alongside the risk-based approach to assurance oversight, control testing and change management to ensure that payment risk is managed within appetite and impact minimised to customers across the Group. All lines of defence are actively involved in changes being made in this dynamically changing environment. As such the Group continues to invest in its payment services capability and the Payment Risk team is a vital component of technology risk. |

### Measurement

The Group has a number of technology risk KRI's which cover the key risk areas outlined above. In addition, there is a suite of Board approved risk appetite metrics which are monitored and reported each month, with breaches escalated to the Board. All technology risks are assessed using the operational risk framework and are monitored and challenged by the 2nd Line of Defence in line with functional and corporate governance.

### Monitoring

Business units are responsible for the day-to-day management of technology risk, with oversight from the risk management function, and independent assurance activities undertaken by internal audit. The Group conducts a series of planned independent assurances, deep dives, change assurance activities and continuous monitoring.

*FINANCIAL CRIME RISK*

Financial crime risk is the risk that the Group's products and services will be used to facilitate financial crime against the Group, its customers or third parties.

It also includes risks associated with external or internal acts intended to defraud, misappropriate, and circumvent policy, funds, information, regulations and property. The Group adopts a risk-based approach to mitigate and maintains an overarching financial crime policy and four policy standards aligned to each material financial crime risk. These are:

*Sanctions* – The Group has no appetite for non-compliance with the legal and regulatory obligations relating to sanctions and embargoes. To reflect the Group's risk appetite and to protect the Group from financial and reputational damage, including regulatory censure, fines and enforcement action, the Sanctions and Embargoes Policy articulates a set of minimum standards and requirements which must be complied with.

*Anti-money laundering* – The Group applies a risk-based approach customer model which sets out the types of customer it has no risk appetite to onboard, as well as customers with whom the Group is prohibited from entering into or maintaining a customer relationship. All other customers shall be subject to controls commensurate with their risk.

*Anti-bribery and corruption* – The Group does not tolerate the direct or indirect offer, payment, solicitation or acceptance of bribes in any form. The Group has in place risk assessments, policies and guidelines on interacting with customers, suppliers and agents, including specific policies for gifts and hospitality. Senior managers across the business are required to complete an evaluation of risk areas as part of the risk assessment process.

# Risk report (continued)

## *FINANCIAL CRIME RISK (continued)*

*Fraud* – The Group accepts that, in order to conduct business in a commercially viable manner, it is willing to sustain fraud losses within an agreed set of parameters. The application of fraud risk management considers customer impacts, industry trends and financial impacts of fraud which, on occasion, provide conflicting priorities. Emerging risks are identified and assessed with action taken to mitigate them. An agreed loss plan is set and performance against this is overseen by the policy owner and reported through the appropriate governance committees. With regard to internal fraud, the Group recognises the risk of internal fraud but has no appetite for it. There is a control framework in place to mitigate that risk.

### Risk Appetite

Financial Crime risk is measured against a defined suite of metrics within the Group RAS.

### Exposures

Financial crime risk is inherent in doing business in the financial services industry and may arise from failure to:

- meet legal and regulatory requirements; and
- maintain effective systems and controls to prevent the risk that the Group might be used for further financial crime.

The Group continues to review the external environment for any change in regulatory or legislative direction, taking action as appropriate.

### Measurement

All financial crime standards are reflected in the Group policy and standards and financial crime prevention manual, the content of which is provided by financial crime risk and updated as appropriate. Financial crime related risk appetite metrics are monitored and reported to the Board on a monthly basis.

### Mitigation

The Group adopts a risk-based approach to financial crime. Risk assessments against the four financial crime policy standards take place on an annual basis. Over and above these assessments, regular oversight of higher-risk activities takes place as part of the formal oversight plan and embedded activity takes place throughout the year. Key performance metrics relative to critical financial crime systems are kept under review to ensure ongoing effectiveness. Training completion and compliance is subject to annual oversight.

### Monitoring

The financial crime risk team is responsible for the control framework, strategy, governance, standard setting, oversight, training and reporting to the competent authorities and governance committees/Board.

Screening customers for sanctions or politically exposed persons and transaction monitoring is carried out by financial crime risk. Sanctions screening for payments is carried out by the Payments team in the first line. Critical financial crime systems oversight is independently tested by Internal Audit.

### *STRATEGIC AND ENTERPRISE RISK*

Strategic and enterprise risk is the risk of significant loss, loss of earnings or damage arising from decisions or actions that impact the long-term interests of the Group's stakeholders or from an inability to adapt to external developments. Strategic Risk can arise if the Group designs or implements an inappropriate strategic plan, designs an appropriate plan but fails to implement it or implements the strategic plan as intended, failing to take account of a change in external circumstances.

This includes the potential for increased execution risk as a result of integration and transformation activity, alongside the requirement to maintain focus on the core operations of the business. There is the risk that this significant programme of change results in increased costs, delayed benefit realisation and customer harm.

Strategic risk also includes an inability to respond effectively to cultural, structural and regulatory change; failure to establish and execute a compelling digital strategy or increase organisational capability in support of this; being an inefficient, high cost, uninspiring or uncompetitive provider of product and service; or failing to respond to Climate Change risks in our direct and indirect operations.

Enterprise Risk includes managing and implementing effective governance, reporting and maintaining external relations to promote the brand and support the Group's ability to successfully achieve strategic goals.

#### Risk appetite

The risk position for strategic & enterprise risk, referenced in the Group's RAS, takes account of the fact that the Group will need to take an acceptable level of risk to successfully grow the business and will also need to implement transformational changes to the operating model and supporting frameworks to achieve this. There is, however, a requirement to pursue these goals in a controlled and prudent manner given the potential downside in financial, reputational, conduct and broader risk implications.

The risks and constraints to growth opportunities will be fully evaluated via the Strategic and Financial Plan and RAS setting to ensure that there is no detrimental impact to the broader strategy.

#### Exposures

The Group operates in an increasingly competitive environment, with rapidly evolving technology and uncertain political and regulatory agendas. In addition, the Group is competing with peer and challenger banks, including some with innovative business models and low-cost bases, such as fast-growing peer-to-peer lenders and crowd funders.

This uncertainty has been exacerbated by the recent share price volatility and the resultant impact on the brand, potentially triggering increased reputation risk. The creation of divisions is enabling enhanced and dedicated focus on customer segments, however, reflective of the generally negative outlook the RAS settings have either been held at existing levels or tightened to reflect the expectations of a tougher competitive and economic environment.

#### Measurement

The Group's risk appetite represents a 'risk envelope' against which chosen strategies and financial plans are assessed and within which chosen strategies must operate. The RAS, and associated risk appetite framework, is therefore a key means of controlling strategic risk. The risk appetite framework comprises an extensive system of measures, thresholds and other controls, which together ensure that the Group operates within the Board's approved appetite for strategic risk.

#### Mitigation

The Group will maintain a register of sectors that give rise to heightened levels of environmental/climate, social and governance related risks. The Group will maintain an approach to these risks where sectors can be prohibited or where additional due diligence is required before exposures may be approved. In assessing sectors the Group will consider the potential impact from transition risks arising from changing legislation and societal views.

Providing a significantly more accurate understanding of the Group's risks through enhanced risk data to track risk levels, concentrations and take better risk-based decisions should also mitigate strategic and enterprise risk.

The Risk function undertakes regular risk oversight activity, with workstreams focussed solely on the execution risk of delivering integration, placing customers' interests at the centre of all aspects of change.

# Risk report (continued)

## *STRATEGIC AND ENTERPRISE RISK (continued)*

Resultant increased capital availability or generation should raise the Group's ability to invest, widening the Group's strategic options and helping to mitigate strategic and enterprise risk.

### Monitoring

A range of financial and non-financial metrics, including Return on Tangible Equity (RoTE), lending growth, customer acquisition, net interest margin (NIM) and others, are key performance indicators used to monitor performance relative to strategic objectives. They are monitored against the Financial Plan approved by the Group's Board and Executive Leadership Team, who react to deviations from targets and modify strategy accordingly. Furthermore, a number of macroeconomic Tier 1 RAS Early Warning Indicators (EWIs) were established during 2019. Whilst the Group is unable to influence these metrics explicitly, they are included in order to provide sight of possible portfolio deterioration ahead of specific internal focused metrics.

## *PEOPLE RISK*

People risk is defined as the risk of not having sufficiently skilled and motivated colleagues who are clear on their responsibilities and accountabilities and who behave in an ethical way. This could lead to inappropriate decision making that is detrimental to customers, other colleagues or our shareholders and could ultimately lead to regulatory sanction.

Our drive to foster a culture which engages and encourages our people to deliver customer-focussed outcomes with a clear set of support Values, and Behaviours is an important step in mitigating people risk.

### Risk appetite

While the organisational structural changes being implemented to support integration activity will drive an inherent increase in people risk, the combined Group will provide a catalyst for cultural transformation, which aims to create a high performing, Purpose driven, customer centric organisation, where colleagues have accountability and responsibility, alongside appropriate reward structures.

The Group will not accept a material increase in risk as a result of colleagues not conducting themselves in the manner expected, nor will the Group act in a manner that may affect the health and well-being of colleagues. The Group will not take intentional action that may impact on its ambition to build an inclusive culture and will continue to embed activities that support the required cultural change.

### Exposures

People risk is inherent in the day-to-day operation of the business and is controlled through a set of Values, Behaviours and Policies.

### Measurement

The Group has a range of Tier 1 and Tier 2 risk appetite metrics in place which help to measure and report people risk.

The Group's operational controls are designed to mitigate the risks associated throughout each element of the colleague life cycle. Bank-wide systems provide tools and online guidance to all colleagues to support them in discharging their accountabilities.

# Risk report (continued)

## *PEOPLE RISK (continued)*

### Mitigation

People risk is mitigated in three core ways:

- Managing people risk across the Group: The changing internal and external environment raises challenges relative to the Group's ability to manage people risk, as part of the overall business strategy. The transformation of the banking industry is changing the demand for skills, particularly in relation to technology, information security, serving customers digitally and responding to market developments. The Group's operating controls, are effective in managing these risks and there is a focus on the Group's ability to plan and predict resource needs during this period of cost challenges, and increased use of technology. The Group's integration evolution will have implications for colleagues and will create an increased level of People Risk during periods of uncertainty. Therefore, material structural changes will follow Organisational Design principles, the Senior Manager and Certification Framework and have appropriate governance
- Managing the people management framework: Controls are deployed effectively by people leaders and senior management in the day-to-day management of people risk. People risk indicators are constantly reviewed to determine if any systemic issues exist and to agree appropriate remediation. These include health and wellbeing, succession and conduct.
- The role of the HR function: HR partners support the Executive Leadership Team and provides broader support to all colleagues regarding all matters impacting the colleague life cycle which runs from recruitment to leaving the Group. The Group has a three-tier model incorporating: ourPeople (web-based); HR Services, supported by specialist teams like Reward; Organisational Development, Payroll; and Case Management; and finally full business partnering to the Executive Leadership Team.

### Monitoring

People risks, including culture, are monitored and reported through Executive and Board Governance Committees. IA is piloting independent deep dives in specific areas of the business, to complement existing reporting and measure alignment between actual and intended culture.

### Stress Testing

The people risks associated within a stressed scenario are automatically captured and analysed through the Group's suite of operational risk scenarios. These scenarios consider both the colleagues needed to maintain business as usual services to customers as well as the key subject matter experts needed to keep critical functions operating while under duress.

# Report of the Directors

The Directors of the Bank and its subsidiary undertakings (which together comprise the 'Group') submit their report and consolidated financial statements for the year ended 30 September 2019.

### Corporate Governance

Details of the corporate governance framework applying to the Bank is set out in the Corporate Governance Report within the Virgin Money UK PLC Annual Report & Accounts.

### Profits and appropriations

The Group loss before tax for the year ended 30 September 2019 was £182m (2018: loss of £276m). The loss attributable to the shareholders for the year ended 30 September 2019 amounted to £139m (2018: loss of £239m). A dividend of £10m has been proposed in respect of the ordinary shares for this financial year (2018: £44m). The Group's strategic highlights and business developments are set out in the Strategic report.

### Future developments and financial risk management objectives and policies

Information regarding future developments and financial risk management objectives and policies of the Group in relation to the use of financial instruments that would otherwise be required to be disclosed in the Report of the Directors, and which is incorporated into this report by reference, can be found in the Strategic report and the Risk report.

### Directors and Directors' interests

The current Directors are shown on page 1. Geeta Gopalan, Darren Pope and Amy Stirling were appointed as Directors on 15 October 2018. Debbie Crosbie resigned on 19 November 2018. Directors who are not full-time employees of the Group or a related body corporate are appointed in accordance with the Articles of Association and may be eligible for reappointment thereafter. No Directors retired by rotation during the year.

*Directors' interests*

No Director had any interest in the shares of the Bank or its subsidiaries at any time during the year.

*Directors' liabilities*

In the prior year, the Group paid a premium for a contract insuring the Directors and officers of the Group, its subsidiaries and controlled entities against personal liabilities which may arise in the course of the performance of their duties, as well as protecting the Group itself to the extent that it is obligated to indemnify Directors and officers for such liability.

### Directors' Indemnities

The Directors have each entered into individual deeds of access, insurance and indemnity with the Group which, amongst other things and subject to certain exceptions, indemnify the Directors to the maximum extent permitted by law and regulation against liabilities to a person other than the Company or an associated company that they may incur as an officer of the Company and any other subsidiary of the Group. Each such provision constitutes a 'third party indemnity provision' and a 'qualifying indemnity provision' for the purposes of section 234 to 236 of the Companies Act 2006. These provisions are in force for the benefit of the Directors at the date of this Report, and were in force when this Report was approved and during the financial year to which this Report relates. Such deeds are available for inspection at the Company's registered office.

# Report of the Directors (continued)

### Directors' Indemnities (continued)

The Group has an insurance policy in place for the benefit of all trustees, colleagues, Directors, officers, members and partners of the Company whilst acting in the capacity of a trustee or administrator of employee benefit or pension plans. This policy therefore indemnifies the Directors of Yorkshire and Clydesdale Bank Pension Trustee Limited and YCB DC Trustee Limited (each a 'Trustee Company'), the trustees of two occupational pension schemes operated by the Company, against liability incurred by them in connection with the management and administration of the pension schemes. This insurance policy constitutes a 'pension scheme indemnity provision' and a 'qualifying indemnity provision' for the purposes of section 235 to 236 of the Companies Act 2006. These provisions are in force for the benefit of the Directors of Trustee Companies at the date of this Report, and were in force when this Report was approved and during the financial year to which this Report relates. Such policy is available for inspection at the Company's registered office.

In addition, the Group had appropriate Directors' and Officers' Liability Insurance cover in place throughout the financial year.

### Colleagues

Policies and practices in respect of colleague issues are managed on a consistent basis across the Virgin Money UK PLC group.

### Engagement and communication

We have continued to evolve and enhance the way we communicate with colleagues. We ask colleagues for their views, thoughts and opinions on a regular basis during the year. Our Leadership Team participate in regular 'Let's Talk' sessions, where colleagues have the opportunity to ask questions, give their views and get a real view from the bridge. We also undertake regular pulse-check surveys, where we ask colleagues their views on key milestones. Colleague sentiment is a key measure of how well we're doing, so we keep our Board up to date on a quarterly basis as part of a people update and culture dashboard.

It is the policy of the Group to promote equality of employment opportunities by giving full and fair consideration to applications from people with disabilities. If existing colleagues become disabled, every effort is made to retain them within the workforce wherever reasonable and practicable. The Group also endeavours to provide equal opportunities in the training, promotion and general career development of disabled colleagues.

Additional information can be found in the Strategic report section of the Virgin Money UK PLC Annual Report and Accounts.

### Political donations

No political donations were made during the year (2018: £Nil).

### Management of risk

Risk and capital related disclosures for the Group are included within the Strategic report and Risk report. The information contained within these disclosures has not been audited by the Group's external auditor, except where labelled accordingly.

Risk and capital related disclosures for Virgin Money UK PLC can be found in the Virgin Money UK PLC Pillar 3 Report, www.virginmoneyukplc.com/investor-relations/results-and-reporting/financial-results/ and also within the Risk report section of the Virgin Money UK PLC Annual Report and Accounts.

### Significant contracts

Details of related party transactions are set out in note 5.3 of the consolidated financial statements.

# Report of the Directors (continued)

### Share capital

Information about share capital is shown in note 4.1 of the consolidated financial statements.

### Research and Development Activities

The Group does not undertake formal research and development activities although it does invest in new platforms and products in each of its business lines in the ordinary course of business. In addition to new products and services the Group also invests in internally generated intangible assets including software and computers systems. Further details can be found in Note 3.10 of the consolidated financial statements.

### Going concern

The Group's Directors have made an assessment of the Group's ability to continue as a going concern and are satisfied that the Group has the resources to continue in business for the foreseeable future.

The Group's use of the going concern basis for preparation of the accounts is discussed in note 1.4 of the Group's consolidated financial statements.

### Events after the balance sheet date

*FSMA Part VII transfer of trade and assets from Virgin Money PLC to Clydesdale Bank PLC*
On 26 September 2019, at a hearing in the Court of Session in Edinburgh, the Court approved a banking business transfer scheme under Part VII of FSMA. The scheme effective date was 21 October 2019 and, in accordance with the court approval, on this date the business of Virgin Money PLC was transferred to the Bank for a cash consideration of £10m. The transfer of the trade and assets is a business transfer under common control and has no impact on the consolidated financial results. The total assets and total liabilities transferred were £49bn and £47bn respectively.

*Change in Parent Company name*
The ultimate holding company, CYBG PLC, changed its name to Virgin Money UK PLC on 30 October 2019. The registered office address also changed from Merrion Way to Jubilee House, Gosforth, Newcastle upon Tyne, NE3 4PL on this date.

*Ordinary dividend*
On 11 November 2019 the Company paid an ordinary dividend of £10m to its holding company Virgin Money UK PLC.

### Auditors

In accordance with section 485 of the Companies Act 2006, a resolution to reappoint Ernst & Young LLP, and to authorise the Directors to agree their remuneration, will be proposed at the next Annual General Meeting.

The Directors who were members of the Board at the time of approving the Report of the Directors are listed on page 1. Having made enquiries of fellow Directors and of the Group's auditor, each of these Directors confirms that:

- to the best of each Director's knowledge and belief, there is no information relevant to the preparation of their report of which the Group's auditor is unaware; and
- each Director has taken all the steps a Director might reasonably be expected to have taken to be aware of relevant audit information and to establish that the Group's auditor is aware of that information.

By order of the Board

Lorna McMillan
**Company Secretary**
**27 November 2019**

# Statement of Directors' responsibilities

The Directors are responsible for preparing the Strategic report, Directors' report and the financial statements in accordance with applicable law and regulations.

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

- select suitable accounting policies in accordance with IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors and then apply them consistently;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the financial performance; and
- state that the Group and Bank have complied with IFRSs, subject to any material departures disclosed and explained in the financial statements.

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

Lorna McMillan
**Company Secretary**
**27 November 2019**

**Independent auditor's report to the members of Clydesdale Bank PLC**

**Opinion**

In our opinion:

- Clydesdale Bank PLC's Group financial statements and Parent Company financial statements (the 'financial statements') give a true and fair view of the state of the Group's and of the Parent Company's affairs as at 30 September 2019 and of the Group's loss for the year then ended;

- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;

- the Parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union as applied in accordance with the provisions of the Companies Act 2006; and

- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006, and, as regards the Group financial statements, Article 4 of the IAS Regulation.

We have audited the financial statements of Clydesdale Bank PLC which comprise:

| Group | Parent Company |
|---|---|
| **Consolidated income statement for the year ended 30 September 2019** | |
| **Consolidated statement of comprehensive income for the year ended 30 September 2019** | |
| **Consolidated balance sheet as at 30 September 2019** | Company balance sheet as at 30 September 2019 |
| **Consolidated statement of changes in equity for the year ended 30 September 2019** | Company statement of changes in equity for the year ended 30 September 2019 |
| **Consolidated statement of cash flows for the year ended 30 September 2019** | Company statement of cash flows for the year ended 30 September 2019 |
| **Related notes 1.1 to 5.6 to the financial statements** | Related notes 6.1 and 6.2 of the financial statements |
| **Certain required disclosures have been presented elsewhere in the Annual Report and Accounts, rather than in the notes to the financial statements. These have been cross-referenced from the financial statements and are identified as audited.** | |

The financial reporting framework that has been applied in their preparation is applicable law and IFRSs as adopted by the European Union and, as regards the Parent Company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

**Basis for opinion**

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the audit of the financial statements section of our report below. We are independent of the Group and Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the Financial Reporting Council's (FRC's) Ethical Standard as applied to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

**Conclusions relating to principal risks, going concern and viability statement**

We have nothing to report in respect of the following information in the annual report, in relation to which the ISAs(UK) require us to report to you whether we have anything material to add or draw attention to:

- the disclosures in the annual report on pages 5-7 that describe the principal risks and explain how they are being managed or mitigated;
- the Directors' confirmation on page 5 in the annual report that they have carried out a robust assessment of the principal risks facing the entity, including those that would threaten its business model, future performance, solvency or liquidity;

- the Directors' statement on page 81 in the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, and their identification of any material uncertainties to the entity's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements;
- whether the Directors' statement in relation to going concern required under the Listing Rules in accordance with Listing Rule 9.8.6R(3) is materially inconsistent with our knowledge obtained in the audit; or
  the Directors' explanation on page 100 in the financial statements as to how they have assessed the prospects of the entity, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the entity will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

**Overview of our audit approach**

| | |
|---|---|
| Key audit matters | • Provisions for PPI.<br>• Impairment of loans.<br>• Revenue recognition – Effective interest method accounting.<br>• Accounting for the acquisition of Virgin Money Holdings (UK) PLC. |
| Audit scope | • We performed an audit of the complete financial information of the Group and Bank.<br>• All audit work performed for the purposes of the Group audit was undertaken by the primary team. |
| Materiality | • Overall Group materiality was £25m which represents 4.8% of underlying profit PBT. |

**Key audit matters**

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

| Risk | Our response to the risk | Key observations communicated to the Board's Audit Committee |
|---|---|---|
| **PPI**<br>The Group has recorded provisions of £379m in relation to PPI redress. Please refer to pages 156 to 158 (Provisions for liabilities and charges note), pages 171 and 172 (Contingent liabilities and commitments note).<br><br>The Group has a material provision relating to its conduct towards its past and present customers linked to its historic practices of PPI sales.<br><br>The FCA deadline of 29 August 2019 (the 'deadline') for customers to lodge PPI related complaints has now passed. The Group received a significant number of complaints and information requests from claims management companies and direct from consumers in the run up to this deadline. As at 30 September 2019, a large number of these complaints remained unprocessed.<br><br>Significant judgements and assumptions are required to be made by the Directors in relation to the quality of the complaints and information requests ('IRs') received, the quantum of future redress payments and the associated administration costs that will be required. The most significant assumption is in relation to the proportion of IRs and complaints that will ultimately require PPI redress payments, and costs associated with doing so. Details of these assumptions are reported in further detail on page 157 in note 3.16. | We tested key controls operating within the PPI case handling process which supported the data used in the determination of the key assumptions. We found that we could rely on these controls.<br><br>We examined the model used by the Directors to determine a best estimate of the provision for mis-sold PPI.<br><br>We assessed the appropriateness of key PPI provision model assumptions which included IR to complaint conversion, uphold and average redress rates, as well as case processing costs, which were informed with reference to the Group's historic experience and comparisons to publicly available information from across the industry. We considered the results of the sampling exercise undertaken by the Directors in relation to the population of IRs and claims received in the two months before the deadline.<br><br>We tested the clerical accuracy of the Directors' provision calculations and sensitivity analysis.<br><br>We determined an independent range of reasonable future PPI cost outcomes using the Group's historical experience of PPI claims and the sampling exercise outcomes, and we compared this range to the Directors' estimate. In evaluating the Directors' provision assumptions, we considered the Group's historical forecasting accuracy in this area and we examined correspondence during the year between the Group and the FCA, and other regulatory pronouncements. We compared the Directors' assumptions to our own expectations based on the Group's historical experience, current trends and our industry knowledge. | We communicated to Audit Committee that the provision for PPI related claims as at 30 September 2019 as held by the Group was within our independently determined range of reasonable outcomes and was compliant with the requirements of the applicable accounting standards.<br><br>We noted that the Group's disclosures describe the uncertainties and risks associated with determination of the provision, and sensitivity of the provision to changes in key assumptions.<br><br>The Directors' best estimate for the cost required to process the remaining unprocessed PPI cases as at 30 September 2019 was determined via probability weighting a number of likely scenarios. We noted to the Audit Committee that while the risk in relation to estimation uncertainty has reduced as a result of the deadline now having passed, the estimation process remains inherently uncertain and required significant judgements to be made by Directors.<br><br>We also noted to the Audit Committee the upper end of our independently determined range illustrated the risk that the costs incurred by the Group could materially exceed the Directors' estimate, which is consistent with the disclosures. |
| **Impairment of loans**<br>The Group adopted the new accounting standard for financial instruments (IFRS 9) from 1 October 2018, which introduced new requirements for the classification and measurement of financial assets and liabilities and the recognition of impairment of financial assets. Please refer to | As IFRS 9 was adopted by the Group on 1 October 2018, we performed audit procedures on the opening balances to gain assurance on the impact of transition from IAS 39. This included evaluating accounting interpretations and disclosures, as well as the calculation of the adjustment against the requirements of IFRS 9. | We communicated that we were satisfied that ECL provisions were reasonable and in compliance with the requirements of IFRS 9.<br><br>We communicated to the Audit Committee that our independent testing of models and underlying modelling assumptions noted some minor differences that were |

| Risk | Our response to the risk | Key observations communicated to the Board's Audit Committee |
|---|---|---|
| page 12 (Credit risk report) and pages 117 to 120 (Impairment provisions on credit exposures).<br><br>At 30 September 2019, the Group reported total gross loans of £73,244 million and £362 million of loan loss provisions.<br><br>Key judgements and estimates in respect of the measurement of ECLs include the:<br><br>• allocation of assets to Stage 1, 2, or 3 using criteria in accordance with the accounting standard;<br><br>• accounting interpretations and modelling assumptions used to build the models that calculate the ECLs;<br><br>• completeness and accuracy of data used to calculate the ECLs;<br><br>• inputs and assumptions used to estimate the impact of multiple economic scenarios;<br><br>• completeness and valuation of post model adjustments;<br><br>• measurements of individually assessed provisions including the assessment of multiple scenarios; and<br><br>• accuracy and adequacy of the financial statement disclosures. | We tested the design and operating effectiveness of controls operating within processes relevant to ECL calculations. This included credit monitoring, individual provisions and production of journal entries.<br><br>We performed independent calculations of the Group's staging, to determine if they were reasonable given the Group's lending portfolio, risk profile, credit risk management practices and the macroeconomic environment. We considered trends in the economy and industries to which the Group is exposed.<br><br>We challenged the criteria used to allocate assets to Stage 1, 2 or 3 in accordance with IFRS 9. We tested assets in Stage 1, 2 and 3 to verify that they were allocated to the appropriate Stage.<br><br>We tested the assumptions, inputs and formulae used in a risk-based sample of ECL models. This included assessing the appropriateness of model design and the calculations used, and recalculating PD, LGD and Exposure at Default (EAD) for a sample of individual loans within a sample of models.<br><br>To assess data quality, we tested data used in the ECL calculation by reconciling and performing sample tests for accuracy of key data fields to source systems. To test credit monitoring, we independently recalculated risk ratings for a sample of performing and non-performing loans and compared to the Group's determinations.<br><br>We assessed the economic scenario base case and alternative economic scenarios adopted by the Directors with economics specialists. We challenged the probability weighting ascribed to the scenarios and compared them to other scenarios from a variety of external sources, as well as EY internally developed forecasts. With the assistance of our economics specialists, we assessed whether forecast macroeconomic variables, such as GDP, unemployment, interest rates and House Price Index, | considered to be immaterial in aggregate.<br>We also communicated that our challenge in respect of the economic scenarios adopted by the Directors, concluded that the resulting position was considered to be within a reasonable range of potential outcomes. |

| Risk | Our response to the risk | Key observations communicated to the Board's Audit Committee |
|---|---|---|
| | were appropriate loan loss provision drivers.<br><br>We assessed the completeness and appropriateness of the Directors' post model adjustments and recalculated a sample. Based on current economic conditions and market circumstances, we considered the need for sector or systemic adjustments. We assessed the appropriateness of the scenarios used and the calculation of the overlay adopted in response to Brexit related economic uncertainty.<br><br>With the support of our internal valuation specialists, we recalculated ECL provisions for a sample of individually assessed loans including comparing to alternative scenarios and challenging probability weights assigned.<br><br>We also assessed a sample of individual loans classified as performing loans within higher risk sectors, such as construction, retail, automotive, commercial real estate, shipping and oil and gas where no specific provision was held.<br><br>We assessed the adequacy and appropriateness of the disclosures made within the financial statements, including those related to the transition from IAS 39 to IFRS 9, for compliance with the accounting standards. | |
| **Revenue recognition – effective interest method**<br>The Group records interest income on its mortgage and credit card portfolio under the effective interest rate (EIR) method. Please refer to note 2.2 on pages 108 to 110.<br><br>Following the acquisition of Virgin Money Holdings (UK) PLC on 15 October 2018, EIR accounting on the Group's credit card portfolio increased in significance. As set out in note 2.2 on page 109, during the year the Group revised its estimation of EIR income, and the associated balance sheet amounts, across its mortgage and credit cards portfolios. | We assessed the Directors' EIR accounting policy and the revised estimation methodology adopted by the Group during the year for compliance with the accounting standard.<br><br>We gained an understanding of the key processes, controls, assumptions and judgements used within the Directors' EIR models.<br><br>We also assessed the Directors' inclusion or exclusion of key streams of income and expenditure within the Group's EIR models. We compared the Directors' forecasts of customer behaviours and balance attrition rates to recent experience and historical trends within the lending portfolios. | We communicated to the Audit Committee that the models, assumptions and calculations informing the EIR calculation as at 30 September 2019 were reasonable and that these resulted in EIR adjustments to interest income which were appropriately derived.<br><br>We also communicated our observations on the Directors' key assumptions. We noted the potential future risks to the EIR adjustments related to potential changes in customer behaviour as a result of wider current economic, market and regulatory pressures, and that we considered the modelling adjustments recorded by the Directors in respect of these |

| Risk | Our response to the risk | Key observations communicated to the Board's Audit Committee |
|---|---|---|
| The fair value adjustments recorded on acquired portfolios are amortised over the projected behavioural lives of the financial instruments. As a result, the unwind of the fair value adjustment recorded on acquisition is naturally connected to the EIR calculation and its key assumptions. This adds additional complexity to the calculation of amounts recognised in the income statement under EIR accounting.<br><br>The EIR method spreads the income statement recognition of income and expense cash flows that are, in substance, integral to the overall yield of the financial instrument over its modelled life. For both secured and unsecured lending the Group utilises models to predict future cashflows, and recognise interest income under the EIR accounting method.<br><br>EIR models are sensitive to judgements about the expected behavioural lives and future yields of the product portfolios to which they relate. Due to the complexity of calculations, the degree of judgement exercised by the Directors in respect of forecast future cash flows, the different products for which fees are recognised, and the sensitivity of the amounts recognised in the financial statements to key assumptions, this was considered a key audit matter. | With respect to the amortisation of the fair value adjustments relating to the acquired portfolios, we assessed the key assumptions adopted by the Directors for consistency and appropriateness against the assumptions used in the Group's EIR models.<br><br>We developed an independent assessment of the reasonable range of forecast future cash flows outcomes using the Group's historical experience and our understanding of the industry, and assessed the Directors' modelled EIR outcomes against this range.<br><br>We performed data integrity testing on the key sources of information used within the EIR calculations.<br>We assessed the accuracy of the disclosures made within the financial statements regarding the key estimates made within the EIR models, and their sensitivity to reasonable alternative assumptions. | risks to be within a reasonable range of outcomes.<br><br>We also noted that the unwind of the fair value adjustments recorded by the Directors were reasonable in comparison to the customer behaviour assumptions used within the Group's EIR models. |
| **Accounting for the acquisition of Virgin Money Holdings (UK) PLC**<br>As set out in note 3.19 on pages 164 and 165, on 15 October 2018, the Group acquired Virgin Money Holdings (UK) PLC which comprised £45bn of assets and £43bn of liabilities. The transaction resulted in the recognition of £11m of goodwill.<br>Under IFRS 3, the assets and liabilities acquired in a business combination are recorded at fair value.<br>Significant judgment was required in determining the fair values of assets and liabilities as at the date of acquisition, particularly: | We gained an understanding of the Directors' fair value modelling process for material asset and liability balances acquired in the business combination.<br><br>With the involvement of our valuation and business modelling specialists, we assessed the Directors' valuation models and the key assumptions used within them, which were used to determine the acquisition fair values of the assets and liabilities acquired.<br><br>We challenged the completeness of the Directors' identification of intangible assets, and valuation ascribed to those assets. | We communicated to the Audit Committee that the methodology, key judgements and assumptions applied by the Directors in determining the acquisition fair values of Virgin Money Holdings (UK) PLC's assets and liabilities led to valuations that were within acceptable ranges.<br><br>Our valuation assessments for intangible assets related to the customer relationships for certain business units and other intangible assets noted minor differences that were not material in the context of the financial statements.<br><br>We noted that the required disclosures related to the business |

| Risk | Our response to the risk | Key observations communicated to the Board's Audit Committee |
|---|---|---|
| • the future cash flow expectations that formed the basis on which the mortgage and credit card portfolio fair values were determined;<br><br>• the appropriateness of the discount rates used in the discounted cash flow valuation models;<br><br>• key judgements regarding the replacement funding costs assumed within the TFS valuation; and<br><br>• the Directors' assessment of other intangible assets. | We assessed the Directors' disclosures of the acquisition of Virgin Money Holdings (UK) PLC for compliance with the disclosure requirements of IFRS 3 and recalculated the resulting goodwill recognised on acquisition. | combination had been made appropriately. |

In the prior year our auditor's report included a key audit matter in respect of small or medium sized enterprise (SME) lending impairment provisions assessed under the previously applicable accounting standard IAS 39. In the current period, IAS 39 was superseded by IFRS 9 which has been identified as a key audit matter as outlined in the table above.

### Our application of materiality

We apply the concept of materiality in planning and performing the audit, in evaluating the effect of identified misstatements on the audit and in forming our audit opinion.

### Materiality

*The magnitude of an omission or misstatement that, individually or in the aggregate, could reasonably be expected to influence the economic decisions of the users of the financial statements. Materiality provides a basis for determining the nature and extent of our audit procedures.*

We determined materiality for the Group and Parent Company to be £25.0m (2018: £15.0m), which represents 4.8% of underlying profit on ordinary activities before tax (consistent with our prior year approach, this is defined as the Group's PBT adjusted to exclude one-off items incurred during the year and those related to conduct provisions and restructuring), which equates to 0.5% of Group equity. This measure of underlying PBT is consistent with the wider industry, and a results-based measure is the most commonly used approach for listed and regulated entities. We observed that this measure is frequently referred to by users of the Group's financial statements. We selected underlying PBT, as this better reflects the longer term performance of the Group. This is also set out on page 4 in the Financial Results, in the Directors' reconciliation of statutory to proforma results.

### Performance materiality

*Performance materiality is the application of materiality at the individual account or balance level. It is set at an amount to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.*

On the basis of our risk assessments, together with our assessment of the Group's overall control environment, our judgement was that performance materiality was 75% (2018: 75%) of our planning materiality, namely £18.8m (2018: £11.3m). We set performance materiality at this percentage due to our previous experience as auditors of the Group, from which we concluded that there is a lower expectation of material financial statement inaccuracies due to the effective control environment and only minor audit differences resulting from our prior and current year work. Our approach is consistent with the prior year.

### Reporting threshold

*This is the amount below which identified misstatements are considered as being clearly trivial.*

We agreed with the Audit Committee that we would report to them all uncorrected audit differences in excess of £1.3m (2018: £0.8m), which is set at 5% of planning materiality, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

We evaluate any uncorrected misstatements against both the quantitative measures of materiality discussed above and in light of other relevant qualitative considerations in forming our opinion.

### Other information

The other information comprises the information included in the Strategic report set out on pages 2 to 9, the Risk report set out on pages 10 to 78, and Additional Information set out on pages 187 to 195 other than the financial statements and our auditor's report thereon. The Directors are responsible for the other information.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in this report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of the other information, we are required to report that fact.

We have nothing to report in this regard.

### Opinions on other matters prescribed by the Companies Act 2006

In our opinion, the part of the Directors' Remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006.

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the Strategic report and the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the Strategic report and the Directors' report have been prepared in accordance with applicable legal requirements.

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

In the light of the knowledge and understanding of the Group and the Parent Company and its environment obtained in the course of the audit, we have not identified material misstatements in the Strategic report or the Directors' report.

We have nothing to report in respect of the following matters in relation to which the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the Parent Company, or returns adequate for our audit have not been received from branches not visited by us; or
- the Parent Company financial statements and the part of the Directors' Remuneration report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

### Responsibilities of Directors

As explained more fully in the Directors' responsibilities statement set out on page 82, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the Directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the Directors are responsible for assessing the Group and Parent Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the

going concern basis of accounting unless the Directors either intend to liquidate the Group or the Parent Company or to cease operations, or have no realistic alternative but to do so.

**Auditor's responsibilities for the audit of the financial statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

**Explanation as to what extent the audit was considered capable of detecting irregularities, including fraud**

The objectives of our audit, in respect of fraud, are: to identify and assess the risks of material misstatement of the financial statements due to fraud; to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and to respond appropriately to fraud or suspected fraud identified during the audit. However, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. Our audit approach in respect of irregularities, including fraud, was as follows:

- we obtained an understanding of the legal and regulatory frameworks that are applicable to the Group and determined that the most significant were the regulations, licence conditions and supervisory requirements of the PRA and the FCA.
- we understood how the Group complies with these legal and regulatory frameworks by making enquiries of management, internal audit, and those responsible for legal and compliance matters. We also: reviewed correspondence between the Group and UK regulatory bodies; reviewed minutes of the Board and Executive Risk Committee; and gained an understanding of the Group's approach to governance, demonstrated by the Board's approval of the Group's governance framework and the Board's review of the Group's RMF and internal control processes.
- we assessed the susceptibility of the Group's financial statements to material misstatement, including how fraud might occur, by considering the controls that the Group has established to address risks identified by the entity, or that otherwise seek to prevent, deter or detect fraud. We also considered performance and incentive plan targets and their potential to influence management to manage earnings or influence the perceptions of investors and stakeholders.
- based on this understanding we designed our audit procedures to identify non-compliance with such laws and regulations identified in the paragraphs above. Our procedures involved inquiries of legal counsel, executive management, internal audit, and focused testing, as referred to in the Key Audit Matters section above.
- the Group operates in the banking industry which is a highly regulated environment. As such the Senior Statutory Auditor considered the experience and expertise of the engagement team to ensure that the team had the appropriate competence and capabilities, which included the use of specialists where appropriate.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

**Other matters we are required to address**:

- following the recommendation of the National Australia Bank Limited (NAB) Group Audit Committee, we were appointed as External Auditor at the AGM on 31 January 2005 to audit the financial statements for the year ending 30 September 2005 of the NAB Group of companies, which at the time included Clydesdale Bank PLC. The period of total uninterrupted engagement as auditors of Clydesdale Bank PLC including previous renewals and reappointments, is 14 years, covering the years ending 30 September 2005 to 30 September 2019;

- the non-audit services prohibited by the FRC's Ethical Standard were not provided to the Group or the Company and we remain independent of the Group and the Company in conducting the audit; and

- the audit opinion is consistent with the additional report to the Audit Committee.

**Use of our report**

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members

those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Steven Robb (Senior Statutory Auditor)
for and on behalf of Ernst & Young LLP, Statutory Auditor
Leeds
27 November 2019

**Notes:**

1. The maintenance and integrity of the Clydesdale Bank PLC website is the responsibility of the Directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.
2. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

# Consolidated income statement for the year ended 30 September

| | Note | 2019 £m | 2018 £m |
|---|---|---|---|
| Interest income | | 2,420 | 1,098 |
| Other similar interest | | 13 | 15 |
| Interest expense and similar charges | | (917) | (258) |
| **Net interest income** | 2.2 | 1,516 | 855 |
| Gains less losses on financial instruments at fair value | | (20) | (3) |
| Other operating income | | 277 | 159 |
| **Non-interest income** | 2.3 | 257 | 156 |
| **Total operating income** | | 1,773 | 1,011 |
| Operating and administrative expenses before impairment losses | 2.4 | (1,703) | (1,246) |
| **Operating profit/(loss) before impairment losses** | | 70 | (235) |
| Impairment losses on credit exposures | 3.2 | (252) | (41) |
| **Loss on ordinary activities before tax** | | (182) | (276) |
| Tax credit | 2.5 | 43 | 37 |
| **Loss for the year** | | (139) | (239) |
| Attributable to: | | | |
| Ordinary shareholders | | (213) | (275) |
| Other equity holders | | 41 | 36 |
| Non-controlling interests | | 33 | - |
| **Loss for the year** | | (139) | (239) |

All material items dealt with in arriving at the loss before tax for the above years relate to continuing activities.

The notes on pages 100 to 186 form an integral part of these financial statements.

# Consolidated statement of comprehensive income for the year ended 30 September

| | 2019 | 2018 |
|---|---|---|
| | £m | £m |
| Loss for the year | (139) | (239) |
| **Items that may be reclassified to the income statement** | | |
| *Change in cash flow hedge reserve* | | |
| Gains/(losses) during the year | 73 | (58) |
| Transfers to the income statement | (58) | 8 |
| Taxation thereon - deferred tax (charge)/credit | (9) | 12 |
| Taxation thereon - current tax credit | 6 | - |
| | 12 | (38) |
| *Change in FVOCI reserve* | | |
| Gains during the year | 13 | - |
| Transfers to the income statement | (4) | - |
| Taxation thereon - deferred tax charge | (2) | - |
| | 7 | - |
| **Total items that may be reclassified to the income statement** | 19 | (38) |
| **Items that will not be reclassified to the income statement** | | |
| *Change in asset revaluation reserve* | | |
| Decrement on revaluation | - | - |
| Taxation thereon - deferred tax (charge)/credit | (1) | 1 |
| | (1) | 1 |
| *Remeasurement of defined benefit pension plans* | 110 | (9) |
| Taxation thereon - deferred tax (charge)/credit | (56) | 3 |
| Taxation thereon - current tax credit | 7 | - |
| | 61 | (6) |
| **Total items that will not be reclassified to the income statement** | 60 | (5) |
| **Other comprehensive income/(losses), net of tax** | 79 | (43) |
| **Total comprehensive losses for the year, net of tax** | (60) | (282) |
| **Attributable to:** | | |
| Ordinary shareholders | (134) | (318) |
| Other equity holders | 41 | 36 |
| Non-controlling interest | 33 | - |
| **Total comprehensive losses for the year, net of tax** | (60) | (282) |

The notes on pages 100 to 186 form an integral part of these financial statements.

# Balance sheets as at 30 September

| | Note | Group 2019 £m | Group 2018[2] £m | Bank 2019 £m | Bank 2018[2] £m |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| *Financial assets at amortised cost* | | | | | |
| Loans and advances to customers | 3.1 | **73,093** | 32,748 | **32,389** | 31,635 |
| Cash and balances with central banks | 3.4 | **10,296** | 6,573 | **6,621** | 6,573 |
| Due from other banks | | **1,018** | 693 | **225** | 233 |
| *Financial assets at fair value through profit or loss* | | | | | |
| Loans and advances to customers | 3.5 | **253** | 362 | **253** | 362 |
| Derivative financial instruments | 3.6 | **366** | 262 | **442** | 151 |
| Other financial assets | 3.5 | **8** | - | **1** | - |
| Due from related entities | 5.3 | **18** | 35 | **2,476** | 1,238 |
| Financial instruments at fair value through other comprehensive income[1] | 3.7 | **4,328** | - | **2,350** | - |
| Financial assets available for sale[1] | 3.8 | **-** | 1,562 | **-** | 1,556 |
| Property, plant and equipment | 3.9 | **145** | 88 | **85** | 88 |
| Intangible assets and goodwill | 3.10 | **516** | 412 | **398** | 412 |
| Investments in controlled entities and associates | 6.2 | **-** | - | **1,776** | 10 |
| Current tax assets | | **10** | - | **29** | 4 |
| Deferred tax assets | 3.11 | **418** | 298 | **350** | 294 |
| Defined benefit pension assets | 3.12 | **396** | 212 | **396** | 212 |
| Other assets | | **236** | 338 | **169** | 338 |
| **Total assets** | | **91,101** | 43,583 | **47,960** | 43,106 |
| **Liabilities** | | | | | |
| *Financial liabilities at amortised cost* | | | | | |
| Customer deposits | 3.13 | **64,000** | 28,904 | **29,771** | 28,904 |
| Debt securities in issue | 3.14 | **7,267** | 3,698 | **709** | 708 |
| Due to other banks | 3.15 | **8,916** | 3,071 | **3,860** | 3,071 |
| *Financial liabilities at fair value through profit or loss* | | | | | |
| Customer deposits | 3.5 | **4** | 15 | **4** | 15 |
| Derivative financial instruments | 3.6 | **273** | 361 | **292** | 361 |
| Due to related entities | 5.3 | **2,315** | 1,313 | **5,336** | 3,885 |
| Deferred tax liabilities | 3.11 | **199** | 77 | **145** | 77 |
| Provisions for liabilities and charges | 3.16 | **459** | 331 | **439** | 331 |
| Other liabilities | 3.17 | **2,527** | 2,522 | **2,448** | 2,519 |
| **Total liabilities** | | **85,960** | 40,292 | **43,004** | 39,871 |
| **Equity** | | | | | |
| Share capital and share premium | 4.1 | **2,792** | 1,013 | **2,792** | 1,013 |
| Other equity instruments | 4.1 | **672** | 425 | **672** | 425 |
| Other reserves | 4.1 | **(13)** | (28) | **18** | (28) |
| Retained earnings | | **1,690** | 1,881 | **1,474** | 1,825 |
| **Total equity** | | **5,141** | 3,291 | **4,956** | 3,235 |
| **Total liabilities and equity** | | **91,101** | 43,583 | **47,960** | 43,106 |

(1) Changes required as a result of the adoption of IFRS 9 from 1 October 2018. Refer to notes 1.9 and 5.4.
(2) The comparative year has been restated in line with the current year presentation. Refer to note 1.10.

The notes on pages 100 to 186 form an integral part of these financial statements.
These financial statements were approved by the Board of Directors on 27 November 2019 and were signed on its behalf by:

David Duffy
**Chief Executive Officer**

Ian Smith
**Chief Financial Officer**

Company name: Clydesdale Bank PLC
Company number: SC001111

# Statements of changes in equity

Group

| | Share capital and share premium | Other equity instruments | Other reserves: Asset reval reserve | Other reserves: Available for sale reserve[1] | Other reserves: FVOCI reserve[1] | Other reserves: Cash flow hedge reserve | Other reserves: Capital contribution reserve | Retained earnings | Non controlling interest | Total equity |
|---|---|---|---|---|---|---|---|---|---|---|
| Note | 4.1.1 | 4.1.2 | 4.1.3 | 4.1.3 | 4.1.3 | 4.1.3 | 4.1.3 | | 4.1.4 | |
| | £m | £m | £m | £m | £m | £m | £m | £m | | £m |
| At 1 October 2017 | 502 | 425 | 1 | 7 | - | 1 | 364 | 2,164 | - | 3,464 |
| Loss for the year | - | - | - | - | - | - | - | (239) | - | (239) |
| Other comprehensive income/(losses), net of tax | - | - | 1 | - | - | (38) | - | (6) | - | (43) |
| Total comprehensive income/(losses) for the year | - | - | 1 | - | - | (38) | - | (245) | - | (282) |
| AT1 distribution paid (net of tax) | - | - | - | - | - | - | - | (29) | - | (29) |
| Dividends paid to ordinary shareholders | - | - | - | - | - | - | - | (9) | - | (9) |
| Ordinary shares issued | 511 | - | - | - | - | - | - | - | - | 511 |
| Capital contribution | - | - | - | - | - | - | (364) | - | - | (364) |
| **At 30 September 2018** | 1,013 | 425 | 2 | 7 | - | (37) | - | 1,881 | - | 3,291 |
| Changes on adoption of IFRS 9 and IFRS 15 (note 5.4) | - | - | - | (7) | 4 | - | - | (18) | - | (21) |
| **As at 1 October 2018** | 1,013 | 425 | 2 | - | 4 | (37) | - | 1,863 | - | 3,270 |
| Loss for the year | - | - | - | - | - | - | - | (139) | - | (139) |
| Other comprehensive (losses)/income, net of tax | - | - | (1) | - | 7 | 12 | - | 61 | - | 79 |
| Total comprehensive (losses)/income | - | - | (1) | - | 7 | 12 | - | (78) | - | (60) |
| Acquisition of Virgin Money Holdings (UK) PLC | 1,549 | - | - | - | - | - | - | (17) | 422 | 1,954 |
| Dividends paid to ordinary shareholders | - | - | - | - | - | - | - | (44) | - | (44) |
| AT1 distribution paid (net of tax) | - | - | - | - | - | - | - | (34) | - | (34) |
| Distributions to non-controlling intererests (net of tax) | - | - | - | - | - | - | - | (26) | - | (26) |
| Ordinary shares issued | 230 | - | - | - | - | - | - | - | - | 230 |
| Capital note redemption | - | - | - | - | - | - | - | 29 | (422) | (393) |
| Settlement of Virgin Money Holdings (UK) PLC share awards | - | - | - | - | - | - | - | (3) | - | (3) |
| AT1 issuance | - | 247 | - | - | - | - | - | - | - | 247 |
| **At 30 September 2019** | 2,792 | 672 | 1 | - | 11 | (25) | - | 1,690 | - | 5,141 |

[1] Changes required as a result of the adoption of IFRS 9 from 1 October 2018. Refer to notes 1.9 and 5.4.

The notes on pages 100 to 186 form an integral part of these financial statements.

# Statements of changes in equity

**Bank**

| | Share capital and share premium | Other equity instruments | Other reserves | | | | | Retained earnings | Total equity |
|---|---|---|---|---|---|---|---|---|---|
| | | | Asset reval reserve | Available for sale reserve[1] | FVOCI reserve[1] | Cash flow hedge reserve | Capital contribution reserve | | |
| Note | 4.1.1 | 4.1.2 | 4.1.3 | 4.1.3 | 4.1.3 | 4.1.3 | 4.1.3 | | |
| | £m | £m | £m | £m | £m | £m | £m | £m | £m |
| At 1 October 2017 | 502 | 425 | 1 | 6 | - | 1 | 364 | 2,129 | 3,428 |
| Loss for the year | - | - | - | - | - | - | - | (260) | (260) |
| Other comprehensive (losses)/income | - | - | 1 | - | - | (37) | - | (6) | (42) |
| Total comprehensive losses (net of tax) | - | - | 1 | - | - | (37) | - | (266) | (302) |
| AT1 distribution (net of tax) | - | - | - | - | - | - | - | (29) | (29) |
| Dividends paid | - | - | - | - | - | - | - | (9) | (9) |
| Shares issued - ordinary | 511 | - | - | - | - | - | - | - | 511 |
| Capital contribution | - | - | - | - | - | - | (364) | - | (364) |
| **At 30 September 2018** | 1,013 | 425 | 2 | 6 | - | (36) | - | 1,825 | 3,235 |
| Changes on adoption of IFRS 9 and IFRS 15 (note 5.4) | - | - | - | (6) | 4 | - | - | (19) | (21) |
| **As at 1 October 2018** | 1,013 | 425 | 2 | - | 4 | (36) | - | 1,806 | 3,214 |
| Loss for the year | - | - | - | - | - | - | - | (315) | (315) |
| Other comprehensive (losses)/income | - | - | (1) | - | 3 | 46 | - | 61 | 109 |
| Total comprehensive (losses)/income (net of tax) | - | - | (1) | - | 3 | 46 | - | (254) | (206) |
| Acquisition of Virgin Money Holdings (UK) PLC | 1,549 | - | - | - | - | - | - | - | 1,549 |
| Dividends paid to ordinary shareholders | - | - | - | - | - | - | - | (44) | (44) |
| AT1 distributions paid (net of tax) | - | - | - | - | - | - | - | (34) | (34) |
| AT1 issuance | - | 247 | - | - | - | - | - | - | 247 |
| Shares issued - ordinary | 230 | - | - | - | - | - | - | - | 230 |
| **At 30 September 2019** | **2,792** | **672** | **1** | **-** | **7** | **10** | **-** | **1,474** | **4,956** |

(1) Changes required as a result of the adoption of IFRS 9 from 1 October 2018. Refer to Notes 1.9 and 5.4.

The notes on pages 100 to 186 form an integral part of these financial statements.

# Statement of cash flows
# for the year ended 30 September

| | Notes | Group 2019 £m | Group 2018 £m | Bank 2019 £m | Bank 2018 £m |
|---|---|---|---|---|---|
| **Operating activities** | | | | | |
| Loss on ordinary activities before tax | | **(182)** | (276) | **(380)** | (302) |
| *Adjustments for:* | | | | | |
| Non-cash or non-operating items included in loss before tax | 5.2 | **(935)** | (761) | **(295)** | (731) |
| Changes in operating assets | 5.2 | **(2,350)** | (1,423) | **(996)** | (1,359) |
| Changes in operating liabilities | 5.2 | **2,662** | (122) | **1,907** | (123) |
| Interest received | | **2,320** | 1,108 | **1,178** | 1,074 |
| Interest paid | | **(808)** | (169) | **(21)** | (174) |
| Tax (paid)/received - Group relief | | **(8)** | (1) | **1** | 4 |
| **Net cash provided by/(used in) operating activities** | | **699** | (1,644) | **1,394** | (1,611) |
| **Cash flows from investing activities** | | | | | |
| Interest received | | **28** | 12 | **17** | 12 |
| Cash acquired on acquisition of Virgin Money Holdings (UK) PLC | | **4,106** | - | **-** | - |
| Proceeds from maturity of financial instruments at FVOCI | | **659** | - | **50** | - |
| Proceeds from maturity of available for sale investments | | **-** | 245 | **-** | 245 |
| Proceeds from sale of financial assets at FVOCI | | **352** | - | **77** | - |
| Proceeds from sale of available for sale investments | | **-** | 822 | **-** | 822 |
| Purchase of financial assets at FVOCI | | **(1,647)** | - | **(838)** | - |
| Purchase of available for sale investments | | **-** | (593) | **-** | (593) |
| Proceeds from sale of 50% (less one share) consideration in Virgin Money Unit Trust Managers Limited | | **45** | - | **-** | - |
| Proceeds from sale of property, plant and equipment | | **3** | 9 | **2** | 9 |
| Purchase of property, plant and equipment | | **(20)** | (22) | **(16)** | (22) |
| Purchase and development of intangible fixed assets | | **(130)** | (144) | **(104)** | (144) |
| **Net cash provided by/(used in) investing activities** | | **3,396** | 329 | **(812)** | 329 |
| **Cash flows from financing activities** | | | | | |
| Interest received | | **-** | 1 | **24** | 18 |
| Interest paid | | **(13)** | (94) | **(194)** | (198) |
| Proceeds from ordinary shares issued | | **-** | 511 | **-** | 511 |
| Proceeds from issuance of other equity instruments | | **247** | - | **-** | - |
| Repayment of Additional Tier 1 securities classified as non-controlling interests | | **(160)** | - | **-** | - |
| Redemption and principal repayment on RMBS and covered bonds | 3.3 | **(2,003)** | (1,372) | **-** | - |
| Issuance of RMBS and covered bonds | 3.3 | **2,226** | 1,049 | **-** | - |
| Issuance of medium term notes/subordinated debt | 3.14 | **-** | - | **-** | - |
| Amounts drawn down under the TFS | | **-** | 1,250 | **-** | 1,250 |
| Amounts repaid under the TFS | | **(1,295)** | (900) | **-** | (900) |
| Net increase in amounts due from related entities | | **(12)** | - | **(1,311)** | (23) |
| Net increase in amounts due to related entities | | **611** | 505 | **987** | 259 |
| Ordinary dividends paid | | **(44)** | (9) | **(44)** | (9) |
| AT1 distributions paid | | **(41)** | (36) | **(41)** | (36) |
| Distributions to non-controlling interests | | **(33)** | - | **-** | - |
| **Net cash (used in)/provided by financing activities** | | **(517)** | 905 | **(579)** | 872 |
| **Net increase/(decrease) in cash and cash equivalents** | | **3,578** | (410) | **3** | (410) |
| Cash and cash equivalents at the beginning of the year | | **6,542** | 6,952 | **6,542** | 6,952 |
| **Cash and cash equivalents at the end of the year** | 5.2 | **10,120** | 6,542 | **6,545** | 6,542 |

# Statement of cash flows (continued) for the year ended 30 September

Reconciliation of movements to liabilities from cash flows arising from financing activities

| Group | TFS | Debt securities in issue | Intercompany loans | Total |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| At 1 October 2018 | 2,254 | 3,698 | 1,313 | **7,265** |
| **Cash flows:** | | | | |
| Issuances | - | 2,226 | 644 | **2,870** |
| Redemptions | - | (2,003) | - | **(2,003)** |
| Drawdowns | - | - | (33) | **(33)** |
| Repayment | (1,295) | - | - | **(1,295)** |
| Maturity | - | - | - | - |
| **Non-cash flows:** | | | | |
| Acquisition of TFS and debt securities in issue | 6,387 | 3,209 | - | **9,596** |
| Movement in FV hedge | - | 42 | - | **42** |
| Movement in accrued interest | (3) | 2 | 13 | **12** |
| Unrealised FX movements | - | 79 | - | **79** |
| Unamortised costs | (1) | - | 28 | **27** |
| Other movement | (34) | 14 | 350 | **330** |
| At 30 September 2019 | **7,308** | **7,267** | **2,315** | **16,890** |

| Bank | TFS | Debt securities in issue | Intercompany loans | Total |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| At 1 October 2018 | 2,254 | 708 | 3,885 | **6,847** |
| **Cash flows:** | | | | |
| Issuances | - | 1 | 650 | **651** |
| Draw downs | - | - | 41 | **41** |
| Other movement | - | - | 296 | **296** |
| **Non-cash flows** | | | | |
| Movement in accrued interest | - | - | 13 | **13** |
| Unamortised costs | - | - | 342 | **342** |
| Other movement | - | - | 109 | **109** |
| At 30 September 2019 | **2,254** | **709** | **5,336** | **8,299** |

The notes on pages 100 to 186 form an integral part of these financial statements.

# Notes to the consolidated financial statements
## Section 1: Basis of preparation

**Overview**

This section sets out the Group's accounting policies that relate to the consolidated financial statements as a whole. Where an accounting policy is specific to one note, the policy is described in the note to which it relates. This section also shows new accounting standards, amendments and interpretations which are relevant to the Group, and whether they are effective in 2019 or later years. We explain how these changes are expected to impact the financial position and performance of the Group.

### 1.1 General information

The Bank is incorporated in the United Kingdom under the Companies Act and registered in Scotland. The consolidated financial statements comprise the Bank and its controlled entities, together the 'Group'.

The Bank's immediate and ultimate parent is Virgin Money UK PLC, a company registered in England and Wales. Virgin Money UK PLC also heads the largest and smallest group in which the results of the Group are consolidated. The financial statements of Virgin Money UK PLC may be obtained from Virgin Money UK PLC's registered office at Jubilee House, Gosforth, Newcastle upon Tyne, NE3 4PL.

### 1.2 Basis of accounting

The consolidated financial statements have been prepared in accordance with IFRS as adopted by the EU and in accordance with the provisions of the Companies Act 2006. No individual income statement is presented for the Bank, as permitted by Section 408 of the Companies Act 2006.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of land and buildings, investment properties and certain other financial assets and liabilities at fair value through profit or loss and other comprehensive income. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

### 1.3 Presentation of risk, offsetting and maturity disclosures

Certain disclosures required under IFRS 7 'Financial instruments: disclosures' and IAS 1 'Presentation of financial statements' have been included within the audited sections of the Risk report. Where information is marked as audited, it is incorporated into these financial statements by this cross reference and it is covered by the Independent auditor's report.

### 1.4 Going concern

The Group's business activities, together with the factors likely to affect its future development, performance and position, are set out in the Strategic report. In addition, the Risk report includes the Group's risk management objectives and the Group's objectives, policies and processes for managing its capital.

In assessing the Group's going concern position as at 30 September 2019, the Directors have considered a number of factors, including the current balance sheet position, the principal and emerging risks which could impact the performance of the Group, the Group's strategic and financial plan and the impact of the acquisition of Virgin Money Holdings (UK) PLC. The assessment concluded that, for the foreseeable future, the Group has sufficient capital to support its operations; has a funding and liquidity base which is strong, robust and well managed with future capacity; and has expectations that performance will continue to improve as the Group's strategy is executed.

As a result of the assessment, the Directors have a reasonable expectation that the Bank and the Group have adequate resources to continue in operational existence for the foreseeable future and therefore believe that the Group is well placed to manage its risks successfully in line with its business model and strategic aims. Accordingly, they continue to adopt the going concern basis in preparing the consolidated financial statements.

## 1.5 Basis of consolidation

Controlled entities are all entities (including structured entities) to which the Bank is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. An assessment of control is performed on an ongoing basis.

Controlled entities are consolidated from the date on which control is established by the Group until the date that control ceases. The acquisition method of accounting is used to account for business combinations other than those under common control. A non-controlling interest is recognised by the Group in respect of any portion of the total assets less total liabilities of an acquired entity or entities that is not owned by the Group. Post-acquisition, income received and expenses incurred by the entity or entities acquired are included in the consolidated income statement on a line-by-line basis in accordance with the accounting policies set out herein. Balances and transactions between entities within the Group and any unrealised gains and losses arising from those transactions are eliminated in full upon consolidation.

The Group's interests in joint venture entities are accounted for using the equity method and then assessed for impairment in the relevant company's financial statements.

The consolidated financial statements have been prepared using uniform accounting policies.

## 1.6 Foreign currency

*Functional and presentation currency*
Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency'). The consolidated financial statements are presented in pounds sterling (GBP), which is also the Group's presentation currency, rounded to the nearest million pounds sterling (£m) unless otherwise stated.

*Transactions and balances*
The Group records an asset, liability, expense or revenue arising from a transaction using the closing exchange rate between the functional and foreign currency on the transaction date. At each subsequent reporting date, the Group translates foreign currency monetary items at the closing rate. Foreign exchange differences arising on translation or settlement of monetary items are recognised in the income statement during the year in which the gains or losses arise.

Foreign currency non-monetary items measured at historical cost are translated at the date of the transaction, with those measured at fair value translated at the date when the fair value is determined. Foreign exchange differences are recognised directly in equity for non-monetary items where any component of associated gains or losses is recognised directly in equity. Foreign exchange differences arising from non-monetary items, whereby the associated gains or losses are recognised in the income statement, are also recognised in the income statement.

## 1.7 Financial assets and liabilities

*Recognition and derecognition*
A financial asset or a financial liability is recognised on the balance sheet when the Group becomes party to the contractual provisions of the instrument. Purchases and sales of financial assets classified within fair value through profit or loss or FVOCI are recognised on trade date.

The Group derecognises a financial asset when the contractual cash flows from the asset expire or it transfers the right to receive contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership are transferred. Financial liabilities are derecognised when the Group has discharged its obligation to the contract, or the contract is cancelled or expires.

*Classification and measurement*
The Group measures a financial asset or liability on initial recognition at its fair value, plus or minus transaction costs that are directly attributable to the acquisition or issue of the financial asset or the financial liability (with the exception of financial assets or liabilities at fair value through profit or loss, where transaction costs are recognised directly in the income statement as they are incurred).

## 1.7 Financial assets and liabilities (continued)

*Financial assets*
Subsequent accounting for a financial asset is determined by the classification of the asset depending on the underlying business model and contractual cash flow characteristics. This results in classification within one of the following categories:

i. Amortised cost

A financial asset is measured at amortised cost when (1) the asset is held within a business model whose objective is achieved by collecting contractual cash flows; and (2) the contractual terms give rise to cash flows on specified dates which are solely payments of principal and interest on the principal amount outstanding.

ii. FVOCI

A financial asset is measured at FVOCI when (1) the asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and (2) the contractual terms give rise to cash flows on specified dates which are solely payments of principal and interest on the principal amount outstanding unless the financial asset is designated at fair value through profit or loss on initial recognition.

iii. Fair value through profit or loss

A financial asset is measured at fair value through profit or loss (FVTPL) if it (1) does not fall into one of the business models described above; (2) is specifically designated as FVTPL on initial recognition in order to eliminate or significantly reduce a measurement mismatch; or (3) is classified as held for trading.

A financial instrument is classified as held for trading if it is acquired principally for the purpose of selling in the near term, forms part of a portfolio of financial instruments that are managed together and for which there is evidence of short-term profit taking, or it is a derivative not in a qualifying hedge relationship.

*Financial liabilities*
All financial liabilities are measured at amortised cost, except for financial liabilities at fair value through profit or loss. Such liabilities include derivatives (other than derivatives that are financial guarantee contracts or are designated and effective hedging instruments), and liabilities designated at fair value through profit or loss on initial recognition.

*Offsetting*
This can only occur, and the net amount be presented on the balance sheet, when the Group currently has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

## 1.8 Critical accounting estimates and judgements

The preparation of financial statements requires the use of certain critical accounting estimates and judgements that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosed amount of contingent liabilities. Assumptions made at each balance sheet date are based on best estimates at that date. Although the Group has internal control systems in place to ensure that estimates can be reliably measured, actual amounts may differ from those estimates. The Group considers the most significant use of accounting estimates and judgements relate to the following areas:

- impairment provisions on credit exposures (note 3.2);
- EIR (note 2.2);
- deferred tax (note 3.11);
- PPI redress provision and other conduct related matters (note 3.16); and
- retirement benefit obligations (note 3.12).

The valuation of the Group's portfolio of loans and advances held at fair value through profit or loss is no longer considered a critical accounting estimate. While unobservable inputs such as the future expectation of credit losses will continue to impact the value of the portfolio, the balance has reduced to a level such that these are no longer considered to be critical to the Group's results.

# Notes to the consolidated financial statements (continued)

## Section 1: Basis of preparation (continued)

### 1.9 New accounting standards and interpretations

The Group has adopted a number of International Accounting Standards Board (IASB) pronouncements in the current financial year.

*IFRS 9 'Financial Instruments'*

IFRS 9 'Financial Instruments' was issued in July 2014 and effective for financial periods beginning on or after 1 January 2018. IFRS 9 replaces IAS 39 'Financial Instruments: Recognition and Measurement' in accounting for financial instruments and introduces changes to the classification and measurement of financial instruments and the impairment of financial assets. IFRS 9 also introduces new requirements for hedge accounting but includes an accounting policy choice for entities to continue to follow the hedge accounting requirements under IAS 39 until the IASB has an agreed strategy for macro hedge accounting. Consequently, the Group has decided to exercise the available accounting policy option and has chosen not to adopt the hedge accounting requirements of IFRS 9 at this time. There is no change to the Group's policy on financial liabilities, which are measured at amortised cost, except for trading liabilities and other financial liabilities designated at fair value through profit or loss.

Financial assets are classified under IFRS 9 using a two-step process: (i) a business model assessment, and (ii) an assessment of whether the contractual terms of the financial asset give rise to cash flows which are consistent with that of solely payments of principal and interest.

The accounting policies for loans and advances to customers (note 3.1), impairment provisions on credit exposures (note 3.2) and financial assets at fair value through profit or loss (note 3.5) have been revised, and an accounting policy for the new category of financial assets 'financial assets at FVOCI introduced (note 3.7).

The accounting policy for financial assets available for sale (note 3.8) is no longer relevant as this financial asset category has been removed with the introduction of IFRS 9. All accounting policies for financial assets under IAS 39 that were applicable for the Group up to and including 30 September 2018 have not been replicated and can be found in the Group's 2018 Annual Report and Accounts.

On transition and as permitted by IFRS 9, the Group has not restated comparative figures, with the impact of adopting IFRS 9 adjusted through retained earnings. Further detail on the transitional impact of IFRS 9 can be found in note 5.4.

## 1.9 New accounting standards and interpretations (continued)

**IFRS 15 'Revenues from Contracts with Customers'**

IFRS 15 'Revenue from Contracts with Customers' was issued in May 2014 and effective for financial periods beginning on or after 1 January 2018. IFRS 15 replaces IAS 11 'Construction Contracts' and IAS 18 'Revenue' as the accounting standard on revenue recognition.

IFRS 15 requires revenue to be reflected as a transfer of goods or services to customers in an amount that recognises the consideration to which the Group expects to be entitled. This is satisfied by following a principles based five-step model for revenue recognition.

The majority of the Group's revenue is interest income generated from financial instruments, with the recognition criteria covered in IFRS 9 and not as part of IFRS 15. Interest income generated from lease contracts is also out of scope for IFRS 15. Fees and commissions together with certain elements of non-interest income are in scope of IFRS 15, with the Group's existing accounting policy materially consistent with the expectations under IFRS 15.

On transition and as permitted by IFRS 15, the Group has not restated comparative figures, with the impact of adopting IFRS 15 adjusted through retained earnings. Further detail on the transitional impact of IFRS 15 can be found in note 5.4.

**Other accounting standards and interpretations**

Except where otherwise stated, the following IASB pronouncements did not have a material impact on the Group's consolidated financial statements:

- amendments to IFRS 2: 'Classification and Measurement of Share-based Payment Transactions' issued in June 2016 and effective for financial years beginning on or after 1 January 2018. The amendments provide guidance on the effects of vesting and non-vesting conditions on the measurement of cash-settled share-based payments; classification of share-based payments with a net settlement feature for withholding tax obligations; and accounting for modifications to a share-based payment that change the classification from cash-settled to equity-settled;
- 'Annual Improvements to IFRS Standards 2014-2016 Cycle' issued December 2016 and effective for financial years beginning on or after 1 January 2018. The amendment relates to IAS 28: 'Investments in Associates and Joint Ventures' and the measurement of an associate or joint venture at fair value;
- IFRIC interpretation 22: 'Foreign Currency Transactions and Advance Consideration' issued December 2016 and effective for financial years beginning on or after 1 January 2018. The new interpretation provides requirements on which exchange rate to use in reporting foreign currency transactions (such as revenue transactions) when payment is made or received in advance; and
- amendments to IFRS 9: 'Prepayment Features with Negative Compensation' issued in October 2017 and effective for financial years beginning on or after 1 January 2019. The amendments allow companies to measure particular prepayable financial assets with negative compensation at amortised cost or FVOCI if a specified condition is met, instead of these being measured at fair value through profit or loss. The Group early adopted this amendment with effect from 1 October 2018 in line with the adoption of IFRS 9.

# Notes to the consolidated financial statements (continued)

## Section 1: Basis of preparation (continued)

### 1.9 New accounting standards and interpretations (continued)

**New accounting standards and interpretations not yet adopted**

There are a number of other standards, interpretations and amendments that have not been applied by the Group in preparing these financial statements as they are either not available for adoption in the EU or are not mandatory for the Group as at 30 September 2019. The pronouncements, while relevant to the Group, are not anticipated to have a material impact and include:

– IFRIC interpretation 23: 'Uncertainty over Income Tax Treatments' issued June 2017 and effective for financial years beginning on or after 1 January 2019. The new interpretation applies to any situation in which there is uncertainty as to whether an income tax treatment is acceptable under tax law and is not limited to actual ongoing disputes;

– 'Annual Improvements to IFRS Standards 2015-2017 Cycle'[1] issued December 2017 and effective for financial years beginning on or after 1 January 2019. The IASB has made amendments to the following standards: IFRS 3 'Business Combinations'; IFRS 11 'Joint arrangements'; IAS 12 'Income Taxes'; and IAS 32 'Borrowing Costs'. The amendment clarifies that the income tax consequences of distributions on financial instruments classified as equity should be recognised alongside the past transactions or events that generated the distributable profits. The Group has assessed that, on adoption of this amendment, the taxation impacts of distributions relating to AT1 securities would be recognised within 'Tax expense' in the Income Statement. Currently these taxation impacts are recognised directly in 'Retained earnings' within Equity. As the amendment impacts only the presentation of taxation impacts but not their calculation, adoption will not result in any change to the Group's net assets but will result in an increase in 'Profit for the year attributable to equity owners' compared to existing practice. If the Group had applied the amendment in these financial statements, the Profit for the year attributable to equity owners would have been £14m (2018: £7m) higher than that disclosed in the income statement, with an equivalent reduction to 'Tax expense';

– amendment to IAS 19: 'Plan amendment, curtailment or settlement'[1] issued in February 2018 and effective prospectively for financial years beginning on or after 1 January 2019. The amendments clarify that after a plan event companies should use these updated assumptions to measure current service cost and net interest for the remainder of the reporting period;

– amendments to references to the 'Conceptual Framework in IFRS Standards'[1] issued in March 2018 and effective for financial years beginning on or after 1 January 2020. The amendments were issued following the IASB's publication of a revised version of its Conceptual Framework for Financial Reporting and updates the references in IFRS standards to previous versions of the Conceptual Framework;

– amendment to IAS 28: 'Long-term Interests in Associates and Joint Ventures' issued in October 2017 and effective for financial years beginning on or after 1 January 2019. The amendment clarifies that an entity applies IFRS 9 Financial Instruments to long-term interests in an associate or joint venture to which the equity method is not applied but that, in substance, form part of the net investment in the associate or joint venture (long-term interests);

– amendments to IAS 1: 'Presentation of Financial Statements' and IAS 8: 'Accounting Policies, Changes in Accounting Estimates and Errors'[1] issued in October 2018 and effective prospectively for financial years beginning on or after 1 January 2020. The amendments provide clarification on the definition of 'material';

– amendments to IFRS 3: 'Business Combinations'[1] issued in October 2018 and effective prospectively for financial years beginning on or after 1 January 2020. The amendment assists in the determination of whether an acquired set of activities and assets meets the test of being classed as a business; and

– Interest Rate Benchmark Reform (Amendments to IFRS 9, IAS 39 and IFRS 7)[1] issued in September 2019 and effective for financial years beginning on or after 1 January 2020. The amendments provide temporary reliefs which enable hedge accounting to continue during the period of uncertainty before the replacement of an existing interest rate benchmark with an alternative nearly risk-free interest rate (an RFR). The Group is working through the implications of the amendment ahead of implementation from 1 October 2020.

[1] Not yet endorsed by the EU.

## 1.9 New accounting standards and interpretations (continued)

## New accounting standards and interpretations not yet adopted (continued)

**Update on IFRS 16: 'Leases'**

IFRS 16 'Leases' was issued in January 2016 and replaces IAS 17 'Leases', IFRIC 4 'Determining whether an Arrangement contains a Lease', SIC-15 'Operating Leases - Incentives' and SIC-27 'Evaluating the Substance of Transactions Involving the Legal Form of a Lease'. IFRS 16 is effective for annual periods beginning on or after 1 January 2019 and was EU endorsed on 31 October 2017. The Group will apply the standard from 1 October 2019.

IFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases and will result in most leases for lessees being brought on to the balance sheet under a single lease model, removing the distinction between finance and operating leases. It requires a lessee to recognise a 'right-of-use' asset and a lease liability. Lessor accounting remains largely unchanged.

The right-of-use asset is initially measured at cost, which comprises the initial amount of the lease liability adjusted for any lease payments made at or before the commencement date, plus any initial direct costs incurred and an estimate of costs to restore the underlying asset, less any lease incentives received.

The right-of-use asset is subsequently depreciated using the straight line method from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. In addition, the right-of-use asset is periodically reduced by impairment losses, if any, and adjusted for certain remeasurements of the lease liability.

The lease liability is initially measured at the present value of the lease payments that are not paid at the commencement date, discounted using the interest rate implicit in the lease or, if that rate cannot be readily determined, the incremental borrowing rate is used for the discount rate.

The lease liability is measured at amortised cost using the effective interest method. It is remeasured when there is a change in future lease payments arising from a change in an index or rate, if there is a change in amount expected to be payable under a residual value guarantee, or if there is a change in the assessment of whether a purchase, extension or termination option will be exercised.

When a lease liability is remeasured in this way, a corresponding adjustment is made to the carrying amount of the right-to-use asset or is recorded in the income statement if the carrying amount of the right-of-use asset has been reduced to zero.

*Transition approach and use of practical expedients*

The Group will elect to apply the practical expedient to grandfather the assessment of which transactions are leases. It will apply IFRS 16 only to contracts that were previously identified as leases by IAS 17. Contracts that were not identified as leases under IAS 17 and IFRIC 4 will not be reassessed. Therefore, the definition of a lease under IFRS 16 will only be applied to contracts entered into or changed on or after 1 October 2019.

The Group will also elect to apply the recognition exemptions for short-term leases (with a remaining lease term of less than 12 months) and low value item leases. Lease payments associated with these leases will be recognised as an expense on a straight line basis over the term of the lease.

The Group will apply IFRS 16 using the modified retrospective approach, under which the cumulative effect of initial application is recognised in retained earnings as at 1 October 2019 and comparatives are not restated.

Under the modified approach, at transition, lease liabilities will be measured at the present value of the remaining lease payments, discounted at the Group's incremental borrowing rate as at 1 October 2019.

For the purposes of applying the modified retrospective approach, the Group will elect to:

- measure the right-of-use asset at an amount equal to the lease liability at the date of initial application adjusted by the amount of any prepaid or accrued lease payments;
- apply the exemption not to recognise right-of-use assets and liabilities for leases with less than 12 months of lease term; and
- apply the practical expedient to rely on its assessment whether the lease was onerous under IAS 37 and therefore adjust the right-of-use asset at the date of initial application by the onerous lease provision rather than conduct an impairment test.

# Notes to the consolidated financial statements (continued)

## Section 1: Basis of preparation (continued)

### 1.9 New accounting standards and interpretations (continued)

*Key accounting judgements*

The Group undertook a technical assessment of IFRS 16. The two key accounting judgements in relation to IFRS 16 are determining the discount rates and lease term.

When measuring the lease liability, lease payments are discounted using the interest rate implicit in the lease or, if that rate cannot be readily determined, the incremental borrowing rate is used for the discount rate. Under the modified retrospective approach, the Group will use its incremental borrowing rate at the date of initial application as the discount rate. Judgement will be required to determine an appropriate incremental borrowing rate.

When determining lease term, an assessment is required of whether an extension or termination option will be exercised. This is reassessed if there is a significant event or significant change in circumstances within the Group's control. Judgement is required when making this assessment.

*Impact of transition to IFRS 16*

On transition to IFRS 16, the Group estimates it will recognise right-of-use assets of approximately £196m and lease liabilities of approximately £207m, with no material impact to retained earnings. The Group will not restate comparative periods.

The Group continues to refine, monitor and validate certain elements of the IFRS 16 model and related controls ahead of full reporting of IFRS 16 impacts in 2020.

The standard is not expected to have any significant impact on lessor accounting by the Group.

### 1.10 Prior period comparatives

The prior period comparatives in the balance sheet have been restated in line with the current year presentation. £34m of derivative collateral in relation to clearing houses has been reclassified between other liabilities and due to other banks and £143m has been reclassified between other assets and due from other banks. In addition, certain line items within assets and liabilities which are not material have been aggregated with other similar line items.

# Notes to the consolidated financial statements (continued)
## Section 2: Results for the year

### 2.1 Segment information

The Group's operating segments are operating units engaged in providing different products or services and whose operating results and overall performance are regularly reviewed by the Group's Chief Operating Decision Maker, the Executive Leadership Team.

Following the acquisition of Virgin Money Holdings (UK) PLC and up until 30 September 2019, the business has been assessed and reported to the Group's Chief Operating Decision Maker as a single segment, with decisions being made on the performance of the Group on that basis.

With effect from 1 October 2019, the business has been aligned to a three operating segments model: Business, Personal and Mortgages. Reporting on this segmental basis will be included in the 2020 Annual Report and Accounts.

**Summary income statement**

| | **2019** | 2018 |
|---|---|---|
| | **£m** | £m |
| Net interest income | **1,516** | 855 |
| Non-interest income | **257** | 156 |
| Total operating income | **1,773** | 1,011 |
| Operating and administrative expenses | **(1,703)** | (1,246) |
| Impairment losses on credit exposures | **(252)** | (41) |
| Segment loss before tax | **(182)** | (276) |
| | | |
| Average interest earning assets | **86,362** | 39,417 |

The Group has no operations outside the UK and therefore no secondary geographical area information is presented. The Group is not reliant on a single customer. Liabilities are managed on a centralised basis.

### 2.2 Net interest income

**Accounting policy**

Interest income is reflected in the income statement using the effective interest method which discounts the estimated future cash payments or receipts over the expected life of the financial instrument to the gross carrying amount of the non-credit impaired financial asset. Interest expense is reflected in the income statement using the same effective interest method on the amortised cost of the financial liability.

When calculating the EIR, cash flows are estimated considering all contractual terms of the financial instrument (e.g. prepayment, call and similar options) excluding future credit losses. The calculation includes all amounts paid or received that are an integral part of the EIR such as transaction costs and all other premiums or discounts. Where it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments) are used.

Loan origination and commitment fees are recognised within the EIR calculation. Non-utilisation of a commitment fee is recognised as revenue upon expiry of the agreed commitment period. Loan related administration and service fees are recognised as revenue over the period of service.

## 2.2 Net interest income (continued)

Interest income on financial assets in impairment Stages 1 and 2 is recognised on the unwind of the discount from the initial recognition of the ECL using the original effective rate of interest. Once a financial asset or group of similar financial assets has been categorised as credit-impaired (Stage 3), interest income is recognised on the net carrying value (after the ECL allowance) using the asset's original EIR. The interest income for purchase or originated credit impaired financial assets is calculated using the credit-adjusted EIR applied to the amortised cost of the financial asset from initial recognition. The Group recognises and presents the reversal of ECLs following the curing of a credit impaired financial asset as a reversal of impairment losses.

Interest income and interest expense on hedged assets and liabilities and financial assets and liabilities designated as fair value through profit or loss are also recognised as part of net interest income.

Interest income and expense on derivatives economically hedging interest bearing financial assets or liabilities (but not designated as hedging instruments) and other financial assets and liabilities held at fair value through profit or loss (either mandatory or by election) are also recognised within net interest income. With effect from 1 October 2018, IAS 1 'Presentation of financial statements' prohibits the inclusion of such interest within 'Interest income'. Therefore interest income or expense on these items is now presented within 'Other similar interest'. Comparatives have been restated.

**Critical accounting estimates and judgements**

***EIR***

Following the acquisition of Virgin Money Holdings (UK) PLC, the Group considered the application of EIR in relation to its reported amounts of assets, liabilities, revenues and expenses. The Group has concluded that sufficient judgement is now exercised on EIR for it to be included within its disclosures on critical accounting estimates and judgements.

The EIR is determined at initial recognition based upon management's best estimate of the future cash flows of the financial instrument. In the event these estimates are revised at a later date, a present value adjustment to the carrying value of the EIR asset may be recognised in profit or loss. Such adjustments can introduce income statement volatility and consequently the EIR method introduces a source of estimation uncertainty. Management considers that material risk of adjustments exists in relation to the application of EIR to the Group's mortgage and credit card portfolios.

**Mortgages**

The main accounting judgement when assessing the cash flows within the Group's secured lending EIR model is the product life (including assumptions based on observed historic customer behaviour when in a standard variable rate (SVR) period) and the early repayment charge income receivable. The Group currently assumes that 83% of customers will have fully repaid or re-mortgaged within two months of reverting to SVR. If this were to increase to 90%, the loans and advances to customers balance would reduce by £20m with the adjustment recognised in net interest income.

**Credit cards**

The Group measures credit card EIR by modelling expected cash flows based on assumptions of future customer behaviour, which is supported by observed experience. Key behavioural assumptions include an estimation of utilisation of available credit, transaction and repayment activity and the retention of the customer balance after the end of a promotional period.

The EIR of new business written in the current year is 5.26% while that on acquired portfolios nearing the end of their promotional periods is 8.22% (this excludes those which were out of their promotional periods at the date of acquisition and therefore do not form part of the EIR modelling). Revisions to the estimates of future cash flows (compared to the original assumptions) that would have resulted in the original EIR across all cohorts being reduced by 25bps, would result in a £16m decrease in the loans and advances to customers balance. This present value adjustment would be recognised in interest income.

The Group holds an appropriate level of model risk reserve across both asset classes to mitigate the risk of estimation uncertainty.

## 2.2 Net interest income (continued)

| | 2019 | 2018 |
|---|---|---|
| | £m | £m |
| **Interest income** | | |
| Loans and advances to customers | 2,320 | 1,057 |
| Loans and advances to other banks | 72 | 26 |
| Financial assets at fair value through other comprehensive income | 27 | - |
| Financial assets available for sale | - | 12 |
| Other interest income | 1 | 3 |
| **Total interest income** | 2,420 | 1,098 |
| | | |
| **Other similar interest** | | |
| Financial assets at fair value through profit or loss | 21 | 29 |
| Financial liabilities at fair value through profit or loss | - | (1) |
| Derivatives economically hedging interest bearing assets | (8) | (13) |
| **Total other similar interest** | 13 | 15 |
| | | |
| **Less: interest expense and similar charges** | | |
| Customer deposits | (580) | (148) |
| Debt securities in issue | (112) | (59) |
| Due to other banks | (144) | (18) |
| Due to related entities | (72) | (33) |
| Other interest expense | (9) | - |
| **Total interest expense and similar charges** | (917) | (258) |
| | | |
| **Net interest income** | 1,516 | 855 |

## 2.3 Non-interest income

**Accounting policy**

***Gains less losses on financial instruments at fair value***

This includes fair value gains and losses from three distinct activities:

- derivatives classified as held for trading - the full change in fair value of trading derivatives is recognised inclusive of interest income and expense arising on those derivatives except when economically hedging other assets and liabilities at fair value as outlined in note 2.2;
- other financial assets and liabilities designated at fair value through profit or loss - these relate to the Group's fixed interest rate loan portfolio and related term deposits (note 3.5), which were designated at inception as fair value through profit or loss. The fair value of these loans is derived from the future loan cash flows using appropriate discount rates and includes adjustments for credit risk and credit losses. The valuation technique used is reflective of current market practice; and
- hedged assets, liabilities and derivatives designated in hedge relationships - fair value movements are recognised on both the hedged item and hedging derivative in a fair value hedge relationship, the net of which represents hedge ineffectiveness, and hedge ineffectiveness on cash flow hedge relationships (note 3.6).

*Fees and commissions*

Fees and commissions receivable which are not an integral part of the EIR are recognised as income as the Group fulfils its performance obligations. The Group's principal performance obligations arising from contracts with customers are in respect of current accounts, debit cards and credit cards. The Group provides the service and consequently generates the fees monthly, with fees recognised in income on this basis. Costs incurred to generate fee and commission income are charged to fees and commissions expense as they are incurred.

## 2.3 Non-interest income (continued)

**Accounting policy** *(continued)*

***Income from insurance, protection and investments***

This includes management fees generated from the sale of and management of funds, stocks and shares Individual Savings Accounts ('ISAs') and pensions to retail investors. The contractual performance obligations to investors are aligned to the obligations required of UK authorised fund managers.

In return for providing these continuous services, a management charge is levied on investors' funds under management. This charge is accrued by the products via adjustment to the closing unit prices of investors' holdings on a daily basis.

| | 2019 | 2018 |
|---|---|---|
| | £m | £m |
| **Gains less losses on financial instruments at fair value** | | |
| Held for trading derivatives | 16 | 16 |
| Financial assets and liabilities at fair value[(1)] | - | (13) |
| Ineffectiveness arising from fair value hedges (note 3.6) | (22) | - |
| Ineffectiveness arising from cash flow hedges (note 3.6) | (14) | (6) |
| | (20) | (3) |
| **Other operating income** | | |
| Net fees and commission income | 195 | 141 |
| Margin on foreign exchange derivative brokerage | 19 | 18 |
| Gains on sale of financial assets at fair value through other comprehensive | 3 | - |
| Gain on sale of Virgin Money Unit Trust Managers Limited[(2)] | 35 | - |
| Share of joint venture results | (2) | - |
| Other income[(3)] | 27 | - |
| | 277 | 159 |
| **Total non-interest income** | 257 | 156 |
| Non-interest income includes the following fee and commission income disaggregated by income type: | | |
| - Current account and debit card fees | 117 | 114 |
| - Credit cards | 42 | 13 |
| - Insurance, protection and investments | 37 | 13 |
| - Non-banking and other fees[(4)] | 31 | 32 |
| Total fee and commission income | 227 | 172 |
| Total fee and commission expense | (32) | (31) |
| **Net fee and commission income** | 195 | 141 |

(1) A credit risk gain on other assets and liabilities at fair value of £2m has been recognised in the current year (2018: £3m gain).

(2) The Group ceased generating management fees directly from the sale and management of funds products from 31 July 2019 when it sold 50% (less one share) of its shareholding in Virgin Money Unit Trust Managers Limited (UTM) to Aberdeen Standard Investments. A gain on sale of £35m was recorded on the partial disposal. Consequently, UTM became a joint venture and is accounted for under the equity method from the date of disposal.

(3) Included within other income is a one-off gain relating to the change in obligor of senior debt from Virgin Money Holdings (UK) PLC to CYBG PLC on 20 August 2019.

(4) Non-banking and other fees include mortgages, invoice and asset finance and ATM fees.

# Notes to the consolidated financial statements (continued)

## Section 2: Results for the year (continued)

### 2.4 Operating and administrative expenses before impairment losses

**Accounting policy**

Personnel expenses primarily consist of wages and salaries, accrued bonus and social security costs arising from services rendered by employees during the financial year.

The Group recognises bonus costs where it has a present obligation that can be reliably measured. Bonus costs are recognised over the relevant service period required to entitle the employee to the reward.

The Group's accounting policies on pension expenses and equity based compensation are included in notes 3.12 and 4.2 respectively.

| | 2019 | 2018 |
|---|---|---|
| | £m | £m |
| Personnel expenses | 419 | 223 |
| Depreciation and amortisation expense (notes 3.9, 3.10) | 108 | 89 |
| Other operating and administrative expenses | 1,176 | 934 |
| **Total operating and administrative expenses** | 1,703 | 1,246 |

Personnel expenses comprise the following items:

| | 2019 | 2018 |
|---|---|---|
| | £m | £m |
| Salaries, wages and non-cash benefits and social security costs | 256 | 139 |
| Defined contribution pension expense | 47 | 33 |
| Defined benefit pension expense (note 3.12) | 9 | 2 |
| Equity based compensation (note 4.2) | 4 | 9 |
| Other personnel expenses | 103 | 40 |
| **Personnel expenses** | 419 | 223 |

On 26 October 2018, the High Court delivered a judgement confirming that defined benefit schemes should equalise pension benefits for men and women in relation to Guaranteed Minimum Pension (GMP) and concluded on the methods that were appropriate. The estimated increase in the Scheme liabilities at the date of the judgement was £11m, which was based on a number of assumptions and the actual impact may be different. This has been reflected as a past service cost within the defined benefit pension expense above, and in the closing net accounting surplus of the Scheme (note 3.12).

The average number of FTE employees of the Group during the year was made up as follows:

| | 2019 | 2018 |
|---|---|---|
| | Number | Number |
| Managers | 2,989 | 2,161 |
| Clerical staff | 5,714 | 3,608 |
| | 8,703 | 5,769 |

The average monthly number of employees was 9,787 (2018: 6,461).

All staff are contracted employees of the Group and its subsidiary undertakings. The average figures above do not include contractors.

## 2.4 Operating and administrative expenses before impairment losses (continued)

Other items of significance to the Group which are included within operating and administrative expenses are:

| | **2019** | 2018 |
|---|---|---|
| | **£m** | £m |
| Restructuring costs | **149** | - |
| Legacy restructuring and separation | **5** | 46 |
| Virgin Money Holdings (UK) PLC transaction costs | **2** | 37 |
| SME transformation | **30** | 16 |
| Intangible asset write-off | **127** | - |
| PPI redress expense (note 3.16) | **415** | 500 |
| Other conduct expenses (note 3.16) | **18** | 44 |
| Operating lease charges | **35** | 26 |

Restructuring costs represent the costs incurred by the Group in the first year of a three year programme to fully integrate both banks. The legacy restructuring and separation costs relate to the Sustain programme and demerger from NAB, both of which completed in the current period.

Incidental to the integration programme, a £127m charge was recognised in the year following a review of the Group's software estate, which identified a number of core assets (including £70m in relation to the Virgin Money Digital Bank asset) that are no longer of value to the Group's future strategy and therefore required to be written down.

Auditor's remuneration included within other operating and administrative expenses:

| | **2019** | 2018 |
|---|---|---|
| | **£'000** | £'000 |
| Fees payable to the Bank's auditor for the audit of the Bank's financial statements | **2,613** | 1,518 |
| Fees payable to the Bank's auditor for the audit of the Bank's subsidiaries[1] | **354** | 75 |
| Total audit fees | **2,967** | 1,593 |
| Other assurance services | **289** | 700 |
| Fees payable to the Bank's auditor in respect of associated pension schemes | **88** | 84 |
| Total fees payable to the Bank's auditor | **3,344** | 2,377 |

(1) Includes the audit of the Group's structured entities, and the audit of Virgin Money Holdings (UK) PLC subsidiaries for the year ending 31 December 2019.

Non-audit services of £289k (2018: £700k) performed by the auditor during the year included agreed upon procedures under the Conduct Indemnity arrangement with NAB; comfort letters for the global medium-term note programme and AT1 issuance; and client money reviews. The decrease in the year is principally due to reporting accountant procedures in relation to the acquisition of Virgin Money Holdings (UK) PLC.

In addition to the above, out of pocket expenses of £161k (2018: £48k) were borne by the Group, principally related to reimbursement of travel expenses incurred by staff when performing the above services.

# Notes to the consolidated financial statements (continued)
## Section 2: Results for the year (continued)

### 2.5 Taxation

**Accounting policy**

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it is related to items recognised directly in equity, in which case the tax is also recognised in equity.

Current tax is the expected tax payable or receivable on the taxable profit or loss for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years. Deferred tax assets and liabilities are recognised on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Deferred tax is determined using tax rates and laws that have been enacted or substantively enacted by the balance sheet date and are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

| | 2019 | 2018 |
|---|---|---|
| | £m | £m |
| **Current tax** | | |
| Current year | **20** | 8 |
| Adjustment in respect of prior years | **(5)** | - |
| | **15** | 8 |
| **Deferred tax** (note 3.11) | | |
| Current year | **(61)** | (33) |
| Adjustment in respect of prior years | **3** | (12) |
| | **(58)** | (45) |
| **Tax credit for the year** | **(43)** | (37) |

The tax assessed for the year differs from that arising from applying the standard rate of corporation tax in the UK of 19%. A reconciliation from the credit implied by the standard rate to the actual tax credit is as follows:

| | 2019 | 2018 |
|---|---|---|
| | £m | £m |
| Loss on ordinary activities before tax | **(182)** | (276) |
| Tax credit based on the standard rate of corporation tax in the UK of 19% (2018: 19%) | **(35)** | (53) |
| *Effects of:* | | |
| Disallowable expenses | **47** | 52 |
| Deferred tax assets recognised | **(49)** | (8) |
| Bank levy | **1** | - |
| Non-taxable gain on partial disposal of UTM (note 2.3) | **(7)** | - |
| Impact of rate changes | **2** | (15) |
| Adjustments in respect of prior years | **(2)** | (13) |
| **Tax credit for the year** | **(43)** | (37) |

Disallowable expenses represent, in the main, conduct charges that are not deductible in computing taxable profits and non-deductible transaction costs predominantly in relation to the acquisition of Virgin Money Holdings (UK) PLC.

Deferred tax assets recognised represent previously unrecognised historic losses that are now brought onto the balance sheet in accordance with the Group's established methodology.

## 3.1 Loans and advances to customers

**Accounting policy**

Loans and advances to customers arise when the Group provides money directly to a customer and includes mortgages, term lending, overdrafts, credit card lending, lease finance and invoice financing. They are recognised initially at fair value and are subsequently measured at amortised cost, using the effective interest method, adjusted for ECLs (note 3.2). They are derecognised when the rights to receive cash flows have expired or the Group has transferred substantially all the risks and rewards of ownership.

Leases entered into by the Group as lessor, where the Group transfers substantially all the risks and rewards of ownership to the lessee, are classified as finance leases. The leased asset is not held on the Group balance sheet; instead, a finance lease is recognised representing the minimum lease payments receivable under the terms of the lease, discounted at the rate of interest implicit in the lease. Interest income is recognised in interest receivable, allocated to accounting periods to reflect a constant periodic rate of return.

In certain limited circumstances, the Group has elected to apply the fair value through profit or loss measurement option to some debt instruments that would otherwise be classified at amortised cost (note 3.5).

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018[1] | **2019** | 2018[1] |
| | **£m** | £m | **£m** | £m |
| Gross loans and advances to customers | **73,244** | 32,943 | **32,613** | 31,827 |
| Impairment provisions on credit exposures (note 3.2) | **(362)** | (195) | **(224)** | (192) |
| Fair value hedge adjustment | **211** | - | **-** | - |
| | **73,093** | 32,748 | **32,389** | 31,635 |

(1) The prior year comparative has been restated in line with the current year presentation (note 1.10).

The Group and Bank have a portfolio of fair valued business loans of £253m (2018: £362m) which are classified separately as financial assets at fair value through profit or loss on the balance sheet (note 3.5). Combined with the above, this is equivalent to total loans and advances of £73,346m (2018: £33,106m) in respect of Group and £32,642m (2018: £31,993m) in respect of Bank.

The fair value hedge adjustment represents an offset to the fair value movement on derivatives designated in hedge relationships to manage the interest rate risk inherent in the Group's fixed rate mortgage portfolio.

The Group and Bank have transferred a proportion of mortgages to the securitisation and covered bond programmes (note 3.3).

**Lease finance**

The Group and Bank lease a variety of assets to third parties under finance lease arrangements, including vehicles and general plant and machinery. The cost of assets acquired by the Group and Bank during the year for the purpose of letting under finance leases and hire purchase contracts amounted to £38m (2018: £20m) and £408m (2018: £399m) respectively.

## 3.1 Loans and advances to customers (continued)

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| **Finance lease and hire purchase receivables** | | | | |
| Gross investment in finance lease and hire purchase receivables: | | | | |
| Due within 1 year | **276** | 269 | **259** | 261 |
| Due within 1 to 5 years | **386** | 376 | **349** | 356 |
| Due after more than 5 years | **23** | 15 | **10** | 7 |
| | **685** | 660 | **618** | 624 |
| Unearned income | **(36)** | (32) | **(30)** | (29) |
| **Net investment in finance lease and hire purchase receivables** | **649** | 628 | **588** | 595 |

The total receivables from finance leases for the Group and Bank were £60m and £Nil (2018: £32m and £Nil) respectively. The total receivables from hire purchase contracts in the Group and Bank were £589m and £588m (2018: £596m and £595m) respectively.

## 3.2 Impairment provisions on credit exposures

**Accounting policy**

At each reporting date, the Group assesses financial assets measured at amortised cost, as well as loan commitments and financial guarantees not measured at fair value through profit or loss, for impairment. The impairment loss allowance is calculated using an ECL methodology. The overarching objective is to calculate an impairment loss allowance that reflects: (i) an unbiased and probability weighted amount; (ii) the time value of money which discounts the impairment loss; and (iii) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

*ECL methodology*

The ECL methodology is based upon the combination of PD, LGD and EAD estimates that consider a range of factors which have a direct bearing on credit risk and consequently the required level of impairment loss provisioning.

The future cash flows used within the ECL calculation are estimated based on the contractual cash flows of the assets, adjusted for the PD occurring and taking account of historical loss experience. In addition, the Group uses reasonable and supportable forecasts of future economic conditions to estimate the ECL allowance. The use of such judgements and reasonable estimates is considered by management to be an essential part of the process which does not impact reliability. The methodology and assumptions are reviewed regularly and updated as necessary.

The ECL assessment is performed on either a collective or individual basis as follows:

*Collectively assessed:* these assets are assessed and provided for on a group or a pooled basis due to the existence of shared risk characteristics. Financial assets with shared risk characteristics are assessed in the sense that assets with similar characteristics at a given point in time will tend to display a similar PD profile but only for as long as they retain those similar characteristics. In particular, movement between stages will tend to occur when individual assets have deteriorated, rather than because a proportion of a pool is presumed to have deteriorated.

*Individually assessed:* these assets are assessed and provided for at the financial instrument level, with the assessment (which is governed by the Group's Credit Policy) taking into consideration a range of likely potential outcomes relating to each customer and their associated financial assets.

It is not possible for an asset to have both an individual and a collectively assessed ECL provision. Regardless of the calculation basis, the Group generates an allowance at the individual financial instrument level.

*SICR assessment*

The impairment loss allowance is calculated as either a 12-month or lifetime ECL depending on whether the financial asset has exhibited a SICR since origination or has otherwise become credit impaired as at the reporting date.

The Group uses a PD threshold curve (distinct for each portfolio) to assess for a SICR and also utilises the 30 DPD and 90 DPD backstops for recognising SICR and credit impairment effectively.

The Group has not made use of the low credit risk option under IFRS 9 for loans and advances at amortised cost.

*Impairment staging*

Financial assets where a 12-month ECL is recognised are classified as Stage 1; financial assets which are considered to have experienced a SICR are classified as Stage 2; and financial assets which have defaulted or are otherwise considered to be credit impaired are classified as Stage 3. The Group adopts the backstop position that a financial asset has experienced a SICR (and therefore falls into Stage 2) when it reaches 30 DPD, and that a financial asset becomes credit impaired (and therefore falls into Stage 3) when it reaches 90 DPD.

In addition to the above stages, POCI financial assets are those which are assessed as being credit impaired upon initial recognition. Once a financial asset is classified as POCI, it remains there until de-recognition irrespective of its credit quality. POCI financial assets are disclosed separately from those financial assets in Stage 3. The Group regards the date of acquisition as the origination date for purchased portfolios.

## 3.2 Impairment provisions on credit exposures (continued)

**Accounting policy (continued)**

Financial assets can move between stages when the relevant staging criteria are no longer satisfied. If the level of impairment loss reduces in a subsequent period, the previously recognised impairment loss allowance is reversed and recognised in the income statement.

*Write-offs and recoveries*

When there is no reasonable expectation of recovery for a loan, it is written off against the related provision. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of the impairment charge in the income statement.

The Group's impairment policy for debt instruments at FVOCI is included in note 3.7. The impact of the ECL methodology on the Group's cash and balances with central banks and due from other banks balances is immaterial.

**Critical accounting estimates and judgements**

The use of an ECL methodology under IFRS 9 requires the Group to apply estimates and exercise judgement when calculating an impairment allowance for credit exposures. The most significant of these are detailed below.

***Accounting estimates***

*Asset lifetimes*

The calculation of the ECL allowance is also dependent on the expected life of the Group's portfolios. The Group assumes the remaining contract term as the maximum period to consider credit losses wherever possible. For the Group's credit card and overdraft portfolios, behavioural factors such as observed retention rates and other portfolio level assumptions are taken into consideration in determining the estimated asset life.

Shortening the Group's credit card portfolio lifetime assumption by three months would equate to an ECL decrease of £1m.

*Economic scenarios*

The Group relies on three economic scenarios over a five-year forecast period when calculating the ECL allowance: base case, mild upside and severe downside. These contain a number of key economic assumptions such as unemployment rates, base rates and inflation, which ensure that non-linear relationships between different forward-looking scenarios and their associated credit losses do not materially impact the ECL calculation. The base case used by the Group for IFRS 9 modelling is also used for the Group's internal planning purposes.

The Group sources forward-looking scenarios and a range of macroeconomic conditions over the forecast period from a third party provider. The Group considers that the resulting 'mild upside' and 'severe downside' scenarios provide a balance in reaching an ECL calculation that is free from bias and addresses concerns around the potential for non-linearity of the ECL calculation. The Group applied the following weightings to the chosen scenarios:

| | 30 September 2019 | 1 October 2018 |
|---|---|---|
| Mild upside | 20% | 25% |
| Base case | 60% | 60% |
| Severe downside | 20% | 15% |

The scenario weightings are considered and debated by an internal review panel and then recommended and approved for use in the IFRS 9 models by ALCO. The slight skew in weightings towards the mild upside scenario on adoption of IFRS 9 reflected the relative conservatism in the Group's base case, which was closer to the chosen downside scenario. The weightings applied at 30 September 2019 were revised to reflect a general deterioration in future economic outlook relative to the base case.

## 3.2 Impairment provisions on credit exposures (continued)

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

***Accounting judgements***

The calculation of the Group's impairment provision is sensitive to changes in the chosen weightings, with the effect on the closing impairment allowance of £362m as a result of applying a 100% weighting separately to each scenario producing the following: Base case – an ECL reduction of £11m; Mild upside – an ECL reduction of £27m; and Severe downside – an ECL increase of £65m.

*SICR*

Considerable management judgement is required in determining the point at which a SICR has occurred, as this is the point at which a 12-month ECL is replaced by a lifetime ECL. Management has developed a series of triggers that indicate where a SICR has occurred when assessing exposures for the risk of default occurring at each reporting date compared to the risk at origination. There is no single factor that influences this decision, rather a combination of different criteria that enable management to make an assessment based on the quantitative and qualitative information available. This includes the impact of forward-looking macroeconomic factors but excludes the existence of any collateral implications.

Indicators of a SICR include deterioration of the residual lifetime PD by set thresholds which are unique to each product portfolio, non-default forbearance programmes, and watch list status. The Group adopts the backstop position that a SICR will have taken place when the financial asset reaches 30 DPD.

Changes to these set of thresholds can impact staging, driving accounts into higher stages. If a further 10% of the business population in Stage 1 were to move Stage this would lead to an increase in ECL held by approximately £13m. In contrast, if a further 10% of the credit card population in Stage 1 were to experience a non-default related forbearance issue and migrate to Stage 2, the level of ECL held would increase by £52m. In mortgages this would increase by £7m. Introducing a PD stress, which increased PDs  upwards by 20% for all portfolios, would result in an overall increase in ECLs of £54m.

*Definition of default*

The PD of a credit exposure is a key input to the measurement of the ECL allowance. Default occurs when there is evidence that a customer is experiencing significant financial difficulty which is likely to affect the ability to repay amounts due. The Group utilises the 90 DPD backstop for default purposes.

*Post Model Adjustments (PMAs)*

The ECL provision is further impacted by management judgements in the form of PMAs, which were also a feature of impairment provisioning under IAS 39. These are judgements that increase the collectively assessed modelled output where management consider that not all of the risks identified in a particular product segment have been, or are capable of being, accurately reflected within those models. This can be the case when modelled inputs are not sufficiently sensitive to sudden changes in economic conditions e.g. Brexit. PMAs can also be applied when assessing potential recoveries on individually assessed provisions where factors such as customer and economic specific conditions need to be considered.

**Movement in impairment provision on credit exposures**

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| Opening balance at 30 September | **195** | 210 | **192** | 207 |
| IAS 39 restatement | **(195)** | - | **(192)** | - |
| IFRS 9 adoption | **224** | - | **220** | - |
| Charge for the year | **252** | 41 | **61** | 41 |
| Decrease due to write-offs | **(142)** | (68) | **(69)** | (68) |
| Recoveries of amounts written off in previous years | **28** | 13 | **12** | 13 |
| Other | **-** | (1) | **-** | (1) |
| **Closing balance** | **362** | 195 | **224** | 192 |

# Notes to the consolidated financial statements (continued)
## Section 3: Assets and liabilities (continued)

### 3.2 Impairment provisions on credit exposures (continued)

Following the adoption of IFRS 9 on 1 October 2018, the Group impairment provision is classified by stage allocation as follows:

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| Stage 1 | **79** | - | **42** | - |
| Stage 2 | **168** | - | **91** | - |
| Stage 3 | **118** | - | **91** | - |
| POCI | **(3)** | - | **-** | - |
| | **362** | - | **224** | - |

The transitional stage allocation on adoption date of 1 October 2018 is presented in the Risk Report on page 15.

# Notes to the consolidated financial statements (continued)
## Section 3: Assets and liabilities (continued)

### 3.3 Securitisation and covered bond programmes

**Accounting policy**

The Bank sponsors the formation of structured entities, primarily for the purpose of facilitation of asset securitisation and covered bond transactions, the full details of which can be found in note 6.2. The Group has no shareholding in these entities, but is exposed, or has rights, to variable returns and has the ability to affect those returns. The entities are consolidated in the Group's financial statements in accordance with note 1.5.

**Securitisation**

The Bank has securitised a portion of its retail mortgage loan portfolio under both master trust (Lanark and Lannraig) and standalone (Gosforth) securitisation programmes. The securitised mortgage loans have been assigned at principal value to bankruptcy remote structured entities. The securitised debt holders have no recourse to the Group other than the principal and interest (including fees) generated from the securitised mortgage loan portfolio.

The externally held securitised notes in issue are included within debt securities in issue (note 3.14). There are a number of notes held internally by the Bank which are used as collateral for repurchases and similar transactions or for credit enhancement purposes.

**Covered bond**

A subset of the Bank's retail mortgage loan portfolio has been ring-fenced and assigned to bankruptcy remote limited liability partnerships, Clydesdale Covered Bond No 2 LLP and Eagle Place LLP, to provide a guarantee for the obligations payable on the covered bonds issued by the Bank.

The covered bond partnerships are consolidated with the mortgage loans retained on the consolidated balance sheet and the covered bonds issued included within debt securities in issue (note 3.14). The covered bond holders have dual recourse: firstly, to the bond issuer on an unsecured basis; and secondly, to the appropriate LLP under the Covered Bond Guarantee secured against the mortgage loans.

Under both the securitisation and covered bond programmes, the mortgage loans do not qualify for balance sheet derecognition because the Group remains exposed to the majority of the risks and rewards of the mortgage loan portfolio, principally the associated credit risk. The Group continues to service the mortgage loans in return for an administration fee and is also entitled to any residual income after all payment obligations due under the terms of the programmes and senior programme expenses have been met. A deemed loan liability is recognised in the mortgage originator for the proceeds of the funding transaction.

**Significant restrictions**

Where the Group uses its financial assets to raise finance through securitisations and the sale of securities subject to repurchase agreements, the assets become encumbered and are not available for transfer around the Group.

### 3.3 Securitisations and covered bond programmes (continued)

The assets and liabilities in relation to securitisation and covered bonds in issue at 30 September are as follows:

| Group | 2019 | | 2018 | |
|---|---|---|---|---|
| | **Loans and Advances Securitised** | **Notes in Issue** | Loans and Advances Securitised | Notes in Issue |
| | **£m** | **£m** | £m | £m |
| **Securitisation Programmes** | | | | |
| Lanark Master Issuer | **5,009** | **4,597** | 5,479 | 4,536 |
| Lannraig Master Issuer | **1,032** | **838** | 933 | 899 |
| Gosforth 2014-1 | **372** | **385** | - | - |
| Gosforth 2015-1 | **707** | **630** | - | - |
| Gosforth 2016-1 | **1,142** | **1,048** | - | - |
| Gosforth 2016-2 | **701** | **579** | - | - |
| Gosforth 2017-1 | **934** | **852** | - | - |
| Gosforth 2018-1 | **1,353** | **1,267** | - | - |
| | **11,250** | **10,196** | 6,412 | 5,435 |
| Less held by the Group | | **(5,154)** | | (2,486) |
| | | **5,042** | | 2,949 |
| **Covered Bond Programmes** | | | | |
| Clydesdale Covered Bond No.2 | **1,253** | **776** | 1,389 | 732 |
| Eagle Place | **2,622** | **1,126** | - | - |
| | **3,875** | **1,902** | 1,389 | 732 |

| Bank | 2019 | | 2018 | |
|---|---|---|---|---|
| | **Loans and Advances Securitsied** | **Notes in Issue** | Loans and Advances Securitsied | Notes in Issue |
| | **£m** | **£m** | £m | £m |
| **Covered Bond Programmes** | | | | |
| Clydesdale Covered Bond No.2 | **1,253** | **699** | 1,389 | 698 |

### 3.3 Securitisations and covered bond programmes (continued)

The carrying amounts of covered bonds differ between Group and Bank due to fair value hedging adjustments which form part of the Group but not the Bank. Further information on the liabilities relating to the Group's securitisation and covered bond programmes can be found in note 3.14.

The Bank securitises mortgages which includes those originated by Yorkshire Bank Home Loans Limited ('YBHL'), a subsidiary of the Bank. A legal sale agreement between the Bank and YBHL has been put in place to ensure that the titles of such mortgages are transferred to the Bank prior to the completion of any securitisation transactions and these mortgages are included in the securitised asset balances disclosed in the table above and are recognised on the Bank balance sheet.

The fair values of financial assets and associated liabilities relating to the securitisation programmes where the counterparty to the liabilities has recourse only to the financial assets were £11,329m and £5,085m respectively (2018: £6,284m and £2,948m).

There were no events during the year that resulted in any Group or Bank transferred financial assets being derecognised.

The Group and Bank have contractual and non-contractual arrangements which may require them to provide financial support as follows:

*Securitisation programmes*

The Group and Bank provides credit support to the structured entities via reserve funds, which are partly funded through subordinated debt arrangements and by holding junior notes. Exposures are shown in the table below.

| | **2019** | | 2018 | |
|---|---|---|---|---|
| | **Group** | **Bank** | Group | Bank |
| | **£m** | **£m** | £m | £m |
| Beneficial interest held | **1,467** | **721** | 1,074 | 1,074 |
| Subordinated loans | **100** | **21** | 23 | 23 |
| Junior notes issued | **1,722** | **887** | 971 | 971 |
| | **3,289** | **1,629** | 2,068 | 2,068 |

Looking forward through future reporting periods there are a number of date-based options on the notes issued by the structured entities which could be actioned by them as issuer. These could require the Bank, as sponsor, to provide additional liquidity support.

*Covered bond programme*

The nominal level of over-collateralisation was £699m in Clydesdale Covered Bond 2 LLP (2018: £860m) and £1,490m in Eagle Place. From time-to-time the obligations of the Group to provide over-collateralisation may increase due to the formal requirements of the programme.

Under all programmes, the Group has an obligation to repurchase mortgage exposures if certain mortgage loans no longer meet the programme criteria.

# Notes to the consolidated financial statements (continued)

## Section 3: Assets and liabilities (continued)

### 3.4 Cash and balances with central banks

**Accounting policy**

Cash and balances with central banks are measured at amortised cost, using the effective interest method, adjusted for ECLs, and are derecognised when the rights to receive cash flows have expired or the Group has transferred substantially all the risks and rewards of ownership. These balances are generally of a short-term nature, and repayable on demand or within a short timescale, generally three months.

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| Cash assets | **1,574** | 1,656 | **1,571** | 1,656 |
| Balances with central banks (including EU payment systems) | **8,722** | 4,917 | **5,050** | 4,917 |
| | **10,296** | 6,573 | **6,621** | 6,573 |
| Less mandatory deposits with central banks [1] | **(183)** | (75) | **(83)** | (75) |
| Included in cash and cash equivalents (note 5.2) | **10,113** | 6,498 | **6,538** | 6,498 |

(1) Mandatory deposits are not available for use in the Group's day-to-day business and are non-interest bearing.

### 3.5 Financial assets and liabilities at fair value through profit or loss

**Accounting policy**

Financial assets and liabilities are designated at fair value through profit or loss, with gains and losses recognised in the income statement as they arise (note 2.3), when this reduces measurement or recognition inconsistencies (e.g. an accounting mismatch) or where the performance is evaluated on a fair value basis in accordance with risk management and investment strategies.

The Group's unlisted securities and other financial assets which were held under IAS 39 as 'available for sale' have been classified as FVTPL on adoption of IFRS 9, with the business model they are held under assessed as neither to hold and collect contractual cash flows nor to hold and collect contractual cash flows and to sell.

## 3.5 Financial assets and liabilities at fair value through profit or loss (continued)

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| **Financial assets at fair value through profit or loss** | | | | |
| Loans and advances | **253** | 362 | **253** | 362 |
| Other financial assets [1] | **8** | - | **1** | - |
| | **261** | 362 | **254** | 362 |
| **Financial liabilities at fair value through profit or loss** | | | | |
| Customer deposits – term deposits | **4** | 15 | **4** | 15 |

(1) Included within other financial assets is £2m (2018: £Nil) of unlisted securities.

**Loans and advances**

Included in financial assets at fair value through profit or loss is a historical portfolio of loans (sales ceased in 2012). Interest rate risk associated with these loans is managed using interest rate derivative contracts and the loans are recorded at fair value to avoid an accounting mismatch. The maximum credit exposure of the loans is £253m (2018: £362m) including accrued interest receivable of £1m (2018: £2m). The cumulative loss in the fair value of the loans attributable to changes in credit risk amounts to £4m (2018: £8m) and the change for the current year is a decrease of £4m (2018: decrease of £3m), of which £2m (2018: £3m) has been recognised in the income statement.

**Other financial assets**

This represents deferred consideration receivable and consists of the rights to future income.

Note 5.4 provides the transitional disclosures for IFRS 9.

Refer to note 3.18 for further information on the valuation methodology applied to financial assets held at fair value through profit or loss and their classification within the fair value hierarchy. Details of the credit quality of financial assets is provided in the Risk report.

**Customer deposits - term deposits**

Included in other financial liabilities at fair value are fixed rate deposits, the interest rate risk on which is hedged using interest rate derivative contracts. The deposits are recorded at fair value to avoid an accounting mismatch.

The change in fair value attributable to changes in the Group's credit risk is £Nil (2018: £Nil). The Group is contractually obligated to pay £Nil (2018: £0.3m) less than the carrying amount at maturity to the deposit holder.

## 3.6 Derivative financial instruments

**Accounting policy**

The Group uses derivative financial instruments to manage exposure to interest rate and foreign currency risk. Interest rate risk arises when there is a mismatch between fixed interest rate and floating interest rates, and different repricing characteristics between assets and liabilities. Currency risk arises when assets and liabilities are not denominated in the functional currency of the entity. Derivatives are recognised on the balance sheet at fair value on trade date and are measured at fair value throughout the life of the contract. Derivatives are carried as assets when the fair value is positive and as liabilities when the fair value is negative. The notional amount of a derivative contract is not recorded on the balance sheet but is disclosed as part of this note.

***Netting***

Derivative assets and liabilities are offset against collateral received and paid respectively, and the net amount reported in the due to and from other banks in the balance sheet only when there is a legally enforceable right to offset the recognised amounts, and there is an intention to settle on a net basis. Amounts offset on the balance sheet represent the Group's centrally cleared derivative financial instruments and collateral paid to/from central clearing houses, which meet the criteria for offsetting under IAS 32.

***Hedge accounting***

The Group elects to apply hedge accounting for the majority of its risk management activity that uses derivatives. This results in greater alignment in the timing of recognition of gains and losses on hedged items and hedging instruments and therefore reduces income statement volatility. The Group does not have a trading book, however, derivatives that do not meet the hedging criteria, or for which hedge accounting is not applied, are classified as held for trading.

IFRS 9 replaces IAS 39 for annual periods beginning on or after 1 January 2018. The Group has elected, as a policy choice permitted under IFRS 9, to continue to apply hedge accounting in accordance with IAS 39. The method of recognising the fair value gain or loss on a derivative depends on whether it is designated as a hedging instrument and the nature of the item being hedged. Certain derivatives are designated as either hedges of highly probable future cash flows attributable to a recognised asset or liability, or a highly probable forecast transaction (a cash flow hedge); or hedges of the fair value of recognised assets or liabilities or firm commitments (a fair value hedge).

***Cash flow hedge***

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in equity. Specifically, the separate component of equity (note 4.1) is adjusted to the lesser of the cumulative gain or loss on the hedging instrument, and the cumulative change in fair value of the expected future cash flows on the hedged item from the inception of the hedge. Any remaining gain or loss on the hedging instrument is recognised in the income statement. The carrying value of the hedged item is not adjusted. Amounts accumulated in equity are transferred to the income statement in the period in which the hedged item affects profit or loss.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss remains in equity and is recognised when the forecast transaction is ultimately recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

***Fair value hedge***

The carrying value of the hedged item on initial designation is adjusted for the fair value attributable to the hedged risk. Subsequently, changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. This movement in the fair value of the hedged item is made as an adjustment to the carrying value of the hedged asset or liability.

Where the hedged item is derecognised from the balance sheet, the adjustment to the carrying amount of the asset or liability is immediately transferred to the income statement. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item is amortised to the income statement over the remaining life of the asset or liability.

### 3.6 Derivative financial instruments (continued)

**Hedge effectiveness**

The Group documents, at the inception of a transaction, the relationship between hedging instruments and the hedged items, and the Group's risk management objective and strategy for undertaking these hedge transactions. The documentation covers how effectiveness will be measured throughout the life of the hedge relationship and its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. A hedge is expected to be highly effective if the changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated are expected to offset in a range of 80% to 125%.

**Derivatives held for trading**

Changes in value of held for trading derivatives are immediately recognised in the income statement (note 2.3).

The tables below analyse derivatives between those designated as hedging instruments and those classified as held for trading:

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| **Fair value of derivative financial assets** | | | | |
| Designated as hedging instruments | **315** | 203 | **398** | 92 |
| Designated as held for trading | **51** | 59 | **44** | 59 |
| | **366** | 262 | **442** | 151 |
| **Fair value of derivative financial liabilities** | | | | |
| Designated as hedging instruments | **191** | 259 | **215** | 259 |
| Designated as held for trading | **82** | 102 | **77** | 102 |
| | **273** | 361 | **292** | 361 |

Cash collateral on derivatives placed with banks totalled £55m (2018: £306m). Cash collateral received on derivatives totalled £149m (2018: £37m). These amounts are included within due from other banks and due to other banks respectively. Collateral placed with clearing houses, which did not meet offsetting criteria, totalled £55m (30 September 2018: £143m) and is included within other assets. Similarly, collateral received from clearing houses is included in other liabilities and totalled £Nil (30 September 2018: £34m).

The derivative financial instruments held by the Group are further analysed below. The notional contract amount is the amount from which the cash flows are derived and does not represent the principal amounts at risk relating to these contracts.

# Notes to the consolidated financial statements (continued)
## Section 3: Assets and liabilities (continued)

### 3.6 Derivative financial instruments (continued)

| Group | Notional contract amount | Fair value of assets | Fair value of liabilities |
|---|---|---|---|
| **Total derivative contracts as at 30 September 2019** | £m | £m | £m |
| **Derivatives designated as hedging instruments** | | | |
| *Cash flow hedges* | | | |
| Interest rate swaps (gross) | 25,023 | 105 | 121 |
| Less: net settled interest rate swaps[1] | (14,513) | (47) | (75) |
| Interest rate swaps (net)[2] | 10,510 | 58 | 46 |
| Cross currency swaps[2] | 1,446 | 162 | - |
| | 11,956 | 220 | 46 |
| *Fair value hedges* | | | |
| Interest rate swaps (gross) | 25,492 | 146 | 526 |
| Less: net settled interest rate swaps[1] | (23,872) | (60) | (389) |
| Interest rate swaps (net)[2] | 1,620 | 86 | 137 |
| Cross currency swaps[2] | 808 | 9 | 8 |
| | 2,428 | 95 | 145 |
| Total derivatives designated as hedging instruments | 14,384 | 315 | 191 |
| **Derivatives designated as held for trading** | | | |
| *Foreign exchange rate related contracts* | | | |
| Spot and forward foreign exchange[2] | 728 | 16 | 15 |
| Cross currency swaps[2] | 1,123 | 11 | 9 |
| Options[2] | 2 | - | - |
| | 1,853 | 27 | 24 |
| *Interest rate related contracts* | | | |
| Interest rate swaps (gross) | 1,159 | 24 | 53 |
| Less: net settled interest rate swaps[1] | (363) | (5) | (2) |
| Interest rate swaps (net)[2] | 796 | 19 | 51 |
| Swaptions[2] | 11 | - | 2 |
| Options[2] | 465 | 2 | 3 |
| | 1,272 | 21 | 56 |
| Commodity related contracts | 55 | 2 | 2 |
| Equity related contracts | 3 | 1 | - |
| **Total derivatives designated as held for trading** | 3,183 | 51 | 82 |

(1) Presented within other assets.
(2) Presented within derivative financial instruments.

# Notes to the consolidated financial statements (continued)
## Section 3: Assets and liabilities (continued)

### 3.6 Derivative financial instruments (continued)

| Group | Notional Contract amount | Fair value of assets | Fair value of liabilities |
|---|---|---|---|
| Total derivative contracts as at 30 September 2018 | £m | £m | £m |
| **Derivatives designated as hedging instruments** | | | |
| *Cash flow hedges* | | | |
| Interest rate swaps (gross) | 24,570 | 88 | 111 |
| Less: net settled interest rate swaps[1] | - | - | - |
| Interest rate swaps (net)[2] | 24,570 | 88 | 111 |
| Cross currency swaps[2] | 690 | 70 | - |
| | 25,260 | 158 | 111 |
| *Fair value hedges* | | | |
| Interest rate swaps (gross) | 2,180 | 45 | 148 |
| Less: net settled interest rate swaps[1] | - | - | - |
| Interest rate swaps (net)[2] | 2,180 | 45 | 148 |
| Total derivatives designated as hedging instruments | 27,440 | 203 | 259 |
| **Derivatives designated as held for trading** | | | |
| *Foreign exchange rate related contracts* | | | |
| Spot and forward foreign exchange[2] | 1,788 | 26 | 23 |
| Cross currency swaps[2] | 455 | 10 | 10 |
| Options[2] | 11 | - | - |
| | 2,254 | 36 | 33 |
| *Interest rate related contracts* | | | |
| Interest rate swaps (gross) | 811 | 15 | 59 |
| Less: net settled interest rate swaps[1] | - | - | - |
| Interest rate swaps (net)[2] | 811 | 15 | 59 |
| Swaptions[2] | 33 | - | - |
| Options[2] | 501 | 1 | 3 |
| | 1,345 | 16 | 62 |
| Commodity related contracts | 53 | 7 | 7 |
| Total derivatives designated as held for trading | 3,652 | 59 | 102 |

(1) Presented within other assets.
(2) Presented within derivative financial instruments.

# Notes to the consolidated financial statements (continued)
## Section 3: Assets and liabilities (continued)

### 3.6 Derivative financial instruments (continued)

| Bank | Notional contract amount | Fair value of assets | Fair value of liabilities |
|---|---|---|---|
| **Total derivative contracts as at 30 September 2019** | £m | £m | £m |
| **Derivatives designated as hedging instruments** | | | |
| *Cash flow hedges* | | | |
| Interest rate swaps (gross) | 89,114 | 463 | 442 |
| Less: net settled interest rate swaps[1] | (41,480) | (65) | (364) |
| Interest rate swaps (net)[2] | 47,634 | 398 | 78 |
| *Fair value hedges* | | | |
| Interest rate swaps (gross) | 2,370 | 47 | 238 |
| Less: net settled interest rate swaps[1] | (1,750) | (47) | (101) |
| Interest rate swaps (net)[2] | 620 | - | 137 |
| Total derivatives designated as hedging instruments | 48,254 | 398 | 215 |
| **Derivatives designated as held for trading** | | | |
| *Foreign exchange rate related contracts* | | | |
| Spot and forward foreign exchange[2] | 728 | 16 | 15 |
| Cross currency swaps[2] | 1,034 | 5 | 4 |
| Options[2] | 2 | - | - |
| | 1,764 | 21 | 19 |
| *Interest rate related contracts* | | | |
| Interest rate swaps (gross) | 796 | 19 | 51 |
| Swaptions[2] | 11 | - | 2 |
| Options[2] | 465 | 2 | 3 |
| | 1,272 | 21 | 56 |
| | | - | - |
| Commodity related contracts | 55 | 2 | 2 |
| **Total derivatives designated as held for trading** | 3,091 | 44 | 77 |

(1) Presented within other assets.
(2) Presented within derivative financial instruments.

### 3.6 Derivative financial instruments (continued)

| Bank<br>Total derivative contracts as at 30 September 2018 | Notional contract amount<br>£m | Fair value of assets<br>£m | Fair value of liabilities<br>£m |
|---|---|---|---|
| Derivatives designated as hedging instruments | | | |
| *Cash flow hedges* | | | |
| Interest rate swaps (gross) | 24,570 | 88 | 111 |
| Less: net settled interest rate swaps[1] | - | - | - |
| Interest rate swaps (net)[2] | 24,570 | 88 | 111 |
| *Fair value hedges* | | | |
| Interest rate swaps (gross) | 1,480 | 4 | 148 |
| Less: net settled interest rate swaps[1] | - | - | - |
| Interest rate swaps (net)[2] | 1,480 | 4 | 148 |
| Total derivatives designated as hedging instruments | 26,050 | 92 | 259 |
| Derivatives designated as held for trading | | | |
| *Foreign exchange rate related contracts* | | | |
| Spot and forward foreign exchange[2] | 1,788 | 26 | 23 |
| Cross currency swaps[2] | 455 | 10 | 10 |
| Options[2] | 11 | - | - |
| | 2,254 | 36 | 33 |
| *Interest rate related contracts* | | | |
| Interest rate swaps (gross) | 811 | 15 | 59 |
| Less: net settled interest rate swaps[1] | - | - | - |
| Interest rate swaps (net)[2] | 811 | 15 | 59 |
| Swaptions[2] | 33 | - | - |
| Options[2] | 501 | 1 | 3 |
| | 1,345 | 16 | 62 |
| Commodity related contracts | 53 | 7 | 7 |
| Total derivatives designated as held for trading | 3,652 | 59 | 102 |

(1) Presented within other assets.
(2) Presented within derivative financial instruments.

## 3.6 Derivative financial instruments (continued)

**Hedge accounting**
The hedging strategy of the Group is divided into micro hedges, where the hedged item is a distinctly identifiable asset or liability, and portfolio hedges, where the hedged item is a homogeneous portfolio of assets and liabilities.

In some hedge accounting relationships, the Group designates risk components of hedged items as follows:
- benchmark interest rate risk as a component of interest rate risk, such as the London Interbank Offered Rate (LIBOR) component;
- exchange rate risk for foreign currency financial assets and financial liabilities; and
- components of cash flows of hedged items, for example certain interest payments for part of the life of an instrument.

Other risks such as credit risk and liquidity risk are managed by the Group but are not included in the hedge accounting relationship. Changes in the designated risk component usually account for the largest portion of the overall change in fair value or cash flows of the hedged item.

**Portfolio fair value hedges**
The Group applies macro fair value hedging to its fixed rate mortgages and fixed rate customer deposits. The Group determines hedged items by identifying portfolios of homogeneous loans or deposits based on their contractual maturity and other risk characteristics. Loans or deposits within the identified portfolios are allocated to repricing time buckets based on expected, rather than contractual, repricing dates. The hedging instruments are designated appropriately to those repricing time buckets. Hedge effectiveness is measured on a monthly basis, by comparing fair value movements of the designated proportion of the bucketed loans due to the hedged risk, against the fair value movements of the derivatives, to ensure that they are within an 80% to 125% range.

The aggregated fair value changes in the hedged loans and deposits are recognised on the Group's balance sheet as an asset and liability respectively. At the end of every month, in order to minimise the ineffectiveness from early repayments and accommodate new exposures, the Group voluntarily de-designates the hedge relationships and redesignates them as new hedges. At de-designation, the fair value hedge accounting adjustments are amortised on a straight line basis over the original hedged life. The Group has elected to commence amortisation at the date of de-designation.

**Micro fair value hedges**
The Group uses this hedging strategy on GBP and foreign currency denominated fixed rate assets held at FVOCI (or available-for-sale fixed rate assets in the year to 30 September 2018) and GBP and foreign currency denominated fixed rate debt issuances by the Group.

**Portfolio cash flow hedges**
The Group applies macro cash flow hedge accounting to a portion of its floating rate financial assets and liabilities. The hedged cash flows are a group of forecast transactions that result in cash flow variability from resetting of interest rates, reinvestment of financial assets, or refinancing and rollovers of financial liabilities. This cash flow variability can arise on recognised assets or liabilities or highly probable forecast transactions. The hedged items are designated as the gross asset or liability positions allocated to time buckets based on projected repricing and interest profiles. The Group aims to maintain a position where the principal amount of the hedged items are greater than or equal to the notional amount of the corresponding interest rate swaps used as the hedging instruments. The hedge accounting relationship is reassessed on a monthly basis with the composition of hedging instruments and hedged items changing frequently in line with the underlying risk exposures. If necessary, the hedge relationships are de-designated and redesignated based on the effectiveness test results.

**Micro cash flow hedges**
Floating rate issuances that are denominated in currencies other than the functional currency of the Group are designated in cash flow hedges with cross currency swaps.

## 3.6 Derivative financial instruments (continued)

**Hedge ineffectiveness**
Hedge ineffectiveness can arise from:
- differences in timing of cash flows of hedged items and hedging instruments;
- changes in expected timings and amounts of forecast future cash flows;
- different interest rate curves applied to discount the hedged items and hedging instruments; and
- derivatives used as hedging instruments having a non-zero fair value at the time of designation.

Additionally, for portfolio fair value hedges of the Group's fixed rate mortgage portfolio, ineffectiveness also arises from the difference between forecast and actual prepayments (prepayment risk).

The below table discloses the impact derivatives held in micro hedging relationships are expected to have on the timing and uncertainty of future cash flows. All notional principal amounts and carrying values are presented gross, prior to any netting permitted for balance sheet presentation as this reflects the derivative position used for risk management and the impact on future cash flows.

| 30 September 2019 - Group | 3 months or less | 3 to 12 months | 1 to 5 years | Total |
|---|---|---|---|---|
| **Cash flow hedges** | | | | |
| *Foreign exchange risk* | | | | |
| Cross currency swaps | | | | |
| Notional principal (£m) | 107 | 445 | 894 | 1,446 |
| Average GBP/EUR rate | 1.3459 | 1.3423 | 1.3680 | |
| Average GBP/USD rate | 1.3263 | 1.3228 | 1.3089 | |

# Notes to the consolidated financial statements (continued)
## Section 3: Assets and liabilities (continued)

### 3.6 Derivative financial instruments (continued)

**Summary of hedging instruments in designated hedge relationships**

In the below table, the Group sets out the accumulated adjustments arising from the corresponding continuing hedge relationships, irrespective of whether or not there has been a change in hedge designation during the year.

| | | Carrying amount | | |
|---|---|---|---|---|
| | Notional contract amount | Assets | Liabilities | Change in fair value of hedging instrument in the year used for ineffectiveness measurement[2] |
| **30 September 2019 - Group** | £m | £m | £m | £m |
| **Cash flow hedges** | | | | |
| *Interest rate risk* | | | | |
| Interest rate swaps[1] | 25,023 | 105 | (121) | - |
| *Foreign exchange risk* | | | | |
| Cross currency swaps | 1,446 | 162 | - | 59 |
| Total derivatives designated as cashflow hedges | 26,469 | 267 | (121) | 59 |
| **Fair value hedges** | | | | |
| *Interest rate risk* | | | | |
| Interest rate swaps[1] | - | 146 | (526) | (283) |
| *Foreign exchange and interest rate risk* | | | | |
| Cross currency swaps | 808 | 9 | (8) | 1 |
| Total derivatives designated as fair value hedges | 808 | 155 | (534) | (282) |

| | | Carrying amount | | |
|---|---|---|---|---|
| | Notional contract amount | Assets | Liabilities | Change in fair value of hedging instrument in the year used for ineffectiveness measurement[2] |
| **30 September 2019 - Bank** | £m | £m | £m | £m |
| **Cash flow hedges** | | | | |
| *Interest rate risk* | | | | |
| Interest rate swaps[1] | 89,114 | 463 | (442) | 48 |
| Total derivatives designated as cashflow hedges | 89,114 | 463 | (442) | 48 |
| **Fair value hedges** | | | | |
| *Interest rate risk* | | | | |
| Interest rate swaps[1] | 2,370 | 47 | (238) | (53) |
| Total derivatives designated as fair value hedges | 2,370 | 47 | (238) | (53) |

(1) As shown in the total derivatives contracts table above, for centrally cleared derivatives, where the IAS 32 'Financial Instruments: Presentation' netting criteria is met, the derivative balances are offset within other assets. For all other derivatives, the derivative balances are presented within derivative financial instruments.

(2) Changes in fair value of cash flow hedging instruments are recognised in other comprehensive income. Changes in fair value of fair value hedging instruments are recognised in the income statement in non-interest income.

# Notes to the consolidated financial statements (continued)

## Section 3: Assets and liabilities (continued)

### 3.6 Derivative financial instruments (continued)

**Summary of hedged items in designated hedge relationships**

In the below table, the Group sets out the accumulated adjustments arising from the corresponding continuing hedge relationships, irrespective of whether or not there has been a change in hedge designation during the year.

| | Carrying amount of hedged items | | | | Cash flow hedge reserve | |
|---|---|---|---|---|---|---|
| | Assets | Liabilities | Accumulated amount of fair value adjustments on the hedged item[7] | Change in fair value of hedged item in the year used for ineffectiveness measurement | Continuing hedges | Discontinued hedges |
| **30 September 2019 - Group** | £m | £m | £m | £m | £m | £m |
| **Cash flow hedges** | | | | | | |
| *Interest rate risk* | | | | | | |
| Gross floating rate assets and gross floating rate liabilities[1] | | | | (14) | (15) | (19) |
| *Foreign exchange risk* | | | | | | |
| Floating rate currency issuances[2] | | | | (59) | - | - |
| Total | | | | (73) | (15) | (19) |
| | | | | | | |
| **Fair value hedges** | | | | | | |
| *Interest rate risk* | | | | | | |
| Fixed rate mortgages[3] | 16,436 | - | 211 | 209 | | |
| Fixed rate customer deposits[4] | - | (4,769) | (10) | (9) | | |
| Fixed rate FVOCI debt instruments[5] | 2,940 | - | 166 | 133 | | |
| Fixed rate issuances[6] | - | (2,368) | 103 | (73) | | |
| *Foreign exchange and interest rate risk* | | | | | | |
| Fixed rate currency FVOCI debt instruments[5] | 82 | - | 3 | 4 | | |
| Fixed rate currency issuances[2] | - | (530) | 1 | (4) | | |
| Total | 19,458 | (7,667) | 474 | 260 | | |

| | Carrying amount of hedged items | | | | Cash flow hedge reserve | |
|---|---|---|---|---|---|---|
| | Assets | Liabilities | Accumulated amount of fair value adjustments on the hedged item[7] | Change in fair value of hedged item in the year used for ineffectiveness measurement | Continuing hedges | Discontinued hedges |
| **30 September 2019 - Bank** | £m | £m | £m | £m | £m | £m |
| **Cash flow hedges** | | | | | | |
| *Interest rate risk* | | | | | | |
| Gross floating rate assets and gross floating rate liabilities[1] | | | | (62) | 12 | 1 |
| Total | | | | (62) | 12 | 1 |
| | | | | | | |
| **Fair value hedges** | | | | | | |
| *Interest rate risk* | | | | | | |
| Fixed rate FVOCI debt instruments[5] | 1,742 | - | 102 | 81 | | |
| Fixed rate issuances[6] | - | (1,278) | 29 | (30) | | |
| Total | 1,742 | (1,278) | 131 | 51 | | |

(1) Future highly probable cash flows arising from loans and advances to customers, due to customers and debt securities in issue.
(2) Hedged item is recorded in debt securities in issue.
(3) Hedged item and the cumulative fair value changes, are recorded in loans and advances to customers.
(4) Hedged item and the cumulative fair value changes, are recorded in due to customers.
(5) Hedged item is recorded in financial instruments at FVOCI.
(6) Hedged items are recorded in debt securities in issue and due to related entities
(7) Includes cumulative unamortised fair value hedge adjustments relating to hedges that have been discontinued and are being amortised to the income statement over the remaining life of the asset or liability.

## 3.6 Derivative financial instruments (continued)

**Gains and losses from hedge accounting**

| | | | Reclassified into income statement as: | |
|---|---|---|---|---|
| | Hedge ineffectiveness recognised in income statement[(1)] | Effective portion recognised in other comprehensive income | Net interest income | Non-interest income |
| **30 September 2019 - Group** | £m | £m | £m | £m |
| **Cash flow hedges** | | | | |
| *Interest rate risk* | | | | |
| Gross floating rate assets and gross floating rate liabilities | (14) | 14 | (1) | - |
| *Foreign exchange risk* | | | | |
| Floating rate currency issuances | - | 59 | - | (57) |
| Total (losses)/gains on cash flow hedges | (14) | 73 | (1) | (57) |
| | | | | |
| **Fair value hedges** | | | | |
| *Interest rate risk* | | | | |
| Fixed rate mortgages | (24) | | | |
| Fixed rate customer deposits | 4 | | | |
| Fixed rate FVOCI debt instruments | (2) | | | |
| Fixed rate issuances | (1) | | | |
| *Foreign exchange and interest rate risk* | - | | | |
| Fixed rate currency FVOCI debt instruments | - | | | |
| Fixed rate currency issuances | 1 | | | |
| Total losses on fair value hedges | (22) | | | |

**Gains and losses from hedge accounting**

| | | | Reclassified into income statement as: | |
|---|---|---|---|---|
| | Hedge ineffectiveness recognised in income statement[(1)] | Effective portion recognised in other comprehensive income | Net interest income | Non-interest income |
| **30 September 2019 - Bank** | £m | £m | £m | £m |
| **Cash flow hedges** | | | | |
| *Interest rate risk* | | | | |
| Gross floating rate assets and gross floating rate liabilities | (14) | 62 | (1) | - |
| Total (losses)/gains on cash flow hedges | (14) | 62 | (1) | - |
| | | | | |
| **Fair value hedges** | | | | |
| *Interest rate risk* | | | | |
| Fixed rate FVOCI debt instruments | (2) | | | |
| Fixed rate issuances | - | | | |
| Total losses on fair value hedges | (2) | | | |

(1) Recognised in gains less losses on financial instruments at fair value (note 2.3).

# Notes to the consolidated financial statements (continued)
## Section 3: Assets and liabilities (continued)

### 3.6 Derivative financial instruments (continued)

The ineffectiveness arising from cash flow and fair value hedges was:

| | **2019** | 2018 |
|---|---|---|
| | **£m** | £m |
| **Loss arising from cash flow hedges** | | |
| Loss from cash flow hedges due to hedge ineffectiveness | **(14)** | (6) |
| **(Loss)/gains arising from fair value hedges** | | |
| Hedging instrument | **(282)** | 14 |
| Hedged item attributable to the hedged risk | **260** | (14) |
| | **(22)** | - |
| Ineffectiveness arising from cash flow and fair value hedges | **(36)** | (6) |

Below is a schedule indicating, as at 30 September 2018, the periods when the hedged cash flows are expected to occur and when they are expected to affect profit or loss:

| **Group** | Forecast receivable cash flows 2018 £m | Forecast payable cash flows 2018 £m |
|---|---|---|
| Within 1 year | 109 | 283 |
| Between 1 and 2 years | 130 | 366 |
| Between 2 and 3 years | 108 | 160 |
| Between 3 and 4 years | 63 | 5 |
| Between 4 and 5 years | 37 | 3 |
| Greater than 5 years | 60 | 10 |
| | 507 | 827 |

| **Bank** | Forecast receivable cash flows 2018 £m | Forecast payable cash flows 2018 £m |
|---|---|---|
| Within 1 year | 109 | 81 |
| Between 1 and 2 years | 130 | 49 |
| Between 2 and 3 years | 108 | 17 |
| Between 3 and 4 years | 63 | 5 |
| Between 4 and 5 years | 37 | 3 |
| Greater than 5 years | 60 | 10 |
| | 507 | 165 |

## 3.7 Financial assets at fair value through other comprehensive income

**Accounting policy**

FVOCI is a new financial asset classification category introduced by IFRS 9 'Financial Instruments'. As permitted by IFRS 9, the Group has not restated its comparative financial statements, consequently no comparative is presented as at 30 September 2018. The Group's listed securities previously classified as 'available for sale' under IAS 39 (note 3.8) have been assessed as meeting the criteria to be classified as FVOCI.

Interest income and impairment gains and losses on FVOCI assets are measured in the same manner as for assets measured at amortised cost and are recognised in the income statement, with all other gains or losses recognised in other comprehensive income as a separate component of equity in the period in which they arise. Gains and losses arising from changes in fair value are included as a separate component of equity until sale when the cumulative gain or loss is transferred to the income statement. For all FVOCI assets, the gain or loss is calculated with reference to the gross carrying amount.

Debt instruments at FVOCI are subject to the same impairment criteria as amortised cost financial assets (note 3.2), with the ECLs element recognised directly in the income statement. As the financial asset is fair valued through other comprehensive income, the change in its value includes the ECL element, with the remaining fair value change recognised in other comprehensive income. Any reversal of the ECL is recorded in the income statement up to the value recognised previously.

The Group exercises the low credit risk option for debt instruments classified as FVOCI, recognising the high credit quality of the instruments accordingly a 12-month ECL is calculated on the assets.

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| Listed securities | **4,328** | - | **2,350** | - |
| **Total financial assets at fair value through other comprehensive income** | **4,328** | - | **2,350** | - |

Refer to note 3.18 for further information on the valuation methodology applied to financial instruments at FVOCI and their classification within the fair value hierarchy. Details of the credit quality of financial assets are provided in the Risk report.

Note 5.4 provides the transitional disclosures for IFRS 9.

### 3.8 Financial assets available for sale

**Accounting policy**

The available for sale classification category for financial assets ceased to apply from 1 October 2018 on the adoption of IFRS 9.

The Group's listed securities have been assessed as meeting the criteria to be classified as FVOCI under IFRS 9 (note 3.7). Unlisted securities and other financial assets have been classified as fair value through profit or loss (note 3.5).

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| Listed securities | - | 1,551 | - | 1,551 |
| Unlisted securities | - | 5 | - | 5 |
| Other financial assets | - | 6 | - | - |
| **Total financial assets available for sale** | - | 1,562 | - | 1,556 |

Refer to note 3.18 for further information on the valuation methodology applied to financial assets available for sale at 30 September 2018 and their classification within the fair value hierarchy. Details of the credit quality of financial assets are provided in the Risk report.

Note 5.4 provides the transitional disclosures for IFRS 9.

### 3.9 Property, plant and equipment

**Accounting policy**

The Group's freehold and long-term leasehold land and buildings are carried at their fair value as determined by the Directors, taking account of advice received from independent valuers. Fair values are determined in accordance with guidance published by the Royal Institution of Chartered Surveyors, including adjustments to observable market inputs reflecting any specific characteristics of the land and buildings. Directors' valuations are performed annually in July, with the independent valuations carried out on a three-year cycle on an open market basis.

All other items of property, plant and equipment are carried at cost, less accumulated depreciation and impairment losses. Cost includes expenditure that is directly attributable to acquisition of the asset. Impairment is assessed whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

With the exception of freehold and long-term leasehold land, all items of property, plant and equipment are depreciated or amortised using the straight line method, at rates appropriate to their estimated useful life to the Group. The annual rates of depreciation or amortisation are:

| | |
|---|---|
| Buildings | 50 years |
| Leases (leasehold improvements) | the lower of the expected lease term or the asset's remaining useful life |
| Fixtures and equipment | 3-10 years |

Residual values and useful lives of assets are reviewed at each reporting date. Depreciation is recognised within operating expenses in the income statement.

## 3.9 Property, plant and equipment

| Group | Freehold land and buildings | Long-term leasehold land and buildings | Building improvements | Fixtures and equipment | Total |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| **Cost or valuation** | | | | | |
| At 1 October 2017 | 5 | 3 | 143 | 102 | 253 |
| Additions | - | - | 9 | 13 | 22 |
| Disposals | (2) | - | (3) | (1) | (6) |
| At 30 September 2018 | 3 | 3 | 149 | 114 | 269 |
| Acquisition of Virgin Money Holdings (UK) PLC | 36 | 3 | 11 | 15 | 65 |
| Additions | - | - | 12 | 8 | 20 |
| Disposals | (1) | - | (4) | - | (5) |
| **At 30 September 2019** | **38** | **6** | **168** | **137** | **349** |
| **Accumulated depreciation** | | | | | |
| At 1 October 2017 | 1 | - | 88 | 78 | 167 |
| Charge for the year | - | - | 10 | 8 | 18 |
| Disposals | - | - | (3) | (1) | (4) |
| At 30 September 2018 | 1 | - | 95 | 85 | 181 |
| Charge for the year (note 2.4) | 3 | - | 11 | 11 | 25 |
| Disposals | - | - | (2) | - | (2) |
| **At 30 September 2019** | **4** | **-** | **104** | **96** | **204** |
| **Net book value** | | | | | |
| **At 30 September 2019** | **34** | **6** | **64** | **41** | **145** |
| At 30 September 2018 | 2 | 3 | 54 | 29 | 88 |

# Notes to the consolidated financial statements (continued)
## Section 3: Assets and liabilities (continued)

### 3.9 Property, plant and equipment (continued)

| Bank | Freehold land and buildings | Long-term leasehold land and buildings | Building improvements | Fixtures and equipment | Total |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| **Cost or valuation** | | | | | |
| At 1 October 2017 | 5 | 3 | 143 | 102 | 253 |
| Additions | - | - | 9 | 13 | 22 |
| Disposals | (2) | - | (3) | (1) | (6) |
| At 30 September 2018 | 3 | 3 | 149 | 114 | 269 |
| Additions | - | - | 11 | 5 | 16 |
| Disposals | (1) | - | (4) | (1) | (6) |
| **At 30 September 2019** | **2** | **3** | **156** | **118** | **279** |
| **Accumulated depreciation** | | | | | |
| At 1 October 2017 | 1 | - | 88 | 78 | 167 |
| Charge for the year | - | - | 10 | 8 | 18 |
| Disposals | - | - | (3) | (1) | (4) |
| At 30 September 2018 | 1 | - | 95 | 85 | 181 |
| Charge for the year (note 2.4) | - | - | 9 | 7 | 16 |
| Disposals | - | - | (3) | - | (3) |
| **At 30 September 2019** | **1** | **-** | **101** | **92** | **194** |
| **Net book value** | | | | | |
| **At 30 September 2019** | **1** | **3** | **55** | **26** | **85** |
| At 30 September 2018 | 2 | 3 | 54 | 29 | 88 |

#### Valuations

A comparison of the carrying value between the revaluation basis and the historical cost basis, for freehold and long-term leasehold land and buildings, is shown below:

| Group | 2019 | 2018 |
|---|---|---|
| | £m | £m |
| Carrying value as included under the revaluation basis | **40** | 5 |
| Carrying value if the historical cost basis had been used | **40** | 5 |

## 3.10 Intangible assets and goodwill

**Accounting policy**

Capitalised software costs are stated at cost, less amortisation and any provision for impairment.

Identifiable and directly associated external and internal costs of acquiring and developing software are capitalised where the software is controlled by the Group, and where it is probable that future economic benefits that exceed its cost will flow from its use over more than one year. Costs associated with maintaining software are recognised as an expense as incurred. Capitalised software costs are amortised on a straight line basis over their expected useful lives, usually between three and ten years. Impairment losses are recognised in the income statement as incurred.

Goodwill arises on the acquisition of an entity and represents the excess of the fair value of the purchase consideration and direct costs of making the acquisition over the fair value of the Group's share of the net assets at the date of the acquisition. Goodwill is not subject to amortisation and is tested for impairment on an annual basis.

Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable, which typically arises when the benefits associated with the software were substantially reduced from what had originally been anticipated or the asset has been superseded by a subsequent investment. In such situations, an impairment loss is recognised for the amount by which the carrying amount of an asset exceeds its recoverable amount. The recoverable amount of an asset is the higher of its fair value less costs of disposal or its value in use.

Intangible assets which are fully amortised are reviewed annually to consider whether the assets remain in use.

| Group | Capitalised software | Goodwill | Core deposit intangible | Total |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| **Cost** | | | | |
| At 1 October 2017 | 589 | - | - | 589 |
| Additions | 144 | - | - | 144 |
| **At 30 September 2018** | 733 | - | - | 733 |
| | | | | |
| Acquisition of Virgin Money Holdings (UK) PLC | 172 | 11 | 6 | 189 |
| Additions | 130 | - | - | 130 |
| Write-off | (85) | - | - | (85) |
| **At 30 September 2019** | **950** | **11** | **6** | **967** |
| | | | | |
| **Accumulated amortisation** | | | | |
| At 1 October 2017 | 250 | - | - | 250 |
| Charge for the year | 71 | - | - | 71 |
| **At 30 September 2018** | 321 | - | - | 321 |
| Charge for the year (note 2.4) | 82 | - | 1 | 83 |
| Impairment (note 2.4) | 115 | - | - | 115 |
| Write-off | (68) | - | - | (68) |
| **At 30 September 2019** | **450** | **-** | **1** | **451** |
| | | | | |
| **Net book value** | | | | |
| **At 30 September 2019** | **500** | **11** | **5** | **516** |
| At 30 September 2018 | 412 | - | - | 412 |

## 3.10 Intangible assets and goodwill (continued)

£31m (2018: £1m) of the £130m (2018: £144m) software additions do not form part of internally generated software projects.

A £127m charge (comprising impairment of £115m and write-offs with a net book value of £12m) was recognised in the year following a review of the Group's software estate, following the acquisition of Virgin Money, which identified a number of core assets (including £70m in relation to the Virgin Money Digital Bank asset) that are no longer of value to the Group's future strategy and therefore required to be written down (note 2.4).

| Bank | 2019 | 2018 |
|---|---|---|
| **Capitalised software costs** | **£m** | £m |
| **Cost** | | |
| At 1 October | **733** | 589 |
| Additions | **104** | 144 |
| Write-off | **(85)** | - |
| **At 30 September** | **752** | 733 |
| | | |
| **Accumulated amortisation** | | |
| At 1 October | **321** | 250 |
| Charge for the year | **71** | 71 |
| Impairment | **30** | - |
| Write-off | **(68)** | - |
| **At 30 September** | **354** | 321 |
| | | |
| **Net book value at 30 September** | **398** | 412 |

## 3.11 Deferred tax

**Accounting policy**

Deferred tax assets and liabilities are recognised on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. A deferred tax asset is recognised for unused tax losses and unused tax credits only if it is probable that future taxable amounts will arise against which those temporary differences and losses may be utilised.

**Critical accounting estimates and judgements**

The Group has deferred tax assets of £418m (2018: £298m), the principal components of which are tax losses, capital allowances and acquisition accounting adjustments.

Tax losses carried forward of £249m (2018: £192m) have increased due to the recognition of historic losses and a re-evaluation of the rate at which they are expected to unwind.

The Group has assessed the recoverability of these deferred tax assets at 30 September 2019 and considers it probable that sufficient future taxable profits will be available against which the underlying deductible temporary differences can be utilised over the corporate planning horizon.

At 30 September 2019, the Group had an unrecognised deferred tax asset of £114m (2018: £157m) representing trading losses with a gross value of £668m (2018: £926m). Although there is no prescribed period after which losses expire, a deferred tax asset has not been recognised in respect of these losses as the Directors have insufficient certainty over their recoverability in the foreseeable future.

**Movement in net deferred tax asset**

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| At 30 September | **221** | 161 | **218** | 156 |
| IFRS 9 adjustment recognised in equity (note 5.4) | **7** | - | **7** | - |
| At 1 October | **228** | 161 | **225** | 156 |
| Recognised in the income statement (note 2.5) | **58** | 45 | **54** | 47 |
| Recognised directly in equity | **(67)** | 15 | **(74)** | 15 |
| **At 30 September** | **219** | 221 | **205** | 218 |

## 3.11 Deferred tax

The Group has recognised deferred tax in relation to the following items:

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| **Deferred tax assets** | **£m** | £m | **£m** | £m |
| Tax losses carried forward | **249** | 192 | **249** | 192 |
| Capital allowances | **90** | 88 | **79** | 84 |
| Cash flow hedge reserve | **3** | 12 | **-** | 12 |
| Acquisition accounting adjustments | **44** | - | **-** | - |
| Transitional adjustment - IFRS 9 | **16** | - | **7** | - |
| Transitional adjustment - available for sale reserve | **1** | 1 | **1** | 1 |
| Employee equity based compensation | **4** | 3 | **3** | 3 |
| Pension spreading | **11** | - | **11** | - |
| Other | **-** | 2 | **-** | 2 |
| | **418** | 298 | **350** | 294 |
| **Deferred tax liabilities** | | | | |
| Defined benefit pension scheme surplus | **(139)** | (74) | **(139)** | (74) |
| Acquisition accounting adjustments | **(51)** | - | **-** | - |
| Cash flow hedge reserve | **-** | - | **(3)** | - |
| Intangible assets | **(4)** | - | **-** | - |
| Gains on unlisted available for sale investments | **-** | (3) | **-** | (3) |
| Gains on financial instruments at fair value through other comprehensive income | **(5)** | - | **(3)** | - |
| | **(199)** | (77) | **(145)** | (77) |
| **Net deferred tax asset** | **219** | 221 | **205** | 217 |

Payments to the pension scheme were greater than 210% of 2018 contributions and therefore in accordance with the legislation, tax relief is spread over four years giving rise to the pension spreading deferred tax asset of £11m. The current and deferred tax impact of pension contributions, and pension spreading, are reflected in the consolidated statement of comprehensive income.

The accounting adjustments relating to the acquisition of Virgin Money Holdings (UK) PLC (note 3.19) resulted in a net deferred tax liability of £22m on the date of acquisition, which has subsequently unwound in line with the related unwind of the fair value adjustments to a net deferred tax liability of £7m at 30 September 2019. The constituent parts of the net liability have been shown as deferred tax assets of £44m and deferred tax liabilities of £51m as they are not expected to unwind at the same time.

In accordance with legislation, the tax relief on the IFRS 9 opening adjustment (note 5.4) is spread evenly over 10 years and will unwind through entity corporation tax computations across the Group. The IFRS 9 deferred tax asset balance of £16m represents the combination of the Group's transitional position as presented in note 5.4 and the IFRS 9 transitional element remaining of the Virgin Money Holdings (UK) PLC adoption of IFRS 9 on 1 January 2018.

The European Securities and Markets Authority (ESMA) issued a Public Statement relating to IAS 12 'Income Taxes' in July 2019. The publication covered considerations on the recognition of deferred tax assets arising from the carry-forward of unused tax losses. As the Group's deferred tax asset, including the element relating to tax losses carried forward, is material, the Group has assessed the content of the ESMA Public Statement and will look to incorporate any potential further disclosure requirements arising from the statement in the financial statements in future reporting periods.

## 3.12 Retirement benefit obligations

**Accounting policy**
The Group makes contributions to both defined benefit and defined contribution pension schemes which entitle employees to benefits on retirement or disability.

**Defined contribution pension scheme**

The Group recognises its obligation to make contributions to the scheme as an expense in the income statement as incurred. Prepaid contributions are recognised as an asset to the extent that a cash refund or a reduction in future payments is available.

**Defined benefit pension scheme**
A liability or asset is recognised on the balance sheet in respect of the defined benefit scheme and is measured as the difference between the present value of the defined benefit obligation less the fair value of the defined benefit scheme assets at the reporting date. The present value of the defined benefit obligation for the scheme is discounted by high quality corporate bond rates that have maturity dates approximating to the terms of the defined benefit obligation. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the scheme. In assessing whether a surplus is recoverable, the Group considers its current right to obtain a refund or a reduction in future contributions and does not anticipate any future acts by other parties that could change the amount of the surplus that may be ultimately recovered.

Pension expense attributable to the Group's defined benefit scheme comprises current service cost, net interest on the net defined benefit obligation/asset, past service cost resulting from a scheme amendment or curtailment, gains or losses on settlement and administrative costs incurred. Where actuarial remeasurements arise, the Group recognises such amounts directly in equity through the statement of comprehensive income in the period in which they occur. Actuarial remeasurements arise from experience adjustments (the effects of differences between previous actuarial assumptions and what has actually occurred) and changes in actuarial assumptions.

The following table summarises the present value of the defined benefit obligation and fair value of plan assets for the Scheme as at 30 September:

| Group and Bank | 2019 £m | 2018 £m |
|---|---|---|
| Active members' defined benefit obligation | **(30)** | (24) |
| Deferred members' defined benefit obligation | **(2,537)** | (2,131) |
| Pensioner and dependant members' defined benefit obligations | **(1,744)** | (1,591) |
| Total defined benefit obligation | **(4,311)** | (3,746) |
| Fair value of Scheme assets | **4,707** | 3,958 |
| **Net defined benefit pension asset** | **396** | 212 |
| | | |
| Post-retirement medical benefits obligations[1] | **(3)** | (3) |

(1) Post-retirement medical benefits obligations are included within other liabilities (note 3.17).

**The Group's pension arrangements**

The Group operates both defined benefit and defined contribution arrangements. Clydesdale Bank PLC is the sponsoring employer in one funded defined benefit pension scheme, the Yorkshire and Clydesdale Bank Pension Scheme ('the Scheme'). The current version of the Scheme was established under trust on 30 September 2009 with the assets held in a trustee administered fund. The Trustee is responsible for the operation and governance of the Scheme, including making decisions regarding the Scheme's funding and investment strategy.

The Scheme is subject to the funding legislation outlined in the Pensions Act 2004 which came into force on 30 December 2005. This, together with documents issued by the Pensions Regulator, sets out the framework for funding defined benefit occupational pension plans in the UK.

## 3.12 Retirement benefit obligations (continued)

The Group has implemented a number of reforms to the Scheme to manage the obligation. It closed the Scheme to new members in 2004 and since April 2006 has determined benefits accruing on a career average revalued earnings basis. On 1 August 2017, the Scheme was closed to future benefit accrual for the majority of current employees, with affected employees' future pension benefits being provided through the Group's existing defined contribution scheme, 'Total Pension'. The income statement charge for this is separately disclosed in note 2.4.

The Group also provides post-retirement health care under a defined benefit scheme for pensioners and their dependant relatives for which provision has been made on a basis consistent with the methodology applied to the defined benefit pension scheme. This is a closed scheme and the provision will be utilised over the life of the remaining scheme members. The obligation in respect of this scheme was £3m at 30 September 2019 (2018: £3m) and is included within other liabilities in note 3.17.

**Scheme valuations**
There are a number of means of measuring liabilities in the defined benefit schemes, with the ultimate aim of the Trustee being that the Scheme is 100% funded on an agreed self-sufficiency basis[1]. The two bases used by the Group to value its obligations are (i) an IAS 19 accounting basis; and (ii) a Trustee's Technical Provision basis.

*(i) IAS 19 accounting basis*

The valuations of the Scheme assets and obligations are calculated on an accounting basis in accordance with the applicable accounting standard IAS 19 which provides the basis for the accounting framework and methodology for entries in the income statement, balance sheet and capital reporting. The principal purpose of this valuation is to allow comparison of pension obligations between companies. The obligation under an accounting valuation can be higher or lower than those under a Trustee's Technical Provision valuation.

The rate used to discount the obligation on an IAS 19 basis is a key driver of any potential volatility and is based on yields on AA rated high-quality corporate bonds, regardless of how the Trustee of the Scheme invests the assets. The accounting valuation under IAS 19 can therefore move adversely because of low rates and narrowing credit spreads which are not fully matched by the Scheme assets. Inflation is another key source of volatility and arises as a result of member benefits having an element of index linking, which causes the obligation to increase in line with rises in long-term inflation assumptions. In practice however, over the long term, the relationship between interest and inflation rates tends to be negatively correlated resulting in a degree of risk offset.

*(ii) Trustee's Technical Provision basis*

This valuation basis reflects how much money the Trustee considers is required now in order to provide for the promised benefits as they come up for payment in the future. The Trustee is responsible for ensuring that the calculation is conducted prudently on an actuarial basis, taking into account factors including the Scheme's investment strategy and the relative financial strength of the sponsoring employer.

A key aspect of this valuation is the investment strategy the Trustee proposes to follow as part of the policy for meeting the Scheme's obligations. Because there are no guarantees about investment returns over long periods, legislation requires the Trustee to consider carefully how much of their expected future investment returns it would be prudent for them to account for in advance.

The last Scheme funding valuation was conducted in accordance with Scheme data and market conditions as at 30 September 2016 and resulted in a reported deficit of £290m[2]. The Group agreed to eliminate this deficit through making contributions as agreed in the recovery plan dated 31 July 2017 and a revised schedule of contributions dated 31 January 2018. The following scheduled contributions of £184m remain to be made over the period to March 2023:

- equal monthly contributions totalling £50m per annum until 31 March 2022; and
- £55m in the year to 31 March 2023.

The next triennial funding valuation is currently in progress and will be calculated with reference to the Scheme data and market conditions as at 30 September 2019. The Group expects this valuation to be agreed with the Trustee of the Scheme by the end of 2020.

Scheme assets are not subject to the same valuation differences as Scheme obligations and are consistently valued at current market value.

[1] This is where the Scheme is essentially self-funded and does not need to call on the Group for any additional funding.
[2] The IAS 19 valuation as at 30 September 2016 reported a Scheme deficit of £75m.

### 3.12 Retirement benefit obligations (continued)

**IAS 19 position**

The Scheme movements in the year are as follows:

| Group and Bank | 2019 | | | | 2018 | | | |
|---|---|---|---|---|---|---|---|---|
| | Present value of obligation | Fair value of plan assets | Total | Cumulative impact in OCI | Present value of obligation | Fair value of plan assets | Total | Cumulative impact in OCI |
| | £m | £m | £m | £m | £m | £m | £m | £m |
| **Balance sheet surplus at 1 October** | (3,746) | 3,958 | 212 | (704) | (3,974) | 4,181 | 207 | (695) |
| **Total expense** | | | | | | | | |
| Current service cost | - | - | - | | (1) | - | (1) | |
| Past service cost | (11) | - | (11) | | (2) | - | (2) | |
| Interest (expense)/income | (100) | 107 | 7 | | (104) | 109 | 5 | |
| Administrative costs | - | (5) | (5) | | - | (6) | (6) | |
| **Total (expense)/income recognised in the consolidated income statement** | (111) | 102 | (9) | | (107) | 103 | (4) | |
| **Remeasurements** | | | | | | | | |
| Return on Scheme assets greater than discount rate | - | 772 | 772 | 772 | - | 27 | 27 | 27 |
| *Actuarial:* | | | | | | | | |
| Loss - experience adjustments | (9) | - | (9) | (9) | (35) | - | (35) | (35) |
| Gain - demographic assumptions | 30 | - | 30 | 30 | 19 | - | 19 | 19 |
| Loss - financial assumptions | (683) | - | (683) | (683) | (20) | - | (20) | (20) |
| **Remeasurement (losses)/gains recognised in other comprehensive income** | (662) | 772 | 110 | 110 | (36) | 27 | (9) | (9) |
| **Contributions and payments** | | | | | | | | |
| Employer contributions | - | 83 | 83 | | - | 18 | 18 | |
| Benefit payments | 96 | (96) | - | | 93 | (93) | - | |
| Transfer payments | 112 | (112) | - | | 278 | (278) | - | |
| | 208 | (125) | 83 | | 371 | (353) | 18 | |
| **Balance sheet surplus at 30 September** | (4,311) | 4,707 | 396 | (594) | (3,746) | 3,958 | 212 | (704) |

### 3.12 Retirement benefit obligations (continued)

The past service cost included within the income statement charge for the current year of £11m relates to GMP equalisation, which is detailed further below. In the prior year, the Group incurred a past service cost of £2m in relation to enhanced early retirement entitlements on redundancy, which was fully offset in the income statement by a corresponding release from the restructuring provision.

The expected contributions and expected benefit payments for the year ending 30 September 2020 are £56m (2019: £77m) and £108m (2019: £98m) respectively.

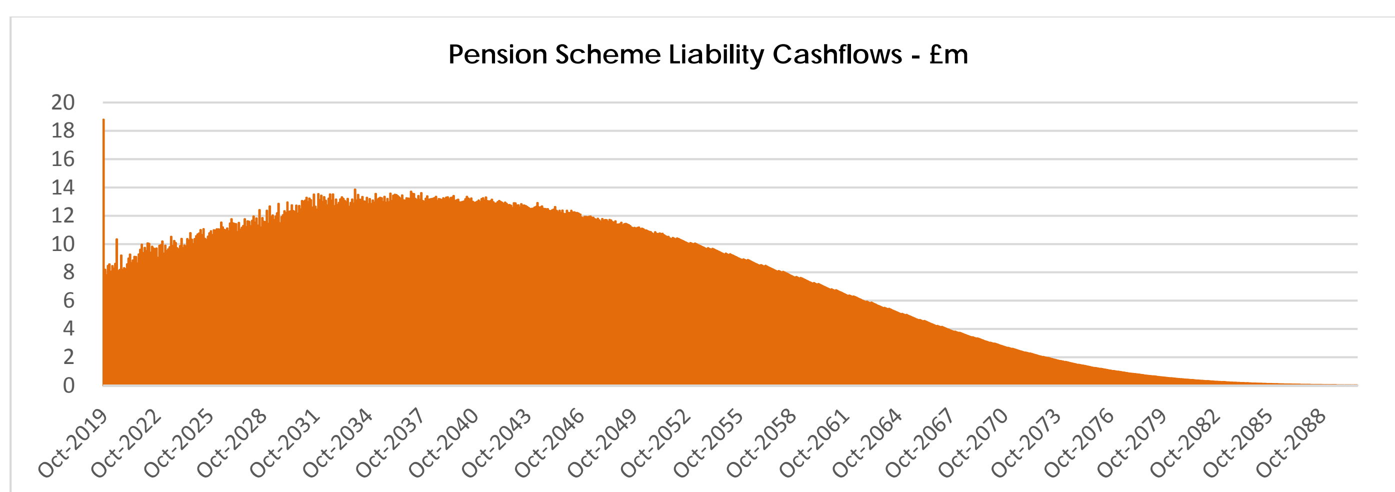
The Group and Trustee have entered into a contingent security arrangement (the 'Security Arrangement') (note 5.3).

**GMP equalisation**

On 26 October 2018, the High Court handed down a judgement concluding that defined benefit schemes should equalise pension benefits for men and women in relation to GMP and concluded on the methods that were appropriate. The estimated increase in the Scheme obligations at the date of the judgement was £11m which is based on a number of assumptions, therefore the actual impact may be different. An allowance for GMP equalisation has been reflected in the income statement and in the closing net accounting surplus of the Scheme.

**Maturity of Scheme liabilities**

The estimated maturity period of Scheme obligations on an IAS 19 accounting basis is as follows:




The discounted mean term of the defined benefit obligation at 30 September 2019 is 20 years (2018: 19 years).

**Scheme assets**

In order to meet the obligations of the Scheme, the Trustee invests in a diverse portfolio of assets, with the level and volatility of asset returns being a key factor in the overall investment strategy. The investment portfolio is subject also to a range of risks typical of the types of assets held, such as: equity risk; credit risk on bonds; currency risk; interest rate and inflation risk; and exposure to the property market. The Trustee's investment strategy (including physical assets and derivatives) seeks to reduce the Scheme's exposure to these risks. In managing interest rate and inflation risks, the investment strategy seeks to hold portfolios of matching assets (including derivatives) that enable the Scheme's assets to better match movements in the value of liabilities due to changes in interest rates and inflation.

As at 30 September 2019, both the interest rate and inflation rate hedge ratios were around 85% and 75% respectively (2018: 81% and 71%) of the obligation when measured on a self-sufficiency basis. This strategy reflects the Scheme's obligation profile and the Trustee's and the Group's attitude to risk. The Trustee monitors the investment objectives and asset allocation policy on a regular basis.

The Trustee's investment strategy involves two main categories of investments:

- matching assets – a range of investments that provide a match to changes in obligation values; and
- return seeking assets – a range of investments designed to provide specific, planned and consistent returns.

# Notes to the consolidated financial statements (continued)

## Section 3: Assets and liabilities (continued)

### 3.12 Retirement benefit obligations (continued)

The major categories of plan assets for the Scheme, stated at fair value, are as follows:

| | 2019 | | | | 2018 | | | |
|---|---|---|---|---|---|---|---|---|
| | Quoted £m | Unquoted £m | Total £m | % | Quoted[3] £m | Unquoted[3] £m | Total £m | % |
| **Bonds** | | | | | | | | |
| Fixed government | 569 | - | 569 | | 478 | - | 478 | |
| Index linked government | 1,757 | - | 1,757 | | 1,539 | - | 1,539 | |
| Global sovereign | 20 | 1 | 21 | | 23 | 1 | 24 | |
| Corporate and other | 531 | 305 | 836 | | 412 | 294 | 706 | |
| | 2,877 | 306 | 3,183 | 68% | 2,452 | 295 | 2,747 | 70% |
| **Equities[1]** | | | | | | | | |
| Global equities | - | 503 | 503 | | - | 555 | 555 | |
| Emerging market equities | - | 50 | 50 | | - | 58 | 58 | |
| UK equities | - | 32 | 32 | | - | 37 | 37 | |
| | - | 585 | 585 | 12% | - | 650 | 650 | 16% |
| **Other** | | | | | | | | |
| Secured income alternatives | - | 358 | 358 | | - | 336 | 336 | |
| Derivatives[2] | - | 219 | 219 | | - | 172 | 172 | |
| Repurchase agreements | - | (534) | (534) | | - | (836) | (836) | |
| Property | - | 129 | 129 | | - | 132 | 132 | |
| Alternative credit | - | 409 | 409 | | - | 260 | 260 | |
| Infrastructure | - | 352 | 352 | | - | 255 | 255 | |
| Cash | - | 1 | 1 | | - | 238 | 238 | |
| Equity options | 5 | - | 5 | | 4 | - | 4 | |
| | 5 | 934 | 939 | 20% | 4 | 557 | 561 | 14% |
| **Total Scheme assets** | 2,882 | 1,825 | 4,707 | 100% | 2,456 | 1,502 | 3,958 | 100% |

(1) Equity investments are classified as unquoted reflecting the nature of the funds in which the scheme invests directly. The underlying investments in these funds are, however, mostly quoted.

(2) Derivative financial instruments are used to modify the profile of the assets of the Scheme to better match the Scheme's liabilities. Derivative holdings may lead to increased or decreased exposures to the physical asset categories disclosed above.

(3) The split of plan assets between quoted and unquoted in the prior year has been restated to reflect their nature.

At 30 September 2019, the Scheme had employer-related investments within the meaning of Section 40 (2) of the Pensions Act 1995 totalling £2m (2018:nil).

## 3.12 Retirement benefit obligations (continued)

### Actuarial assumptions

The following assumptions were used in arriving at the IAS 19 defined benefit obligation:

| | 2019<br>% p.a. | 2018<br>% p.a. |
|---|---|---|
| **Financial assumptions** | | |
| Discount rate | **1.77** | 2.75 |
| Inflation (RPI) | **3.20** | 3.30 |
| Inflation (CPI) | **2.20** | 2.30 |
| Career average revalued earnings (CARE) revaluations: | | |
| Pre 31 March 2012 benefits (RPI) | **3.20** | 3.30 |
| Post 31 March 2012 benefits (CPI capped at 5% per annum) | **2.20** | 2.30 |
| Pension increases (capped at 2.5% per annum) | **2.10** | 2.13 |
| Pension increases (capped at 5% per annum) | **3.07** | 3.15 |
| Rate of increase for pensions in deferment | **2.20** | 2.30 |

| | 2019<br>Years | 2018<br>Years |
|---|---|---|
| **Demographic assumptions** | | |
| *Post retirement mortality:* | | |
| Current pensioners at 60 - male | **28.0** | 28.2 |
| Current pensioners at 60 - female | **29.6** | 29.8 |
| Future pensioners at 60 - male | **29.1** | 29.3 |
| Future pensioners at 60 - female | **30.8** | 31.0 |

# Notes to the consolidated financial statements (continued)

## Section 3: Assets and liabilities (continued)

### 3.12 Retirement benefit obligations (continued)

**Critical accounting estimates and judgements**

The value of the Group's defined benefit pension scheme requires management to make several assumptions. The key areas of estimation uncertainty are:

*Discount rate applied:* this is set with reference to market yields at the end of the reporting period on high quality corporate bonds in the currency and with a term consistent with the Scheme's obligations. The average duration of the Scheme's obligations is approximately 20 years. The market for bonds with a similar duration is illiquid and, as a result, significant management judgement is required to determine an appropriate yield curve on which to base the discount rate.

*Inflation assumptions*: this is set with reference to market expectations of the RPI measure of inflation for a term consistent with the Scheme's obligations, based on data published by the BoE. Other measures of inflation (such as CPI, or inflation measures subject to an annual cap) are derived from this assumption.

*Mortality assumptions*: the cost of the benefits payable by the Scheme will also depend upon the life expectancy of the members. The assumptions for mortality rates are based on standard mortality tables (as adjusted to reflect the characteristics of Scheme members) which allow for future improvements in life expectancies.

The table below sets out the sensitivity and impact on the balance sheet surplus position of the Scheme, the defined benefit obligation and pension cost to changes in the key actuarial assumptions:

| Assumption change | | Balance sheet surplus £m | Obligation £m | Pension cost £m |
|---|---|---|---|---|
| **Discount rate** | + 0.25% | **(6)** | **(205)** | **(5)** |
| | - 0.25% | **8** | **220** | **4** |
| **Inflation** | + 0.25% | **(9)** | **145** | **3** |
| | - 0.25% | **9** | **(137)** | **(2)** |
| **Life expectancy** | +1 year | **(169)** | **169** | **3** |
| | -1 year | **164** | **(164)** | **(3)** |

The above sensitivity analyses are based on a change in an assumption while holding all other assumptions constant. In practice, changes in some of the assumptions may be correlated.

## 3.13 Customer deposits

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| Interest bearing demand deposits | **38,551** | 19,895 | **20,714** | 19,895 |
| Term deposits | **22,239** | 6,192 | **5,995** | 6,192 |
| Non-interest bearing demand deposits | **3,002** | 2,756 | **2,993** | 2,756 |
| Other wholesale deposits | **1** | 1 | **1** | 1 |
| | **63,793** | 28,844 | **29,703** | 28,844 |
| Accrued interest payable | **207** | 60 | **68** | 60 |
| | **64,000** | 28,904 | **29,771** | 28,904 |

## 3.14 Debt securities in issue

**Accounting policy**

Debt securities comprise short and long-term debt issued by the Group including commercial paper, medium-term notes, term loans, covered bonds and residential mortgage-backed securities (RMBS) notes.

Debt securities are initially recognised at fair value, being the issue proceeds, net of transaction costs incurred. These instruments are subsequently measured at amortised cost using the effective interest method resulting in premiums, discounts and associated issue costs being recognised in the income statement over the life of the instrument.

The breakdown of debt securities in issue is shown below:

**2019**

| **Group** | **Medium-term notes** | **Securitisation** | **Covered bonds** | **Total** |
|---|---|---|---|---|
| | **£m** | **£m** | **£m** | **£m** |
| Carrying value | **300** | **5,040** | **1,828** | **7,168** |
| Fair value hedge adjustments | **1** | **2** | **74** | **77** |
| Total debt securities | **301** | **5,042** | **1,902** | **7,245** |
| Accrued interest payable | **3** | **9** | **10** | **22** |
| | **304** | **5,051** | **1,912** | **7,267** |

2018

| Group | Medium-term notes | Securitisation | Covered bonds | Total |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Amortised cost | - | 2,949 | 698 | 3,647 |
| Fair value hedge adjustments | - | - | 34 | 34 |
| Total debt securities | - | 2,949 | 732 | 3,681 |
| Accrued interest payable | - | 7 | 10 | 17 |
| | - | 2,956 | 742 | 3,698 |

# Notes to the consolidated financial statements (continued)
## Section 3: Assets and liabilities (continued)

### 3.14 Debt securities in issue (continued)

**2019**

| **Bank** | **Medium-term notes** | **Securitisation** | **Covered bonds** | **Total** |
|---|---|---|---|---|
| | **£m** | **£m** | **£m** | **£m** |
| Amortised cost | - | - | **699** | **699** |
| Fair value hedge adjustments | - | - | - | - |
| Total debt securities | - | - | **699** | **699** |
| Accrued interest payable | - | - | **10** | **10** |
| | - | - | **709** | **709** |

2018

| Bank | Medium-term notes | Securitisation | Covered bonds | Total |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Amortised cost | - | - | 698 | 698 |
| Fair value hedge adjustments | - | - | - | - |
| Total debt securities | - | - | 698 | 698 |
| Accrued interest payable | - | - | 10 | 10 |
| | - | - | 708 | 708 |

The acquisition of Virgin Money Holdings (UK) PLC on 15 October 2018 resulted in recognition of the following debt securities (excluding accrued interest) within the Group, which are included in the above balances as at 30 September 2019:

| | Medium-term notes | Securitisation | Covered bonds | Total |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Fair value of acquisition balances | 647 | 2,909 | - | 3,556 |

The following table provides details of the medium-term notes in issuance at 30 September 2019:

| | **2019** | 2018 |
|---|---|---|
| **Medium term notes (excluding accrued interest)** | **£m** | £m |
| VM PLC 2.25% fixed rate senior notes due 2020 | **301** | - |

Details of securitisation and covered bond issues are included in note 3.3.

During the year, the Group issued £1,102m in Sterling and US Dollar denominations and redeemed £769m in Sterling and Euro denominations from the securitisation programmes, and issued £1,132m in Sterling and Euro denominations from the Eagle Place covered bond programme.

On 20 August 2019, following a consent exercise with the Noteholders, a medium-term note issued by Virgin Money Holdings (UK) PLC changed obligor and transferred to CYBG PLC, the Bank's Parent Company, at a fair value of £347m.

## 3.15 Due to other banks

**Accounting policy**
*Repurchase agreements*

Securities sold subject to sale and repurchase agreements ('repos') are retained in their respective balance sheet categories. The associated liabilities are included in amounts due to other banks based upon the counterparties to the transactions.

The difference between the sale and repurchase price of repos is treated as interest and accrued over the life of the agreements using the effective interest method.

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018[1] | **2019** | 2018[1] |
| | **£m** | £m | **£m** | £m |
| Secured loans | **7,308** | 2,254 | **2,254** | 2,254 |
| Securities sold under agreements to repurchase[2] | **1,554** | 802 | **1,554** | 802 |
| Transaction balances with other banks | **12** | 12 | **12** | 12 |
| Deposits from other banks | **42** | 3 | **40** | 3 |
| | **8,916** | 3,071 | **3,860** | 3,071 |

(1) The comparative year has been restated in line with the current year presentation. Derivative collateral in relation to clearing houses has been reclassified between other assets/liabilities and due from/to other banks (note 1.10).
(2) The underlying securities sold under agreements to repurchase have a carrying value of £2,324m (2018: £1,172m).

Secured loans comprise amounts drawn under the TFS (including accrued interest).

## 3.16 Provision for liabilities and charges

**Accounting policy**

Provisions for liabilities and charges are recognised when a legal or constructive obligation exists as a result of past events, it is probable that an outflow of economic benefits will be necessary to settle the obligation, and the obligation can be reliably estimated. Provisions for liabilities and charges are not discounted to the present value of their expected net future cash flows except where the time value of money is considered material.

**Critical accounting estimates and judgements**

***PPI redress provision and other conduct related* matters**

With the FCA's deadline on PPI complaints now passed the level of uncertainty in determining the quantum of PPI related liability has reduced. However, owing to the significant volumes received in the weeks preceding the time bar there continues to be significant judgement required to determine the key assumptions used to estimate the quantum of the provision, including the level of conversion rate if information requests convert into complaints, uphold rates (how many claims are, or may be, upheld in the customer's favour), and redress costs (the average payment made to customers). The provision, therefore, continues to be subject to inherent uncertainties as a result of the subjective nature of the assumptions used in quantifying the overall estimated position at 30 September 2019, consequently the provision calculated may be subject to change in the future if outcomes differ to those currently assumed. Sensitivity analysis indicating the impact of reasonably possible changes in key assumptions on the PPI provision is presented within this note.

There are similar uncertainties and judgements for other conduct risk related matters, however the level of liability is materially lower.

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| **PPI redress provisions** | | | | |
| Opening balance | **275** | 422 | **275** | 422 |
| Charge to the income statement (note 2.4) | **415** | 500 | **415** | 500 |
| Utilised | **(311)** | (647) | **(311)** | (647) |
| Closing balance | **379** | 275 | **379** | 275 |
| **Customer redress and other provisions** | | | | |
| Opening balance | **41** | 109 | **41** | 109 |
| Virgin Money Holdings (UK) PLC provision on acquisition | **11** | - | **-** | - |
| Charge to the income statement (note 2.4) | **18** | 44 | **17** | 44 |
| Utilised | **(45)** | (112) | **(36)** | (112) |
| Closing balance | **25** | 41 | **22** | 41 |
| **Restructuring provision** | | | | |
| Opening balance | **15** | 23 | **15** | 23 |
| Virgin Money Holdings (UK) PLC provision on acquisition | **2** | - | **-** | - |
| Charge to the income statement | **64** | 15 | **36** | 15 |
| Utilised | **(26)** | (23) | **(13)** | (23) |
| Closing balance | **55** | 15 | **38** | 15 |
| **Total provisions for liabilities and charges** | **459** | 331 | **439** | 331 |

## 3.16 Provision for liabilities and charges (continued)

**PPI redress**

In common with the wider UK retail banking sector, the Group continues to deal with complaints and redress issues arising out of historic sales of PPI. During the year, the Group reassessed the level of provision that was considered appropriate to meet current and future expectations in relation to the mis-selling of PPI policies and concluded that a further charge of £415m was required due to the significant volume of information requests received, mainly from claims management companies ahead of the August 2019 industry deadline. It also incorporated a reassessment of the costs of processing cases and the impact of experience adjustments. The total provision raised to date in respect of PPI is £3,055m (2018: £2,640m), with £379m of this remaining (2018: £275m) for closing out the remaining stock of complaints and information requests including costs of administration.

To 30 September 2019, the Group has received 629,000 complaints (2018: 483,000) and has allowed for 86,000 further complaints converted from information requests received prior to the time bar (2018: 83,000).

The overall provision is based on a number of assumptions derived from a combination of past experience, estimated future experience, industry comparison and the exercise of judgement in the key areas identified. There remain risks and uncertainties in relation to these assumptions and consequently in relation to the ultimate costs of redress and related costs, including: (i) the number of PPI claims arising from the volume of information requests submitted prior to the time bar; (ii) the number of those claims that ultimately will be upheld; (iii) the amount that will be paid in respect of those claims; and (iv) the costs of administration.

As such, the factors discussed above mean there is a risk that existing provisions for PPI customer redress may not cover all potential costs. In light of this, the eventual costs of PPI redress and complaint handling may therefore differ materially from that estimated and further provision could be required.

The table below sets out the key assumptions and the effect on the provision at 30 September 2019 of future, potential, changes in key assumptions:

| Assumptions | Change in assumption | Sensitivity[1] |
|---|---|---|
| Number of expected complaints converted from the stock of information requests at 30 September 2019 | +/-5% | £44m |
| Uphold rate on stock of complaints at 30 September 2019 and expected converted complaints from information requests | +/-1% | £5m |
| Average redress costs [2] | +/-1% | £2m |

(1) There are inter-dependencies between several of the key assumptions which add to the complexity of the judgements the Group has to make. This means that no single factor is likely to move independently of others, however, the sensitivities disclosed above assume all other assumptions remain unchanged.

(2) Sensitivity to a change in average redress across customer initiated complaints.

## 3.16 Provision for liabilities and charges (continued)

**Customer redress and other provisions**

Other provisions include amounts in respect of a number of non-PPI conduct related matters, legal proceedings, and claims arising in the ordinary course of the Group's business. Over the course of the year, the Group has raised further provisions of £18m in relation to non-PPI conduct matters (note 2.4). The ultimate cost to the Group of these customer redress matters is driven by a number of factors relating to offers of redress, compensation, offers of alternative products, consequential loss claims and administrative costs. The matters are at varying stages of their life cycle and in certain circumstances, usually early in the life of a potential issue, elements of the potential exposure are contingent. These factors could result in the total cost of review and redress varying materially from the Group's estimate. The final amount required to settle the Group's potential liabilities in these matters is therefore uncertain and further provision could be required.

**Restructuring provision**

Restructuring of the business is currently ongoing and a provision is held to cover redundancy payments, property vacation costs and associated enablement costs. During the year £64m (2018: £15m) was provided for in accordance with the requirements of IAS 37. £26m (2018: £23m) of the total provision was utilised in the year.

Included within the restructuring provision is an amount for committed rental expense on surplus lease space consistent with the expected exposure on individual leases where the property is unoccupied. This element of the provision will be utilised over the remaining life of the leases or until the leases are assigned and is measured at present values by discounting anticipated future cash flows.

## 3.17 Other liabilities

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018[1] | **2019** | 2018[1] |
| | **£m** | £m | **£m** | £m |
| Notes in circulation | **2,277** | 2,254 | **2,277** | 2,254 |
| Accruals and deferred income | **124** | 125 | **90** | 123 |
| Other[2] | **126** | 143 | **81** | 142 |
| | **2,527** | 2,522 | **2,448** | 2,519 |

(1) The prior year comparative has been restated in line with the current year presentation. £34m of derivative collateral in relation to clearing houses has been reclassified between other liabilities and due to other banks (note 1.10).

(2) Other includes £3m (2018: £3m) of post retirement medical benefit obligations (note 3.12).

### 3.18 Fair value of financial instruments

**Accounting Policy**

Fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants at the valuation date.

When available, the Group measures the fair value of an instrument using quoted prices in an active market for that instrument. Where no such active market exists for the particular asset or liability, the Group uses a valuation technique to arrive at the fair value, including the use of transaction prices obtained in recent arm's length transactions where possible, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. In doing so, fair value is estimated using a valuation technique that makes maximum possible use of market inputs and that places minimal possible reliance upon entity-specific inputs.

The best evidence of the fair value of a financial instrument at initial recognition is the transaction price, which represents the fair value of the consideration paid or received, unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Group recognises profits or losses on the transaction date.

In certain limited circumstances, the Group applies the fair value measurement option to financial assets including loans and advances, where the inherent market risks (principally interest rate and option risk) are individually hedged using appropriate interest rate derivatives. The loan is designated as being carried at fair value through profit or loss to offset the movements in the fair value of the derivative within the income statement and therefore avoid an accounting mismatch. When a loan is held at fair value, a statistical-based calculation is used to estimate expected losses attributable to adverse movements in credit risk on the assets held. This adjustment to the credit quality of the asset is then applied to the carrying amount of the loan to arrive at fair value and recognised in the income statement.

Analysis of the fair value disclosures uses a hierarchy that reflects the significance of inputs used in measuring fair value. The level in the fair value hierarchy within which a fair value measurement is categorised is determined on the basis of the lowest level input that is significant to the fair value measurement in its entirety. The fair value hierarchy is as follows:

- Level 1 fair value measurements - quoted prices (unadjusted) in active markets for an identical financial asset or liability;
- Level 2 fair value measurements - inputs other than quoted prices within Level 1 that are observable for the financial asset or liability, either directly (as prices) or indirectly (derived from prices); and
- Level 3 fair value measurements - inputs for the financial asset or liability that are not based on observable market data (unobservable inputs).

For the purpose of reporting movements between levels of the fair value hierarchy, transfers are recognised at the beginning of the reporting period in which they occur.

## 3.18 Fair value of financial instruments (continued)

### (a) Fair value of financial instruments recognised on the balance sheet at amortised cost

The tables overleaf show a comparison of the carrying amounts of financial assets and liabilities measured at amortised cost, and their fair values, where these are not approximately equal.

There are various limitations inherent in this fair value disclosure, particularly where prices are derived from unobservable inputs, due to some financial instruments not being traded in an active market. The methodologies and assumptions used in the fair value estimates are therefore described in the notes to the tables. The difference between carrying value and fair value is relevant in a trading environment, but is not relevant to assets such as loans and advances.

**Group**

| | **30 September 2019** | | 30 September 2018 | |
|---|---|---|---|---|
| | **Carrying value** | **Fair value** | Carrying value | Fair value |
| **Financial assets** | **£m** | **£m** | £m | £m |
| Loans and advances to customers[1] | **73,093** | **73,117** | 32,748 | 32,307 |
| **Financial liabilities** | | | | |
| Due to other banks[2] | **8,916** | **8,874** | 3,071 | 3,040 |
| Customer deposits[2] | **64,000** | **64,166** | 28,904 | 28,968 |
| Debt securities in issue[3] | **7,267** | **7,365** | 3,698 | 3,773 |
| Due to related entities[2] | **2,315** | **2,318** | 1,313 | 1,325 |

**Bank**

| | **30 September 2019** | | 30 September 2018 | |
|---|---|---|---|---|
| | **Carrying value** | **Fair value** | Carrying value | Fair value |
| **Financial assets** | **£m** | **£m** | £m | £m |
| Loans and advances to customers[1] | **32,389** | **32,609** | 31,635 | 31,251 |
| **Financial liabilities** | | | | |
| Due to other banks[2] | **3,860** | **3,837** | 3,071 | 3,040 |
| Customer deposits[2] | **29,771** | **29,813** | 28,904 | 28,968 |
| Debt securities in issue[2] | **709** | **850** | 708 | 824 |
| Due to related entities[2] | **5,336** | **5,337** | 3,885 | 4,263 |

(1) Loans and advances to customers are categorised as Level 3 in the fair value hierarchy with the exception of £1,513m (2018: £1,110m) of overdrafts which are categorised as Level 2.
(2) Categorised as Level 2 in the Fair Value Hierarchy.
(3) Categorised as Level 2 in the Fair Value Hierarchy with the exception of £305m of listed debt (2018: £Nil) which is categorised as Level 1.

## 3.18 Fair value of financial instruments (continued)

### (a) Fair value of financial instruments recognised on the balance sheet at amortised cost (continued)

The Group and Bank's fair values disclosed for financial instruments at amortised cost are based on the following methodologies and assumptions:

(a) *Loans and advances to customers* - The fair value of loans and advances is determined by firstly segregating them into portfolios of similar characteristics. Contractual cash flows are then adjusted for ECLs and expectations of customer behaviour based on observed historic data. The cash flows are then discounted using current market rates for instruments of similar terms and maturity to arrive at an estimate of their fair value.

(b) *Due to other banks* - The fair value is determined from a discounted cash flow model using current market rates for instruments of similar terms and maturity.

(c) *Customer deposits* - The fair value of deposits is determined using a replacement cost method which assumes alternative funding is raised in the most advantageous market. The contractual cash flows have been discounted using a funding curve with credit spreads reflecting the tenor of each deposit.

(d) *Debt securities in issue* - The fair value is taken directly from quoted market prices where available or determined from a discounted cash flow model using current market rates for instruments of similar terms and maturity.

(e) *Amounts due to related entities* - The fair value of subordinated debt due to related entities is derived from quoted market prices of the related debt security in issue by Virgin Money UK PLC after accounting for differences in credit spread. All other amounts due from related entities are redeemable at call and therefore carrying value approximates fair value.

### (b) Fair value of financial instruments recognised on the balance sheet at fair value

The following tables provide an analysis of financial instruments that are measured subsequent to initial recognition at fair value, using the fair value hierarchy described above.

| Group | Fair value measurement at 30 September 2019 | | | | Fair value measurement at 30 September 2018 | | | |
|---|---|---|---|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total | Level 1 | Level 2 | Level 3 | Total |
| | £m | £m | £m | £m | £m | £m | £m | £m |
| **Financial assets** | | | | | | | | |
| Loans and advances at FVTPL | **-** | **253** | **-** | **253** | - | 362 | - | 362 |
| Derivative financial assets | **-** | **366** | **-** | **366** | - | 262 | - | 262 |
| Other financial assets at FVTPL | **-** | **-** | **8** | **8** | - | - | - | - |
| Financial instruments at fair value through other comprehensive income[1] | **4,328** | **-** | **-** | **4,328** | - | - | - | - |
| AFS investments[1] | **-** | **-** | **-** | **-** | 1,551 | - | 11 | 1,562 |
| **Total financial assets at fair value** | **4,328** | **619** | **8** | **4,955** | 1,551 | 624 | 11 | 2,186 |
| **Financial liabilities** | | | | | | | | |
| Customer deposits | **-** | **4** | **-** | **4** | - | 15 | - | 15 |
| Derivative financial liabilities | **-** | **273** | **-** | **273** | - | 361 | - | 361 |
| **Total financial liabilities at fair value** | **-** | **277** | **-** | **277** | - | 376 | - | 376 |

[1] Changes required as a result of the adoption of IFRS 9 from 1 October 2018. Refer to notes 1.9 and 5.4.

## 3.18 Fair value of financial instruments (continued)

### (b) Fair value of financial instruments recognised on the balance sheet at fair value (continued)

| Bank | Fair value measurement at 30 September 2019 | | | | Fair value measurement at 30 September 2018 | | | |
|---|---|---|---|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total | Level 1 | Level 2 | Level 3 | Total |
| | £m | £m | £m | £m | £m | £m | £m | £m |
| **Financial assets** | | | | | | | | |
| Loans and advances at FVTPL | - | 253 | - | 253 | - | 362 | - | 362 |
| Derivative financial assets | - | 442 | - | 442 | - | 151 | - | 151 |
| Other financial assets at FVTPL | - | - | 1 | 1 | - | - | - | - |
| Financial instruments at fair value through other comprehensive income[1] | 2,350 | - | - | 2,350 | - | - | - | - |
| AFS investments[1] | - | - | - | - | 1,551 | - | 5 | 1,556 |
| **Total financial assets at fair value** | 2,350 | 695 | 1 | 3,046 | 1,551 | 513 | 5 | 2,069 |
| **Financial liabilities** | | | | | | | | |
| Customer deposits | - | 4 | - | 4 | - | 15 | - | 15 |
| Derivative financial liabilities | - | 292 | - | 292 | - | 361 | - | 361 |
| **Total financial liabilities at fair value** | - | 296 | - | 296 | - | 376 | - | 376 |

(1) Changes required as a result of the adoption of IFRS 9 from 1 October 2018. Refer to notes 1.9 and 5.4.

There were no transfers between Level 1 and 2 in the current or prior year.

The Group and Bank's valuations for financial instruments that are measured subsequent to initial recognition at fair value are based on the following methodologies and assumptions:

(a) *Financial assets and liabilities at fair value through profit or loss:*

- Loans and advances to customers and customer deposits (Level 2) – The fair values are derived from data or valuation techniques based upon observable market data and non-observable inputs as appropriate to the nature and type of the underlying instrument.

- Other financial assets at fair value through profit or loss (Level 3) – Primarily represents £5m of deferred consideration receivable and consists of the rights to future commission. The valuation is determined from a discounted cash flow model incorporating estimated attrition rates and investment growth rates appropriate to the underlying funds under management. The remaining £3m represents unlisted debt and equity investments for which the Group's share of the net asset value or the transaction price respectively is considered the best representation of the exit price and is the Group's best estimate of fair value[1].

(b) *Derivative financial assets and liabilities* (Level 2) - The fair values of derivatives, including foreign exchange contracts, interest rate swaps, interest rate and currency option contracts, and currency swaps, are obtained from discounted cash flow models or option pricing models as appropriate.

(c) *FVOCI* - The fair values of listed investments are based on quoted closing market prices[1].

(1) These balances were disclosed under available for sale in 2018 and were reclassified as a result of IFRS 9 (note 1.9).

# Notes to the consolidated financial statements (continued)
## Section 3: Assets and liabilities (continued)

### 3.18 Fair value of financial instruments (continued)

#### (b) Fair value of financial instruments recognised on the balance sheet at fair value (continued)

| Level 3 movements analysis: | 2019 | | | 2018 | | |
|---|---|---|---|---|---|---|
| | Financial assets available for sale | Financial assets at fair value through profit or loss | Financial liabilities at fair value | Financial assets available for sale | Financial assets at fair value through profit or loss | Financial liabilities at fair value |
| Group | £m | £m | £m | £m | £m | £m |
| **Balance at the beginning of year** | 11 | - | - | 10 | 477 | 26 |
| Transfer to Level 2[1] | - | - | - | - | (477) | (26) |
| Reclassification on adoption of IFRS 9[2] | (11) | 11 | - | - | - | - |
| Fair value (losses)/gains recognised[3] | | | | | | |
| In profit or loss - unrealised | - | - | - | (1) | - | - |
| In profit or loss - realised | - | 3 | - | 1 | - | - |
| In available for sale reserve - unrealised | - | - | - | 1 | - | - |
| Purchases | - | 1 | - | - | - | - |
| Sales[4] | - | (4) | - | - | - | - |
| Settlements | - | (3) | - | - | - | - |
| **Balance at the end of the year** | - | 8 | - | 11 | - | - |

| Level 3 movements analysis: | 2019 | | | 2018 | | |
|---|---|---|---|---|---|---|
| | Financial assets available for sale | Financial assets at fair value through profit or loss | Financial liabilities at fair value | Financial assets available for sale | Financial assets at fair value through profit or loss | Financial liabilities at fair value |
| Bank | £m | £m | £m | £m | £m | £m |
| **Balance at beginning of year** | 5 | - | - | 4 | 477 | 26 |
| Transfer to Level 2[1] | - | - | - | - | (477) | (26) |
| Reclassification on adoption of IFRS 9[2] | (5) | 5 | - | - | - | - |
| Fair value (losses)/gains recognised[3] | | | | | | |
| In profit or loss - unrealised | - | - | - | 1 | - | - |
| In profit or loss - realised | - | 3 | - | - | - | - |
| Sales[4] | - | (4) | - | - | - | - |
| Settlements | - | (3) | - | - | - | - |
| **Balance at the end of the year** | - | 1 | - | 5 | - | - |

(1) The financial assets at fair value comprise a portfolio of loans which are no longer on sale. The continued run-off of these loans resulted in the unobservable credit risk inputs no longer being significant to their fair value. As such, in the prior year, the loans (and associated liabilities) were reclassified to Level 2 in the fair value hierarchy. In accordance with the Group's accounting policy, the transfer was deemed to have occurred at the beginning of the reporting period.
(2) Changes required as a result of the adoption of IFRS 9 from 1 October 2018. Refer to notes 1.9 and 5.4.
(3) Net gains or losses were recorded in non-interest income, or available for sale reserve as appropriate.
(4) Sales relate to unlisted equity investments sold to Virgin Money UK PLC in the year.

## 3.18 Fair value of financial instruments (continued)

**Qualitative information about significant unobservable inputs in Level 3 valuations**

The table below lists key unobservable inputs to Level 3 financial instruments, and provides the range of those inputs as at 30 September 2019.

| | Fair value | Valuation Technique | Unobservable inputs | High range |
|---|---|---|---|---|
| **Other financial assets at FVTPL** | **£m** | | | |
| Equity investments | 2 | Discounted cash flow | Exit price | 100% |
| Debt investments | 6 | Discounted cash flow | Funds under management attrition rate | 20% |

**Sensitivity of Level 3 fair value measurements to reasonably possible alternative assumptions**

Where valuation techniques use non-observable inputs that are significant to a fair value measurement in its entirety, changing these inputs will change the resultant fair value measurement.

The most significant input impacting the carrying value of the FVTPL-debt investment is the 'Funds Under Management attrition' rate. The Group currently assumes an annual 15% attrition rate. If this rate was 20% the fair value would reduce by £1m; if it was 10% the fair value would increase by £2m.

Other than these significant Level 3 measurements, the Group has a limited remaining exposure to Level 3 fair value measurements, and changing one or more of the inputs to reasonable alternative assumptions would not change the fair value significantly with respect to profit or loss, total assets, total liabilities or equity.

## 3.19 Acquisition of Virgin Money Holdings (UK) PLC

On 15 October 2018, CYBG PLC acquired all the voting rights in Virgin Money Holdings (UK) PLC by means of a scheme of arrangement under Part 26 of the UK Companies Act 2006 for a purchase consideration of £1,532m. This comprised the fair value of approximately 541m new CYBG PLC ordinary shares in exchange for all Virgin Money Holdings (UK) PLC shares at a ratio of 1.2125 CYBG shares for each Virgin Money Holdings (UK) PLC share. Immediately following completion, Virgin Money Holdings (UK) PLC shareholders owned approximately 38% of the Combined Group (on a fully diluted basis). On 17 October 2018, the Bank subsequently acquired all the voting rights in Virgin Money Holdings (UK) PLC for a consideration of £1,549m, by issuing one ordinary shares of £0.10 and recognising £1,549m of share premium.

The fair value of the shares issued was calculated using the CYBG PLC market price of 286.4 pence per share on the London Stock Exchange (LSE) at its close of business on 12 October 2018.

In seeking to address the underlying trends of scale and adaptability within the banking industry, the combination brings together the two challenger banks to create a national competitor to the large incumbent banks. The combination offers retail and business customers an alternative to the status quo.

The table below sets out the fair values of the identifiable net assets and liabilities acquired.

### 3.19 Acquisition of Virgin Money Holdings (UK) PLC (continued)

| | Book value at 15 October 2018 | Fair value adjustments | Fair value at 15 October 2018 |
|---|---|---|---|
| | £m | £m | £m |
| **Assets** | | | |
| Cash and balances with central banks | 4,146 | - | 4,146 |
| Due from other banks | 598 | - | 598 |
| Financial instruments at fair value through other comprehensive income[1][2] | 2,028 | - | 2,028 |
| Other financial assets at fair value through profit or loss | 1 | - | 1 |
| Derivative financial instruments | 71 | - | 71 |
| Loans and advances to customers[3] | 37,840 | 34 | 37,874 |
| Property, plant and equipment | 73 | (7) | 66 |
| Intangible assets | 172 | 6 | 178 |
| Deferred tax assets | 23 | 22 | 45 |
| Other assets | 93 | - | 93 |
| **Total assets** | 45,045 | 55 | 45,100 |
| **Liabilities** | | | |
| Due to other banks[3] | 7,171 | (114) | 7,057 |
| Derivative financial instruments | 41 | - | 41 |
| Customer deposits | 32,111 | 10 | 32,121 |
| Debt securities in issue | 3,548 | 8 | 3,556 |
| Deferred tax liabilities | - | 44 | 44 |
| Other liabilities | 337 | 1 | 338 |
| **Total liabilities** | 43,208 | (51) | 43,157 |
| **Net assets** | 1,837 | 106 | 1,943 |
| **Fair value of net assets acquired** | | | 1,943 |
| **Fair value of non-controlling interests[4]** | | | (422) |
| **Goodwill arising on acquisition** | | | 11 |
| **Total consideration[2][5]** | | | 1,532 |

(1) Under IFRS 9 'Financial Instruments', debt investments which would previously have been classified in the available for sale category are reclassified to the new FVOCI category.
(2) Adjusted to remove the CYBG debt securities held by Virgin Money Holdings (UK) PLC.
(3) Included within Loans and advances to customers and Due to other banks is c.£300m of fair value assets which will unwind through the income statement over the next three to five years.
(4) At the acquisition date, Virgin Money Holdings (UK) PLC had in issue Fixed Rate Resettable AT1 securities issued on the Luxembourg Stock Exchange. In accordance with IAS 32 these were classified as equity instruments. The Group did not acquire the AT1 securities which remained in issue to third parties, consequently these represented a non-controlling interest. As the AT1 instruments were actively traded, the fair value of £422m was calculated based on the market price on the Luxembourg Stock Exchange at its close of business on 12 October 2018. Subsequently on 20 August 2019, the securities were transferred from Virgin Money Holdings (UK) PLC to CYBG PLC, and so are no longer a non-controlling interest at 30 September (note 4.1.4).
(5) Includes 'shares to be issued' in the future relating to employee share plans in regard to the settlement of the outstanding Virgin Money Holdings (UK) PLC share awards, partially offset by the purchase of 'own shares' (note 4.1.5).

At acquisition date, the contractual amount of loans and advances receivable from customers was £37,664m. The best estimate of the amounts not expected to be collected was £123m. The goodwill arising on the acquisition of Virgin Money Holdings (UK) PLC is mainly attributable to expected cash flows from new customers and significant synergies which are expected to be realised. The goodwill arising on acquisition is not expected to be deductible for tax purposes.

The amounts of net interest income and PBT contributed to the Group's consolidated income statement for the year ended 30 September 2019 from the acquired Virgin Money Holdings (UK) PLC business were £559m and £149m respectively. If the acquisition had occurred on 1 October 2018, the Group's total net interest income for the year would have increased by £22m to £1,538m and the loss before tax would have increased by £33m to £215m.

Transaction costs of £48m were incurred by CYBG PLC in relation to the acquisition.

# Notes to the consolidated financial statements (continued)

## Section 4: Capital

### 4.1 Equity

**Accounting policy**

**Equity**

The financial instruments issued by the Company are treated as equity (i.e. forming part of shareholders' funds) only to the extent that they meet the following two conditions:

(a) they include no contractual obligations upon the Company to deliver cash or other financial assets or to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable to the Group; and

(b) where the instrument will or may be settled in the Company's own equity instruments, it is either a non-derivative that includes no obligation to deliver a variable number of the Company's own equity instruments, or is a derivative that will be settled by the Company exchanging a fixed amount of cash or other financial assets for a fixed number of its own equity instruments.

To the extent that this definition is not met, the proceeds of issue are classified as a financial liability.

Incremental costs directly attributable to the issue of new shares or options or to the acquisition of a business are shown in equity as a deduction, net of tax, from the proceeds.

**Dividends**

Final dividends on ordinary shares are recognised as a liability and deducted from equity when they are approved by the Bank's shareholders. Interim dividends are deducted from equity when they are no longer at the discretion of the Bank.

Proposed final dividends for the year are disclosed as an event after the balance sheet date.

#### 4.1.1 Share capital and share premium

| | **2019** | 2018 |
|---|---|---|
| | **£m** | £m |
| Share capital | **1,243** | 1,013 |
| Share premium | **1,549** | - |
| **Share capital and share premium** | **2,792** | 1,013 |

| **Group and Bank** | **2019** | 2018 | **2019** | 2018 |
|---|---|---|---|---|
| **Allotted, called up and fully paid** | **Number of shares** | Number of shares | **£m** | £m |
| **Ordinary shares of £0.10 each** | | | | |
| Opening ordinary share capital | **10,131,538,207** | 5,024,705,826 | **1,013** | 502 |
| Issued during the year | **2,300,000,001** | 5,106,832,381 | **230** | 511 |
| **Closing ordinary share capital** | **12,431,538,208** | 10,131,538,207 | **1,243** | 1,013 |

**Acquisition of virgin Money Holdings (UK) PLC**

On 17 October 2018, the Bank acquired all the voting rights in Virgin Money Holdings (UK) PLC for a consideration of £1.5bn, by issuing one ordinary share of £0.10 and recognising £1.5bn of share premium. On 20 August 2019, 2.3bn ordinary shares of £0.10 were issued to CYBG PLC to facilitate the change in obligor of £230m of other equity instruments from Virgin Money Holdings (UK) PLC to CYBG PLC.

All ordinary shares issued were at par and fully paid up.

The holders of ordinary shares are entitled to dividends as declared from time to time and are entitled to one vote per share at meetings of the shareholders of the Bank. All shares in issue at 30 September 2019 rank equally with regard to the Bank's residual assets. A final dividend of £44m was paid in respect of the year ended 30 September 2018 (2017: £9m). These dividends were deducted from retained profits in the current year.

## 4.1 Equity (continued)

### 4.1.1 Share capital and share premium (continued)

On 11 November 2019 the Bank paid an ordinary dividend of £10m to its holding company Virgin Money UK PLC. This ordinary dividend was equal in amount to an AT1 distribution made by Virgin Money UK PLC to investors on the same date. This follows the successful completion of an investor consent exercise in August 2019 to transfer the obligations of Virgin Money Holdings (UK) plc on its outstanding AT1 instrument (£230m) to Virgin Money UK PLC. The proceeds of the transfer were used by Virgin Money UK PLC to subscribe for £230m of ordinary shares in Clydesdale Bank PLC. The financial statements do not reflect the recommended dividend.

Share premium represents the aggregate of all amounts that have ever been paid above par value to the Bank when it has issued ordinary shares.

A description of the other equity categories included within the consolidated statement of changes in equity, and significant movements during the year, is provided below.

### 4.1.2 Other equity instruments

Other equity instruments consist of the following Perpetual Contingent Convertible Notes which were issued to CYBG PLC:

- Perpetual securities (fixed 8% up to the first reset date) issued on 8 February 2016 with a nominal value of £450m and optional redemption on 8 December 2022.
- Perpetual securities (fixed 9.25% up to the first reset date) issued on 13 March 2019 with a nominal value of £250m and optional redemption on 8 June 2024.

The issues are treated as equity instruments in accordance with IAS 32 'Financial Instruments: Presentation' with the proceeds included in equity, net of transaction costs of £3m (2018: £Nil). AT1 distributions of £41m were made in the year, £34m net of tax (2018: £36m paid, £29m net of tax).

### 4.1.3 Other reserves

#### *4.1.3.1 Asset revaluation reserve*

The asset revaluation reserve includes the gross revaluation increments and decrements arising from the revaluation of land and buildings.

#### *4.1.3.2 Available for sale (AFS) reserve*

The AFS reserve recorded the gains and losses arising from changes in the fair value of AFS financial assets prior to 1 October 2018. On adoption of IFRS 9 'Financial Instruments' with the removal of the AFS category for financial assets, part of the balance on the reserve was transferred to the FVOCI reserve with £3m being released to retained earnings (note 5.4).

#### *4.1.3.3 Cash flow hedge reserve*

The cash flow hedge reserve represents the effective portion of cumulative post-tax gains and losses on derivatives designated as cash flow hedging instruments that will be recycled to the income statement when the hedged items affect profit or loss.

# Notes to the consolidated financial statements (continued)

## Section 4: Capital (continued)

### 4.1 Equity (continued)

#### *4.1.3.3 Cash flow hedge reserve (continued)*

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| At 1 October | **(37)** | 1 | **(36)** | 1 |
| **Amounts recognised in other comprehensive income:** | | | | |
| **Cash flow hedge – interest rate risk** | | | | |
| Effective portion of changes in fair value of interest rate swaps | **14** | (57) | **62** | (57) |
| Amounts transferred to the income statement | **(1)** | 8 | **(1)** | 8 |
| Taxation | **(3)** | 12 | **(15)** | 12 |
| **Cash flow hedge – Foreign exchange risk** | | | | |
| Effective portion of changes in fair value of cross currency swaps | **59** | (1) | **-** | - |
| Amounts transferred to the income statement | **(57)** | - | **-** | - |
| Taxation | **-** | - | **-** | - |
| **At 30 September** | **(25)** | (37) | **10** | (36) |

#### *4.1.3.4 FVOCI reserve*

The FVOCI reserve records the unrealised gains and losses arising from changes in the fair value of financial assets at FVOCI. The movements in this reserve are detailed in the consolidated statement of comprehensive income. On adoption of IFRS 9 'Financial Instruments' with the removal of the AFS category for financial assets, £4m of the balance on the AFS reserve was transferred to the FVOCI reserve (note 5.4).

#### *4.1.4 Non-controlling interests*

At the acquisition date, Virgin Money Holdings (UK) PLC had in issue Fixed Rate Resettable AT1 securities issued on the Luxembourg Stock Exchange. In accordance with IAS 32 these are classified as equity instruments. The Group did not acquire the AT1 securities which remained in issue to third parties, consequently these represented a non-controlling interest. As the AT1 instruments are actively traded, the fair value on acquisition of £422m was calculated based on the market price on the Luxembourg Stock Exchange at its close of business on 12 October 2018. Following the change in obligor from Virgin Money Holdings (UK) PLC to CYBG PLC on 20 August 2019, the non-controlling interest has reduced to £Nil.

Distributions to non-controlling interests of £33m were made in the year, £26m net of tax (2018: £Nil).

## 4.2 Equity based compensation

**Accounting policy**

The Group operates a number of equity settled share based compensation plans in respect of services received from certain of its employees. The fair value of the services received is recognised as an expense. The total amount to be expensed is measured by reference to the fair value of Virgin Money's shares, performance options or performance rights granted, including, where relevant, any market performance conditions and any non-vesting conditions. The impacts of any service and non-market performance vesting conditions are not included in the fair value and instead are included in estimating the number of awards or options that are expected to vest.

The total expense is recognised over the vesting period, which is the period over which all of the specified vesting conditions are to be satisfied. A corresponding credit is recognised in the equity based compensation reserve, adjusted for deferred tax. In some circumstances, employees may provide services in advance of the grant date and therefore the grant date fair value is estimated for the purposes of recognising the expense during the period between the start of the service period and the grant date.

At the end of each reporting period, the Group revises its estimates of the number of shares, performance options and performance rights that are expected to vest based on the non-market and service vesting conditions. The impact of the revision to original estimates, if any, is recognised in the income statement, with a corresponding adjustment to the equity based compensation reserve.

The equity settled share based payment charge for the year is £4m (2018: £9m).

**CYBG awards**

The Group made a number of awards under its share plans:

| Plan | Eligible employees | Nature of award | Vesting conditions[1] | Grant dates[2] |
|---|---|---|---|---|
| Deferred Equity Plan (DEP) [3] | Selected employees | Conditional rights to shares | Continuing employment or leaving in certain limited circumstances | 2016, 2017 and 2018 |
| Long Term Incentive Plan (LTIP) | Selected senior employees | Conditional rights to shares | Continuing employment or leaving in certain limited circumstances and achievement of delivery of the Group's strategic goals and growth in shareholder value | 2017 and 2018 |
| Share Incentive Plan (SIP) | All employees | Non-conditional share award | Continuing employment | 2016 and 2017 |

(1) All awards are subject to vesting conditions and therefore may or may not vest.
(2) The year in which grants have been made under the relevant plan.
(3) Grants made under the DEP are made the year following the financial year to which they relate.

Further detail on each plan is provided below:

**DEP**

Under the plan employees were awarded conditional rights to CYBG PLC shares. The shares are subject to forfeiture conditions including forfeiture as a result of resignation, termination by the Group or failure to meet compliance requirements. Awards include:

- the upfront and deferred elements of bonus awards where required to comply with the PRA Remuneration Code or the Group's deferral policy;
- buyout of equity from previous employment for senior new hires; and
- Demerger awards which are also subject to the achievement of performance conditions over a three-year period. Details of the performance conditions are set out in the Directors' remuneration report section of the Virgin Money UK PLC Annual Report and Accounts.

## 4.2 Equity based compensation (continued)

**LTIP**

Under the plan, employees were awarded conditional rights to CYBG PLC shares. The shares are subject to forfeiture conditions including forfeiture as a result of resignation, termination by the Group or failure to meet compliance requirements.

The performance conditions of the plan must be met over a three-year period. The measures reflect a balanced approach between financial and non-financial performance and are aligned to the organisation's strategic goals. Measures, relative weightings and the quantum for assessing performance are outlined in the Directors' remuneration report section of the Virgin Money UK PLC Annual Report and Accounts.

**SIP**

Employees eligible at the date of the award were awarded CYBG Group shares, which are held in the SIP Trust. Awards are not subject to performance conditions and participants are the beneficial owners of the shares granted to them, but not the registered owners. Voting rights over the shares are normally exercised by the registered owner at the direction of the participants. For the 2015 Demerger award, leavers (with the exception of gross misconduct) retain their awards but they must withdraw their shares from the SIP Trust.

**Awards/rights made during the year:**

| Plan | Number outstanding at 1 October 2018 | Number awarded | Number forfeited | Number released | **Number outstanding at 30 September 2019** | **Average fair value of awards at grant pence** |
|---|---|---|---|---|---|---|
| **Deferred Equity Plan** | | | | | | |
| 2015 Demerger | 2,038,052 | - | (223,829) | (1,785,999) | **28,224** | 196.96 |
| 2015 Bonus | 54,953 | - | - | (54,953) | **-** | 195.17 |
| 2015 Commencement | 25,685 | - | - | (25,685) | **-** | 194.67 |
| 2016 Bonus | 21,403 | - | - | (10,700) | **10,703** | 266.03 |
| 2016 Commencement | 57,271 | - | - | (36,867) | **20,404** | 266.03 |
| 2017 Bonus | 592,807 | - | (31,943) | (329,794) | **231,070** | 313.20 |
| 2017 Commencement | 68,167 | - | (34,324) | (28,734) | **5,109** | 313.20 |
| 2018 Bonus | - | 1,634,582 | - | (1,462,777) | **171,805** | 192.35 |
| **Long Term Incentive Plan** | | | | | | |
| 2016 LTIP | 2,232,391 | - | (203,923) | - | **2,028,468** | 266.03 |
| 2017 LTIP | 2,314,487 | - | (207,534) | - | **2,106,953** | 313.20 |
| 2018 LTIP | - | 5,857,259 | (61,455) | - | **5,795,804** | 190.47 |
| **Share Incentive Plan** | | | | | | |
| 2015 Demerger | 1,297,152 | - | (512) | (270,148)[1] | **1,026,492** | 194.67 |
| 2017 Free Share | 906,141 | - | (477) | (68,688) | **836,976** | 313.20 |
| 2019 Free Share | - | 2,343,888 | (84,870) | (48,216) | **2,210,802** | 202.53 |

(1) Shares withdrawn from SIP Trust on leaving the Group.

**Determination of grant date fair values**

Participants of the DEP and LTIP plans are not entitled to dividends until the awards vest, but the number of shares which vest may be increased to reflect the value of dividends that would have been paid up to the end of the holding period for the awards, subject to the extent permitted under the relevant remuneration regulation. Accordingly, the grant date fair value of the awards with only service conditions and/or non-market performance conditions has been taken as the market value of CYBG's ordinary shares at the grant date. Where awards are subject to non-market performance conditions, an estimate is made of the number of awards expected to vest in order to determine the overall share based payment charge to be recognised over the vesting period.

The Group has not issued awards under any CYBG plan with market performance conditions.

# Notes to the consolidated financial statements (continued)

## Section 5: Other notes

### 5.1 Contingent liabilities and commitments

**Accounting policy**

**Financial guarantees**
The Group provides guarantees in the normal course of business on behalf of its customers. Guarantees written are conditional commitments issued by the Group to guarantee the performance of a customer to a third party and are primarily issued to support direct financial obligations such as commercial bills or other debt instruments issued by a counterparty. The rating of the Group as a guarantee provider enhances the marketability of the paper issued by the counterparty in these circumstances. Financial guarantee contracts are initially recorded at fair value which is equal to the premium received, unless there is evidence to the contrary.

The ECL requirements of IFRS 9 as set out in note 3.2 are equally applicable to loan commitments and financial guarantee contracts.

**Operating lease commitments**
The leases entered into by the Group are primarily operating leases, with operating lease rentals charged to the income statement on a straight line basis over the period of the lease. The Group discloses its obligations for future minimum payments under non-cancellable leases.

**Contingent liabilities**
Contingent liabilities are possible obligations whose existence will be confirmed only by uncertain future events or present obligations where the transfer of economic benefit is uncertain or cannot be reliably measured. Contingent liabilities are not recognised on the balance sheet but are disclosed unless they are remote.

The table below sets out the amounts of financial guarantees and commitments which are not recorded on the balance sheet. Financial guarantees and commitments are credit-related instruments which include acceptances, letters of credit, guarantees and commitments to extend credit. The amounts do not represent the amounts at risk at the balance sheet date but the amounts that would be at risk should the contracts be fully drawn upon and the customer defaults. Since a significant portion of guarantees and commitments is expected to expire without being drawn upon, the total of the contract amounts is not representative of future liquidity requirements.

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| **Financial guarantees** | | | | |
| Guarantees and assets pledged as collateral security: | | | | |
| Due in less than 3 months | **24** | 26 | **24** | 26 |
| Due between 3 months and 1 year | **24** | 36 | **24** | 36 |
| Due between 1 year and 3 years | **6** | 10 | **6** | 10 |
| Due between 3 years and 5 years | **11** | 2 | **11** | 2 |
| Due after 5 years | **48** | 45 | **48** | 45 |
| | **113** | 119 | **113** | 119 |
| **Other credit commitments** | | | | |
| Undrawn formal standby facilities, credit lines and other commitments to lend at call | **15,158** | 7,016 | **6,677** | 6,887 |

The Group's loan commitments and financial guarantee contracts attracted ECLs of £5m at 30 September 2019. The balance calculated on adoption of IFRS 9 is disclosed in note 5.4.

**Capital commitments**

The Group and Bank had future capital expenditure which had been contracted for, but not provided for, at 30 September 2019 of £0.2m (2018: £0.5m).

## 5.1 Contingent liabilities and commitments (continued)

### Operating lease commitments

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| **Leases as lessor** | | | | |
| Future minimum lease payments under non-cancellable operating leases: | | | | |
| Within 1 year | **2** | 1 | **2** | 1 |
| Between 1 year and 5 years | **4** | 4 | **4** | 4 |
| Over 5 years | **1** | 1 | **1** | 1 |
| | **7** | 6 | **7** | 6 |
| **Leases as lessee** | | | | |
| Future minimum lease payments under non-cancellable operating leases: | | | | |
| Within 1 year | **35** | 29 | **27** | 29 |
| Between 1 year and 5 years | **135** | 96 | **114** | 96 |
| Over 5 years | **244** | 124 | **232** | 124 |
| | **414** | 249 | **373** | 249 |

### Other contingent liabilities

*Conduct risk related matters*

There continues to be significant uncertainty and thus judgement is required in determining the quantum of conduct risk related liabilities with note 3.16 reflecting the Group's current position in relation to redress provisions including those for PPI. The final amount required to settle the Group's potential liabilities for these, and other conduct related matters, is materially uncertain. Contingent liabilities include those matters where redress is likely to be paid and costs incurred but the amounts cannot currently be estimated.

The Group will continue to reassess the adequacy of provisions for these matters and the assumptions underlying the calculations at each reporting date based upon experience and other relevant factors at that time.

*Legal claims*

The Group is named in and is defending a number of legal claims arising in the ordinary course of business. No material adverse impact on the financial position of the Group is expected to arise from the ultimate resolution of these legal actions.

## 5.2 Notes to the statement of cash flows

| | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| **Adjustments included in loss before tax** | | | | |
| Interest receivable | **(2,432)** | (1,113) | **(1,222)** | (1,097) |
| Interest payable | **917** | 258 | **354** | 266 |
| Depreciation and amortisation (note 2.4) | **108** | 89 | **87** | 89 |
| Derivative financial instruments fair value movements | **94** | (3) | **2** | 3 |
| Impairment losses on credit exposures (note 3.2) | **252** | 41 | **61** | 41 |
| Software impairments and write-offs | **132** | - | **48** | - |
| Impairment of investment in subsidiaries | **-** | - | **303** | - |
| Costs recharged to parent entity | **29** | (33) | **72** | (33) |
| Gain on sale of 50% (less one share) consideration in Virgin Money Unit Trust Managers Limited | **(35)** | - | **-** | - |
| | **(935)** | (761) | **(295)** | (731) |
| **Changes in operating assets** | | | | |
| Net (increase)/decrease in: | | | | |
| Balances with supervisory central banks | **(22)** | (31) | **(8)** | (31) |
| Due from other banks | **274** | (25) | **8** | 32 |
| Derivative financial instruments | **(45)** | 18 | **(318)** | (31) |
| Financial assets at fair value through OCI | **(60)** | - | **-** | - |
| Financial assets at fair value through profit or loss | **98** | 117 | **113** | 117 |
| Loans and advances to customers | **(2,655)** | (1,488) | **(842)** | (1,433) |
| Defined benefit pension assets | **(74)** | - | **(74)** | - |
| Other assets | **134** | (14) | **125** | (13) |
| | **(2,350)** | (1,423) | **(996)** | (1,359) |
| **Changes in operating liabilities** | | | | |
| Net increase/(decrease) in: | | | | |
| Due to other banks | **(3)** | (1,053) | **1,074** | (1,053) |
| Derivative financial instruments | **(129)** | (16) | **(69)** | (16) |
| Financial liabilities at fair value through profit or loss | **(11)** | (11) | **(12)** | (11) |
| Customer deposits | **2,837** | 1,186 | **862** | 1,186 |
| Provisions for liabilities and charges | **128** | (223) | **108** | (223) |
| Defined benefit pension obligations | **-** | (14) | **-** | (14) |
| Other liabilities | **(160)** | 9 | **(56)** | 8 |
| | **2,662** | (122) | **1,907** | (123) |

For the purposes of the statement of cash flows, cash and cash equivalents comprise the following balances with less than three months maturity from the date of acquisition. This includes cash and liquid assets and amounts due from other banks (to the extent less than 90 days).

| | Group 2019 | Group 2018 | Bank 2019 | Bank 2018 |
|---|---|---|---|---|
| Cash and balances with central banks (note 3.4) | **10,113** | 6,498 | **6,538** | 6,498 |
| Other assets | **43** | 86 | **43** | 86 |
| Due to other banks | **(20)** | (12) | **(20)** | (12) |
| Other liabilities | **(16)** | (30) | **(16)** | (30) |
| | **10,120** | 6,542 | **6,545** | 6,542 |

## 5.3 Related party transactions

| Amounts due from related entities | Group 2019 £m | Group 2018 £m | Bank 2019 £m | Bank 2018 £m |
|---|---|---|---|---|
| **Loans** | | | | |
| Virgin Money UK PLC | **11** | - | **11** | - |
| Controlled entities of the Bank | **-** | - | **2,353** | 1,119 |
| | **11** | - | **2,364** | 1,119 |
| **Other receivables** | | | | |
| Virgin Money UK PLC | **7** | 35 | **7** | 35 |
| Controlled entities of the Bank | **-** | - | **105** | 84 |
| | **7** | 35 | **112** | 119 |
| **Total amounts due from related entities** | **18** | 35 | **2,476** | 1,238 |
| **Interest income on the above amounts was as follows:** | | | | |
| Controlled entities of the Bank | **-** | - | **24** | 17 |
| | **-** | - | **24** | 17 |

| Amounts due to related entities | Group 2019 £m | Group 2018 £m | Bank 2019 £m | Bank 2018 £m |
|---|---|---|---|---|
| **Deposits** | | | | |
| Virgin Money UK PLC | - | 36 | **-** | 36 |
| Controlled entities of the Bank | - | - | **248** | 150 |
| | - | 36 | **248** | 186 |
| **Debt securities** | | | | |
| Virgin Money UK PLC | **2,311** | 1,276 | **2,311** | 1,276 |
| Controlled entities of the Bank | **-** | - | **-** | 1 |
| | **2,311** | 1,276 | **2,311** | 1,277 |
| **Other payables** | | | | |
| Virgin Money UK PLC | **4** | 1 | **-** | - |
| Controlled entities of the Bank | **-** | - | **2,777** | 2,422 |
| | **4** | 1 | **2,777** | 2,422 |
| **Total amounts due to related entities** | **2,315** | 1,313 | **5,336** | 3,885 |
| **Interest expense on the above amounts was as follows (note 2.2):** | | | | |
| Virgin Money UK PLC | **72** | 33 | **72** | 33 |
| Controlled entities of the Bank | **-** | - | **42** | 36 |
| | **72** | 33 | **114** | 69 |

## 5.3. Related party transactions (continued)

**Debt securities**

| | Group and Bank | |
|---|---|---|
| | **2019** | 2018 |
| | **£m** | £m |
| Subordinated debt | **732** | 480 |
| Medium-term notes | **1,579** | 796 |
| **Total debt securities** | **2,311** | 1,276 |

Subordinated debt comprises dated, unsecured loan capital and is issued to Virgin Money UK PLC. These debts will, in the event of the winding-up of the issuer, be subordinated to the claims of the depositors and all other creditors of the issuer, other than creditors whose claims rank junior to the claims of the holders of the subordinated liabilities. The debt is employed in the general business of the Bank.

Medium-term notes comprise dated, unsecured loans and are issued to Virgin Money UK PLC. These securities will, in the event of the winding-up of the issuer, be subordinated to the claims of the depositors and all other creditors of the issuer, other than creditors whose claims rank junior to the claims of the medium-term note liabilities, including those of subordinated debt holders. The debt is employed in the general business of the Bank.

| **Derivatives held with related entities:** | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| **Derivative financial assets** | | | | |
| Designated as hedging instruments | **-** | - | **339** | - |
| **Derivative financial liabilities** | | | | |
| Designated as hedging instruments | **-** | - | **(31)** | - |
| **Interest income on the above amounts was as follows (note 2.2):** | | | | |
| Controlled entities of the Bank | **-** | - | **4** | - |

| **Other transactions with related entities** | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| | **£m** | £m | **£m** | £m |
| **Non-interest income received** | | | | |
| Controlled entities of the Bank | **-** | - | **244** | 5 |
| **Administrative expenses** | | | | |
| Controlled entities of the Bank | **-** | - | **-** | - |
| | **-** | - | **-** | - |

# Notes to the consolidated financial statements (continued)
## Section 5: Other notes (continued)

### 5.3. Related party transactions (continued)

| Other Related Party Transactions | Group | | Bank | |
|---|---|---|---|---|
| | **2019** | 2018 | **2019** | 2018 |
| **Assets with related entities** | **£m** | £m | **£m** | £m |
| **Investments in joint ventures and associates** | | | | |
| Virgin Money Unit Trust Managers Limited[1] | **8** | - | - | - |
| **Other assets** | | | | |
| Amounts due from Virgin Money Unit Trust Managers Limited[1] | **2** | - | - | - |
| **Total assets with related entities** | **10** | - | - | - |
| **Liabilities with related entities** | | | | |
| **Customer deposits** | | | | |
| The Virgin Money Foundation | **1** | - | - | - |
| **Other liabilities** | | | | |
| Group pension deposits[2] | **17** | 36 | **17** | 36 |
| Commissions and charges due to Virgin Atlantic Airways Limited [3] | **6** | - | - | - |
| **Total liabilities with related entities** | **24** | 36 | **17** | 36 |
| **Non-interest income** | | | | |
| Net fees and commissions to Virgin Atlantic Airways Limited[3] | **(15)** | - | - | - |
| Share of post-tax result of Virgin Money Unit Trust Managers Limited[1] | **(1)** | - | - | - |
| **Operating and administrative expenses** | | | | |
| Donations to the Virgin Money Foundation[4] | **(2)** | - | - | - |
| Costs recharged to Virgin Money Unit Trust Managers Limited[1] | **2** | - | - | - |
| **Total income statement** | **(16)** | - | - | - |

(1) The Group entered into a joint venture with Aberdeen Standard Investments (ASI) on 31 July 2019, under the terms of which ASI acquired 50% (less one share) of Virgin Money Holdings (UK) PLC's investments and pensions business (UTM). Following this date, UTM is presented as a joint venture rather than a controlled entity, and is equity accounted for in the consolidated accounts.

(2) The Bank and the Trustee to the pension scheme have entered into a contingent Security Arrangement which provides additional support to the Scheme by underpinning recovery plan contributions and some additional investment risk. The security is in the form of a pre-agreed maximum level of assets that are set aside for the benefit of the Pension Scheme in certain trigger events. These assets are held by Red Grey Square Funding LLP, an insolvency remote consolidated structured entity. The Group incurred costs in relation to pension scheme administration. These costs, which amounted to £0.1m in the year ended 30 September 2019 (2018: £0.3m), were charged to the Scheme. Pension contributions of £83m (2018: £18m) were made during the year to the Scheme (note 3.12).

(3) The Group incurs credit card commissions and air mile charges to Virgin Atlantic Airways Limited (VAA) in respect of an agreement between the two parties. In June 2017 an agreement was signed with VAA which will give rise to related party transactions in future periods. An asset and liability was recognised during 2017 in relation to the committed payment under this agreement. £4m of cash costs payable to VAA have been deferred on the balance sheet.

(4) The Group has made donations to the Foundation in the current year to enable the Foundation to pursue its charitable objectives. The Group has also provided a number of support services to the Foundation on a pro bono basis, including use of facilities and employee time. The estimated gift in kind for support services provided during the year was £0.6m and is included in the total value disclosed above.

## 5.3. Related party transactions (continued)

**Compensation of key management personnel (KMP)**

KMP comprise Directors of the Bank and members of the Executive Leadership Team.

| | 2019 £m | 2018 £m |
|---|---|---|
| Salaries and short-term benefits | 14 | 9 |
| Other long-term employee benefits | - | - |
| Termination benefits | 5 | - |
| Equity based compensation[1] | 2 | 1 |
| | 21 | 10 |

[1] Basis of the expense recognised in the year in accordance with IFRS 2 'Equity-based compensations', including associated employers' NIC.

**Directors' emoluments**

Total emoluments of all Directors for the year ended 30 September 2019 were £5m (2018: £5m).

For the year ended 30 September 2019 the total emoluments disclosed do not include the value of shares or share rights awarded under long term incentive schemes in accordance with Schedule 5 paragraph 1(3)(a) of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

None of the Directors were members of the Group's defined contribution pension scheme during 2019 (2018: none). None of the Directors were members of the Group's defined benefit pension scheme during 2019 (2018: none).

None of the Directors hold share options and none were exercised during the year (2018: none).

**Disclosures in respect of the highest paid Director**

| | 2019 £m | 2018 £m |
|---|---|---|
| Aggregate remuneration | 2 | 2 |
| Share based awards[1] | - | - |
| | 2 | 2 |

[1] Reflects deferred bonus and other share based awards for the year, excluding LTIP

The highest paid Director does not hold any share options, nor were they a member of any pension plan during 2019, nor 2018.

**Transactions with KMP**

KMP, their close family members and any entities controlled or significantly influenced by the KMP have undertaken the following transactions with the Group in the normal course of business. The transactions were made on the same terms and conditions as applicable to other Group employees, or on normal commercial terms.

| | 2019 £m | 2018 £m |
|---|---|---|
| Loans and advances | 4 | 2 |
| Deposits | 3 | 3 |

No provisions have been recognised in respect of loans provided to KMPs (2018: £Nil). There were no debts written off or forgiven during the year to 30 September 2019 (2018: £Nil). Included in the above are four (2018: six) loans totalling £1m (2018: £2m) made to Directors. In addition to the above, there are guarantees of £Nil (2018: £Nil) made to Directors and their related parties.

## 5.4 Transition to IFRS 9 'Financial Instruments' from IAS 39 'Financial Instruments: Recognition and Measurement' and the adoption of IFRS 15 'Revenue from Contracts with Customers'

***IFRS 9***

IFRS 9 replaced IAS 39 as the accounting standard for financial instruments and was adopted (except for the hedge accounting requirements) by the Group with effect from 1 October 2018. The requirements of IFRS 9 allow for the transitional adjustments to be reflected through the opening retained earnings line, without the need to produce comparative information on an IFRS 9 basis.

The following table summarises the locations of the policies and key judgement areas and impact on the Group's financial position of adopting IFRS 9 on 1 October 2018[1]:

| Detail | Location |
|---|---|
| New accounting standards | Note 1.9 |
| Loans and advances to customers | Note 3.1 |
| Impairment provisions on credit exposures | Note 3.2 |
| Critical accounting estimates and judgements in relation to ECL | Note 3.2 |
| FVTPL | Note 3.5 |
| FVOCI | Note 3.7 |
| AFS | Note 3.8 - and only applicable for the year ended 30 September 2018 as this category for financial assets was removed with the introduction of IFRS 9 |
| Other relevant credit risk disclosures | Pages 12 to 38 of the Risk report |

The carrying amount of the Group's financial assets and financial liabilities (in the scope of IFRS 9) at 30 September 2018 under IAS 39 and at 1 October 2018 under IFRS 9 are as follows:

| | | | Group | | Bank | |
|---|---|---|---|---|---|---|
| **Financial assets** | **Measurement under IAS 39** | **Measurement under IFRS 9** | **IAS 39 carrying amount[2] £m** | **IFRS 9 carrying amount £m** | **IAS 39 carrying amount[2] £m** | **IFRS 9 carrying amount £m** |
| Cash and balances with central banks | Amortised cost | Amortised cost | 6,573 | 6,573 | 6,573 | 6,573 |
| Due from other banks | Amortised cost | Amortised cost | 693 | 693 | 233 | 233 |
| Financial assets available for sale[3] | Available for sale | Fair value through profit or loss | 1,562 | 11 | 1,556 | 5 |
| | | FVOCI | n/a | 1,551 | n/a | 1,551 |
| Loans and advances to customers at fair value through profit or loss | Fair value through profit or loss | Fair value through profit or loss | 362 | 362 | 362 | 362 |
| Derivative financial instruments | Fair value through profit or loss | Fair value through profit or loss | 262 | 262 | 151 | 151 |
| Loans and advances to customers | Amortised cost | Amortised cost | 32,748 | 32,719 | 31,635 | 31,607 |
| **Financial liabilities** | | | | | | |
| Other financial liabilities at fair value | Fair value through profit or loss | Fair value through profit or loss | 15 | 15 | 15 | 15 |

[1] The acquisition of Virgin Money Holdings (UK) PLC on 15 October 2018 has no impact or effect on the Group's disclosures on the transition to IFRS 9, which is based on the Group balance sheet position as at 30 September 2018 which was prior to the acquisition.

[2] The prior year comparative has been restated in line with the current year presentation (note 1.10).

[3] The Group's listed securities, comprising of UK Government Securities, and other listed securities (e.g. bonds issued by supra-nationals and AAA rated covered bonds), are held in a business model that is 'to hold to collect and sell' and classified at FVOCI. The Group's unlisted securities, and other financial assets held as available for sale, have been classified at fair value through profit or loss.

### 5.4 Transition to IFRS 9 'Financial Instruments' from IAS 39 'Financial Instruments: Recognition and Measurement' and the adoption of IFRS 15 'Revenue from Contracts with Customers' (continued)

The changes required (net of deferred tax) to the Group's financial assets and liabilities on adoption of IFRS 9 have been adjusted through the Group's retained earnings figure for 30 September 2018.

*Initial adoption approach*

The methodology and nature of the key judgements applied on the initial adoption of IFRS 9 were consistent with the Group policy as outlined in detail in note 3.2, and are therefore not repeated here.

Consistent with the Group's approach to the application of economic scenarios to the ECL calculation at 30 September 2019, similar scenarios fed into the ECL calculation at 1 October 2018. The Group applied the following weightings to the chosen scenarios at 1 October 2018:

| | |
|---|---|
| Mild upside | 25% |
| Base case | 60% |
| Severe downside | 15% |

Refer to note 3.2 for further detail regarding the approach and comparison of the weightings applied at 1 October 2018 and 30 September 2019.

*Future macroeconomic conditions*

A range of future macroeconomic conditions is used in the scenarios over a five year forecast period and reflects the best estimates of future conditions under each scenario. The Group has identified the following key macroeconomic conditions as the most significant inputs for IFRS 9 modelling purposes: UK GDP growth, CPI inflation, house prices, bank rates, unemployment rates and CRE capital values. These are assessed and reviewed by an internal panel on a six-monthly basis to ensure appropriateness and relevance to the ECL calculation. Where model inputs are not reflective of the current market conditions at the date of the financial statements, the Group may reflect these through the use of temporary adjustments to the ECL calculation using expert credit judgement.

The simple forward-looking five-year averages for the key model inputs used in the ECL calculations at 1 October 2018 are:

| 1 October 2018 | UK GDP growth % | CPI inflation % | House prices % | Bank rate % | ILO Unemployment % |
|---|---|---|---|---|---|
| Mild upside | 2.6 | 2.4 | 4.9 | 2.5 | 3.3 |
| Base case | 2.1 | 1.9 | 4.3 | 1.1 | 4.2 |
| Severe downside | 0.6 | 0.8 | (1.7) | 0.1 | 6.2 |

The revised simple forward-looking five-year averages for the key model inputs used in the ECL calculations at 30 September 2019 are:

| 30 September 2019 | UK GDP growth % | CPI inflation % | House prices % | Bank rate % | ILO Unemployment % |
|---|---|---|---|---|---|
| Mild upside | 2.7 | 2.3 | 5.8 | 2.0 | 3.4 |
| Base case | 1.8 | 1.7 | 2.9 | 0.9 | 3.8 |
| Severe downside | 0.2 | 0.8 | (4.6) | 0.4 | 5.8 |

### 5.4 Transition to IFRS 9 'Financial Instruments' from IAS 39 'Financial Instruments: Recognition and Measurement' and the adoption of IFRS 15 'Revenue from Contracts with Customers' (continued)

***IFRS 15***

The Group also adopted IFRS 15 'Revenue from Contracts with Customers' with effect from 1 October 2018.

The requirements of IFRS 15 allow for the transitional adjustments to be reflected through the opening retained earnings line, without the need to produce comparative information on an IFRS 15 basis.

The majority of the Group's income was either not in scope for IFRS 15 or was being recognised in a way that was consistent with the requirements of the new standard. The limited exception to this was income recognised in relation to the Group's rights to future commission on the deferred consideration receivable. This was held as an 'other' available for sale financial asset under IAS 39 and reclassified to FVTPL on transition to IFRS 9 as detailed in this note. As a result of this remeasurement, a further £1m of future commission income was recognised on transition to IFRS 15, which has been reflected in increases to both other assets and retained earnings on transition.

***Quantitative impact of IFRS 9 and IFRS 15 on adoption at 1 October 2018***

The change to the carrying amounts of the Group's assets, liabilities, reserves and retained earnings as at 30 September 2018 as a result of the IFRS 9 and IFRS 15 reclassifications and remeasurements required on 1 October 2018 are as follows:

| Group | IAS 39 carrying amount as at 30 Sept 2018[1] | IFRS 9 - reclassifications | IFRS 9 - remeasurement in ECL | IFRS 9 - release of Available for sale reserve | IFRS 15 remeasurement | Carrying amount as at 1 Oct 2018 |
|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m |
| **Assets** | | | | | | |
| Financial assets available for sale | **1,562** | (1,562) | - | - | - | - |
| Financial assets at fair value through other comprehensive income | - | 1,551 | - | - | - | **1,551** |
| Other financial assets at fair value | **362** | 11 | - | - | - | **373** |
| Loans and advances to customers | **32,748** | - | (29) | - | - | **32,719** |
| Deferred tax | **298** | - | 7 | - | - | **305** |
| Other assets | **338** | - | - | - | 1 | **339** |
| **Equity** | | | | | | |
| Available for sale reserve | **(7)** | 4 | - | 3 | - | - |
| FVOCI reserve | - | (4) | - | - | - | **(4)** |
| Retained earnings | **(1,881)** | - | 22 | (3) | (1) | **(1,863)** |

(1) The prior year comparative has been restated in line with the current year presentation (note 1.10).

### 5.4 Transition to IFRS 9 'Financial Instruments' from IAS 39 'Financial Instruments: Recognition and Measurement' and the adoption of IFRS 15 'Revenue from Contracts with Customers' (continued)

| Bank | IAS 39 carrying amount as at 30 Sept 2018[1] | IFRS 9 - reclassifications | IFRS 9 - remeasurement in ECL | IFRS 9 - release of Available for sale reserve | IFRS 15 remeasurement | Carrying amount as at 1 Oct 2018 |
|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m |
| **Assets** | | | | | | |
| Financial assets available for sale | **1,556** | (1,562) | - | - | - | **(6)** |
| Financial assets at fair value through other comprehensive income | - | 1,551 | - | - | - | **1,551** |
| Other financial assets at fair value | **362** | 11 | - | - | - | **373** |
| Loans and advances to customers | **31,635** | - | (29) | - | - | **31,606** |
| Deferred tax | **294** | - | 7 | - | - | **301** |
| Other assets | **338** | - | - | - | 1 | **339** |
| **Equity** | | | | | | |
| Available for sale reserve | **(6)** | 4 | - | 3 | - | **1** |
| FVOCI reserve | - | (4) | - | - | - | **(4)** |
| Retained earnings | **(1,825)** | - | 22 | (3) | (1) | **(1,807)** |

(1) The prior year comparative has been restated in line with the current year presentation (note 1.10).

The move to IFRS 9 has resulted in a net £19m decrease in retained earnings at 1 October 2018 primarily due to the change in the measurement in impairment losses, which are now calculated on an ECL basis as opposed to the incurred loss methodology used in IAS 39. The gross impairment loss adjustment of £29m as at 1 October 2018 includes £5m of ECLs calculated on the Group's loan commitments and financial guarantee contracts. In addition, while an ECL calculation is also performed on the Group's financial assets held at FVOCI, the resultant impairment provision is not material enough to be reported separately in the above tables.

## 5.5 Pillar 3 disclosures

**Basel III CRD IV**

Pillar 3 disclosure requirements are set out in Part Eight of the CRR. The consolidated disclosures of Virgin Money UK PLC, for the 2019 financial year, will be issued concurrently with the Annual Report and Accounts and will be found at www.virginmoneyukplc.com/investor-relations/results-and-reporting/financial-results/.

## 5.6 Post balance sheet events

**FSMA Part VII transfer of trade and assets from Virgin Money PLC to Clydesdale Bank PLC**

On 26 September 2019, at a hearing in the Court of Session in Edinburgh, the Court approved a banking business transfer scheme under Part VII of FSMA. The scheme effective date was 21 October 2019, and in accordance with the court approval, on this date the business of Virgin Money PLC was transferred to the Bank for a cash consideration of £10m. The transfer of the trade and assets is a business transfer under common control and has no impact on the consolidated Group financial results. The total assets and total liabilities transferred were £49bn and £47bn respectively.

**Change in Parent Company name**

The ultimate holding company, CYBG PLC, changed its name to Virgin Money UK PLC on 30 October 2019. The registered office address changed from Merrion Way to Jubilee House, Gosforth, Newcastle upon Tyne, NE3 4PL.

**Ordinary dividend**

On 11 November 2019 the Company paid an ordinary dividend of £10m to its holding company Virgin Money UK PLC.

# Notes to the consolidated financial statements (continued)

## Section 6: Notes to the Bank financial statements

### 6.1 Bank income statement

No individual income statement is presented for the Bank, as permitted by Section 408 of the Companies Act 2006.

### 6.2 Bank investments in controlled entities

*Accounting policy*

The Bank's investments in controlled entities are valued at cost or valuation less any provision for impairment. Such investments are reviewed annually for potential evidence of impairment, or more frequently when there are indications that impairment may have occurred. Losses relating to impairment in the value of shares in controlled entities are recognised in the income statement.

| | Bank | |
|---|---|---|
| | **2019** | 2018 |
| | **£m** | £m |
| At 30 September | **1,776** | 10 |

The table below represents the wholly owned subsidiary undertakings of the Group and Company as at 30 September 2019:

| **Wholly owned subsidiary undertakings** | **Nature of business** | **Class of share held** | **Proportion held** | **Country of incorporation** | **Registered office** | **Financial year end** |
|---|---|---|---|---|---|---|
| **Direct holdings** | | | | | | |
| CGF No 9 Limited | Leasing | Ordinary | 100% | Scotland | 30 St Vincent Place, Glasgow, G1 2HL | 30 September |
| Clydesdale Bank Asset Finance Limited | Leasing | Ordinary | 100% | Scotland | 30 St Vincent Place, Glasgow, G1 2HL | 30 September |
| Clydesdale Bank (Head Office) Nominees Limited | In liquidation | Limited by guarantee | 100% | Scotland | Saltire Court, 20 Castle Terrace, Edinburgh, EH1 2DB | 30 September |
| CYB Intermediaries Limited | Insurance intermediary | Ordinary | 100% | England | 20 Merrion Way, Leeds, Yorkshire, LS2 8NZ | 30 September |
| St Vincent (Equities) Limited | Investment company | Ordinary | 100% | Scotland | 30 St Vincent Place, Glasgow, G1 2HL | 30 September |
| Virgin Money Holdings (UK) PLC | Banking | Ordinary | 100% | England | Jubilee House, Gosforth, Newcastle upon Tyne, NE3 4PL | 31 December |
| Yorkshire Bank Home Loans Limited | Mortgage finance | Ordinary | 100% | England | 20 Merrion Way, Leeds, Yorkshire, LS2 8NZ | 30 September |
| CB Nominees Limited | Dormant | Limited by guarantee | 100% | Scotland | 30 St Vincent Place, Glasgow, G1 2HL | 30 September |
| CYB SSP Trustee Limited | Dormant | Ordinary | 100% | England | 20 Merrion Way, Leeds, Yorkshire, LS2 8NZ | 30 September |
| YCB DC Trustee Limited | Dormant | Ordinary | 100% | Scotland | 30 St Vincent Place, Glasgow, G1 2HL | 30 September |
| YCBPS Property Nominee Company Limited | Dormant | Ordinary | 100% | England | 20 Merrion Way, Leeds, Yorkshire, LS2 8NZ | 30 September |

# Notes to the consolidated financial statements (continued)
## Section 6: Notes to the Bank financial statements (continued)

### 6.2 Bank investments in controlled entities (continued)

| Wholly owned subsidiary undertakings (continued) | Nature of business | Class of share held | Proportion held | Country of incorporation | Registered office | Financial year end |
|---|---|---|---|---|---|---|
| **Direct holdings (continued)** | | | | | | |
| Yorkshire and Clydesdale Bank Pension Trustee Limited | Dormant | Ordinary | 100% | Scotland | 30 St Vincent Place, Glasgow, G1 2HL | 30 September |
| Yorkshire Bank PLC | Dormant | Ordinary | 100% | England | 20 Merrion Way, Leeds, Yorkshire, LS2 8NZ | 30 September |
| **Indirect holdings** | | | | | | |
| Virgin Money Giving Limited | Charitable donations | Ordinary | 100% | England | Jubilee House, Gosforth, Newcastle upon Tyne, NE3 4PL | 31 December |
| Virgin Money Management Services Limited | Service company | Ordinary | 100% | England | Jubilee House, Gosforth, Newcastle upon Tyne, NE3 4PL | 31 December |
| Virgin Money Personal Financial Service Limited | Insurance Intermediary | Ordinary | 100% | England | Jubilee House, Gosforth, Newcastle upon Tyne, NE3 4PL | 31 December |
| Virgin Money PLC | Banking | Ordinary | 100% | England | Jubilee House, Gosforth, Newcastle upon Tyne, NE3 4PL | 31 December |
| Northern Rock Limited | Dormant | Ordinary | 100% | England | Jubilee House, Gosforth, Newcastle upon Tyne, NE3 4PL | 31 December |
| Virgin Money Nominees Limited | Dormant | Ordinary | 100% | England | Jubilee House, Gosforth, Newcastle upon Tyne, NE3 4PL | 31 December |

## 6.2 Bank investments in controlled entities (continued)

**Investment in Virgin Money Holdings (UK) PLC**

On 15 October 2018, the Bank's ultimate Parent Company, CYBG PLC, acquired all the voting rights in Virgin Money Holdings (UK) PLC by means of a scheme of arrangement under Part 26 of the UK Companies Act 2006 for a purchase consideration of £1.5bn. Following completion, the investment in Virgin Money Holdings (UK) PLC was transferred to the Bank (note 3.19) with CYBG PLC acquiring Bank shares equal to the fair value determined for the Virgin Money Holdings (UK) PLC shares.

On 13 March 2019, the Bank acquired Perpetual Securities (fixed 9.25%) with a principal amount of £250m from Virgin Money Holdings (UK) PLC. These are carried at cost in accordance with IAS 27. These are perpetual securities with no fixed maturity or redemption date and are structured to qualify as AT1 instruments under CRD IV.

On 20 August 2019, the Bank acquired a further £230m of ordinary share capital in Virgin Money Holdings (UK) PLC to facilitate the change in obligor of £230m of other equity instruments from Virgin Money Holdings (UK) PLC to CYBG PLC.

**Impairment in Virgin Money Holdings (UK) PLC**

An impairment test on the carrying value of the Bank's investment in Virgin Money Holdings (UK) PLC has been undertaken during the year, resulting in an impairment charge of £303m as at 30 September 2019 (2018: Nil). For the purposes of the impairment test, Virgin Money Holdings (UK) PLC is regarded as the cash generating unit with the value in use calculation compared to the current carrying value of the investment in Virgin Money Holdings (UK) PLC in the Bank balance sheet.

**Investment in Virgin Money Unit Trust Managers Limited**

Following receipt of all regulatory approvals and conclusion of contractual negotiations, the investments and pensions joint venture with Aberdeen Standard Investments was completed on 31 July 2019. The Group recognised a gain on sale of £35m within non-interest income (note 2.3) from the disposal of 50% (less one share)of its interest in Virgin Money Unit Trust Managers Limited. Investments in joint ventures are recognised in the consolidated financial statements within other assets.

The Group has interests in two charitable foundations:

- The Bank has an interest in the Yorkshire and Clydesdale Bank Foundation, a charitable foundation registered in Scotland as a company limited by guarantee. The Bank acts as a guarantor for £10 and is the main donor.
- Virgin Money Holdings (UK) PLC has an interest in the Virgin Money Foundation, a charitable foundation registered in England as a company limited by guarantee. Virgin Money UK PLC acts as a guarantor for £1 and Virgin Money PLC is a donor.

## 6.2 Bank investments in controlled entities (continued)

The Bank also has an interest in a number of structured entities:

| Other controlled entities | Nature of business | Country of incorporation | Registered office | Financial year end |
|---|---|---|---|---|
| Clydesdale Covered Bonds No. 2 LLP | Acquisition of mortgage loans | England | 20 Merrion Way, Leeds, Yorkshire, LS2 8NZ | 30 September |
| Eagle Place Covered Bonds LLP | Acquisition of mortgage loans | England | Jubilee House, Gosforth, Newcastle upon Tyne, NE3 4PL | 31 December |
| Gosforth Funding 2014-1 PLC | Issuer of securitised notes | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Funding 2015-1 PLC | Issuer of securitised notes | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Funding 2016-1 PLC | Issuer of securitised notes | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Funding 2016-2 PLC | Issuer of securitised notes | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Funding 2017-1 PLC | Issuer of securitised notes | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Funding 2018-1 PLC | Issuer of securitised notes | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Holdings 2014-1 Limited | Holding company | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Holdings 2015-1 Limited | Holding company | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Holdings 2016-1 Limited | Holding company | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Holdings 2016-2 Limited | Holding company | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Holdings 2017-1 Limited | Holding company | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Holdings 2018-1 Limited | Holding company | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Mortgages Trustee 2014-1 Limited | Trust | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Mortgages Trustee 2015-1 Limited | Trust | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Mortgages Trustee 2016-1 Limited | Trust | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Mortgages Trustee 2016-2 Limited | Trust | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Mortgages Trustee 2017-1 Limited | Trust | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Gosforth Mortgages Trustee 2018-1 Limited | Trust | England | Fifth Floor, 100 Wood Street, London, EC2V 7EX | 31 December |
| Lanark Funding Limited | Funding company | England | Third Floor, Suite 2, 11-12 St James's Square, London, SW1Y 4LB | 30 September |
| Lanark Holdings Limited | Holding company | England | Third Floor, Suite 2, 11-12 St James's Square, London, SW1Y 4LB | 30 September |

# Notes to the consolidated financial statements (continued)
## Section 6: Notes to the Bank financial statements (continued)

### 6.2 Bank investments in controlled entities (continued)

| Other controlled entities (continued) | Nature of business | Country of incorporation | Registered office | Financial year end |
|---|---|---|---|---|
| Lanark Master Issuer PLC | Issuer of securitised notes | England | Third Floor, Suite 2, 11-12 St James's Square, London, SW1Y 4LB | 30 September |
| Lanark Trustees Limited | Mortgages trustee | England | Third Floor, Suite 2, 11-12 St James's Square, London, SW1Y 4LB | 30 September |
| Lannraig Funding Limited | Funding company | England | 35 Great St. Helen's London EC3A 6AP United Kingdom | 30 September |
| Lannraig Holdings Limited | Holding company | England | 20 Merrion Way, Leeds, Yorkshire, LS2 8NZ | 30 September |
| Lannraig Master Issuer PLC | Issuer of securitised notes | England | 35 Great St. Helen's London EC3A 6AP United Kingdom | 30 September |
| Lannraig Trustees Limited | Mortgages trustee | Jersey | 44 Esplanade, St Helier, Jersey, JE4 9WG Channel Islands | 30 September |
| Red Grey Square Funding LLP | Security provider | England | 35 Great St. Helen's London EC3A 6AP United Kingdom | 30 September |

Details of the Group's interests in consolidated structured entities associated with securitisation and covered bond arrangements are set out in note 3.3.

The Group also has a participating interest in the following undertakings as either an associate (A) or a joint venture (JV):

| Name of undertaking | Status | % of share class held by immediate Parent Company (or by the Group where this varies) | Registered office address (UK unless stated otherwise) |
|---|---|---|---|
| Eagle Place Covered Bonds Finance Limited | A | 20% | 35 Great St. Helen's, London, EC3A 6AP |
| Salary Finance Loans Limited | JV | 50% | One Hammersmith Broadway, London, W6 9DL |
| Virgin Money Unit Trust Managers Limited | JV | 50% and 1 share | Jubilee House, Gosforth, Newcastle-Upon-Tyne, NE3 4PL |

# Measuring financial performance - glossary

*Asset quality:*

| Term | Definition |
|---|---|
| Impairment charge to average customer loans **(cost of risk)** | Impairment losses on credit exposures plus credit risk adjustment on fair value loans to average customer loans (defined as loans and advances to customers, other financial assets at fair value and due from customers on acceptances). |
| 90+ days past due **(DPD)** plus impaired assets to customer loans | Customer loans that are either impaired or where the repayment is more than 90 days overdue as a percentage of total customer loans at a given date. |
| Net write-offs to customer loans | Net write-offs, including loans at fair value, as a percentage of total customer loans at a given date. |

*Capital optimisation:*

| Term | Definition |
|---|---|
| Common Equity Tier 1 **(CET1)** ratio | CET1 capital divided by RWAs at a given date. |
| Tier 1 ratio | Tier 1 capital as a percentage of risk weighted assets. |
| Total capital ratio | Total capital resources divided by risk weighted assets at a given date. |
| CRD IV Leverage ratio | This is a regulatory standard ratio proposed by Basel III as a supplementary measure to the risk based capital requirements. It is intended to constrain the build-up of excess leverage in the banking sector and is calculated by dividing Tier 1 capital resources by a defined measure of on- and off-balance sheet items plus derivatives. |
| Modified leverage ratio | The Group's leverage ratio on a modified basis, excluding qualifying central bank claims from the exposure measure in accordance with the policy statement issued by the PRA in October 2017. |
| Liquidity coverage ratio **(LCR)** | Measures the surplus (or deficit) of the Bank's high quality liquid assets relative to weighted net stressed cash outflows over a 30 day period. It assesses whether the Bank has sufficient liquid assets to withstand a short-term liquidity stress based on cash outflow assumptions provided by regulators. |
| Net stable funding ratio **(NSFR)** | The total amount of available stable funding divided by the total amount of required stable funding, expressed as a percentage. The Group monitors the NSFR based on its own interpretations of current guidance available for CRD IV NSFR reporting. Therefore, the reported NSFR may change over time with regulatory developments. Due to possible differences in interpretation of the rules, the Group's ratio may not be directly comparable with those of other financial institutions. |

# Measuring financial performance - glossary (continued)

***Underlying adjustments to the Statutory view of performance***
In arriving at an underlying basis, the effects of certain items that do not promote an understanding of historical or future trends of earnings or cash flows are removed, as management consider that this presents more comparable results year-on-year. These items are all significant and are typically one-off in nature. Additional detail is provided below where considered necessary to further explain the rationale for their exclusion from underlying performance, in particular for new items in the current year or recurring non-underlying items:

| Item | FY 2019 £m | FY 2018 £m | Reason for exclusion from the Group's current underlying performance |
|---|---|---|---|
| **Restructuring costs** | **(149)** | - | These are part of the Group's publicised three-year integration plan following the acquisition of Virgin Money Holdings (UK) PLC and comprise a number of one-off expenses that are required to realise the anticipated cost synergies. |
| **ACQUISITION COSTS:** | | | All costs incurred as a direct result of the acquisition of Virgin Money Holdings (UK) PLC, have been removed from underlying performance due to the scale and nature of the transaction. Further information on the items is provided below to aid understanding. |
| Acquisition accounting | **(87)** | - | This consists principally of the unwind of the IFRS 3 fair value adjustments created on the acquisition of Virgin Money Holdings (UK) PLC in October 2018 (£23m gain) and the IFRS 9 impairment impact on acquired assets (£105m charge) with other smaller items amounting to £5m. These represent either one-off adjustments or are the scheduled reversals of the accounting adjustments that arose following the fair value exercise required by IFRS 3. These will continue to be treated as non-underlying adjustments over the expected three to five-year period until they have been fully reversed. |
| Intangible asset write-off | **(127)** | - | The charge for the software write-off is significant and has arisen in respect of software assets which are no longer considered to be of value relative to the Group's strategy following the acquisition of Virgin Money Holdings (UK) PLC. |
| Mortgage EIR adjustments | **80** | - | The alignment of accounting practices is a one-off exercise arising from the acquisition. |
| Virgin Money Holdings (UK) PLC transaction costs | **-** | (7) | These costs related directly to the transaction and comprised legal, advisory and other associated costs required to complete the transaction. |
| **Total acquisition costs** | **(134)** | **(7)** | |
| **Legacy conduct** | **(433)** | **(544)** | These costs are historical in nature and are not indicative of the Group's current practices. |
| **Other:** | | | |
| Consent solicitation | **22** | - | A one-off gain relating to the change in obligor of senior debt from Virgin Money Holdings (UK) PLC to CYBG on 20 August 2019. |
| SME transform-ation | **(30)** | (16) | These costs are significant and considered to be one-off due to the unique growth opportunities currently available to the Group in respect of its Business lending. |
| Gain on sale of UTM | **35** | - | A one-off gain recognised on the disposal of 50% (less one share) of Virgin Money Unit Trust Managers Limited. |
| UTM transition costs | **(1)** | - | |
| GMP equalisation cost | **(11)** | - | A one-off charge for GMP equalisation in the Group's defined benefit scheme. |
| Legacy restructuring and separation | **(5)** | (46) | These legacy costs were significant in prior periods and related to the Sustain programme, and demerger from NAB, both of which completed in the current period. |
| Gain on disposal of VocaLink | **4** | - | |
| **Total other** | **14** | **(62)** | |

# Main Glossary

| Term | Definition |
| --- | --- |
| Additional Tier 1 **(AT1)** | Securities that are considered AT1 capital in the context of CRD IV. |
| arrears | A customer is in arrears when they fail to adhere to their contractual payment obligations resulting in an outstanding loan that is unpaid or overdue. |
| average assets | Represents the average of assets over the year adjusted for any disposed operations. |
| B | The Group's digital application suite, offering retail customers money management capabilities across Web, Android and Apple platforms. |
| Bank | Clydesdale Bank PLC. |
| Basel II | The capital adequacy framework issued by the Basel Committee on Banking Supervision (BCBS) in June 2004. |
| Basel III | Reforms issued by the BCBS in December 2017 with subsequent revision. |
| basis points **(bps)** | One hundredth of a percent (0.01%); meaning that 100 bps is equal to 1%. This term is commonly used in describing interest rate movements. |
| Board | Refers to the Virgin Money UK PLC Board or the Clydesdale Bank PLC Board as appropriate. |
| Business lending | Lending to non-retail customers, including overdrafts, asset and lease financing, term lending, bill acceptances, foreign currency loans, international and trade finance, securitisation and specialised finance. |
| Capped Indemnity | The indemnity from NAB in favour of the Group in respect of certain qualifying conduct costs incurred by the Group, under the terms of the Conduct Indemnity Deed. |
| carrying value (also referred to as carrying amount) | The value of an asset or a liability in the balance sheet based on either amortised cost or fair value principles. |
| collateral | The assets of a borrower that are used as security against a loan facility. |
| collective impairment provision | Impairment assessment on a collective basis for homogeneous groups of loans that are not considered individually significant and to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment. |
| Combined Group | Virgin Money UK PLC and its controlled entities following the acquisition of Virgin Money Holdings (UK) PLC. |
| commercial paper | An unsecured promissory note issued to finance short-term credit requirements. These instruments have a specified maturity date and stipulate the face amount to be paid to the investor on that date. |
| Common Equity Tier 1 capital **(CET1)** | The highest quality form of regulatory capital that comprises total shareholders' equity and related non-controlling interests, less goodwill and intangible assets and certain other regulatory adjustments. |
| Company | Clydesdale Bank PLC. |
| Conduct Indemnity Deed | The deed between NAB and Virgin Money UK PLC setting out the terms of:<br>• the Capped Indemnity; and<br>• certain arrangements for the treatment and management of Relevant Conduct Matters. |
| conduct risk | The risk of treating customers unfairly and/or delivering inappropriate outcomes resulting in customer detriment, regulatory fines, compensation, redress costs and reputational damage. |
| counterparty | The other party that participates in a financial transaction, with every transaction requiring a counterparty in order for the transaction to complete. |
| Coverage ratio | Impairment allowance as at the period end shown as a percentage of gross loans and advances as at the period end. |
| covered bonds | A corporate bond with primary recourse to the institution and secondary recourse to a pool of assets that act as security for the bonds on issuer default. Covered bonds remain on the issuer's balance sheet and are a source of term funding for the Group. |
| CRD IV | European legislation to implement Basel III. It replaces earlier European CRD with a revised package consisting of a new CRD and a new CRR. CRD IV sets out capital and liquidity requirements for European banks and harmonises the European framework for bank supervision. See also 'Basel III'. |
| Credit conversion factor (CCF) | CCFs are used in determining the EAD in relation to a credit risk exposure. The CCF is an estimate of the proportion of undrawn and off-balance sheet commitments expected to be drawn down at the point of default. |

# Main Glossary (continued)

| | |
|---|---|
| Credit impaired financial assets | Financial assets that are in default or have an individually assessed provision. This is also referred to as a 'Stage 3' impairment loss and subject to a lifetime ECL calculation. The Group considers 90 DPD as a backstop in determining whether a financial asset is credit impaired. |
| credit risk adjustment/credit valuation adjustment | An adjustment to the valuation of financial instruments held at fair value to reflect the creditworthiness of the counterparty. |
| Credit risk mitigation (CRM) | Techniques to reduce the potential loss in the event that a customer (borrower or counterparty) becomes unable to meet its obligations. This may include the taking of financial or physical security, the assignment of receivables or the use of credit derivatives, guarantees, credit insurance, set-off or netting. |
| customer deposits | Money deposited by individuals and corporate entities that are not credit institutions, and can be either interest bearing, non-interest bearing or term deposits. |
| CYBI | CYB Investments Limited |
| default | A customer is in default when either they are more than 90 DPD on a credit obligation to the Group, or are considered unlikely to pay their credit obligations in full without recourse to actions such as realisation of security (if held). |
| delinquency | See 'arrears'. |
| Demerger | The Demerger of CYBG Group from NAB pursuant to which all of the issued share capital of CYBI was transferred to CYBG PLC by NAB in consideration for the issue and transfer of CYBG shares to NAB in part for the benefit of NAB (which NAB subsequently sold pursuant to the Initial Public Offering (IPO)) and in part for the benefit of NAB shareholders under a scheme of arrangement under part 5.1 of the Australian Corporations Act. |
| Demerger date | 8 February 2016. |
| derivative | A financial instrument that is a contract or agreement whose value is related to the value of an underlying instrument, reference rate or index. |
| earnings at risk **(EaR)** | A measure of the quantity by which net interest income might change in the event of an adverse change in interest rates. |
| effective interest rate **(EIR)** | The carrying value of certain financial instruments which amortises the relevant fees over the expected life of the instrument. |
| encumbered assets | Assets that have been pledged as security, collateral or legally 'ring-fenced' in some other way which prevents those assets being transferred, pledged, sold or otherwise disposed. |
| exposure | A claim, contingent claim or position which carries a risk of financial loss. |
| Exposure at default (EAD) | The estimate of the amount that the customer will owe at the time of default. |
| fair value | The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions. |
| Financial Ombudsman Service | An independent body set up by the UK Parliament to resolve individual complaints between financial businesses and their customers. |
| Financial Services Compensation Scheme (FSCS) | The UK's compensation fund of last resort for customers of authorised financial services firms and is funded by the financial services industry. The FSCS may pay compensation if a firm is unable, or likely to be unable, to pay claims against it. This is usually because it has stopped trading or has been declared in default. |
| forbearance | The term generally applied to the facilities provided or changes to facilities provided to assist borrowers who are experiencing, or are about to experience, a period of financial stress. |
| funding risk | A form of liquidity risk arising when the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required. |
| Group | Clydesdale Bank PLC and its controlled entities. |
| hedge ineffectiveness | Represents the extent to which the income statement is impacted by changes in fair value or cash flows of hedging instruments not being fully offset by changes in fair value or cash flows of hedged items. |
| IFRS 9 | The new financial instrument accounting standard which was adopted by the Group with effect from 1 October 2018. |
| impairment allowances | An ECL provision held on the balance sheet for financial assets calculated in accordance with IFRS 9. The impairment allowance is calculated as either a 12-month or a lifetime ECL. |

# Main Glossary (continued)

| | |
|---|---|
| impairment losses | The ECLs calculated in accordance with IFRS 9 and recognised in the income statement with the carrying value of the financial asset reduced by creating an impairment allowance. Impairment losses are calculated as either a 12-month or lifetime ECL. |
| interest rate hedging products **(IRHP)** | This incorporates: (i) standalone hedging products identified in the Financial Services Authority (FSA) 2012 notice; (ii) the voluntary inclusion of certain of the Group's more complex tailored business loan (TBL) products; and (iii) the Group's secondary review of all fixed-rate tailored business loans (FRTBLs) complaints which were not in scope for the FSA notice. |
| Internal Capital Adequacy Assessment Process (ICAAP) | The Group's assessment of the levels of capital that it needs to hold through an examination of its risk profile from regulatory and economic capital viewpoints. |
| Internal Liquidity Adequacy Assessment Process (ILAAP) | The Group's assessment and management of balance sheet risks relating to funding and liquidity. |
| Internal Ratings-Based approach (IRB) | A method of calculating credit risk capital requirements using internal, rather than supervisory, estimates of risk parameters. |
| investment grade | The highest possible range of credit ratings, from 'AAA' to 'BBB', as measured by external credit rating agencies. |
| Level 1 fair value measurements | Financial instruments whose fair value is derived from unadjusted quoted prices for identical instruments in active markets. |
| Level 2 fair value measurements | Financial instruments whose fair value is derived from quoted prices for similar instruments in active markets and financial instruments valued using models where all significant inputs are observable. |
| Level 3 fair value measurements | Financial instruments whose fair value is derived from valuation techniques where one or more significant inputs are unobservable. |
| Lifetime ECL | The ECL calculation performed on financial assets where a SICR since origination has been identified. This can be either a 'Stage 2' or 'Stage 3' impairment loss depending on whether the financial asset is credit impaired. |
| Listing Rules | Regulations applicable to any company listed on a United Kingdom stock exchange, subject to the oversight of the UK Listing Authority (UKLA). The Listing Rules set out mandatory standards for any company wishing to list its shares or securities for sale to the public. |
| loan to value ratio (LTV) | A ratio that expresses the amount of a loan as a percentage of the value of the property on which it is secured. |
| Loss given default (LGD) | The estimate of the loss that the Group will suffer if the customer defaults (incorporating the effect of any collateral held). |
| medium-term notes | Debt instruments issued by corporates, including financial institutions, across a range of maturities. |
| Minimum Requirement for Own Funds and Eligible Liabilities (MREL) | MREL is a minimum requirement for institutions to maintain equity and eligible debt liabilities, to help ensure that when an institution fails the resolution authority can use these financial resources to absorb losses and recapitalise the continuing business. The BoE set out its approach to setting banks' MREL in November 2016. |
| net interest income | The amount of interest received or receivable on assets, net of interest paid or payable on liabilities. |
| Net Promoter Score (NPS) | This is an externally collated customer loyalty metric that measures loyalty between a provider, who in this context is the Group, and a consumer. |
| operational risk | The risk of loss resulting from inadequate or failed internal processes, people strategies and systems or from external events. |
| Overall Liquidity Adequacy Rule (OLAR) | An FCA and PRA rule that firms must at all times maintain liquidity resources which are adequate both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due. This is included in the Group's risk appetite and subject to approval by the Board as part of the ILAAP. |
| pension risk | The risk that, at any point in time, the available assets to meet pension liabilities are at a value below current and future scheme obligations. |
| Personal lending | Lending to individuals rather than institutions and excludes mortgage lending which is reported separately. |
| PPI redress | Includes PPI customer redress and all associated costs excluding fines. |
| probability of default (PD) | The probability that a customer will default over either the next 12 months or lifetime of the account. |
| regulatory capital | The capital which the Group holds, determined in accordance with rules established by the PRA. |
| relevant Conduct Matters | The legacy conduct issues covered by the Capped Indemnity, including certain conduct issues relating to PPI, standalone IRHP, voluntary scope TBLs and FRTBLs and other conduct matters in the period prior to the Demerger date whether or not known at the Demerger date. |

# Main Glossary (continued)

| Term | Definition |
| --- | --- |
| residential mortgage-backed securities (RMBS) | Securities that represent interests in groups or pools of underlying mortgages. Investors in these securities have the right to cash received from future mortgage payments (interest and principal). |
| ring-fencing | A new regime of rules which require banks to change the way that they are structured by separating retail banking services from investment and international banking. This is to ensure the economy and taxpayers are protected in the event of any future financial crises. |
| risk appetite | The level and types of risk the Group is willing to assume within the boundaries of its risk capacity to achieve its strategic objectives. |
| risk-weighted assets (RWA) | On and off balance sheet assets of the Group are allocated a risk weighting based on the amount of capital required to support the asset. |
| sale and repurchase agreement ('repo') | A short-term funding agreement that allows a borrower to create a collateralised loan by selling a financial asset to a lender. As part of the agreement, the borrower commits to repurchase the security at a date in the future repaying the proceeds of the loan. For the counterparty (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement or a reverse repo. |
| Scheme | The Group's defined benefit pension scheme, the Yorkshire and Clydesdale Bank Pension Scheme. |
| secured lending | Lending in which the borrower pledges some asset (e.g. property) as collateral for the lending. |
| securitisation | The practice of pooling similar types of contractual debt and packaging the cash flows from the financial asset into securities that can be sold to institutional investors in debt capital markets. It provides the Group with a source of secured funding than can achieve a reduction in funding costs by offering typically 'AAA' rated securities secured by the underlying financial asset. |
| Significant increase in credit risk (SICR) | The assessment performed on financial assets at the reporting date to determine whether a 12-month or lifetime ECL calculation is required. Qualitative and quantitative triggers are assessed in determining whether there has been a SICR since origination. The Group considers 30 DPD as a backstop in determining whether a SICR since origination has occurred. |
| specific impairment provision | A specific provision relates to a specific loan, and represents the estimated shortfall between the carrying value of the asset and the estimated future cash flows, including the estimated realisable value of securities after meeting securities realisation costs. |
| standardised approach | In relation to credit risk, a method for calculating credit risk capital requirements using External Credit Assessment Institutions (ECAI) ratings and supervisory risk weights. In relation to operational risk, a method of calculating the operational capital requirement by the application of a supervisory defined percentage charge to the gross income of eight specified business lines. |
| Statutory return on tangible equity | Statutory profit/(loss) after tax attributable to ordinary equity holders as a percentage of average tangible equity (total equity less intangible assets, AT1 and non-controlling interests) for a given period. |
| stress testing | The term used to describe techniques where plausible events are considered as vulnerabilities to ascertain how this will impact the own funds or liquidity which a bank holds. |
| structured entities (SE) | An entity created to accomplish a narrow well-defined objective (e.g. securitisation of financial assets). An SE may take the form of a corporation, trust, partnership or unincorporated entity. SEs are often created with legal arrangements that impose strict limits on the activities of the SE. May also be referred to as an SPV. |
| subordinated debt | Liabilities which rank after the claims of other creditors of the issuer in the event of insolvency or liquidation. |
| Term Funding Scheme (TFS) | Launched in 2016 by the BoE to allow banks and building societies to borrow from the BoE at rates close to base rate. This is designed to increase lending to businesses by lowering interest rates and increasing access to credit. |
| Tier 1 capital | A measure of a bank's financial strength defined by CRD IV. It captures CET1 capital plus other Tier 1 securities in issue, subject to deductions. |
| Tier 2 capital | A component of regulatory capital, including qualifying subordinated debt, eligible collective impairment allowances and other Tier 2 securities as defined by CRD IV. |

# Main Glossary (continued)

| | |
|---|---|
| unaudited | Financial information that has not been subject to validation by the Group's external auditor. |
| unsecured lending | Lending in which the borrower pledges no assets as collateral for the lending (such as credit cards and current account overdrafts). |
| value at risk (VaR) | A measure of the loss that could occur on risk positions as a result of adverse movements in market risk factors (e.g. rates, prices, volatilities) over a specified time horizon and to a given level of confidence |
| Virgin Money | Virgin Money UK PLC |
| Virgin Money Holdings | Virgin Money Holdings (UK) PLC |

# Abbreviations

| Abbreviation | Meaning |
|---|---|
| **AFS** | Available for sale |
| **AIRB** | Advanced internal ratings based |
| **ALCO** | Assets and Liability Committee |
| **BCBS** | Basel Committee on Banking Supervision |
| **BoE** | Bank of England |
| **bps** | Basis points |
| **BTL** | Buy-to-let |
| **CCF** | Credit Conversion Factor |
| **CCyB** | Countercyclical Capital Buffer |
| **CET1** | Common Equity Tier 1 Capital |
| **CPI** | Consumer Price Index |
| **CRD** | Capital Requirements Directive |
| **CRM** | Credit risk mitigation |
| **CRR** | Capital Requirements Regulation |
| **CSRBB** | Credit spread risk in the banking book |
| **DEP** | Deferred Equity Plan |
| **DPD** | Days past due |
| **EaR** | Earnings at risk |
| **EBA** | European Banking Authority |
| **ECL** | Expected credit loss |
| **EIR** | Effective interest rate |
| **FCA** | Financial Conduct Authority |
| **FIRB** | Foundation internal ratings based |
| **FPC** | Financial Policy Committee |
| **FRC** | Financial Reporting Council |
| **FSCS** | Financial Services Compensation Scheme |
| **FSMA** | Financial Services and Markets Act 2000 |
| **FVTPL** | Fair value through profit or loss |
| **GMP** | Guaranteed Minimum Pension |
| **IAS** | International Accounting Standard |
| **IASB** | International Accounting Standards Board |
| **ILO** | International Labour Organisation |
| **IPO** | Initial Public Offering |
| **IRB** | Internal ratings based |
| **ISDA** | International Swaps and Derivatives Association |
| **LCR** | Liquidity coverage ratio |
| **LDR** | Loan to deposit ratio |
| **LGD** | Loss given default |
| **LIBOR** | London Interbank Offered Rate |
| **LSE** | London Stock Exchange |
| **LTIP** | Long term incentive plan |
| **LTV** | Loan to value ratio |
| **MREL** | Minimum Requirement for Own Funds and Eligible Liabilities |
| **NAB** | National Australia Bank Limited |
| **NIM** | Net interest margin |
| **NPS** | Net Promoter Score |
| **NSFR** | Net stable funding ratio |
| **OLAR** | Overall liquidity adequacy rule |
| **PBT** | Profit before tax |
| **PD** | Probability of Default |
| **POCI** | Purchased or originated credit impaired |
| **PPI** | Payment protection insurance |
| **PRA** | Prudential Regulation Authority |
| **RAS** | Risk Appetite Statement |
| **RMBS** | Residential mortgage-backed securities |
| **RMF** | Risk Management Framework |
| **RoTE** | Return on Tangible Equity |
| **RPI** | Retail Price Index |
| **RWA** | Risk-weighted assets |
| **SICR** | Significant increase in credit risk |
| **SIP** | Share Incentive Plan |
| **SME** | Small or medium sized enterprises |
| **SRB** | Systemic Risk Buffer |
| **TCC** | Transactional Credit Committee |
| **TFS** | Term Funding Scheme |
| **VAA** | Virgin Atlantic Airways Limited |
| **VaR** | Value at Risk |

# Other information

### Country by Country Reporting ('CBCR')

The Capital Requirements (Country-by-Country Reporting) Regulations 2013 came into effect on 1 January 2014 and place certain reporting obligations on financial institutions that are within the scope of the European Union's CRD IV. The purpose of the Regulations is to provide clarity on the source of the Group's income and the locations of its operations.

The vast majority of entities that are consolidated within the Group's financial statements are UK registered entities. The activities of the Group are described in the Strategic report.

| | 2019<br>UK |
|---|---|
| Average FTE employees (number) | 8,703 |
| Total operating income (£m) | 1,773 |
| Loss before tax (£m) | (182) |
| Corporation tax paid (£m) | 7 |
| Public subsidies received (£m) | - |
| Return on assets (%) | (0.16)% |

The only other non-UK registered entity of the Group is a Trustee company that is part of the Group's securitisation vehicles (Lanark and Lannraig). Lannraig Trustees Limited is registered in Jersey. This entity plays a part in the overall securitisation process by having the beneficial interest in certain mortgage assets assigned to it. This entity has no assets or liabilities recognised in its financial statements with the securitisation activity taking place in other UK registered entities of the structures. This entity does not undertake any external economic activity and has no employees. The results of this entity as well as those of the entire Lanark and Lannraig securitisation structures are consolidated in the financial statements of the Group.

**Website** www.virginmoneyukplc.com/investor-relations/results-and-reporting/financial-results/.

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# Forward-looking statements

The information in this document may include forward-looking statements, which are based on assumptions, expectations, valuations, targets, estimates, forecasts and projections about future events. These can be identified by the use of words such as 'expects', 'aims', 'targets', 'seeks', 'anticipates', 'plans', 'intends', 'prospects' 'outlooks', 'projects', 'forecasts', 'believes', 'estimates', 'potential', 'possible', and similar words or phrases. These forward-looking statements, as well as those included in any other material discussed at any presentation, are subject to risks, uncertainties and assumptions about the Group and its securities, investments and the environment in which it operates, including, among other things, the development of its business and strategy, any acquisitions, combinations, disposals or other corporate activity undertaken by the Group (including but not limited to the acquisition of Virgin Money Holdings (UK) plc), trends in its operating industry, changes to customer behaviours and covenant, macroeconomic and/or geopolitical factors, changes to its board and/ or employee composition, exposures to terrorist activity, IT system failures, cyber-crime, fraud and pension scheme liabilities, changes to law and/or the policies and practices of the BoE, the FCA and/or other regulatory and government bodies, inflation, deflation, interest rates, exchange rates, changes in the liquidity, capital, funding and/ or asset position and/or credit ratings of the Group, future capital expenditures and acquisitions, the repercussions of the UK's referendum vote to leave the European Union (EU), the UK's exit from the EU (including any change to the UK's currency), Eurozone instability, and any referendum on Scottish independence.

In light of these risks, uncertainties and assumptions, the events in the forward-looking statements may not occur. Forward-looking statements involve inherent risks and uncertainties. Other events not taken into account may occur and may significantly affect the analysis of the forward-looking statements. No member of the Group or their respective Directors, officers, employees, agents, advisers or affiliates gives any assurance that any such projections or estimates will be realised or that actual returns or other results will not be materially lower than those set out in this document and/or discussed at any presentation. All forward-looking statements should be viewed as hypothetical. No representation or warranty is made that any forward-looking statement will come to pass. No member of the Group or their respective Directors, officers, employees, agents, advisers or affiliates undertakes any obligation to update or revise any such forward-looking statement following the publication of this document nor accepts any responsibility, liability or duty of care whatsoever for (whether in contract, tort or otherwise) or makes any representation or warranty, express or implied, as to the truth, fullness, fairness, merchantability, accuracy, sufficiency or completeness of, the information in this document.

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