Risk review

Executive summary

During the year, the Group maintained a low and stable risk profile in line with the Board's risk management objectives. The Group continued to invest in its risk management infrastructure and resources to support the Group's growth objectives and to ensure ongoing compliance with the emerging industry good practice and regulatory standards.

By effectively leveraging its risk management framework, the Group actively managed its risk profile in accordance with the Board approved risk appetite. Through continuous monitoring and assessment of the underlying risk drivers, whilst actively engaging the Board and senior management, the Group took appropriate and timely management actions in the context of the changing economic, business and regulatory environment.

Through taking judicious and considered investment decisions, the Group improved its risk assessment and monitoring capabilities. In particular, the Group focused its risk-based investment to enhance its data governance and controls, upgrading its operational resilience assessment and management framework and delivering improvements to its risk analytical capabilities. The Group also expanded its risk management capacity through the recruitment of specialist risk and compliance resources within its UK and Indian operations.

The Group delivered strong and profitable growth whilst maintaining a low and stable risk profile. The underlying asset quality profile has continued to exhibit very strong performance and has continued to maintain sizeable and high quality buffers against minimum prudential solvency and liquidity requirements.

The underlying asset quality profile and the strength of its financial position helped to position the Group favourably in the context of uncertain economic, political and regulatory conditions. In particular, the Group continues to be mindful of the uncertainty surrounding Brexit negotiations and has leveraged its stress testing capabilities to identify potential points of vulnerability.

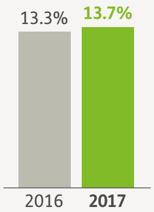
The new regulatory standards relating to Buy-to-Let underwriting and affordability testing represented an important area of focus for the Risk and Compliance functions. The inherent strength of the Group's underwriting procedures and its continued investment in customer data management enabled the Group to respond effectively to the regulatory changes. The Group also continued to improve its funding and liquidity forecasting procedures and has credible plans for when the Bank of England withdraws its Term Funding Scheme.

The other key regulatory developments to which the Group is responding include the General Data Protection Regulation ('GDPR') and Payment Services Directive ('PSD2'). Both these regulatory initiatives are supported by dedicated resources, structured programmes and engagement of external advisors to ensure that the Group complies effectively with the emerging requirements.

The Group continued to maintain a robust and secure IT infrastructure and remains acutely conscious that the level and sophistication of cyber-risk continues to evolve. Dedicated resources, improved detection capabilities and planning have helped the Group to minimise the risk of cyber-attacks.

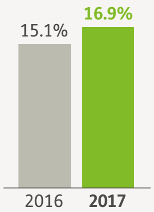
Key risk indicators — Commentary

CET1 ratio



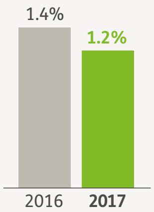
The Group further strengthened its fully-loaded CET1 ratio to 13.7% during 2017 (2016: 13.3%) demonstrating the strong organic capital generation capability of the business to support significant growth.

Total capital ratio



The Group's total capital ratio increased by 1.8% to 16.9% during 2017 driven by the strengthened CET1 ratio and the issuance of £60m of AT1 securities.

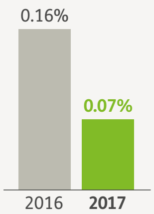
3+ months in arrears*



There was a reduction in the percentage of loans more than three months in arrears during 2017 driven by a strong performance across newly originated loans.

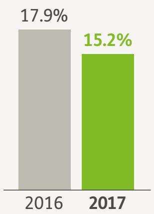
*Note: 3+ months in arrears ratio excludes legacy problem loans.

Cost of risk



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.

Liquidity ratio



The Group's liquidity ratio remained well above regulatory and risk appetite limits in 2017 finishing the year at 15.2%.

The Group managed liquidity levels within its target range in the year and its liquidity coverage ratio was 225% against a regulatory minimum of 90%.

High level key risk indicators
The Group aligns its risk appetite to a select range of key performance indicators that are used to assess the Group's success against strategic, business, operational and regulatory objectives. Actual performance against these indicators is continually assessed and reported. The table above outlines the comparative analysis of the leading risk indicators with supporting commentary.

Key achievements in 2017
The Group further enhanced and integrated its Strategic Risk Management Framework ('SRMF') to inform, guide and support business and strategic decision making. The Group generated shareholder value through the optimisation of its risk and reward profile within the constraints of its risk appetite.

The Group's approach to setting its risk appetite was enhanced through the use of improved borrower and loan level risk assessment, greater alignment with the financial planning process and the use of stress testing. The Board actively guided the process of setting risk appetite, ensuring that the risk appetite is fully reflective of the Board's attitude and tolerance for risks to its objectives.

The IFRS 9 programme continued to progress according to plan with the core processes being subject to a full parallel run throughout 2017. An independent validation of all underlying models, implementation standards and governance arrangements was performed. The Group was fully prepared to begin reporting under the IFRS 9 regime on 1 January 2018, the 'go-live' date.

The Group's secured business model, sensible loan to value profile and strong arrears performance result in a manageable day one impact post adoption of the IFRS 9 standard of c.£4m. For arrears balances purchased via the portfolio acquisition process, the Group conservatively assesses expected loss at the point of acquisition which is offset against the modelled future cash flows to derive the effective interest rate for the book. This incurred loss protection is therefore recognised over the life of the book against the unwind of any purchase discount or premium through interest income providing further protection.

The Internal Ratings Based ('IRB') programme was formally established to enable the Group to transition to the advanced approach to measuring its credit risk-based capital requirements. The programme progressed in accordance with the Board approved plan and the Group is well placed to commence parallel running its IRB models and capital calculation engine. The Group completed an internal self-assessment exercise against the Capital Requirements Regulation ('CRR') to develop detailed plans and a roadmap of key steps towards a formal regulatory application. The Group will be engaging actively with the PRA and external subject matter experts to ensure successful delivery of the programme.

As the Group increased the use of risk-based analytics and models, it also improved model validation, monitoring and back-testing. Appropriate controls were established to assess the ongoing robustness and usage of all risk models. The Group established Board and senior management oversight and governance procedures through a Board approved model risk policy.

A Group-wide programme was established to enhance the Bank's approach to data governance and controls in the context of industry good practice and regulatory standards. The programme is overseen by a senior level Steering Committee with cross-functional executive sponsorship. The programme is designed to deliver improved data controls and models, aggregation capabilities and end user reporting capabilities. The programme will support other strategic and regulatory initiatives including IRB, GDPR and securitisation.

To ensure a holistic and integrated approach to operational resilience, the Group established an Operational Resilience Programme to align its current approach to emerging industry good practice and regulatory standards. The programme will help to deliver an integrated approach to the ongoing assessment of critical operational functions and key dependencies, assessment of potential points of vulnerability and business continuity planning and crisis management.

The Group continued to enhance its Internal Capital Adequacy Assessment Process ('ICAAP'), through improved risk-based capital assessments and the use of stress testing. The Group worked with industry experts and engaged with the PRA to ensure that its ICAAP adheres to regulatory standards and represents an important mechanism by which the Board and senior management assess the adequacy and effectiveness of the Group's business and capital plans under normal and stressed operating conditions. Fully integrated funding and liquidity planning and stress testing analysis is used to support the Internal Liquidity Adequacy Assessment Process ('ILAAP'). The Group also enhanced its Recovery Plan through active assessment of risk drivers, identification of business model vulnerabilities and development of credible and reliable business recovery options.

Risk-based management information has been an important area of continued improvement. Through the use of a broad range of early warning indicators and risk drivers, a more forward-looking approach to risk identification and management was established. In particular, enhancements were made to the credit portfolio risk triggers by leveraging credit bureau data to supplement internal risk assessments. The Group is actively using its early warning risk indicators and risk assessment capabilities to identify and analyse any emerging trends, particularly during the current period of economic and market uncertainty.

Improved Financial Crime and Compliance team structures were implemented with continued investments made to materially build out specialist capabilities in relation to monitoring, testing and assurance.

Priority areas for 2018
The priority for both the Risk and Compliance functions during 2018 is to further embed the risk management frameworks into the culture and decision making processes at all levels of the organisation. Both functions intend to utilise the enhanced level of specialist risk and compliance resources to deliver on a number of key initiatives including:

- Delivery of an enhanced and integrated data governance and controls framework. Improved data aggregation, analytics and distribution channels to support ongoing business reporting requirements as well as key strategic and regulatory initiatives
- Continued progress against the Group's IRB plan, with particular focus on delivery of second generation credit risk models, improved adherence to emerging regulatory

Risk review continued

  requirements and meeting the 'use-test' requirements. Improved model governance and controls, supported by an extensive training and awareness programme
- Continued improvements to the underlying risk forecasting and stress testing capabilities which supporting the Group ICAAP and ILAAP, including the roll-out of IRB and IFRS 9 compliant stress testing capabilities
- The Group's operational resilience programmes to deliver an integrated approach to operational resilience assessment and improved aligned to Business Continuity Plan ('BCP') development and testing, through the leveraging of an integrated system solution.

The Board and senior management are providing an appropriate level of oversight across all key initiatives. The Group also engages external subject matter experts and consults with supervisory authorities to ensure appropriate levels of transparency and successful outcomes are achieved.

Risk management

Approach to risk management

Ongoing risk identification, assessment, monitoring and reporting are the primary risk disciplines underpinning the Group's growth strategy and adherence to the prudential and conduct regulatory requirements. The Group's approach to risk management is outlined within the SRMF.

The SRMF is the overarching framework which enables the Board and senior management to actively manage and optimise the risk-reward profile within the constraints of the Group risk appetite. Specifically, the SRMF enables the Board and senior management to take informed decisions by appropriately balancing the interests and expectations of the various stakeholders and to manage potential trade-offs within the context of the risk appetite.

The SRMF is a structured approach to aligning the Board's overarching objectives against the risks assumed and the ongoing management of these risks. The SRMF enables the Board to articulate its expectations and tolerance in relation to the nature and level of risks it is willing to assume in pursuit of its strategic and business agenda. The Board also uses the SRMF to outline its expectations with respect to the appropriate level of risk management capabilities and the sophistication needed to actively manage the risk profile.

The modular construct of the SRMF provides for an agile approach to responding effectively to the evolving nature of the business and regulatory environment. The SRMF and its core modular components are subject to periodic review and approval by the Board and its oversight committees.

The following sections describe the key modules of the SRMF structure.

Key modular component 1: Risk principles and culture

The Board adopted a principle-based approach to articulating its expectations and guidance relating to how the Group should frame its risk management approach. The risk management principles are designed to set a clear 'tone from the top' with respect to the Group's risk culture and values. The risk principles also provide the background context in which to articulate the Group's risk management objectives, strategy and appetite.

The risk principles are:
- Customer outcomes: fair treatment and good customer outcomes are core business values which cannot be put at risk
- Proportionate and scalable: the approach to risk management needs to be commensurate with the complexity of the underlying risk profile and appropriately agile to respond to changing business and regulatory needs

- Actively managed: the risk profile needs to be actively managed within the Board approved risk appetite
- Comprehensive coverage: all risks and their underlying drivers impacting the Group's strategic, business, operational and regulatory objectives should be actively assessed, monitored and reported
- Segregation of duties: risk-taking, oversight and assurance responsibility to be organised in adherence to the 'three lines of defence' principle
- Integration and usage: risk assessment should be a critical feature of decision making processes at all levels of the organisation
- Versatile and progressive: the approach to managing risks should be subject to continuous review and challenge to keep pace with emerging good practice and regulatory standards.

In adherence to the risk management principles, the Group Board and senior management have cultivated a risk culture which encourages a proactive, transparent and analytical approach to risk management. Risks are assumed in a balanced and considered manner, taking into account stakeholder expectations, good customer outcomes, risk management capabilities and controls.

Key modular component 2: Risk strategy and appetite

Risk strategy

OSB's risk strategy is to create value through informed risk-based decisions and leveraging the Group's risk data and analytics in a timely and accurate manner to optimise the risk-reward profile. Risks are only to be assumed which can be effectively identified, assessed, measured and controlled across all phases of the risk life cycle.

This risk strategy is based on three key components:
- Creating value through generating returns which sufficiently exceed the cost of risk, funding costs and operating costs
- Risks are only to be assumed where they are subject to a structured and disciplined approach to risk management
- Risk management capabilities are scalable and agile enough to adequately address future evolution of the risk profile.

Risk appetite

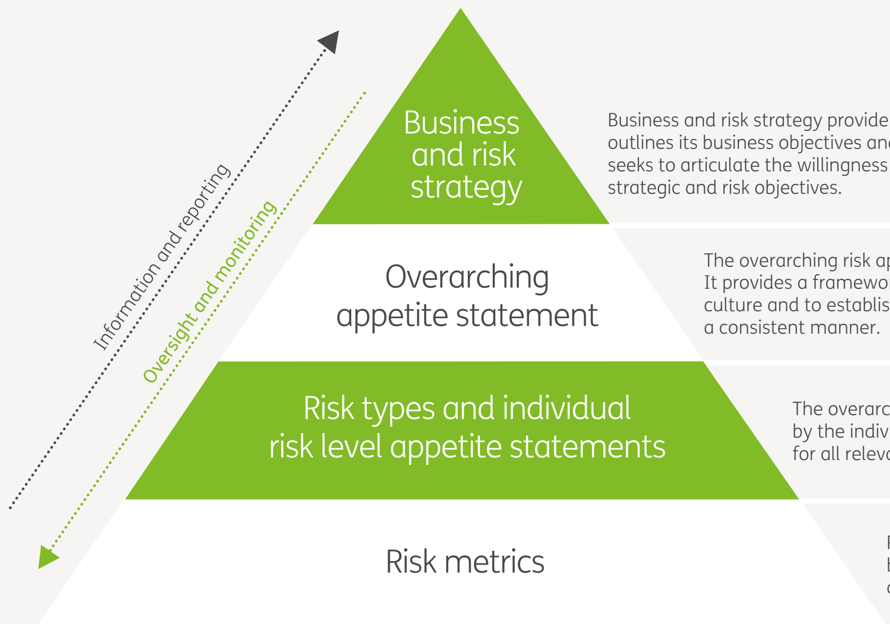
The Group effectively aligned its strategic and business objectives with its risk appetite, ensuring that the Board and senior management are able to monitor the underlying risk profile relative to the overarching risk principles, risk strategy and financial performance objectives of the Group. The risk appetite is a critical mechanism though which the Board and senior management are able to identify adverse trends and respond to unexpected developments in a timely and considered manner.

The risk appetite is calibrated to reflect the Group's strategic objectives, business operating plans, as well as external economic, business and regulatory constraints. In particular, the risk appetite is calibrated to ensure that the Bank continues to deliver against its strategic objectives and operates with sufficient financial buffers even when subjected to plausible but extreme stress scenarios. The objective of the Board risk appetite is to ensure that the strategy and business operating model is sufficiently resilient.

The risk appetite is calibrated using statistical analysis and stress testing to inform the process by which the Board set management triggers and limits against key risk indicators. The Board and senior management actively monitor actual performance against Board approved management triggers and limits to respond in a timely manner to adverse trends and breaches.

Overarching risk appetite statement

The Bank has a prudent and proportionate approach to risk taking and management, which is reflective of its straightforward business model. The inherent resilience of the Group's business model is underpinned by the fact that the Bank only lends on a secured basis, has established robust underwriting practices and relies on intermediary based distribution. The Group supports its lending activities by being predominantly reliant on stable retail funding, supported by strong and high quality financial buffers. The highly efficient business operating model is an important source of competitive advantage. The Group also places significant importance on its strong conduct and compliance culture as an important driver of its overall success.



Business and risk strategy provide the context within which the Group outlines its business objectives and establishes its SRMF. The risk appetite seeks to articulate the willingness of the Group to take risks in light of its strategic and risk objectives.

The overarching risk appetite sets the tone for risk management. It provides a framework to develop and cascade the Group's risk culture and to establish risk policies, controls and limits in a consistent manner.

The overarching risk appetite statement is supported by the individual, risk type level appetite statements for all relevant risks.

Risk appetite statements are supported by a broad range of qualitative and quantitative metrics.

Risk review continued

Key modular component 3: Risk governance and function organisation

Risk governance refers to the processes and structures established by the Board to ensure that risks are assumed and managed within the Board approved risk appetite, with clear delineation between risk-taking, oversight and assurance responsibilities. The Group's risk governance framework is structured to adhere to the 'three lines of defence' model. All risk-taking, oversight and assurance functions are allocated to accountable Executives.

The Group Board has the ultimate responsibility for the oversight of the Group's risk profile and management framework and where it deems it appropriate, it delegates its authority to its nominated Committees. The Board and its Committees are provided with appropriate and timely information relating to the nature and level of the risks to which the Group is exposed and the adequacy of the risk controls and mitigants. The Internal Audit function provides independent assurance to the Board and its Committees as to the effectiveness of the systems and controls and the level of adherence with internal policies and regulatory requirements.

The Executive Committee has day-to-day responsibility for managing the Group's risk profile within the parameters of the Board approved risk appetite. The Executive Committee discharges its risk control and oversight responsibilities through a number of management level risk committees covering all principal risks.

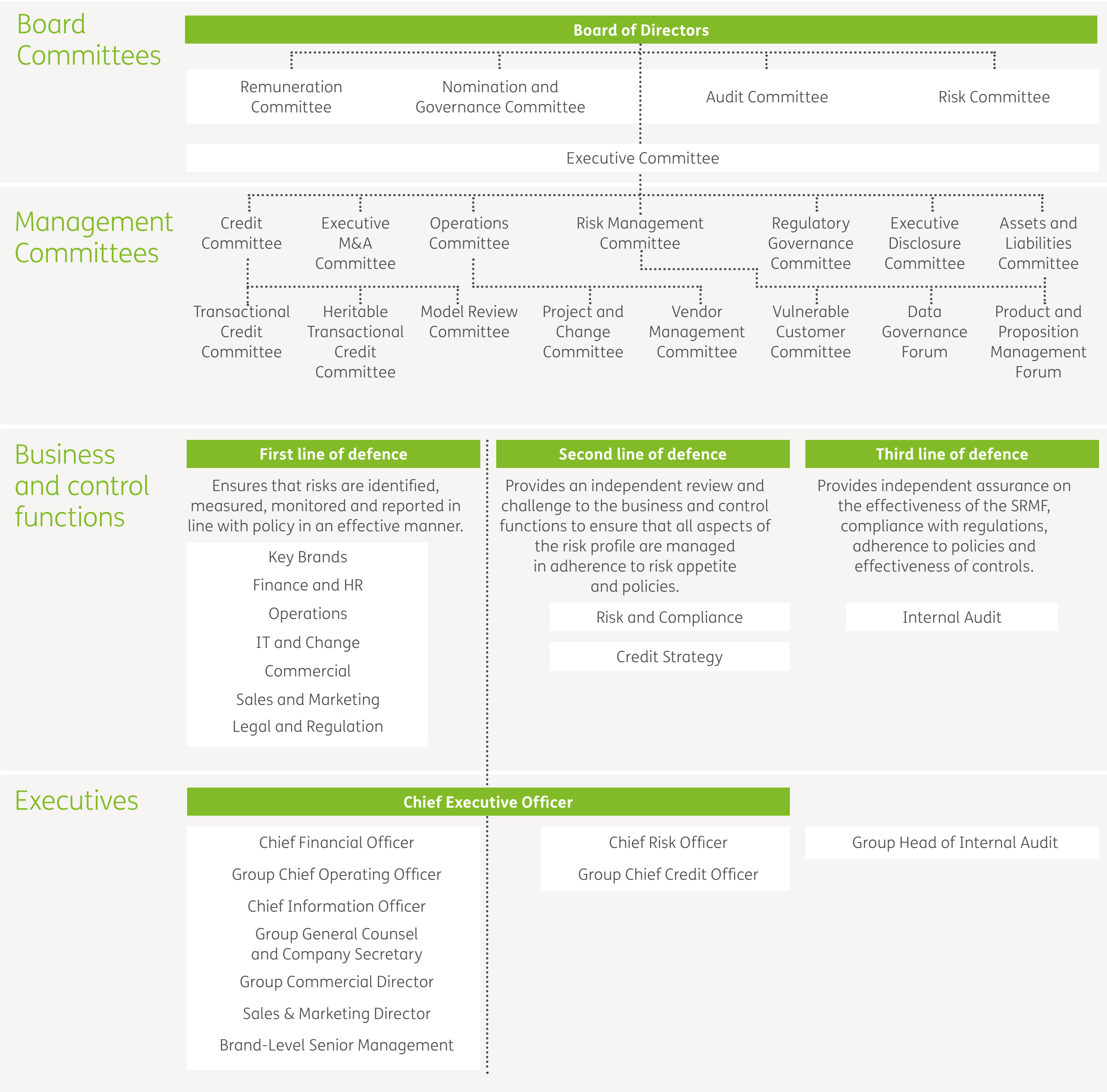
The Chief Risk Officer ('CRO') is the accountable Executive responsible for establishing an effective risk management framework supported by appropriately organised Risk and Compliance functions. In discharging his duties, the CRO has dual reporting lines into the Group CEO and the Chair of the Risk Committee. The CRO ensures that the Risk function is appropriately resourced and capable of identifying, assessing and reporting all principal risks to which the Bank is exposed.

The various management level risk committees have been established to ensure a more focused approach to monitoring and managing the specific risks. Additional sub-committees and working groups have also been established to focus on specific risk initiatives or projects.

The OSB risk governance structure is detailed below:

Risk	Credit	Market	Liquidity	Operational	Regulatory	Conduct
Board governance	Board					
	Risk Committee					
Management governance	**Executive Committee**					
	Credit Committee	Assets and Liabilities Committee		Risk Management Committee	Regulatory Governance Committee	
	Chief Risk Officer					
Frameworks	Strategic Risk Management Framework, Stress Testing Framework					
Key policies and documents	Credit Risk Management Framework, Lending Policy, Arrears, Repossession and Forbearance policies	Interest Rate Risk in the Banking Book Policy	Market & Liquidity Risk Management Framework, Treasury Policy, Funding and Liquidity Risk Policy	Operational Risk Management Framework, Operational Resilience Policy, Vulnerable Customer and Suicide Awareness Policy	Compliance Risk Management Framework, Financial Crime Risk Management Framework, Group Anti-Money Laundering and Counter Terrorist Financing Policy, SMR policies	Conduct Risk Management Framework, Conduct Risk Policy
	Risk Appetite Statement, ICAAP, Recovery Plan, Resolution pack					
		ILAAP				
Management information	Credit MI pack	ALCO MI pack		Operational risk MI pack	Compliance and Financial Crime MI pack	Conduct risk MI pack

The OSB risk organisational structure is detailed below:



Risk review continued

Key modular component 4: Risk definitions and categorisation

The Group's business activities, business model and external operating environment result in a unique risk profile. To ensure that the Bank is actively monitoring and responding to the evolving nature of its risk profile, it has established a broad range of early warning indicators and maintains risk registers covering all principal risks. Outlined below are the various financial and non-financial risks which constitute the Group's risk profile.

Business model characteristics

• Specialist, and primarily secured lender to underserved sectors	• Desired levels of credit exposure to key segments (Buy-to-Let/SME, residential) • Potential for concentrations	• Also incurs exposure to potentially riskier sub-sectors (second charge, bridging and development finance)	• Manage infrastructure and operations to support its core business activities • Perform activities to ensure regulatory compliance	• The Bank is subject to variations in the macroeconomic environment and movements in key variables (e.g. Gross Domestic Product, unemployment, interest rates)

Risk profile

Financial risks	Non-financial risks		
Portfolio credit risk The risk of losses due to one or more borrowers failing to meet all or part of their obligations towards the Bank. Credit risk also includes other elements such as pre-settlement and settlement risk, residual risk of credit risk mitigation and concentration risk. **Market risk (inc. IRRBB)** The risk of losses in on and off-balance sheet positions arising from adverse movements in market prices.	**Strategic and business risk** 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.	**Reputational risk** Refers to the potential 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.	**Operational risk** Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. It includes legal risk but excludes strategic and reputational risk. **Conduct risk** Conduct risk is the risk that the firm's culture, organisation, behaviours and actions result in poor outcomes and detriment for customers and/or damage to consumer trust and integrity in the markets in which we operate. **Regulatory/compliance risk** The risk of failure due to non-adherence to provisions of the PRA handbook and all relevant prudential and conduct standards in the UK or non-compliance with reporting requirements or submission of incorrect information.

Solvency risk

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.

Liquidity and funding risk

The potential inability of the Bank to fund increases in assets, manage unplanned changes to funding sources and to meet obligations when required. It primarily arises due to the maturity mismatch associated with the Bank's assets and liabilities and the growth in mortgage lending.