Operating and financial review

OneSavings Bank
Group overview

OneSavings Bank delivered another year of strong performance in 2017 which reflects the continued successful delivery of our strategy to:

- be a leading specialist lender in our chosen sub-sectors
- retain our focus on bespoke underwriting
- further deepen our relationships and reputation for delivery with the intermediaries who distribute our mortgage products
- leverage our efficient, scalable and cost-effective operating model, and
- maintain and build on our stable retail savings franchise.

Business highlights

2017 was another year of exceptional performance underpinned by organic originations of £2.6bn at attractive margins, strong risk management and cost-efficiency and discipline.

Net loans and advances grew by 23% in 2017 to £7.3bn. The growth was due primarily to an increase in new lending in the Buy-to-Let sub-segment, as the market became increasingly focused on our core audience of professional landlords. Regulatory change, introducing more complex underwriting standards to the Buy-to-Let industry in 2017, has driven additional business flow to specialist lenders resulting in growth in our market share. This growth was achieved whilst improving the Group's CET1 ratio to 13.7% from 13.3% in 2016, demonstrating the strength of the capital generation capability of the business through profitability. The Group's capital position was further strengthened in May 2017 by the issuance of £60m of Additional Tier 1 capital securities ('AT1 securities'), with the total capital ratio strengthening to 16.9% from 15.1% in 2016 and the leverage ratio also increasing to 6% from 5.5%. The successful issuance of AT1 securities highlights OSB's strong balance sheet and attractive investment proposition to debt investors.

The Group remains focused on organic origination as its core growth strategy and gross new organic lending of £2.6bn in 2017 was up 14% compared with £2.3bn in 2016. OSB continued to experience high demand for its products during 2017, particularly in Buy-to-Let where the Group targets professional landlords with larger portfolios. Buy-to-Let/SME is the Group's largest segment comprising 77% of the gross loan book with Residential Mortgages at 23% as at 31 December 2017. New organic originations in our residential book decreased, which, combined with redemptions in the back book and acquired mortgages in run-off contributed to the first charge gross loan book reducing to £1,240.6m from £1,322.1m in 2016.

The Bank made no portfolio acquisitions during 2017 (2016: portfolios of first and second charge residential mortgages for £180.7m). However, we continue to evaluate selective inorganic opportunities that provide long-term value and meet our strategic objectives when they arise. The Group conducts extensive due diligence when considering any portfolio acquisitions and in 2017, market pricing for deals under consideration did not meet the Group's stringent return conditions.

For all our lending segments, we manually underwrite all risks, providing us with a competitive advantage over more automated lenders, as we are able to identify and understand complex cases that others cannot. The weighted average LTV of the mortgage book remained low at 64% at the end of 2017, with an average LTV of 69% on new origination during the year, reflecting the strength of our balance sheet. Both the loan loss ratio and portfolio arrears rate improved in the year to 7bps and 1.2% respectively (2016: 16bps and 1.4% respectively), further demonstrating our disciplined underwriting and lending criteria. We also have limited exposure to high value properties, with only 4% of our total loan book secured on properties valued at greater than £2m and with an LTV above 65%.

The broker-led Choices mortgage product transfer scheme that we introduced in 2016 has encouraged greater levels of retention among those borrowers reaching the end of their initial product term. Since the implementation of the scheme in mid-2016, we have seen a consistently strong proportion of our borrowers choose a new product within three months of their initial product ending, at around 60% by December 2017. This is driven by success in switching borrowers who were otherwise remaining on standard variable rate ('SVR') and who, by definition, were therefore in the market for other lenders.

The Bank continued to offer secured funding lines to non-bank lenders, however kept a cautious approach in light of macroeconomic uncertainty. Total credit approved limits as at 31 December 2017 were £336.6m with total loans outstanding of £122.1m (31 December 2016: £330.2m and £122.3m respectively). During the year, two new funding lines in the Buy-to-Let/SME segment were extended.

The Group remained predominantly retail funded during the year with a loan to deposit ratio of 92%[1] as at 31 December 2017 (2016: 90%[1]).

Our customer-centric strategy of providing transparent savings products which offer long-term value for money continued to deliver high levels of customer satisfaction and loyalty during the year. Our customer NPS increased to +62 for 2017 and the maturing fixed term bond and ISA balance retention rate remained strong at 90% (2016: +59 and 87% respectively). Retail deposits were up 12% to £6.7bn as at 31 December 2017.

The business savings account, which was introduced in 2016, had a successful year with total deposits constituting just over 1% of the entire savings book, or £69.5m as at 31 December 2017.

Whilst remaining committed to our retail savings franchise, throughout 2017 we complemented it as a funding source by taking advantage of the government funding schemes: Term Funding Scheme ('TFS') and Funding for Lending Scheme ('FLS'). By the end of 2017, the Bank had completed its planned transition out of the FLS into the TFS and as at 31 December 2017, TFS drawdowns stood at £1,250.0m (31 December 2016: TFS at £101.0m and FLS £524.6m). Total funding through the schemes increased by £624.4m in the year.

Financial overview

The Group reported strong profit growth in 2017. Statutory profit before taxation of £167.7m was 3% higher than in 2016 (2016: £163.1m) despite the £24.9m net gain on exceptional items in the prior year. On an underlying basis, profit before taxation increased by 21% to £167.7m (2016: restated £138.2m[2]). This significant improvement in underlying profitability reflects the strength of our lending and funding franchises and our efficient operating model. Statutory and underlying basic earnings per share ('EPS') strengthened to 51.1p (2016: 49.4p and 41.7p respectively).

Our focus on cost discipline and efficiency continued throughout 2017, helping to deliver a very strong cost to income ratio of 27% (2016: 27%[2]) despite increased investment in the business and in meeting the growing cost of regulation.

Return on equity remained strong at 28% (2016: 29%) despite our strengthened capital position.

The Board is recommending a final dividend of 9.3 pence per share, which together with the interim dividend of 3.5 pence per share, represents 25% of underlying profit after taxation attributable to ordinary shareholders for the year, in line with the Bank's stated dividend policy.

1. Excluding the impact of TFS/FLS drawdowns. The unadjusted ratio was 109% as at 31 December 2017 (2016: 100%).
2. 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.

Operating and financial review continued

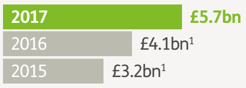
Buy-to-Let/SME

Gross loan book

£5,654.1m

+38%

2016: restated £4,104.3m[1]

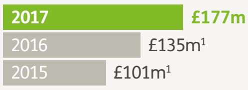


Net interest income

£177.1m

+31%

2016: restated £135.2m[1]

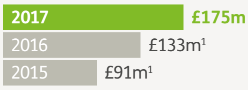


Contribution to profit

£174.8m

+32%

2016: restated £132.9m[1]



This segment comprises Buy-to-Let mortgages secured on residential property held for investment purposes by experienced and professional landlords, commercial mortgages secured on commercial and semi-commercial properties held for investment purposes or for owner occupation, bridge finance, residential development finance to small and medium sized developers and secured funding lines to other lenders.

Buy-to-Let/SME sub-segments: gross loans

	Group 31-Dec-2017 £m	Group 31-Dec-2016 £m
Buy-to-Let	**5,033.8**	3,613.3
Commercial	**370.8**	268.3
Residential development	**143.9**	141.6
Funding lines	**104.5**	71.7
Personal loans[1]	**1.1**	9.4
Total	**5,654.1**	4,104.3

The Buy-to-Let market contracted during the year in response to tax and regulatory changes, which led to increased withdrawal of the amateur landlord from the private rented sector. According to UK Finance, Buy-to-Let gross advances in 2017 fell by 12% to £35.8bn[2] (2016: £40.6bn) with the decrease also reflecting the spike in lending recorded in March 2016 ahead of the Stamp Duty Land Tax ('SDLT') change. Even though the overall Buy-to-Let market shrank in 2017, the demand from professional landlords with larger portfolios continued its momentum, leading to strong growth in our market share over the year from c.4% of new Buy-to-Let mortgages in 2016 to c.6% in 2017. Professional/multi-property landlords accounted for 80% of completions for OSB by value during 2017, up from 75% in 2016.

The Group significantly increased its volume of new organic lending in this segment in 2017 to £2.4bn, an increase of 23% on 2016 new organic lending of £1.9bn. This included a significant increase in the Buy-to-Let and Commercial sub-segments lending through the Kent Reliance and InterBay brands. We continued to see strong growth opportunities, particularly in Buy-to-Let with gross loans of £5,033.8m at 31 December 2017 (2016: £3,613.3m), weighted average LTV of 69% and average loan size of c.£250,000.

A significant proportion of the Buy-to-Let market comes from refinancing. OSB's Buy-to-Let refinancing percentage was 60% during 2017, up from 58% in 2016.

From 1 October 2017, more comprehensive underwriting rules, including affordability assessment for multi-property landlords, came into effect. We have always assessed affordability for borrowers through our specialist underwriting model and apply stringent stress tests. Our weighted average interest coverage ratio ('ICR') for Buy-to-Let origination during 2017 increased to 185% (2016: 171%). The new underwriting rules and an expectation of further interest rate rises also caused a shift in the demand amongst our professional landlords towards five-year fixed rate products, which accounted for c.43% of Buy-to-Let completions in 2017.

In addition, to aid brokers in complying with the new underwriting rules, OSB partnered with a technology provider to develop a bespoke tool for assessing the health of a landlord's overall property portfolio, the first of its kind in the market.

Recent tax changes also had an impact on how borrowers structure their portfolios. In 2016, we saw a clear trend for borrowers to form limited companies in order to mitigate reductions in yield resulting from changes to personal taxation, and in 2017 OSB saw an increase in applications from limited companies for our main Buy-to-Let brand Kent Reliance, from 42% in 2016 to 69% in 2017.

We invested in sales capability across all of our lending brands and attracted new talent from large lenders during the year.

Through the Kent Reliance and InterBay brands, the Bank distributes via intermediaries throughout England and Wales with a bias towards properties in London and the South East, where the demand-supply gap is widest and most sustainable. We have further extended the geographical coverage of our business through investment in the intermediary sales team, ensuring we are seeing appropriate opportunities in other regions.

We have grown our commercial lending with a gross value of the portfolio at £370.8m as at 31 December 2017 (2016: £268.3m), low weighted average LTV of 63% and average loan size of £330,000. In March, we successfully piloted an entry to the bespoke bridging market, again leveraging the Bank's strengths in asset risk assessment and manual underwriting.

The Bank's Heritable Development Finance business provides development finance to smaller residential developers, with a preference for forging relationships with those active outside prime central London. The business continued to grow in spite of new entrants to the market, as customers sought an experienced and cautious lender. However, in line with our prudent approach given macroeconomic uncertainty, the number of potential development schemes which have withstood the business' stringent stress testing has reduced significantly. The residential development funding gross loan book at the end of 2017 was £143.9m, with a further £78.0m committed (31 December 2016: £141.6m and £70.0m respectively). Gross advances during 2017 totalled £123.7m (31 December 2016: £98.4m). Since inception the business has written £479m of loans.

In addition, the Bank continued to grow the provision of secured funding lines it provides to non-bank lenders which operate in certain high-yielding, specialist sub-segments, such as bridging finance and asset finance. Total credit approved limits as at 31 December 2017 were £303.0m with total loans outstanding of £104.5m (31 December 2016: £244.0m and £71.7m respectively). During 2017, two new funding lines were added. The pipeline remains robust, however given the macroeconomic uncertainties, the Bank continues to adopt a cautious approach.

OSB's combined Buy-to-Let/SME net loan book grew by 38% in 2017 to £5,640.9m (2016: restated £4,087.1m[1]) due to the gross new lending in the year, partially offset by back book redemptions, and is the Group's largest segment. Buy-to-Let/SME made a contribution to profit of £174.8m in 2017, up 32% compared to £132.9m[1] in 2016, reflecting the growth in the loan book, and low impairment losses of £0.8m (2016: restated £1.8m[1]).

The Group remains highly focused on the credit quality of new lending as demonstrated by the average LTV in the Buy-to-Let/SME segment as at 31 December 2017 of 69% (31 December 2016: 69%) with only 0.7% of loans exceeding 90% LTV (31 December 2016: 0.4%). The average LTV for new Buy-to-Let/SME origination was 70% (2016: 70%).

1. The personal loan portfolio has largely completed its run-off and is therefore no longer considered as a separate segment by the Group. The remaining net loan book of £0.9m (31 December 2016: £9.1m) and negative contribution to profit for the period of £0.8m (2016: contribution to profit of £2.7m) have been reported in the Buy-to-Let/SME segment with comparatives restated accordingly.
2. UK Finance, New and outstanding buy-to-let new mortgages, 2 Feb 2018.

YEAR ENDED 31-DEC-2017	BTL/SME £m	Residential mortgages £m	Total £m
BALANCES AT THE REPORTING DATE			
Gross loans and advances to customers	**5,654.1**	**1,673.5**	**7,327.6**
Provision for impairment losses on loans and advances	**(13.2)**	**(8.4)**	**(21.6)**
Loans and advances to customers	**5,640.9**	**1,665.1**	**7,306.0**
Risk weighted assets	**2,642.8**	**705.7**	**3,348.5**
PROFIT OR LOSS FOR THE YEAR			
Net interest income	**177.1**	**68.3**	**245.4**
Other income/(expense)	**(1.5)**	**(5.8)**	**(7.3)**
Total income	**175.6**	**62.5**	**238.1**
Impairment (losses)/gains	**(0.8)**	**(3.6)**	**(4.4)**
Contribution to profit	**174.8**	**58.9**	**233.7**

YEAR ENDED 31-DEC-2016	Restated[1] BTL/SME £m	Residential mortgages £m	Total £m
BALANCES AT THE REPORTING DATE			
Gross loans and advances to customers	4,104.3	1,859.9	5,964.2
Provision for impairment losses on loans and advances	(17.2)	(7.8)	(25.0)
Loans and advances to customers	4,087.1	1,852.1	5,939.2
Risk weighted assets	1,944.3	798.7	2,743.0
PROFIT OR LOSS FOR THE YEAR			
Net interest income	135.2	71.4	206.6
Other income / (expense)	(0.5)	(4.7)	(5.2)
Total income	134.7	66.7	201.4
Impairment losses	(1.8)	(7.2)	(9.0)
Contribution to profit	132.9	59.5	192.4

Operating and financial review continued

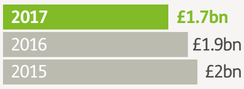
Residential mortgages

Gross loan book

£1,673.5m

-10%

2016: £1,859.9m

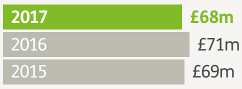


Net interest income

£68.3m

-4%

2016: £71.4m

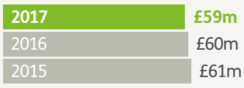


Contribution to profit

£58.9m

-1%

2016: £59.5m



This segment comprises lending to owner occupiers, secured via either first or second charges against the residential home. The Bank provides funding lines to non-bank lenders who operate in high-yielding, specialist sub-segments such as residential bridge finance.

Residential sub-segments: gross loans

	Group 31-Dec-2017 £m	Group 31-Dec-2016 £m
First charge	**1,240.6**	1,322.1
Second charge	**415.3**	487.2
Funding lines	**17.6**	50.6
Total	**1,673.5**	1,859.9

During the year, the Group organically originated residential lending of £243.9m (2016: £382.1m). We saw a significant reduction in originations in the residential sector in 2017. This contributed to the first charge gross loan book reducing to £1,240.6m from £1,322.1m in 2016, with new organic lending more than offset by redemptions in the back book and acquired mortgages in run-off.

Organic lending remains the Group's core strategy, however we continue to actively consider inorganic opportunities as they arise, particularly where we have in-house servicing expertise. However, in 2017, the Group made no acquisitions of portfolios due to market pricing not meeting our return hurdles (2016: portfolios of first and second charge mortgages for £180.7m).

Our Kent Reliance brand provides bespoke first charge mortgages, typically to prime credit quality borrowers with more complex circumstances, for example high net worth borrowers with multiple income sources and self-employed borrowers. These circumstances often preclude them from the mainstream market, where most lenders favour automated decision making over manual underwriting.

Kent Reliance also operates in the shared ownership market, where borrowers buy a property in conjunction with a housing association.

Our second charge mortgage brand, Prestige Finance, provides secured finance to good credit quality borrowers who are seeking a loan to raise funds rather than refinancing their first charge mortgage. Competitive pressure in the second charge market caused price reductions and we allowed our market share to fall to ensure we continue to appropriately price for risk. The second charge residential loan book had a gross value as at 31 December 2017 of £415.3m (2016: £487.2m).

OSB continued to provide secured funding lines to non-bank lenders which operate in certain high-yielding, specialist sub-segments, such as residential bridge finance. The Bank continued its cautious approach in the more cyclical businesses given macroeconomic uncertainty. Total credit approved limits at 31 December 2017 were £33.6m with total loans outstanding of £17.6m (2016: £86.2m and £50.6m respectively). During 2017, one facility of £34.4m matured.

Innovative solutions

As the Bank has grown, we have continued to seek innovative solutions to help maintain our market leading efficiency. The finance team is a great example. We provide a 'one finance team' approach across locations in the UK and India, utilising the strengths that each site provides. We have further realised opportunities with an increasing amount of the financial reporting preparation work undertaken by OSBIndia.

We know that it is important for everyone to feel part of the team. So, as well as regular calls and virtual meetings, members of the Bangalore based team come to Chatham for specific projects such as the Annual Report, to work directly with their colleagues in head office. It bonds the finance team and helps build relationships with other functions across the Group.

The understanding formed by these visits makes sure we have a joined up team, and deliver the true efficiencies from working together.

PREETAM NANDA
FINANCIAL REPORTING ASSISTANT MANAGER

Market leading efficiency

OSB's total residential loan portfolio had a net carrying value of £1,665.1m as at 31 December 2017 (2016: £1,852.1m). The average LTV remained low at 56% (2016: 58%) with only 3% of loans by value with LTVs exceeding 90% (2016: 3%). The average LTV of new residential origination during 2017 was 65% (2016: 66%).

Residential mortgages made a contribution to Group profit of £58.9m in 2017, down 1% (2016: £59.5m), reflecting the fall in the loan book, partially offset by the benefit of lower cost of funds and impairment losses. Impairment losses in 2016 included the impact of additional prudence in collectively assessed provision assumptions following the EU referendum result.