Principal risks and uncertainties

The Board has carried out a robust assessment of the principal risks and uncertainties facing the Group, including those that could threaten its strategic objectives, business operating model, future financial performance and regulatory compliance commitments. The principal risks and uncertainties are outlined in the table below:

Strategic and business risk

Definition – The risk to the Bank's earnings and profitability arising from its strategic decisions, change in the business conditions, improper implementation of decisions or lack of responsiveness to industry changes.

Risk appetite statement	Risk	Mitigation	Direction
The Group's strategic and business risk appetite states that the Group does not intend to undertake any long to medium-term strategic actions that would put at risk its vision of being a leading specialist lender, backed by a strong and dependable saving franchise. The Group adopts a long-term sustainable business model which, while focused on niche sub-sectors, is capable of adapting to growth objectives and external developments.	**Performance against targets** Performance against strategic and business targets does not meet stakeholder expectations. This has the potential to damage the Group's franchise value and reputation.	Regular monitoring by the Board and the Executive Committee of business and financial performance against strategic agenda and risk appetite. The balanced business scorecard is the primary mechanism to support the Board and assesses management performance against key targets. Use of stress testing to flex core business planning assumptions to assess potential performance under stressed operating conditions.	**Increased** The Group's strategic and business operating environments are subject to ongoing changes primarily driven by market competition, economic outlook and regulation.
	Regulatory and economic environment The regulatory and economic environment are important factors impacting the strategic and business risk profile. In particular, the emerging regulatory underwriting standards and tax changes impacting the Buy-to-Let sector have resulted in a general slowdown in the sector.	The Group's robust underwriting standards and its focus on professional landlords have helped mitigate the impact of the regulatory changes and enabled to Group to continue to grow its share of the sector. The Group has continued to utilise and enhance its stress testing capabilities to assess and minimise potential areas of macroeconomic vulnerabilities.	**Increased** The Group's strategic and business risk profile is impacted by the uncertainty surrounding Brexit negotiations and potential future changes to regulatory standards.
	Term Funding Scheme withdrawal The withdrawal of the Term Funding Scheme ('TFS') could potentially increase competition for retail and wholesale savings resulting in increased funding costs. In particular, there is an increased level of risk related to the refinancing of the TFS drawdowns in 4 years time.	The Group's funding plan ensures a diverse funding profile and initiatives have been put in place to replace TFS with a comprehensive Retail Mortgage Backed Securities ('RMBS') programme.	**Increased** The full impact of the TFS withdrawal remains uncertain.
	Regulatory requirements The potential for emerging regulatory requirements to increase the demands on the Group's operational capacity and increase the cost of compliance.	The Group continues to invest in its IT and data management capabilities to increase the ability to respond to regulatory change. A structured approach to change management and fully leveraging internal and external expertise allows the Group to respond effectively to regulatory change.	**Increased** Performance against strategic and business targets does not meet stakeholder expectations. This has the potential to damage the Group's franchise value and reputation.

Reputational risk

Definition – The potential risk of adverse effects that can arise from the Bank's reputation being sullied due to factors such as unethical practices, adverse regulatory actions, customer dissatisfaction and complaints or negative/adverse publicity. Reputational risk can arise from a variety of sources and is a second order risk – the crystallisation of a credit risk or operational risk can lead to a reputational risk impact.

Risk appetite statement	Risk	Mitigation	Direction
The Group does not knowingly conduct business or organise its operations to put its reputation and franchise value at risk.	Potential loss of trust and confidence that our stakeholders place in us as a responsible and fair provider of financial services.	Culture and commitment to treating customers fairly and being open and transparent in communication with key stakeholders. Established processes to proactively identify and manage potential sources of reputational risk.	**Unchanged** The Group has increased the size and capabilities of its Risk and Compliance function to ensure appropriate oversight and challenge to how the Group discharges its responsibilities to the various stakeholders.

Principal risks and uncertainties continued

Credit risk

Definition – Potential for loss due to the failure of counterparty to meet its contractual obligation to repay a debt in accordance with the agreed terms.

Risk appetite statement	Risk	Mitigation	Direction
The Group seeks to maintain a high quality lending portfolio that generates adequate returns, under normal and stressed periods. The portfolio is actively managed to operate within set criteria and limits based on profit volatility, focusing on key sectors, recoverable values, and affordability and exposure levels. The Group aims to continue to generate sufficient income and control credit losses to a level such that it remains profitable even when subjected to a credit portfolio stress of a 1 in 20 intensity stress scenario.	**Individual borrower defaults** Borrowers may encounter idiosyncratic problems in repaying their loans, for example loss of a job or execution problems with a development project. While most of the Bank's lending is secured, some borrowers may fail to maintain the value of the security.	All loans are extended only after thorough bespoke and expert underwriting to ensure ability and propensity of borrowers to repay and sufficient security in case of default. Should there be problems with a loan, the collections and recoveries team works with customers unable to meet their loan service obligations to reach a satisfactory conclusion while adhering to the principle of treating customers fairly. Our strategic focus on lending to professional landlords means that properties are likely to be well managed, with income from a diversified portfolio mitigating the impact of rental voids or maintenance costs. Lending to owner-occupiers is subject to a detailed affordability assessment, including the borrower's ability to continue payments if interest rates increase. Lending on commercial property is more based on security, and is scrutinised by the Group's independent Real Estate team as well as by external valuers. Development lending is extended only after a deep investigation of the borrower's track record and stress testing the economics of the specific project. The Group's Transactional Credit Committee actively reviews and approves larger or more complex mortgage applications.	**Unchanged** The Group continues to observe strong and stable credit profile performance.
	Macroeconomic downturn A broad deterioration in the economy would adversely impact both the ability of borrowers to repay loans and the value of the Group's security. Credit losses would impact across the lending portfolio, so even if individual impacts were to be small, the aggregate impact on the Group could be significant.	The Group works within portfolio limits on LTV, affordability, name, sector and geographic concentration that are approved by the Risk Committee and the Board. These are reviewed on a semi-annual basis. In addition, stress testing is performed to ensure that the Group maintains sufficient capital to absorb losses in an economic downturn and continue to meet its regulatory requirements.	**Unchanged** Although the UK economy has remained stable during 2017, the economic outlook is uncertain with the final terms of Brexit to be confirmed.
	Wholesale credit risk The Bank has wholesale exposures both through call accounts used for transactional and liquidity purposes and through derivative exposures used for hedging.	The Group transacts only with high quality wholesale counterparties. Derivative exposures include collateral agreements to mitigate credit exposures.	**Unchanged** The Group continues to utilise a reserve account with the Bank of England, enabling it to eliminate credit risk on most of its liquidity portfolio.

Market risk

Definition – Potential loss due to changes in market prices or values.

Risk appetite statement	Risk	Mitigation	Direction
The Group actively manages market risk arising from structural interest rate positions. The Group does not seek to take a significant interest rate position or a directional view on rates and it limits its mismatched and basis risk exposures.	**Interest rate risk** An adverse movement in the overall level of interest rates could lead to a loss in value due to mismatches in the duration of assets and liabilities.	The Group's Treasury department actively hedges to match the timing of cash flows from assets and liabilities.	**Unchanged** The Group continues to assess interest on a monthly basis ensuring that the interest rate risk exposure is limited in the current economic environment.
	Basis risk A divergence in market rates could lead to a loss in value, as assets and liabilities are linked to different rates.	The Group strategically focuses on products linked to administered rates to keep control of yield.	**Unchanged** Product design and hedging has enabled the Group to maintain the overall level of basis risk through the year.

Liquidity and funding risk

Definition – The risk that the Group will be unable to meet its financial obligations as they fall due.

Risk appetite statement	Risk	Mitigation	Direction
The Group actively maintains stable and efficient access to funding and liquidity to support its ongoing operations. It also maintains an appropriate level and quality of liquid asset buffer so as to withstand market and idiosyncratic liquidity-related stresses.	**Retail funding stress** As the Group is primarily funded by retail deposits, a retail run could put it in a position where it could not meet its financial obligations. Increased competition for retail savings driving up funding costs, adversely impacting retention levels and wider damage to OSB franchise.	The Group's funding strategy is focused on a highly stable retail deposit franchise. The large number of depositors provides diversification and a high proportion of balances are covered by the FSCS and so there is no material risk of a retail run. In addition, the Group performs in-depth liquidity stress testing and maintains a liquid asset portfolio sufficient to meet obligations under stress. The Group holds prudential liquidity buffers to manage funding requirements under normal and stressed conditions. The Group proactively manages its savings proposition through both the Liquidity Working Group and the ALCO. Finally, the Group has prepositioned mortgage collateral with the Bank of England which allows it to consider other alternative funding sources to ensure it is not solely reliant on retail savings. The Group's funding plan ensures a diverse funding profile and initiatives have been put in place to replace TFS with a comprehensive Retail Mortgage Backed Securities ('RMBS') programme.	**Increased** The end of the Bank of England Term Funding Scheme ('TFS') may create increased competition for retail and wholesale funding.
	Term Funding Scheme withdrawal The potential impact of the withdrawal of the TFS programme is uncertain.	The Group's funding plan ensures a diverse funding profile and initiatives have been put in place to replace TFS with a comprehensive Retail Mortgage Backed Securities ('RMBS') programme.	**Increased** The end of the Bank of England Term Funding Scheme ('TFS') may create increased competition for retail and wholesale funding.

Principal risks and uncertainties continued

Solvency risk

Definition – The potential inability of the Bank to ensure that it maintains sufficient capital levels for its business strategy and risk profile under both the base and stress case financial forecasts.

Risk appetite statement	Risk	Mitigation	Direction
OSB seeks to ensure that it is able to meet its Board level capital buffer requirements under a 1 in 20 stress scenario. The Group's solvency risk appetite is constrained within the leverage ratio related requirements. We manage our capital resources in a manner which avoids excessive leverage and allows us flexibility in raising capital.	Key risks to solvency arise from balance sheet growth and unexpected losses which can result in the Bank's capital requirements increasing or capital resources being depleted such that it no longer meets the solvency ratios as mandated by the PRA and Board risk appetite. The regulatory capital regime is subject to change and could lead to increases in the level and quality of capital that the Group needs to hold to meet regulatory requirements.	Currently the Bank operates from a strong capital position and has a consistent record of strong profitability. The Bank actively monitors its capital requirements and resources against financial forecasts and plans and undertakes stress testing analysis to subject its solvency ratios to extreme but plausible scenarios. The Bank also holds prudent levels of capital buffers based on CRD IV requirements and expected balance sheet growth. The Group engages actively with regulators, industry bodies, and advisers to keep abreast of potential changes and provide feedback through the consultation process.	**Decreased** The Group has improved both its CET1 capital and total capital position increasing its resilience against unexpected losses. In particular, the Group's capital position was strengthened in May 2017 by the issuance of £60m of Additional Tier 1 securities ('AT1 securities').

Operational risk

Definition – The risk of loss or negative impact to the Group resulting from inadequate or failed internal processes, people, or systems or from external events.

Risk appetite statement	Risk	Mitigation	Direction
The Group's operational processes, systems and controls are designed to minimise disruption to customers, damage to the Bank's reputation and any detrimental impact on financial performance. The Bank actively promotes the continual evolution of its operating environment through the identification, evaluation and mitigation of risks, whilst recognising that the complete elimination of operational risk is not possible.	**Cyber/data security risk** The risk of a loss of customer or proprietary data as a result of theft or through ineffective data management.	A series of tools designed to identify and prevent network/system intrusions are deployed across the Group. The effectiveness of the controls is overseen by a dedicated IT Security Governance Committee, with specialist IT security staff employed by the Bank.	**Increased** Whilst the Bank has made a series of enhancements to its defences with respect to IT security threats during 2017, it recognises that the threats to the industry continue to grow both in respect of the volume and the level of sophistication.
	Data risk The use of inaccurate, incomplete or outdated data may result in a range of risks impacting risk management and reporting services.	The Bank continues to invest in and enhance its data management architecture, systems, governance and controls.	**Increased** The increase in data risk has been primarily driven by the increased scale of operations and the multiple sources from which data is derived.
	Regulatory risk The operational risks arising from the management of a significant volume of regulatory change.	The Bank operates a series of controls to identify any relevant regulatory change at an early stage. Regulatory related changes are appropriately prioritised and resourced in order to ensure the timely implementation of any operational changes required.	**Increased** The increase in regulatory change has to date been offset by the increase in the Bank's change management capacity. Regulatory change continues to be well managed with the appropriate level of focus and oversight.

Operational risk (continued)

Risk appetite statement	Risk	Mitigation	Direction
	Operational and IT resilience Banks should have business resiliency, continuity monitoring and plans in place to ensure an ability to operate on an ongoing basis and limit losses in the event of severe business disruption. Technical failures (including bugs, network or data) resulting in critical system outage. These would include OSB's primary mortgage origination and servicing systems, savings processing system and core reporting and data management systems leading to loss of service, revenue, business performance and potential customer detriment.	The Bank has established an Operational Resilience Programme that is delivering a Group-wide approach in respect to planning and testing. In addition, the programme is designed to highlight any areas of specific vulnerability. A range of back-up technologies employed to provide real-time replication on various critical systems while disaster recovery capabilities are tested annually. Real-time system performance monitoring established and a dedicated testing team in place.	**Increased** The increasing scale and globalisation of operations together with dependencies on a number of third party service and network providers. The sophistication of cyber-crime continues to evolve.
	Operational execution and scalability The inability of the Bank to automate current operational processes at the speed the business requires in order to successfully meet future growth.	In order to mitigate incidents materialising from manual processes an established two-tier (dependent and independent within the first line) risk-based quality control programme is in place.	**Increased** The ongoing growth of the Bank has challenged its automation programmes and resulted in an increase in the number of manual processes. Whilst key manual processes are well managed and there is continuing investment in automation, the challenges presented by the pace of growth remain a key area of management focus.

Conduct risk

Definition – The risk that the Group's behaviours or actions result in customer detriment or negative impact on the integrity of the markets in which it operates.

Risk appetite statement	Risk	Mitigation	Direction
The Bank considers its culture and behaviours in ensuring the fair treatment of customers and in maintaining the integrity of the markets in which it operates a fundamental part of its strategy and a key driver to sustainable profitability and growth. OSB does not tolerate any systemic failure to deliver fair customer outcomes. On an isolated basis incidents can result in detriment owing to human and / or operational failures. Where such incidents occur they are thoroughly investigated, and the appropriate remedial actions are taken to address any customer detriment and to prevent recurrence.	**Product suitability** Whilst the Group originates relatively simple products, there remains a risk that (primarily legacy) products may be deemed to be unfit for their original purpose in line with the current regulatory definitions.	The Group has a strategic commitment to provide simple, customer-focused products. In addition, a Product Governance framework is established to oversee both the origination of new products and to revisit the ongoing suitability of the existing product suite. A dedicated Product Governance team – which is part of an independent Conduct Risk team – serves to effectively manage this risk.	**Decreased** Whilst this risk has further reduced in 2017 as a result of increased awareness and dedicated oversight, the Bank remains aware of the changes to the regulatory environment and their possible impact on product suitability.
	Data protection The risk that customer data is accessed inappropriately either as a consequence of network/system intrusion or through operational errors in the management of the data.	In addition to a series of network/system controls (documented within as part of the operational risks) the Bank performs extensive root cause analysis of any data leaks in order to ensure that the appropriate mitigating actions are taken.	**Unchanged** Despite a number of additional controls being introduced in 2017 the network/system threats continue to evolve in both volume and sophistication.

Principal risks and uncertainties continued

Compliance/regulatory risk

Definition – The risk that a change in legislation or regulation or an interpretation that differs from the Group's will adversely impact the Group.

Risk appetite statement	Risk	Mitigation	Direction
The Group views ongoing conformance with regulatory rules and standards across all the jurisdictions in which it operates as a critical facet of its risk culture. The Group does not knowingly accept compliance risk which could result in regulatory sanctions, financial loss or damage to its reputation. The Group will not tolerate any systemic failure to comply with applicable laws, regulations or codes of conduct relevant given its business operating model.	Key compliance regulatory changes that impacted the Bank included PRA's Buy-to-Let underwriting standards, certification regime under the SM&CR, PSD2, GDPR, Criminal Finances Act, European Fourth Money Laundering Directive, FCA guidance on automatic capitalisation for residential mortgage customers.	The Bank has an effective horizon scanning process to identify regulatory change. All significant regulatory initiatives are managed by structured programmes overseen by the change management team and sponsored at Executive management level. The Bank has proactively sought external expert opinions to support interpretation of the requirements and validation of its response.	**Increased** The Bank has historically responded effectively to regulatory changes however, the level and sophistication of emerging regulation continues to increase.
	Conduct regulation Regulatory changes focused on the conduct of business could force changes in the way the Group carries out business and impose substantial compliance costs. For example, the Financial Policy Committee's increased focus on Buy-to-Let lending or tax changes such as the Bank profits surcharge must be considered.	The Group has a programme of regulatory horizon scanning linking into a formal regulatory change management programme. In addition, the focus on simple products and customer oriented culture means that current practice may not have to change significantly to meet new conduct regulations.	**Increased** The regulatory environment has tightened and this is likely to continue, exposing the Group to increased risk.

The Group proactively scans for emerging risks which may have an impact on its ongoing operations and strategy. The Group considers its top emerging risks to be:

Emerging risks	Description	Mitigation action
Political and macroeconomic uncertainty	As a result of the UK government triggering Article 50 and the subsequent general election result, there is an increased likelihood of a period of macroeconomic uncertainty. The Group's lending activity is solely focused in the United Kingdom and, as such, will be impacted by any risks emerging from changes in the macroeconomic environment.	The Group has implemented robust monitoring processes and via various stress testing activity (i.e. ad hoc, risk appetite and ICAAP) understands how the Group performs over a variety of macroeconomic stress scenarios and has subsequently developed a suite of early warning indicators which are closely monitored to identify changes in the economic environment.
General data usage	From 25 May 2018, the Group will comply with GDPR. This will result in increased regulatory requirements with respect to processing customer and employee personal and other data in the course of day-to-day business activities.	The Group has mobilised a project (with dedicated resources) to implement the GDPR as required.

RISK PROFILE PERFORMANCE OVERVIEW

Credit risk

Credit profile performance

The Group's credit profile performed strongly in 2017, driven by deep market knowledge of the specialist markets in which it operates, prudent lending policies and sound credit risk management.

During the year, the Group's portfolio composition mix continued to evolve with pre-2011 lending (prior to OneSavings Bank PLC being established) continuing to run off. Legacy problem loans reduced further in 2017 from £13.8m to £8.6m, following careful management by our experienced collections team. The Group's acquired portfolios also continued to perform in line with expectations in terms of run-off rates and credit profile performance.

The Group's funding lines and development finance businesses delivered a strong performance in 2017, with no impairment recognised across either segment.

Strong Group originations performance was observed in 2017, driven by performance across the Buy-to-Let/SME segment. Importantly, this lending was underwritten at sensible LTV levels, where tightened underwriting policy, following the United Kingdom's decision to leave the European Union, resulted in a greater clustering of LTV levels against the portfolio average. Post-2011 lending, incorporating enhanced lending criteria, continued to make up an increasing proportion of the Group's total loans and advances to customers, where 38,500 loans have been underwritten with only 137 loans being greater than three months arrears with aggregate loans totalling £18.4m with aggregate weighted average LTV of 63%.

This portfolio mix shift, coupled with strong credit risk management and continuing favourable economic conditions, supported the portfolio arrears rate reducing to 1.2% as at 31 December 2017 excluding legacy problem loans (31 December 2016: 1.4%).

Segment	Measure	31-Dec-2017	31-Dec-2016	Variance	Commentary
BTL/SME	New origination average LTV	**70%**	70%	–	New lending average LTV remained stable
	Weighted average Interest Coverage Ratio for new lending	**185%**	171%	+14%	Resulting from a tightening of affordability rules
Residential lending	New origination average LTV	**65%**	66%	-1%	New lending average LTV reduced
	Percentage of new residential lending with a loan to income (LTI) greater than 4.5	**3.2%**	2.6%	+0.6%	Increase in cases with LTI > 4.5

Other key risk measures also performed strongly within the period:

- Gross exposure to semi-commercial/commercial lending remains low at £370.8m with weighted average LTV of 63%
- Gross exposure to residential development finance remains low at £143.8m with a further £78.0m committed with a weighted average LTV of 37.7%
- The Group has limited exposure to high LTV loans on properties worth more than £2m. In total only 4% of the Group's loan portfolio is secured on properties valued at greater than £2m with a LTV greater than 65%.

Forbearance

Where borrowers experience financial difficulties which impacts their ability to service their financial commitments under the loan agreement, forbearance may be used to achieve an outcome which is mutually beneficial to both the borrower and the Bank.

By identifying borrowers who are experiencing financial difficulties pre-arrears or in arrears, a consultative process is initiated to ascertain the underlying reasons and to establish the best course of action to enable the borrower to develop credible repayment plans and to see them through the period of financial stress.

The specific tools available to assist customers vary by product and the customers' status. The various treatments considered for customers are as follows:

- Temporary switch to interest only: a temporary account change to assist customers through periods of financial difficulty where arrears do not accrue at the original contractual payment. Any arrears existing at the commencement of the arrangement are retained.
- Interest rate reduction: the Group may, in certain circumstances, where the borrower meets the required eligibility criteria, transfer the mortgages to a lower contractual rate. Where this is a formal contractual change the borrower will be requested to obtain independent financial advice as part of the process.
- Loan term extension: a permanent account change for customers in financial distress where the overall term of the mortgage is extended, resulting in a lower contractual monthly payment.
- Payment holiday: a temporary account change to assist customers through periods of financial difficulty where arrears accrue at the original contractual payment. Any arrears existing at the commencement of the arrangement are retained.
- Voluntary assisted sale: a period of time is given to allow borrowers to sell the property and arrears accrue based on the contractual payment.
- Reduced monthly payments: a temporary arrangement for customers in financial distress. For example, a short-term arrangement to pay less that the contractual payment. Arrears continue to accrue based on the contractual payment.

- Capitalisation of interest: arrears are added to the loan balance and are repaid over the remaining term of the facility or at maturity for interest only products. A new payment is calculated which will be higher than the previous payment.
- Full or partial debt forgiveness: where considered appropriate, the Group will consider writing off part of the debt. This may occur where the borrower has an agreed sale and there will be a shortfall in the amount required to redeem the Group's charge, in which case repayment of the shortfall may be agreed over a period of time subject to an affordability assessment or where possession has been taken by the Group, and on the subsequent sale where there has been a shortfall loss.

The Group aims to proactively identify and manage forborne accounts, utilising external credit reference bureau information to analyse probability of default and customer indebtedness trends over time, feeding pre-arrears watch list reports. Watch list cases are in turn carefully monitored and managed as appropriate.

Throughout 2017, the Group continued to observe low levels of accounts in forbearance.

Analysis of forbearance measures undertaken in 2017 by forbearance type:

Forbearance type	**Number of accounts 2017**	**2017 year-end balance £m**	Number of accounts 2016	2016 year-end balance £m (restated)	'17 vs. '16 variance number of accounts	'17 vs. '16 variance of balances £m
Interest only switch	**35**	**3.8**	60	6.3	-25	-2.5
Interest rate reduction	**–**	**–**	3	2.2	-3	-2.2
Term extension	**29**	**4.9**	31	5.9	-2	-1.0
Payment holiday	**50**	**1.5**	37	1.6	13	-0.1
Voluntary assisted sale	**2**	**0.7**	–	–	2	0.7
Payment concession (reduced monthly payments)	**42**	**0.8**	58	3.5	-16	-2.7
Capitalisation	**–**	**–**	3	0.1	-3	-0.1
Total	**158**	**11.7**	**192**	**19.6**	**-34**	**-7.9**

Analysis of forbearance measures undertaken in 2017 by loan type:

Loan type	**Number of accounts 2017**	**2017 year-end balance £m**	Number of accounts 2016	2016 year-end balances £m (restated)	'17 vs. '16 variance number of accounts	'17 vs. '16 variance of balances £m
First charge owner-occupier	**55**	**4.5**	117	12.4	-62	-7.9
Second charge owner-occupier	**77**	**1.6**	60	1.3	17	0.3
Buy-to-Let	**26**	**5.6**	14	5.5	12	0.1
Commercial	**–**	**–**	1	0.4	-1	-0.4
Total	**158**	**11.7**	**192**	**19.6**	**-34**	**-7.9**

Note: The 2016 year end forbearance balances have been restated for second charge owner occupier to remove the related first charge balance, to align to the enhanced approach adopted for 2017.

Fair value of collateral methodology

The Group ensures that security valuations are reviewed on an ongoing basis for accuracy and appropriateness. Commercial properties are subject to annual indexing, whereas residential properties are indexed against monthly house price index ('HPI') data. Where the Group identifies that an index is not representative, a formal review is carried out by the Group Real Estate function to ensure that property valuations remain appropriate.

The Group Real Estate function ensures that newly underwritten lending cases are written to appropriate valuations, where an independent assessment is carried out by an appointed, qualified surveyor accredited by RICS.

Impairment performance

Low arrears, sensible loan to values and growth in loans and advances to customers resulted in the Group observing a historically low impairment performance with a loan loss ratio of 0.07% (31 December 2016: 0.16%). Improved impairment performance was primarily driven by increased prudence 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.

During the year, the Group made no changes to provisioning policy or methodologies utilised, however a number of key inputs and estimates used within the collectively assessed provisioning calculations were refreshed utilising the most recently available data and as per the standard governance process. This drove an increase in impairment provision during the six months from 30 June 2017 to 31 December 2017 of 0.09%, versus the annualised loan loss reported for the period 30 June 2017 of 0.04%.

The Group continues to closely monitor impairment coverage levels:

Impairment coverage review	31 December 2017	31 December 2016
Gross loans and advances to customers £m	**7,327.6**	5,964.2
Provisions for impairment losses £m	**21.6**	25.0
Incurred loss remaining £m[1]	**7.9**	8.4
Coverage ratio versus loans and advances %[2]	**0.40**	0.56
Coverage ratio versus impaired balances %[3]	**36.2**	41.5

1. Incurred loss is the expected loss of the portfolio at the point of acquisition and is offset against the modelled future cash flows to derive the effective interest rate for the book. The incurred loss protection is therefore recognised over the life of the book against the unwind of any purchase discount or premium through interest income. Incurred loss remaining is this protection reduced by the cumulative losses observed since acquisition.
2. Coverage ratio versus loans and advances is the total collective and specific provisions plus incurred losses remaining versus gross loans and advances.
3. Coverage ratio versus impaired balances is the total collective and specific provisions plus incurred losses remaining versus impaired balances. Impaired balances are defined as loans where a specific provision has been raised. Personal loans are not included in impaired balances.

The coverage ratio with respect to loans and advances to customers reduced to 0.40% from 0.56% as at 31 December 2016 driven by strong loans and advances growth. Coverage versus impaired balances remained strong at 36.2%. The reduction in provision balances was primarily driven by the resolution of a number of individually assessed legacy problem loans within the year.

Solvency risk

The Bank has maintained an appropriate level and quality of capital to support its prudential requirements with sufficient contingency to withstand a severe but plausible stress scenario. The solvency risk appetite is based on a stacking approach, whereby the various capital requirements (Pillar 1, ICG, CRD IV buffers and Board and management buffers) are incrementally aggregated as a percentage of available capital (CET1 and total capital).

Solvency risk is a function of balance sheet growth, profitability, access to capital markets and regulatory changes. The Bank actively monitors all key drivers of solvency risk and takes prompt action to maintain its solvency ratios at acceptable levels. The Board and management also assess solvency when reviewing the Bank's business plans and inorganic growth opportunities.

In 2017, the Bank strengthened its CET1 ratio by 0.4% to 13.7% and total capital ratio by 1.8% to 16.9% despite strong organic growth, demonstrating both the strength of internal capital generation capabilities through profitability and the ability to raise additional capital in the market.

Liquidity and funding risk

The Bank has a prudent approach to liquidity management through maintaining sufficient liquidity resources to cover cash flow imbalances and fluctuations in funding under both normal and stressed conditions arising from market-wide and Bank specific events. The Bank's liquidity risk appetite has been calibrated to ensure that the Bank always operates above the minimum prudential requirements with sufficient contingency for unexpected stresses whilst actively minimising the risk of holding excessive liquidity which would adversely impact the financial efficiency of the business model.

The Bank has successfully utilised the Bank of England FLS and TFS secured funding facilities to manage its liquidity throughout 2017, and continues to attract new retail savers and retain existing customers through loyalty-based product offerings.

In 2017 the Bank actively managed its liquidity and funding profile within the confines of its risk appetite as set out in the ILAAP. Its liquidity ratio at 15.2% and liquidity coverage ratio ('LCR') at 250% remain well above risk appetite and regulatory minimums.

Market risk

The Bank proactively manages its risk profile in respect of adverse movements in interest rates, foreign exchange rates and counterparty exposures. The Bank accepts interest rate risk and basis risk as a consequence of structural mismatches between fixed rate mortgage lending, sight and fixed term savings and the maintenance of a portfolio of high quality liquid assets. Interest rate exposure is mitigated on a continuous basis through portfolio diversification, reserve allocation and the use of financial derivatives within limits set by ALCO and approved by the Board.

Interest rate risk

The Bank does not actively assume interest rate risk, does not execute client or speculative securities transactions for its own account, and does not seek to take a significant directional interest rate position. Limits have been set to allow management to run occasional unhedged positions in response to balance sheet dynamics and capital has been allocated for this. Exposure limits are calibrated in accordance with a statistically-derived risk appetite, and are calibrated in proportion to available CET1 capital in order to accommodate balance sheet growth.

The Group sets limits on the tenor and rate reset mismatches between fixed rate assets and liabilities, including derivatives hedges, with exposure and risk appetite assessed with reference to historic and potential stress scenarios cast at consistent levels of modelled severity.

Throughout 2017 the Bank managed its interest rate risk exposure within its risk appetite limits. The Bank has also made significant progress in a project to replace its current interest rate risk management system with a new system allowing greater functionality which will enhance the management of interest rate risk. Implementation of the new system is scheduled to be completed during the first half of 2018.

Basis risk

Basis risk arises from assets and liabilities repricing with reference to different interest rate indices, including positions which reference variable market, policy and managed rates. As with structural interest rate risk, the Bank does not seek to take a significant basis risk position, but maintains defined limits to allow operational flexibility.

As with structural interest rate risk, capital allocation has been set in proportion to Common Equity Tier 1 capital, with exposure assessed and monitored monthly across a range of 'business as usual' and stressed scenarios.

Throughout 2017 the Bank managed its basis risk exposure within its risk appetite limits.

Operational risk

OSB continues to adopt a proactive approach to the management of operational risks. The operational risk management framework has been designed to ensure a robust approach to the identification, measurement and mitigation of operational risks, utilising a combination of both qualitative and quantitative evaluations in order to promote an environment of progressive operational risk management. The Group's operational processes, systems and controls are designed to minimise disruption to customers, damage to the Bank's reputation and any detrimental impact on financial performance. The Bank actively promotes the continual evolution of its operating environment through the identification, evaluation and mitigation of risks, whilst recognising that the complete elimination of operational risk is not possible.

Where risks continue to exist, there are established processes to provide the appropriate levels of governance and oversight, together with an alignment to the level of risk appetite stated by the OSB Board.

A strong culture of transparency and escalation has been cultivated throughout the organisation, with the operational risk function having a Group-wide remit, ensuring a risk management model that is well embedded and consistently applied. In addition, a community of Risk Champions representing each business line and location have been identified. Operational Risk Champions ensure that the operational risk identification and assessment processes are established across the Group in a consistent manner. Risk Champions are provided with appropriate support and training by the Operational Risk function.

Regulatory and compliance risk

The Bank is committed to the highest standards of regulatory conduct and aims to minimise breaches, financial costs and reputational damage associated with non-compliance. However, given the growing scale and complexity of regulatory changes, it is acknowledged that there may be isolated instances whereby the Bank's interpretation and response to new regulatory requirements reflects the Bank's specific circumstances and its desire to give the best customer outcomes.

The Bank has an established Compliance function which actively identifies, assesses and monitors adherence with current regulation and the impact of emerging regulation.

In order to minimise regulatory risk, OSB maintains a proactive relationship with key regulators, engages with industry bodies such as UK Finance, and seeks external advice from our auditors and/or other third parties. The Group also assesses the impact of upstream regulation on OSB and the wider market in which we operate, and undertakes robust assurance assessments from within the Risk and Compliance functions.

Conduct risk

The Bank considers its culture and behaviour in ensuring the fair treatment of customers and in maintaining the integrity of the markets in which it operates to be a fundamental part of its strategy and a key driver to sustainable profitability and growth. OSB does not tolerate any systemic failure to deliver fair customer outcomes.

On an isolated basis, incidents can result in detriment owing to human and/or operational failures. Where such incidents occur they are thoroughly investigated, and the appropriate remedial actions are taken to address any customer detriment and to prevent recurrence.

OSB considers effective conduct risk management to be a product of the positive behaviour of all employees, influenced by the culture throughout the organisation and therefore continues to promote a strong sense of awareness and accountability.

Strategic and business risk

The Board has clearly articulated the Bank's strategic vision and business objectives supported by performance targets. The Bank does not intend to undertake any medium to long-term strategic actions which would put at risk the Bank's vision of being a leading specialist lender in its chosen markets and being backed by a strong and dependable saving franchise.

To deliver against its strategic objectives and business plan, the Bank has adopted a sustainable business model based on a focused approach to core niche markets where its experience and capabilities give it a clear competitive advantage.

The Bank remains highly focused on delivering against its core strategic objectives and strengthening its market position further through strong and sustainable financial performance.

Reputational risk

The Bank considers reputational risk to be a second order risk which is likely to be the result of a failure related to one of its other principal risks. The Bank monitors reputational risk through tracking media coverage, customer satisfaction scores, the share price and net promoter scores provided by brokers.