KPMG

Independent auditor's report

to the members of OneSavings Bank plc

1. Our opinion is unmodified

We have audited the financial statements of OneSavings Bank plc ('the Bank') for the year ended 31 December 2017 which comprise the Consolidated Statement of Profit or Loss, the Consolidated Statement of Other Comprehensive Income, the Consolidated and Bank Statements of Financial Position, the Consolidated and Bank Statements of Changes in Equity, the Consolidated and Bank Statements of Cash Flows, and the related notes, including the accounting policies in note 1.

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the parent Company's affairs as at 31 December 2017 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union (IFRSs as adopted by the EU);
- the parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ('ISAs (UK)') and applicable law. Our responsibilities are described below. We believe that the audit evidence we have obtained is a sufficient and appropriate basis for our opinion. Our audit opinion is consistent with our report to the Audit Committee.

We were appointed as auditor on 28 May 2010. The period of total uninterrupted engagement is for the 8.25 financial years ended 31 December 2017. We have fulfilled our ethical responsibilities under, and we remain independent of the Group in accordance with, UK ethical requirements including the FRC Ethical Standard as applied to listed public interest entities. No non-audit services prohibited by that standard were provided.

Overview	
Materiality: group financial statements as a whole	£6.4m (2016: £5.2m) 4% (2016: 4%) of group profit before tax
Coverage	100% (2016:100%) of group profit before tax
	Risks of material misstatement vs 2016
Recurring risks	
	Recognition of revenue on organic and acquired loans ▼
	Loan impairment ▲

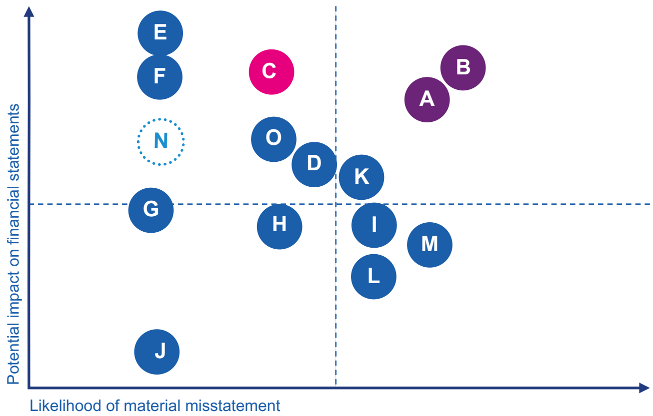
2. Key audit matters: our assessment of risks of material misstatement

Key audit matters are those matters that, in our professional judgement, were of most significance in the audit of the financial statements and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by us, including 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. We summarise on the following pages the key audit matters, in decreasing order of audit significance, in arriving at our audit opinion above, together with our key audit procedures to address those matters and, as required for public interest entities, our results from those procedures. These matters were addressed, and our results are based on procedures undertaken, in the context of, and solely for the purpose of, our audit of the financial statements as a whole, and in forming our opinion thereon, and consequently are incidental to that opinion, and we do not provide a separate opinion on these matters.

Our assessment of the Group's, and the Bank's, significant risks was the starting point for our audit. This considered both internal and external risks to the Group's business model and how these have been mitigated. The internal factors considered were:
Control environment – we considered the Group's control environment and in particular whether its systems were processing transactions completely and faithfully, and included appropriate controls designed to prevent fraud; and
Capital and liquidity – we considered the strength of the Group's capital and liquidity position, the diversification of assets, the flexibility and composition of its balance sheet and the management of its cost base.
Business activity – we assessed the risk in relation to recognition of revenue on acquired books to have decreased due to there being no new loan books purchased in the year.

The external factors considered were:
Economic changes – we considered the audit risk in relation to loan impairment to have been increased by the impact on the economy of the results of the EU referendum, given the Group's exposure to properties in London and the South East, and the recent Bank of England base rate change, which introduces unpredictability of forecasting in comparison to the previously benign market.
Political and regulatory changes – the regulatory and tax changes in the buy-to-let market, together with the greater competition in this market, have introduced greater uncertainty over the expected remaining lives of current buy-to-let lending.
Market developments – increasing levels of competition in the market, and the advancement of technological solutions and platformisation, including the upcoming changes from Open Banking.

We first considered these in June 2017, and refreshed our assessments through our half year review and year end audit. That consideration includes conversations not only with the Group, and ongoing knowledge gained through reading pertinent information, but also reflected the views of the Prudential Regulatory Authority, market analysts, specialists within our firm, and peer comparisons. The final result of our risk consideration is shown in the table.



A – Loan impairment including forborne loans
B – Recognition of revenue on organic and acquired loans
C – Management override of controls (risk required by ISAs)
D – Valuation of treasury and hedge accounting
E – Going concern risk and longer term viability
F – Risk of fraudulent transactions
G – Recoverability of deferred tax assets
H – Accounting for executive compensation scheme
I – Use of third parties for loan book servicing
J – Valuation of investments in subsidiaries
K – IT environment and effectiveness of general IT controls
L – Legal, compliance and regulatory developments
M – Financial reporting and robustness of reporting processes
N – Disposal of Rochester securitisation vehicle (2016 only)
O – Uncertain economic outlook

- Risks of greater significance – assessed below
- Other financial statement audit risks
- Significant risk as required by the International Standards on Auditing

Consistent with 2016, we are of the view that the recognition of revenue on organic and acquired loans and loan impairment carry the greatest significance. As in the prior year, due to the similarity in the underlying principles of revenue recognition on acquired loans, EIR on organic loans and amortisation of the fair value hedge asset, we have continued to assess these as one key audit matter below. As described on pages 74 to 76 these are also areas that have been focused on by the Group's Audit Committee.

Given the proportion of the Group that the Bank comprises, and the fact that the Bank is the main trading entity of the Group, we have considered the Bank and Group significant risk areas to be the same.

Recognition of revenue on organic and acquired loans

(£332.7 million; 2016: £309.5 million)

Refer to pages 75 and 76 (Audit Committee Report), page 113 (accounting policy) and page 124 (financial disclosures).

The risk

Group and Parent
Subjective estimate:
The effective interest rate calculation, which uses relevant interest rates, fees and transaction costs, incorporates assumptions around loan expected lives (driven by estimations of loan repayment profiles). Forecast loan repayment profiles also underpin the amortisation of the fair value hedge asset. In the case of acquired credit impaired mortgages and loans, additional variables such as the purchase price and estimated recoverable values of the loans are also used.

Originated assets
The directors apply judgement in deciding and assessing the expected repayment profiles used to determine the EIR period. The most critical element of judgement in this area is the estimation of the future redemption profiles of the loans, which is informed by product mix and past customer behaviour of when loans are repaid.

Due to the relatively low levels of historical organic lending in comparison to the significant recent growth, the Group has limited information available from which to assess trends in prepayment, redemption and product transfers, resulting in increased subjectivity to these assumptions, as detailed patterns of customer behaviour have not been clearly established from which to estimate future customer behaviour and performance.

Acquired loan portfolios
For the Group's acquired debt portfolio, the risk is that estimated future cash collections are not reflected by actual cash receipts. Estimation of future cash collections requires significant judgement to make assumptions about the value, probability and timing of expected future cash flows for each type of asset class within a portfolio.

For acquired loan portfolios, any change in the repayment profile results in the discount received or premium paid on purchase of the portfolio to be adjusted through a 'catch 'up' adjustment and spread over the revised expected life.

As further portfolios are purchased by the Group, there is a need to assess the consistency and accuracy of the effective interest rate calculations across the individual models.

A number of the acquired portfolios are serviced by third parties, leading to data inputs from a number of sources. This increases the risk that the loan and repayment data used in the model is inaccurate.

Fair value hedge asset
The fair value hedge asset relating to the legacy back book mortgages matched to interest rate swaps prior to their cancellation is being amortised in line with the estimated expected future cash flows at the point of cancellation, driven by the assumed future redemption profile of the mortgages. Where this redemption profile subsequently differs from the expectation at the time of cancellation there is a risk that the amortisation profile may not be correctly adjusted to reflect this change.

Our response

For organic loans our procedures included:

- **Methodology implementation:** We tested the consistency of methodology and application across the loan portfolios owned by the Group;
- **Test of details:** We tested the accuracy of data inputs from the mortgage systems into the effective interest rate models, including interest rates and product lives;
- We compared the observed repayment profiles of loans originated by the Bank to the assumed repayment profiles and assessed the quantitative impact of variations noted;
- **Sensitivity analysis:** We performed stress testing analysis on the assumptions noted above;
- **Independent reperformance:** We checked the mathematical accuracy of models through re-performance of the model calculations, and tested that the effective interest rates used within the monthly interest calculations agreed to the models; and
- **Assessing transparency:** We considered the adequacy of the Group's disclosures in respect of the degree of estimation involved in arriving at the revenue recognised.

In addition, for acquired loans we also performed the following:

- **Historical comparisons:** We performed regression testing to assess any significant deviations from the original forecast cash flows;
- **Assessing forecasts:** We considered whether any 'catch up' adjustments were required on portfolios where the repayment profile actual cash flow experience had differed from that originally predicted. For those loans where catch up adjustments have been recorded, we assessed the appropriateness of the payment assumptions used in the forecast cash flow calculations, by comparing to payment rates previously experienced;
- **Control operations:** We visited each of the servicers for the mortgage books where these were not administered by the Group to test the relevant controls over the recording of loan balances and interest at these entities; and
- **Data capture:** We performed sample testing to assess the accuracy and consistency of the information provided by the servicer companies to the Group and that this was appropriately captured in the models.

We tested the amortisation of the fair value hedge asset through:

- **Assessing forecasts:** We considered whether any 'catch up' adjustments were required to the amortisation where the actual cash flow experience had differed from the repayment profile originally predicted and determined whether the correct amounts had been recognised.

Our results
As a result of our work we found the level of revenue recognised to be acceptable (2016: acceptable)

Loan impairment

(£21.6 million; 2016: £25.0 million)

Refer to pages 74 and 75 (Audit Committee Report), pages 115 and 116 (accounting policy) and pages 134 and 135 (financial disclosures).

The risk

Group and Parent
Subjective estimate:
This is a key judgemental area due to the level of subjectivity inherent in estimating the recoverability of loan balances, compounded by the fact that lower levels of lending historically have provided the Group with limited historical experience to use in predicting the likelihood of loans falling into arrears.

Individual impairment – the Group identifies individual mortgage loan cases for a specific impairment assessment based on the current level of arrears and nature of the loan. The individual impairment requirement for the loan is determined based on estimated future cash flows discounted to present value at the rate inherent in the loan. This is a highly manual process, with a number of data inputs and assumptions including the cost of obtaining and selling the repossessed property, probable sale proceeds and any rental income prior to sale.

Collective impairment – an assessment is performed collectively on all other loans for impairment, with the key assumptions being:

- the probability of an account falling into arrears and subsequently defaulting,
- the market valuations of any collateral provided,
- the emergence period for losses, and
- the estimated time and cost to sell any collateral property repossessed by the Group.

The assumptions noted above differ across the Group's loan portfolios of residential lending (comprising first charge, second charge and shared ownership lending), Buy-To-Let and SME lending, development finance, and personal loans, which reflects the diverse nature of lending performed by the Group and different characteristics of each book.

There is a risk that the overall provision is not reflective of the incurred losses at the end of the period due to changes in customer credit quality resulting in unrepresentative probabilities of default, the period of time assumed that it takes for incurred losses to emerge, or other market factors not sufficiently incorporated into the model, such as house prices. Given the relatively young nature of these loan books, which result in limited historical information, and sensitivity of the impairment assessments to these assumptions, there is increased risk that actual experience may differ from the Group's current expectations.

Our response

For loans assessed for specific impairment, our procedures included:

- **Test of details:** We tested the completeness of the loans identified by the Group as high risk through a consideration of all loans for risk factors such as magnitude, arrears and previous loan restructures;
- We agreed the key data inputs to third party documentation; namely projected selling price and costs to valuation reports, rental income to tenancy agreements and discount rates to the interest rate of the loan;
- **Sensitivity analysis:** We stress tested the collateral valuations, time to sale and discount rates to assess the sensitivity of the provision to these assumptions; and
- **Independent reperformance:** We re-performed the impairment provision calculation for a sample of loans, utilising the outcome of our testing of the data inputs and assumptions.

For loans assessed collectively for impairment:

- **Methodology choice:** We assessed the methodology used by the Group to calculate the propensity of accounts with different arrears profiles to fall into and out of default, and considered the consistency of the probabilities of default and the emergence periods with the limited historical internal data available;
- **Test of detail:** We agreed the data inputs in the model to the mortgage data system and third party reports;
- **Our sector experience:** We critically assessed the assumptions inherent in the model against our understanding of the different loan portfolios across the Group, their recent performance and industry developments;
- **Independent reperformance:** We recalculated the probability of default rates based on the Group's actual historical experience. We also re-performed the collective impairment model calculations based on the outcome of the testing of key assumptions to assess the overall validity of the assumptions used in the collective impairment assessment;
- **Sensitivity analysis:** We stress tested the collateral valuations, forced sales discount, and time and costs to sell the collateral (being the expected recovery on sale of the property) to assess the sensitivity of the impairment provision to these assumptions;
- **Historical comparisons:** We considered the accuracy of previous estimates of the collective provision against the current book arrears profile and losses incurred in the year;

Loan impairment (continued)

The risk

Increased lending in recent years has been at a time of historically low interest rates, which may distort customer behaviour and loss experience data for use in future assumptions, particularly if interest rates were to increase in coming years.

The Group implements a number of forbearance procedures on selected loans in arrears, such as restructuring of a loan or capitalisation of arrears balances. As this is a manual process, there is the risk that these measures are not appropriately taken into consideration when calculating the required provisions, as the apparent improvement in the arrears on the loans could result in a lower impairment provision if the loans are not identified as forborne.

Data capture:
The collective impairment model uses a combination of static (e.g. original collateral valuations) and dynamic data (e.g. current balances and interest rates) about the Group's loans as well as from external sources (e.g. house price index tables to derive indexed collateral valuations).

Owing to the majority of the acquired portfolios being serviced by third parties, the collective provision calculation requires data inputs from a number of different sources, increasing the risk that data included in the models is inaccurate.

Our response

For all loans:

- **Control operations:** We tested the design, implementation and operating effectiveness of key controls over the monitoring and reporting of loans and advances to customers;
- **Benchmarking assumptions:** We compared the provision coverage rates and the Group's assumptions such as forced sale discounts, emergence period and costs to sell collateral rates against other similar institutions to assess both the level of the impairment provision in comparison to industry norms and the continuing appropriateness of the assumptions used;
- **Assessing application:** We monitored credit trends in the portfolio over the year, to assess whether emerging trends are reflected in the provision level;
- **Methodology implementation:** We checked that forbearance activity is accurately reflected in the impairment provision calculation by checking that for each forborne loan, the uplift to the propensity to default assumption in the collective impairment assessment was appropriately applied;
- **Assessing transparency:** We assessed the adequacy of the Group disclosures in relation to the degree of estimation involved in arriving at the provisions;
- **Data comparison:** We checked a sample of the internal data and the data totals used in the models back to the Group's underlying source systems. We also checked the external inputs used by the Group such as house price indices to external sources;
- **Control operations:** We visited each of the servicers for the mortgage books where these were not administered by the Group to test the relevant controls over the recording of loan balances and arrears status of loans at these entities; and
- **Data capture:** We performed sample testing to assess the accuracy and consistency of the information provided by the servicer companies to the Group.

Our results

- We found the resulting estimate of the provision for loan impairment to be acceptable (2016: acceptable).

3. Our application of materiality and an overview of the scope of our audit

Materiality

Materiality for the group financial statements as a whole was set at £6.4 million, determined with reference to a benchmark of group profit before tax, of which it represents 4% (2016: 4% of profit before tax adjusted to remove the exceptional profit on disposal of Rochester Financing No1 plc).

Materiality for the parent company financial statements as a whole was set at £4.8m, determined with reference to a benchmark of company profit before tax, of which it represents 4%. This figure represents 3% of Group profit before tax.

We agreed to report to the Audit Committee any corrected or uncorrected identified misstatements exceeding £0.3m, in addition to other identified misstatements that warranted reporting on qualitative grounds.

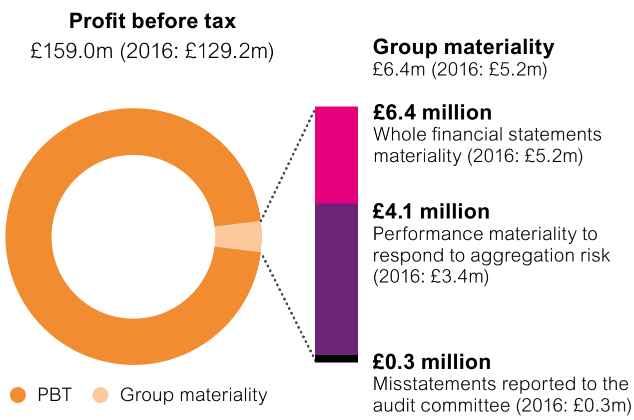
Scope – Group

In 2017, as in 2016, the Group audit team performed the audit of the Group as if it was a single aggregated set of financial information, completing testing over the Interbay, Prestige and OSBIndia components, and visiting the Prestige and Interbay client offices. The audit was performed using the materiality level set out above and covered 100% of total Group revenue, Group profit before tax, and total Group assets.

Scope – disclosure of IFRS 9 effect

The Group is adopting IFRS 9 Financial Instruments from 1 January 2018 and have included an estimate of the financial impact of the change in accounting standard in accordance with IAS 8 Changes in Accounting Estimates and Errors as set out in note 1. While further testing of the financial impact will be performed as part of our 2018 year end audit, we have performed sufficient audit procedures for the purposes of assessing the disclosures made in accordance with IAS 8. We spent considerable time assessing the key areas of judgement inherent in the IFRS 9 transition which supports our assessment of the appropriateness of the disclosure but also supports our 2018 year end audit. Specifically we have:

- Considered the appropriateness of key technical decisions, judgements, assumptions and elections made by management
- Considered key Classification and Measurement decisions, including Business Model Assessments and Solely Payment of Principal and Interest (SPPI) outcomes
- Risk rated key credit models to determine our level of work and considered credit risk modelling decisions and macroeconomic variables, including forward economic guidance and generation of multiple economic scenarios
- Considered key data flows, transitional controls and governance processes related to the approval of the estimated transitional impact.



4. We have nothing to report on going concern

We are required to report to you if:

- we have anything material to add or draw attention to in relation to the Directors' statement in note 1 to the financial statements on the use of the going concern basis of accounting with no material uncertainties that may cast significant doubt over the Group and Company's use of that basis for a period of at least 12 months from the date of approval of the financial statements; or
- the related statement under the Listing Rules set out on page 97 is materially inconsistent with our audit knowledge.

We have nothing to report in these respects.

5. We have nothing to report on the other information in the Annual Report

The directors are responsible for the other information presented in the Annual Report together with the financial statements. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except as explicitly stated below, any form of assurance conclusion thereon.

Our responsibility is to read the other information and, in doing so, consider whether, based on our financial statements audit work, the information therein is materially misstated or inconsistent with the financial statements or our audit knowledge. Based solely on that work we have not identified material misstatements in the other information.

Strategic report and Directors' report

Based solely on our work on the other information:

- We have not identified material misstatements in the strategic report and the Directors' report;
- In our opinion, the information given in those reports for the financial year is consistent with the financial statements; and
- In our opinion, those reports have been prepared in accordance with the Companies Act 2006.

Directors' remuneration report

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

Disclosures of principal risks and longer-term viability

Based on the knowledge we acquired during our financial statements audit, we have nothing material to add or draw attention to in relation to:

- the Directors' confirmation within the viability statement on page 49 that they have carried out a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency and liquidity;
- the Principal Risks and Uncertainties disclosures describing these risks and explaining how they are being managed and mitigated; and
- the Directors' explanation in the viability statement of how they have assessed the prospects of the Group, over what period they have done so and why they considered that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group 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.

Under the Listing Rules, we are required to review the viability statement. We have nothing to report in this respect.

Corporate governance disclosures

We are required to report to you if:

- we have identified material inconsistencies between the knowledge we acquired during our financial statements audit and the Directors' statement that they consider that the Annual Report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's position and performance, business model and strategy; or
- the section of the Annual Report describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee.

We are required to report to you if the Corporate Governance Report does not properly disclose a departure from the 11 provisions of the UK Corporate Governance Code specified by the Listing Rules for our review.

We have nothing to report in these respects.

6. We have nothing to report on the other matters on which we are required to report by exception

Under the Companies Act 2006, we are required 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 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.

We have nothing to report in these respects.

7. Respective responsibilities

Directors' responsibilities

As explained more fully in their statement set out on page 98, the Directors are responsible for: the preparation of the financial statements including being satisfied that they give a true and fair view; such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; 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 they 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

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud, other irregularities, or error, and to issue our opinion in an auditor's report. Reasonable assurance is a high level of assurance, but does not guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud, other irregularities or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. The risk of not detecting a material misstatement resulting from fraud or other irregularities is higher than for one resulting from error, as they may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control and may involve any area of law and regulation not just those directly affecting the financial statements.

A fuller description of our responsibilities is provided on the FRC's website at www.frc.org.uk/auditorsresponsibilities

Irregularities – ability to detect

We identified areas of laws and regulations that could reasonably be expected to have a material effect on the financial statements from our sector experience, through discussion with the Directors and other management (as required by auditing standards), and from inspection of the Group's regulatory and legal correspondence.

We had regard to laws and regulations in areas that directly affect the financial statements including financial reporting (including related company legislation) and taxation legislation. We considered the extent of compliance with those laws and regulations as part of our procedures on the related annual accounts items.

In addition, we considered the impact of laws and regulations in the specific areas of regulatory capital and liquidity and certain aspects of company legislation recognising the financial and regulated nature of the Group's activities and its legal form. With the exception of any known or possible non-compliance, and as required by auditing standards, our work in respect of these was limited to enquiry of the Directors and other management and inspection of regulatory and legal correspondence. We considered the effect of any known or possible non-compliance in these areas as part of our procedures on the related annual accounts items.

We communicated identified laws and regulations throughout our team and remained alert to any indications of non-compliance throughout the audit.

As with any audit, there remained a higher risk of non-detection of irregularities, as these may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal controls.

8. The purpose of our audit work and to whom we owe our responsibilities

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.

Pamela McIntyre (Senior Statutory Auditor)
for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants
15 Canada Square
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E14 5GL

15 March 2018

KPMG