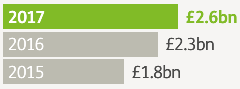
Financial review

Strong growth in gross new organic lending

£2.6bn

+14%

2016: £2.3bn

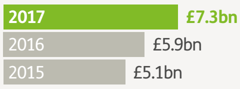


Net loan book growth

23%

2016: 16%

(20% excluding the impact of Rochester disposal)

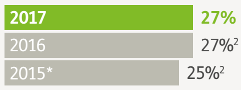


Cost to income ratio

27%

Strong income growth and continued focus on cost discipline and efficiency

2016: 27%[2]



* Restated

	Group 31-Dec-2017 £m	Group 31-Dec-2016 £m
SUMMARY PROFIT OR LOSS		
Net interest income	**245.4**	206.6
Net losses on financial instruments	**(6.3)**	(4.3)
Net fees and commissions	**0.5**	1.7
External servicing fees	**(1.5)**	(2.6)
Administrative expenses[1]	**(65.1)**	(53.7)
FSCS and other regulatory provisions	**(0.9)**	(0.5)
Impairment losses	**(4.4)**	(9.0)
Exceptional items	**–**	24.9
Profit before taxation	**167.7**	163.1
Profit after taxation	**126.9**	120.9
Underlying profit before taxation[3]	**167.7**	138.2[2]
Underlying profit after taxation[3]	**126.9**	102.4[2]
KEY RATIOS		
Net interest margin[3]	**316bps**	316bps[2]
Cost to income ratio[3]	**27%**	27%[2]
Management expense ratio[4]	**0.86%**	0.86%
Loan loss ratio[3]	**0.07%**	0.16%
Basic EPS[3], pence per share	**51.1**	49.4
Underlying basic EPS[3], pence per share	**51.1**	41.7
Return on equity[3]	**28%**	29%
Dividend per share, pence per share	**12.8**	10.5

	£m	£m
EXTRACTS FROM THE STATEMENT OF FINANCIAL POSITION		
Loans and advances	**7,306.0**	5,939.2
Retail deposits	**6,650.3**	5,952.4
Total assets	**8,589.1**	6,580.9
KEY RATIOS		
Liquidity ratio[5]	**15.2%**	17.9%
CET1 capital ratio[6]	**13.7%**	13.3%
Total capital ratio	**16.9%**	15.1%
Leverage ratio	**6.0%**	5.5%

1. Including depreciation and amortisation.
2. Prior to 2017, OSB deducted coupons on equity Perpetual Subordinated Bonds ('PSBs') accounted for as dividends from underlying profit before and after tax, net interest margin and cost to income ratio. Following a review of market practice in advance of the Bank's AT1 issue in May 2017, OSB no longer deducts these coupons from the calculation of these key performance indicators. The comparatives have been restated accordingly. Interest payments on AT1 securities classified as dividends are treated in the same way.
3. See definition in Key performance indicators table on pages 26-27.
4. Administrative expenses including depreciation and amortisation as a percentage of average total assets.
5. Liquid assets as a percentage of funding liabilities.
6. Fully-loaded under Basel III/CRD IV.

Alternative performance measures

OSB believes that the use of alternative performance measures ('APMs') for profitability and earnings per share provides valuable information to the readers of the financial statements and presents a more consistent basis for comparing the Group's performance between financial periods, by adjusting for exceptional non-recurring items. APMs also reflect an important aspect of the way in which operating targets are defined and performance is monitored by the Board. However, any APMs in this document are not a substitute for IFRS measures and readers should consider the IFRS measures as well.

	Profit before taxation		Profit after taxation	
Reconciliation of statutory profit to underlying profit	**Group 31-Dec-2017 £m**	Restated Group 31-Dec-2016 £m	**Group 31-Dec-2017 £m**	Restated Group 31-Dec-2016 £m
Statutory profit	**167.7**	163.1	**126.9**	120.9
Gain on Rochester 1 disposal	**–**	(34.7)	**–**	(25.8)
Exceptional amortisation of fair value adjustments on hedged assets	**–**	9.8	**–**	7.3
Underlying profit	**167.7**	138.2	**126.9**	102.4

Statutory basic EPS of 51.1 pence per share (2016: 49.4 pence per share) is calculated by dividing profit attributable to ordinary shareholders of £124.2m (2016: £120.0m) which is profit after taxation of £126.9m (2016: £120.9m) less coupons on equity PSBs, including the tax effect of £0.7m (2016: £0.9m) and coupons on AT1 securities, including the tax effect of £2.0m (2016: £nil) by the weighted average number of ordinary shares in issue during the year of 243.2m (2016: 243.1m).

Underlying basic EPS of 51.1 pence per share (2016: 41.7 pence per share) is calculated by dividing underlying profit attributable to ordinary shareholders of £124.2m (2016: £101.5m), which is underlying profit after taxation of £126.9m (2016: restated £102.4m) less coupons on equity PSBs, including the tax effect of £0.7m (2016: £0.9m) and coupons on AT1 securities of £2.0m (2016: £nil) by the weighted average number of ordinary shares in issue during the year of 243.2m (2016: 243.1m). Further information can be found in note 12 to the financial statements.

Prior to 2017, OSB deducted coupons on equity PSBs accounted for as dividends from underlying profit before and after tax. Following a review of market practice in advance of the Bank's issuance of AT1 securities in May 2017, OSB no longer deducts these coupons and underlying profit before and after tax for 2016 have been restated throughout this document accordingly.

The table below illustrates the key ratios under previous and current methods and the impact of the change in calculation methodology.

Change in key ratio calculation	**2017 %**	2016 %
Cost to income ratio		
Previous method	**27**	27
Add back coupons on equity PSBs	**(0)**	(0)
Current method	**27**	27
Net interest margin		
Previous method	**3.15**	3.14
Add back coupons on equity PSBs	**0.01**	0.02
Current method	**3.16**	3.16

	2017 £m	2016 £m
Underlying profit before tax		
Previous method	**166.7**	137.0
Add back coupons on equity PSBs	**1.0**	1.2
Current method	**167.7**	138.2
Underlying profit after tax		
Previous method	**126.2**	101.5
Add back coupons on equity PSBs	**0.7**	0.9
Current method	**126.9**	102.4

Financial review continued

Strong profit growth

The Group reported profit growth of 3% in 2017 with profit before taxation of £167.7m (2016: £163.1m including net gain from exceptional items of £24.9m). On an underlying basis, the Bank recorded a 21% increase in underlying profit before taxation to £167.7m (2016: restated £138.2m[1]) reflecting strong balance sheet growth and a stable net interest margin combined with continued focus on cost discipline and efficiency.

Profit after taxation in 2017 increased by 5% to £126.9m (2016: £120.9m including the net gain after taxation from exceptional items of £18.5m). On an underlying basis, profit after taxation increased by 24% to £126.9m (2016: restated £102.4m[1]). The Group's effective tax rate was 24.1%[2] in 2017 (2016: 25.6%), with a lower proportion of the Group's profits subject to the Bank Corporation Tax Surcharge.

Net interest margin

The Group reported an increase in net interest income of 19% to £245.4m in 2017 (2016: £206.6m) reflecting the growth in the loan book and a stable NIM of 316bps (2016: restated 316bps[1]). The stable NIM in 2017 represents a reduction in asset yields in line with the falling cost of funds.

The average cost of retail funds fell year on year, although market rates started to rise again in 2017.

The Bank benefited from a higher average balance in the Bank of England schemes in 2017 versus the prior year and the transition from FLS into the cheaper TFS. As at December 2017, the TFS drawdowns stood at £1,250.0m (2016: £101.0m) and FLS at £nil (2016: £524.6m).

Margins on the Bank's fixed rate mortgage products, particularly five-year fixed rate Buy-to-Let, declined in the fourth quarter of 2017 as the market did not reprice these products following the Bank of England base rate rise and subsequent widening of swap spreads in anticipation of future increases in interest rates.

Losses on financial instruments

Fair value loss on financial instruments in 2017 of £6.3m (2016: loss £4.9m) includes £7.3m amortisation of fair value adjustments on hedged assets relating to cancelled swaps (2016: £4.9m). The amortisation of fair value adjustments in both years includes the impact of accelerating the amortisation in line with the run-off of the underlying legacy long-term fixed rate mortgages due to faster than expected prepayments.

In 2016, the Group also made a £0.6m gain on disposal of a portion of non-performing personal loans with a gross value of £10.9m.

Net fees and commissions

Net fees and commission income of £0.5m (2016: £1.7m) comprises fees and commission receivable of £1.5m (2016: £2.5m) partially offset by commission expense of £1.0m (2016: £0.8m). Fees and commissions receivable decreased in 2017 due primarily to lower arrangement fees on funding lines.

External servicing fees

External servicing fees decreased to £1.5m in 2017 (2016: £2.6m) due to the transfer of servicing for acquired first charge residential loan book to the Bank's operation in India during the year and the further run-off of the personal loans portfolio.

Efficient and scalable operating platform

Administrative expenses including depreciation were up 21% to £65.1m in 2017 (2016: £53.7m), reflecting the growth in the business and the increased demands of regulation, including projects relating to IFRS 9 and an internal ratings based approach to risk weights ('IRB').

The Group's cost to income ratio of 27% and the management expense ratio of 0.86% remained stable (2016: 27%[1] and 0.86% respectively) despite the increased cost of regulation, reflecting the Bank's focus on efficiency and use of its scalable low cost back office based in Bangalore, India.

FSCS and other regulatory provisions

Regulatory provisions expense of £0.9m (2016: £0.5m) includes levies due to the Financial Services Compensation Scheme ('FSCS') which continued to decrease (see note 31 to the financial statements for further details) and other regulatory provisions.

Impairment losses

Impairment losses decreased to £4.4m in 2017 (2016: £9.0m) representing 7bps on average gross loans and advances (2016: 16bps). The decrease was primarily due to increased prudency in assumptions introduced in 2016 following the UK referendum vote to leave the EU, as well as lower underlying loan losses on acquired residential portfolios, and the effect of increasing property values reducing potential loss.

The performance of the front book of mortgages remains strong, reflecting the continued strength of the Bank's underwriting and lending criteria. We kept tight control on credit quality, as seen in our reportable arrears statistics. From more than 38,500 loans totalling £8.3bn of new organic originations since the Bank's creation in February 2011, there were only 137 cases of arrears over three months or more as at 31 December 2017, with an aggregate value of just £18.4m and average LTV of 63%.

IFRS 9

We had a successful parallel run of the IFRS 9 models throughout 2017 and were operating live under the new standard from 1 January 2018. The day one impact of the implementation of IFRS 9 is an increase in the provisions of c.£4m, representing 9bps on the Bank's CET1 ratio as at 31 December 2017 on an end game basis, reflecting the strength of security underpinning our loan book. The Group continues to monitor the performance of the underlying IFRS 9 models whilst assessing the ongoing appropriateness of all key judgement and estimate areas ahead of the full reporting of IFRS 9 impact later in 2018.

Exceptional items

There were no exceptional items in 2017.

Exceptional items in 2016 of £24.9m comprised the gain on disposal of the Bank's entire economic interest in Rochester 1 of £34.7m and an exceptional loss of £9.8m in respect of accelerated amortisation of fair value adjustments on hedged assets relating to legacy back book long-dated swap cancellations, in line with the underlying mortgage asset run-off, due to faster than expected prepayments. The exceptional loss represented the impact of accelerating the amortisation in prior years from 2012 to 2015.

Dividend

The Board recommends a final dividend for 2017 of 9.3 pence per share. Together with the 2017 interim dividend of 3.5 pence per share, this represents 25% of underlying profit after taxation attributable to ordinary shareholders for 2017 in line with the Bank's target dividend payout ratio. The proposed final dividend will be paid on 16 May 2018, subject to approval at the AGM on 10 May 2018, with an ex-dividend date of 22 March 2018 and a record date of 23 March 2018.

Balance sheet growth

Net loans and advances grew by 23% in 2017 to £7,306.0m (31 December 2016: £5,939.2m) attributable primarily to an increase in new lending in the Buy-to-Let/SME segment.

Retail deposits and total assets grew by 12% and 30% respectively in 2017 with additional funding of £624.4m supplied by the FLS and TFS throughout the year. By the end of 2017, the Group had completed its planned transition out of the FLS scheme (31 December 2016: £524.6m) to the TFS with drawings under the scheme of £1,250.0m (31 December 2016: £101.0m).

The TFS drawdowns are offered in the form of collateralised cash loans. The scheme closed to new drawings at the end of February 2018 and the Group has four years from the date of each individual drawing to repay the existing loans.

Liquidity

OneSavings Bank operates under the PRA's liquidity regime. The Bank operates within a target liquidity runway in excess of the minimum regulatory requirement. In addition, the Bank maintains a strong retention track record on fixed term bond and ISA maturities. As at 31 December 2017, our liquidity coverage ratio of 250% (2016: 239%) was significantly in excess of the 2017 regulatory minimum of 90%, including drawings under the Bank of England FLS and TFS funding facilities. The Group's liquidity ratio as at 31 December 2017 was 15.2% (31 December 2016: 17.9%).

Capital

The Bank's fully-loaded CET1 capital ratio under CRD IV strengthened to 13.7% as at 31 December 2017 (31 December 2016: 13.3%), demonstrating the strong organic capital generation capability of the business to support significant growth through profitability.

We further optimised our capital structure through the issuance of £60m of AT1 securities in May 2017.

The Bank had a total capital ratio of 16.9% and a leverage ratio of 6.0% as at 31 December 2017 (31 December 2016: 15.1% and 5.5% respectively).

The Bank had a Pillar 2a requirement of 1.1% of risk weighted assets as at 31 December 2017 (31 December 2016: 1.2%).

Cash flow statement

In 2017, the Group replaced £524.6m of Bank of England FLS off balance sheet securities with cash drawn down under the TFS. This led to cash and cash equivalents increasing by £680.6m during the year to £1,165.9m as at 31 December 2017 (2016: restated £485.3m[3]).

The Group's loans and advances to customers grew by £1,371.2m during the year, partially funded by an additional £697.9m of deposits from retail customers which mainly contributed to £512.9m of cash used in operating activities. The remaining funding came primarily from additional drawdowns under the TFS, which in conjunction with replacing the FLS securities, totalled £1,149.0m during the year. Together with £59.4m of funding from the issuance of AT1 securities, this generated £1,167.5m of cash from financing activities. Cash generated from investing activities was £26.0m, primarily driven by the sale and maturity of investment securities and the purchase of additional equipment and intangible assets.

In 2016, the Group increased its loans and advances to customers by £1,031.3m. This was partially funded by an additional £588.6m of deposits from retail customers. Collectively, these were the main drivers of the £323.8m (restated[3]) of cash used in operating activities. The remaining funding came primarily from the Group replacing its maturing on balance sheet available for sale investment securities (£309.4m decrease, restated[3]) with off balance sheet securities under the FLS (£363.9m increase) in its liquidity portfolio. Together with £80.2m of cash received from the Rochester 1 disposal, this generated £381.9m (restated[3]) of cash inflows from investing activities. In addition, the Group drew down £101.0m of cash under the TFS which is reflected in the cash generated from financing activities.

Further information can be found in the Statement of Cash Flows on page 111.

1. Prior to 2017, OSB deducted coupons on equity PSBs accounted for as dividends from underlying profit before and after tax, net interest margin and cost to income ratio. Following a review of market practice in advance of the Bank's AT1 issue in May 2017, OSB no longer deducts these coupons from the calculation of these key performance indicators. The comparatives have been restated accordingly. Interest payments on AT1 securities classified as dividends are treated in the same way.
2. Effective tax rate excludes £0.4m of adjustments relating to prior years.
3. The 2016 comparatives have been reclassified to include investment securities with maturity less than three months and to exclude encumbered loans and advances to credit institutions within cash and cash equivalents.

SUMMARY CASH FLOW STATEMENT	**Group 31-Dec-2017 £m**	Restated[3] Group 31-Dec-2016 £m
Profit before tax	**167.7**	163.1
Net cash generated/(used in):		
Operating activities	**(512.9)**	(323.8)
Investing activities	**26.0**	381.9
Financing activities	**1,167.5**	56.7
Net increase/(decrease) in cash and cash equivalents	**680.6**	114.8
Cash and cash equivalents at the beginning of the period	**485.3**	370.5
Cash and cash equivalents at the end of the period	**1,165.9**	485.3