Audit Committee Report

Dear Shareholder,

I am pleased to present the report of the Audit Committee for 2017. During the year the Committee continued to focus on areas of significant judgement in the financial statements as set out in the report below.

The Committee also closely monitored the Group's preparations for IFRS 9, including key areas of interpretation and assumption, the impact analysis from the parallel run, the use of models and the governance and control environment.

The Committee also commenced a competitive tender process for the external audit of the Group from 2019, against the backdrop of the UK's adoption of EU legislation to reform the statutory audit market, which became effective for the Bank in 2017.

Membership and meetings

The Committee met six times in 2017, reflecting the workload of the Committee during the year. All members of the Audit Committee are independent Non-Executive Directors. The Chair of the Committee, Eric Anstee, has a wealth of recent and relevant financial and accounting experience in financial services. Taken as a whole, the Committee has an appropriate balance of skills, including recent and relevant financial experience. Standing invitations are extended to the Executive Directors, Chief Risk Officer, Group Head of Internal Audit and Group Head of Compliance, all of whom attend meetings as a matter of practice. Other non-members may be invited to attend all or part of any meeting as and when appropriate.

The Company Secretary acts as Secretary to the Committee. The Group Head of Internal Audit and the external auditors attend all meetings and also meet in private with the Committee; they also have regular contact with the Chair throughout the year. The Chair also meets with the Chief Financial Officer and Group Head of Internal Audit in advance of each meeting to agree the agenda and receive a full briefing on the key agenda items.

Nathan Moss served on the Committee from 7 February 2017 until 31 May 2017 when he resigned from the Board.

Further details on the activities of the Committee during the year and how it discharged its responsibilities are also provided in the report below.

Eric Anstee
Chair of the Audit Committee
15 March 2018

Responsibilities

The primary role of the Committee is to assist the Board in overseeing the systems of internal control and external financial reporting across the Group. The Committee's specific responsibilities are set out in its terms of reference, which are reviewed at least annually. These are available on the Company's website www.osb.co.uk and cover external and internal audit, financial and narrative reporting, compliance, whistleblowing, fraud and internal controls.

In addition, the Chair of the Audit Committee has informed management that he is available to meet with the Company's investors on request, in accordance with the Financial Reporting Council's Stewardship Code.

Activities during 2017

The principal activities undertaken by the Committee during the year are described below.

Significant areas of judgement considered by the Committee

The following significant accounting judgements were considered by the Committee in relation to the 2017 Annual Report and financial statements. In its assessment, the Committee considered and challenged reports from management prior to both the interim and full year results, explaining each area of judgement and management's recommended approach. The Committee also received reports from the external auditor setting out its views on the accounting treatment and judgements underpinning the financial statements.

Loan book impairments

Specific provision assessments for individually significant loans or portfolios of loans involve significant judgement in relation to estimating future cash flows, including the cost of obtaining and selling collateral, the likely sale proceeds and any rental income prior to sale.

All assets without a specific provision are assessed collectively. Collective provisions are calculated using 12 month delinquency roll rates and one year probability of default rates ('PD') on different segments of the loan book. The PD calculations include assumptions for emergence periods, cure rates and forbearance. Loss given default ('LGD') includes assumptions on forced sale discounts and the level of house prices. Significant judgement needs to be exercised in deciding how to apply historic experience to current market conditions in both the PD and LGD calculations.

The Committee received and challenged reports from management prior to each reporting date, explaining the approach taken to provisioning and the resulting changes in provision levels during the period. The Committee assessed the appropriateness of proposed enhancements to the methodologies, judgements and estimates underpinning the collective provision calculations. During the year the management did not make any changes to collectively assessed impairment methodologies, however it did assess the ongoing appropriateness of all judgements and estimates. The Committee assessed and approved enhancements proposed by management relating to forced sale discount and time to sale assumptions, which fed LGD calculations.

The Committee reviewed additional information by loan book during the year including provision coverage ratios, assumed probability of default, loss given default and loan to value ratios for loans three months or more in arrears and impaired balances to help with their assessment of the reasonableness of provisions.

The Committee asked the Risk Committee to review and provide advice on the collective provision methodologies and assumptions and to review the 'top 20' impaired loans for the half year and year end. At least two members of the Committee were also members of the Risk Committee throughout 2017 and as such received additional detailed credit information on the loan book throughout the year.

The Committee is satisfied that the approach taken and judgements made were reasonable.

The Committee also received regular reports from management on the Group's preparations for and approach to IFRS 9: Financial Instruments, which became effective from 1 January 2018. The reports covered the classification and measurement of financial instruments and the determination of impairment provisions and a hedging update. The key focus was on IFRS 9 models, interpretation of results, key assumptions and judgements, scenario and macroeconomic variables used within models, the results of the 2017 parallel run and the proposed ongoing business as usual as well as model governance, controls and procedures.

Loan book acquisition accounting and income recognition
Acquired loan books are initially recognised at cost. Significant judgement is required in calculating their effective interest rate ('EIR'), using cash flow models which include assumptions on the likely macroeconomic environment, including HPI, unemployment levels and interest rates, as well as loan level and portfolio attributes and history used to derive prepayment rates, the probability and timing of defaults and the amount of incurred losses. The EIRs on loan books purchased at significant discounts are particularly sensitive to the prepayment and default rates derived as the purchase discount is recognised over the expected life of the loan book through the EIR. New defaults are modelled at zero loss (as losses will be recognised in profit and loss as impairment losses and therefore have the same impact on EIR as prepayments). Incurred losses at acquisition are calculated using the Group's collective provision model. The Committee reviewed and challenged reports from management before each reporting date on the approach taken. Particular focus was given to loan books purchased at significant discounts, including sensitivity analysis on the impact of estimated future prepayment rates and other assumptions on carrying value and the timing of the release of discounts to profit and loss. The Committee reviewed a comparison of actual cash flows to those assumed in the cash flow models by book to challenge management's assessment of the need to update cash flow projections and adjust carrying values accordingly. Based on this work, the Committee is satisfied that the approach taken and judgements made were reasonable.

Effective interest rate
A number of assumptions are made when calculating the effective interest rate for newly originated loan assets. These include their expected lives, likely redemption profiles and the anticipated level of any early redemption charges. Certain mortgage products offered by the Bank include significant directly attributable net fee income, in particular Buy-to-Let, and/or revert to the standard variable rate ('SVR') after an initial discount or fixed period. Judgement is used in assessing the expected rate of prepayment during the discounted or fixed period of these mortgages and the expected life of those that prepay. The Group uses historical experience in its assessment. Judgement is also used in assessing whether and for how long mortgages that reach the end of the product term stay on SVR. The most significant area of judgement is the period spent on SVR. The Group prudently assumes no period on SVR before the borrower refinances onto a new product or redeems, until a consistent trend has emerged from the newly enhanced broker led retention programme. The Committee reviewed and challenged the assumptions used in EIR calculations, in particular the period over which net fee income is spread, and also received sensitivity analysis for different product lives including a period on the Company's SVR. Based on this work, the Committee is satisfied that the approach taken and judgements made were reasonable.

Further details of the above significant areas of judgement can be found in note 2 to the financial statements.

In addition, the Committee reviewed the Group's approach to hedge accounting and received reports on the effectiveness of the Group's macro-hedging throughout the year.

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The Committee also considered the results of management's regular reviews of the amortisation profile of fair value adjustments on hedged assets associated with cancelled swaps against the roll-off of the underlying legacy back book of long-dated fixed rate mortgages. Following the half year review, the Group accelerated the amortisation of fair value adjustments on hedged assets in line with the mortgage asset run-off, due to faster than expected prepayments.

Fair, balanced and understandable

The Committee considered on behalf of the Board whether the 2017 Annual Report and financial statements taken as a whole are fair, balanced and understandable, and whether the disclosures are appropriate. The Committee reviewed the Group's procedures around the preparation, review and challenge of the Report and the consistency of the narrative sections with the financial statements and the use of alternative performance measures and associated disclosures.

Following its review, the Committee is satisfied that the Annual Report is fair, balanced and understandable, and provides the information necessary for shareholders and other stakeholders to assess the Group's position and performance, business model and strategy, and has advised the Board accordingly.

Pillar 3 disclosures – The Committee approved the Group's Pillar 3 regulatory disclosures for publication on the Group's website, following a review of the governance and control procedures around their preparation.

Internal Audit

The Company continued to use in-house Internal Audit resource during the year with the Group Head of Internal Audit and her team supported by a panel of external accountancy firms who provided expert resource when requested on specific internal audits, on a co-source basis.

The primary role of Internal Audit is to help the Board and executive management to protect the Group's assets, reputation and sustainability. It assists the Company in accomplishing its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of the risk management, control and governance processes.

The Internal Audit Charter, which formally defines internal audit's purpose, authority and responsibility, was approved by the Committee in December 2017. The Committee also approved the annual Internal Audit Plan, which was developed, based on a prioritisation of the audit universe using a risk-based methodology, including input from senior management and the Committee. A written report is prepared following the conclusion of each internal audit engagement and distributed to the Committee and senior management. Responsibility for ensuring appropriate corrective action is taken lies with management. The Internal Audit function follows up on engagement findings and recommendations until remedial action has been completed.

The Committee carries out an annual review of the effectiveness of the Internal Audit function. This was facilitated for 2017 by a survey completed by Committee members, certain executives and the external auditors who had interacted with the Internal Audit function during the year. Following the review, the Committee was satisfied that the Internal Audit function operated effectively during the year.

Systems of internal control and risk management

The Committee received regular reports from the Internal Audit function during 2017, which included progress updates against the Internal Audit Plan, the results of audits undertaken and any outstanding audit action points. The Committee approved the annual review of the Compliance Framework and Assurance Plan and received reports from the Group's Compliance function and the Annual Statement of Compliance from the Group Head of Compliance. The Committee used the Internal Audit and Compliance Reports as the basis for its assessment of the effectiveness of the Group's system of internal controls and risk management. The Committee also received a report on the effectiveness of the Group's system of controls from the CEO, which was based on a self-assessment process completed by senior managers and executives in the Group.

The Committee received and reviewed reports from management on the status of the substantiation of balance sheet general ledger accounts prior to the reporting date.

The Committee reviewed and approved a number of policies following their annual refresh, including: anti-bribery and corruption, data protection, data retention and record management, fraud, sanctions and whistleblowing and anti-money laundering and counter terrorist financing. The Committee received reports on fraud prevention arrangements and fraud incidents, whistleblowing and an annual report from the Group's MLRO during the year.

The Committee also received regular updates on data governance and controls as the Group enhances its data governance arrangements in connection with its planned application for an Internal Ratings Based ('IRB') model for capital requirements.

External auditor

The Committee is responsible for overseeing the Group's relationship with its external auditor, KPMG LLP ('KPMG'). This includes the ongoing assessment of the auditor's independence and the effectiveness of the external audit process, the results of which inform the Committee's recommendation to the Board relating to the auditor's appointment (subject to shareholder approval) or otherwise.

Appointment and tenure

KPMG was appointed as the first external auditor of the Group for the period ended 31 December 2011. Prior to that date it fulfilled the external audit function for Kent Reliance Building Society from the period ended 31 December 2010. The current lead audit partner, Pamela McIntyre, has been in role since the 2016 audit. The Audit Committee confirms that the Group is in compliance with the Statutory Audit Services for Large Companies Market Investigation (mandatory use of competitive tender processes and Audit Committee Responsibilities) Order 2014 which requires FTSE 350 companies to put their statutory audit services out to tender not less frequently than every ten years.

New EU legislation adopted by the UK in 2016 set a maximum audit tenure of 20 years and also requires a tender at least every ten years. The new legislation is effective for financial periods commencing on or after 17 June 2016. Against this backdrop, the Group has decided to put the external audit contract out for tender for its 2019 financial year.

To that end, a formal tender process was launched in the fourth quarter of 2017 with a desk top review of audit firms, focusing on expertise and experience in FTSE 350 audits in financial services. A number of firms were then invited to take part in a request for information ('RFI') process in December, followed by face to face meetings between the proposed lead audit partners and senior managers and a sub-set of the Committee in early 2018. The Committee then selected a shortlist of two firms in March 2018 to take through to a formal request for proposal ('RFP') process.

Effectiveness

The Committee assesses the effectiveness of the external audit function on an annual basis. In 2017, the review was facilitated through a survey completed by members of the Committee, certain Executive Directors and other key employees who had significant interaction with the external audit team during the year. The survey assessed the effectiveness of the lead partner and audit team, the audit approach and execution, the role of management in the audit process, communication, reporting and support to the Committee as well as the independence and objectivity of the external auditor. The assessment concluded that the external audit process was effective.

The audit carried out by KPMG in respect of the Group's financial statements for 2016 was the subject of an in-depth review during the year by the Financial Reporting Council's (FRC) Audit Quality Review Team. The Committee reviewed the findings and discussed them with KPMG and the matters raised have been addressed in the planning and execution for the audit for 2017. The Committee remains satisfied with the efficiency and effectiveness of the audit.

Prohibited services	Approved permitted services
Book-keeping and preparing accounting records and financial statements	General accounting advice on the application of IFRS and training support
Financial information systems design and implementation. Internal control or risk management procedures relating to financial information design or implementation	Regulatory advice and reporting tools
Valuation services, including those in connection with actuarial or litigation support services	Comfort letters, accounting opinions as required by the regulator, FLS/TFS net lending assurance opinions, agreed upon procedures in relation to securitisations
HR and payroll services	Other audit-related services; interim profit verification; half year review
Services linked to the financing, capital structure and allocation and investment strategy of the Company other than assurance services in relation to the financial statements such as comfort letters	Such other activities as may be agreed by the Committee from time to time
Promoting, dealing in or underwriting shares in the Company	
Legal services with respect to the provision of general counsel, negotiating on behalf of the audit entity and acting in an advocacy role in the resolution of litigation	
Internal audit services	
HR and payroll services	
Tax services, including tax compliance and advice	
Services that play any part in the management or decision making of the Company	

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Non-audit services

The engagement of the external auditor to provide non-audit services to the Group could impact the assessment of its independence and objectivity. The Group has therefore established a policy governing the use of the external auditor for non-audit services. The policy specifies prohibited and approved permitted services (as detailed in the table on page 77 for 2017) and sets the framework within which permitted non-audit services may be provided. Prohibited services comprise activities that are generally perceived to involve the auditor making judgements or decisions that are the responsibility of management.

The Group's policy governing the use of the external auditor for non-audit services was updated in 2017 to comply with new EU statutory audit market reform legislation adopted in the UK. Restrictions on the nature of permissible non-audit services became effective for financial periods commencing on or after 17 June 2016. These included certain restrictions on the use of the statutory auditor for tax compliance and advice. Accordingly, the Group ceased using KPMG for tax compliance or advice after 31 December 2016.

The Group maintains active relationships with several other large firms and any decision to appoint the external auditor is taken in the context of whether their understanding of the Group places them in a better position than other firms to undertake the work and includes an assessment of the cost-effectiveness and practicality of using an alternative firm.

The new EU statutory audit market reform legislation adopted in the UK also applies a cap on permissible non-audit services of 70% of the proceeding three-year average of audit fees. This is applicable for financial periods commencing on or after 17 June 2019.

The Committee pre-approved a number of permitted services in 2017: interim profit verifications and the half year review. The Committee also pre-approved other permitted non-audit services subject to an overall threshold of 50% of the final cost of the 2016 Group annual audit services and subject to any single item above £100,000 being pre-agreed with the Committee Chair. The Committee reviews a schedule of year-to-date non-audit services at each meeting.

The fees paid to the external auditor in respect of non-audit services during 2017 totalled £151,000 representing 19% of 2017 Group audit services of £816,000 (2016: £250,000 representing 47% of 2016 Group audit services of £535,000) and are detailed in the table below. The 2017 audit fee includes non-recurring fees of £207,000 in respect of the audit of system migrations and the Group's adoption of IFRS 9.

The Committee's assessment of the external auditor's independence in 2017 took into account the non-audit services provided during the year, and confirmations given by KPMG as to its continued independence at various stages in the year.

Nature of service	**2017 £'000**	2016 £'000
Audit-related assurance services including half year review and interim profit verifications	**96**	96
Tax compliance and advice	**–**	70
Regulatory advice and support	**8**	36
Other[1]	**47**	48
Total non-audit services	**151**	250

1. Other non-audit services included AT1 issuance and hedge accounting advice in 2017 and in 2016 related to agreed upon procedures in respect of a new securitisation vehicle and assurance work in relation to net lending for the Funding For Lending Scheme.

Training

The Committee undertook a significant amount of training during the year, including making extensive use of the Audit Committee Institute and training programmes run by the major accountancy firms. In addition, Committee members attended a number of executive level Committee meetings and met with key staff during the year to increase their knowledge and understanding of the business.

Effectiveness

The Committee formally considers its effectiveness annually. The assessment was facilitated for 2017 using a survey completed by members of the Committee. The review concluded that the Committee operated effectively throughout 2017 with no significant improvements required.