The financial information in this document has been prepared in accordance with International Financial Reporting Standards (IFRS) as endorsed by the EU (see section 2 of this document regarding the narrow-scope amendments to IFRS 9 which are awaiting endorsement at the date of this document). IFRS comprises accounting standards issued by the International Accounting Standards Board (IASB), including interpretations issued by the International Financial Reporting Interpretations Committee (IFRS IC) of the IASB.

This purpose of this document is to assist the reader's understanding of IFRS 9 *Financial Instruments* impact on Santander UK Group Holdings plc and its subsidiaries (Santander UK), including its principal subsidiary Santander UK plc.

The information contained in this announcement and in the appendices is unaudited and does not constitute statutory accounts within the meaning of section 434 of the Companies Act 2006 or interim financial statements in accordance with International Accounting Standard 34 'Interim Financial Reporting'.

A glossary of Santander UK specific terms used in this document is available on our website at www.santander.co.uk/uk/about-santander-uk/investor-relations-glossary.

Santander UK Group Holdings plc

Transition to IFRS 9

28 February 2018

Contacts

Bojana Flint	Head of Investor Relations	020 7756 6474
Andy Smith	Head of Media Relations	020 7756 4212
For more information:	www.aboutsantander.co.uk	ir@santander.co.uk

Contents

1. Overview and key highlights **3**
2. Classification and measurement requirements **5**
3. Expected Credit Loss (ECL) impairment methodology **6**
3.1 The impact of new ECL rules on our credit risk 6
3.2 Measuring ECL 6
3.3 Forward-looking information 7
3.4 Significant increase in credit risk (SICR) 7
3.5 Governance around ECL impairment allowances 8
4. Loss allowance movements analysis **9**
4.1 Comparison of loss allowance methodology concepts 9
4.2 Movement in loss allowance 9
5. Areas of significant management judgement **11**
5.1 Classification and measurement 11
5.2 ECL impairment methodology 11
Appendix A: Credit Risk Exposures, Loss Allowances and Coverage **12**
Appendix B: IFRS 7 statutory reporting and disclosures **13**
Appendix C: Provisional accounting policy changes for IFRS 9 ..... **15**

1. Overview and key highlights

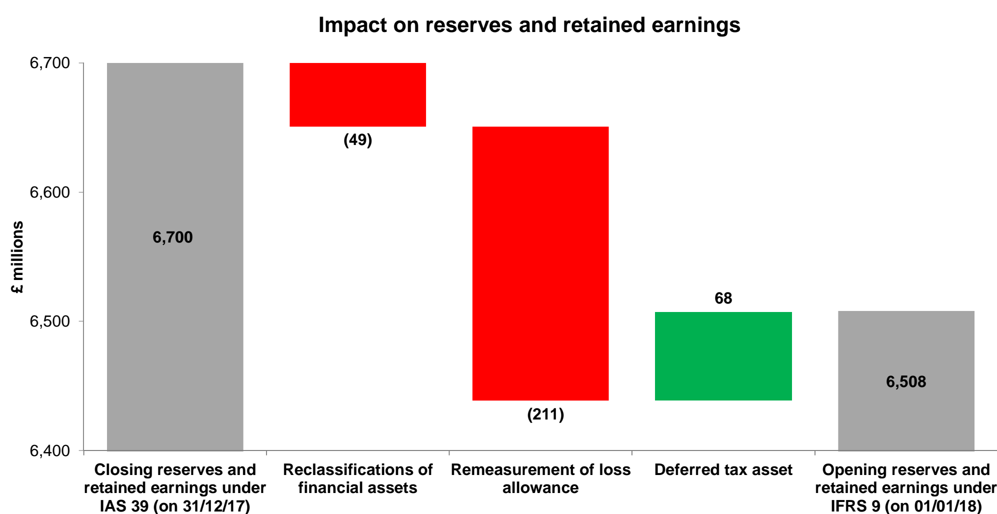
IFRS 9 *Financial Instruments* replaced IAS 39 *Financial Instruments: Recognition and Measurement* on 1 January 2018. The purpose of this *Transition to IFRS 9* Document (TD) is to assist readers in understanding the transitional impact[1] of IFRS 9 for Santander UK at that date.

The information in this TD serves as a point-in-time bridge between IAS 39 and IFRS 9. This includes the day one impact on retained earnings, regulatory capital and changes to the classification and measurement of certain financial assets. The changes to our credit risk under the new Expected Credit Loss (ECL) impairment methodology is in no way predictive of impacts beyond the transition date.

Details of our provisional IFRS 9 accounting policies can be found in Appendix C. These policies, together with the disclosures in connection with ECL (as referred to in section 5.2) remain subject to change.

Impact of IFRS 9 on shareholders' equity

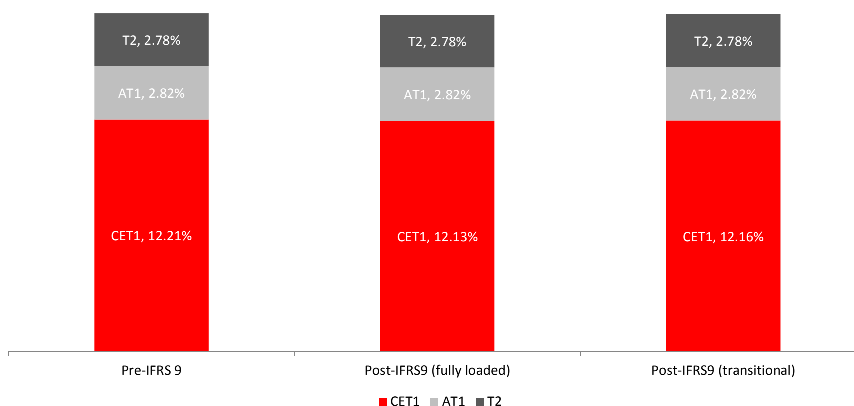
The adoption of IFRS 9 **decreases shareholders' equity** at 1 January 2018 by **£192m (net of tax)**. This is comprised of a £49m decrease from the application of the new classification and measurement requirements for financial assets and a £211m decrease arising from the application of the new ECL impairment methodology, these amounts being partially offset by the recognition of a £68m deferred tax asset (DTA).



[1] Certain financial liabilities are presented at fair value through profit or loss (FVTPL) where they contain embedded derivatives or where associated derivatives used to economically hedge the risk are held at fair value. We elected to apply the IFRS 9 requirement for the presentation of gains and losses on financial liabilities relating to own credit in other comprehensive income in 2017. A cumulative own credit adjustment of £18m (net of tax) was recognised against opening retained earnings on 1 January 2017. The impact of IFRS 9 outlined in this TD excludes the impact of the presentation of own credit relating to financial liabilities designated at FVTPL. We will continue to apply the IAS 39 hedge accounting requirements until such time as macro hedge accounting rules have been finalised.

Impact of IFRS 9 on regulatory capital

The impact of IFRS 9 is a **decrease in the CET1 capital ratio of 8bps** before the application of any transitional arrangements which we will adopt and which are expected to reduce the amount impacting the CET1 capital ratio in 2018. As a result, the adoption of IFRS 9 does not have a material impact on our capital position.



In comparison to incurred losses under IAS 39, we expect IFRS 9 ECL charges to be more volatile, which could result in material swings – both favourable and unfavourable – to the income statement. Whilst the first-time impacts are based on estimates prepared during a supportive economic environment, a period of economic instability could significantly impact the income statement and the net carrying amount of our financial assets, as well as influence the amount of capital we are required to hold. Volatility of ECL will be taken into account in our capital planning strategy.

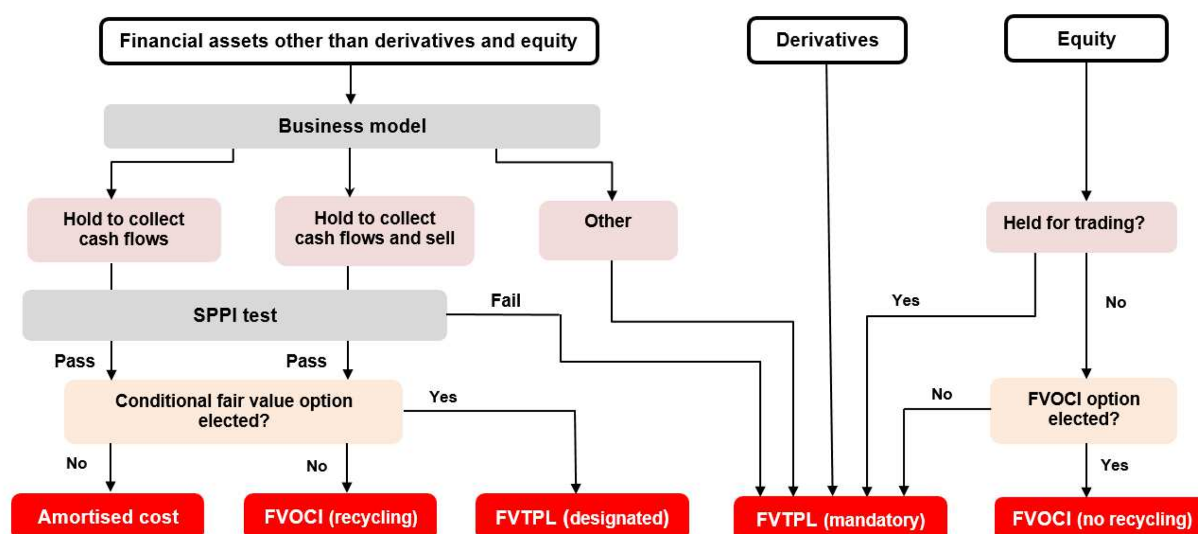
This increased volatility of ECL relative to IAS 39 incurred loss-based provisioning will impact our CET1 capital levels, resulting in increased pro-cyclicality of risk-based capital and leverage ratios. However, the impact is currently mitigated by our surplus of expected losses over provisions for exposures using Internal Rating Based (IRB) approaches. For such exposures (which include Residential Mortgages) the adverse impact to CET1 capital of provision increases from reserve movements is offset by the associated reduction of the CET1 capital adjustment for regulatory expected loss amounts. Furthermore, the EU transitional arrangements for the capital impact of IFRS 9 mean that adverse CET1 effects from increases in ECL-based provisions from the level of such provisions at 1st January 2018 are partially reduced until the end of 2022.

We reflect projections of ECL-based provisions in our capital position forecasting under base case and stress scenarios for ICAAP and capital management purposes and are continuing to consider the impact of the dynamics of ECL in the assessment, monitoring and management of capital risk.

2. Classification and measurement requirements

The classification and measurement (C&M) of financial assets is based upon an entity's business model for managing financial assets (the Business Model test) and whether contractual cash flows of those assets represent solely payments of principal and interest (the SPPI test). As illustrated below, these factors determine whether financial assets are measured at amortised cost (AC), at fair value through other comprehensive income (FVOCI) or at fair value through profit or loss (FVTPL). We have applied both tests to financial assets as at 31 December 2017 and have reviewed our use of the fair value option.

Classification & Measurement flowchart



SPPI testing has been embedded into our operations for all newly originated and purchased assets and we will perform Business Model testing on an ongoing basis. All new product initiatives will include a C&M section to assess the appropriate business model and to complete an SPPI test. The implementation of SPPI testing processes may impact the terms and conditions that are negotiated with customers in some operating segments. Apart from these potential changes, the new C&M requirements are not expected to have a significant impact on our credit risk policies and practices. We will continue to review and update our policies and procedures as appropriate.

A breakdown of the changes to C&M of financial assets on transition to IFRS 9 are presented in Appendix B. These should be read in conjunction with the provisional IFRS 9 accounting policies for financial assets and liabilities, which can be found in Appendix C.

Impact of C&M changes on shareholders' equity

The main asset reclassification relates to social housing loans which are classified as AC under IFRS 9[2]. These loans were previously designated at FVTPL under IAS 39, and we have not elected to apply the fair value option under IFRS 9. This reclassification reduced shareholders' equity by £32m after tax (£45m pre-tax). Other assets have been reclassified from loans and receivables under IAS 39 to fair value under IFRS 9 either due to failing the SPPI test or to being held in a "hold to collect and sell" business model. The net negative impact on retained earnings of these reclassifications is £3m after tax (£4m pre-tax). We have not elected to present equity instruments in other comprehensive income. Consequently, changes in fair value are presented in retained earnings. The combined impact on reserves and retained earnings is zero for equity instruments. See Appendix B, Schedule 3 for more details of the impact of changes.

[2] These impacts take into account the narrow-scope amendments made to IFRS 9 by the IASB in October 2017 entitled 'Prepayment Features with Negative Compensation (Amendments to IFRS 9)'. These amendments, which are not effective until annual periods beginning on or after 1 January 2019, can be adopted early and permit some prepayable financial assets with negative compensation to be measured at amortised cost that, but for the amendment, would have been measured at fair value through profit or loss. The amendments are awaiting EU endorsement.

3. Expected Credit Loss (ECL) impairment methodology

3.1 The impact of new ECL rules on our credit risk

The adoption of the new ECL impairment methodology is not expected to materially change our credit risk policies and practices. Our credit risk appetite in terms of target markets, market share and the credit quality of customers to whom we wish to lend is not directly impacted by IFRS 9 and we expect this to remain broadly the same.

IFRS 9 impacts the timing of the recognition of the credit impairment charge, but not the quantum of credit write-offs. Retail collections and recoveries procedures are unchanged. Risk-adjusted hurdle rates for Corporate lending may be reviewed, but this is not expected to lead to a significant change in credit policy.

3.2 Measuring ECL

The ECL approach must reflect both current and forecast changes in macroeconomic data over a horizon that extends from 12 months to the remaining life of the asset if a borrower's credit risk is deemed to have deteriorated significantly at the reporting date compared to the origination date, or if the exposure is considered to be credit-impaired. ECLs reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes and considering reasonable and supportable information at the reporting date.

For accounts not in default at the reporting date, a monthly ECL is estimated for each individual exposure and for each month until the end of the forecast period. Each monthly ECL is calculated as the discounted product of the survival rate (SR), probability of default (PD), exposure at default (EAD) and loss given default (LGD) for the relevant forecast month. The discount rate used in the ECL calculation is the original effective interest rate or an approximation thereof. The lifetime ECL is the sum of the monthly ECLs over the forecast period while the 12-month ECL is limited to the first 12 months. For accounts that are in default at the reporting date, the EAD is taken as the reporting date balance. An LGD value is also calculated to reflect the current default status of the exposure. PD and SR values are not required for accounts in default.

An account is classified as default, for the purposes of calculating the ECL, if it is greater than 90 days past due or meets an unlikeliness to pay criteria. The criteria for unlikeliness to pay varies across portfolios and where the advanced IRB basis is used for that portfolio in capital calculations, the same default definitions have been used for IFRS 9 purposes.

An assessment of each facilities' credit risk profile will determine whether they are to be allocated to one of three stages:

- Stage 1: when it is deemed there has been no significant increase in credit risk since initial recognition, a loss allowance equal to a 12-month ECL – i.e. the proportion of lifetime expected losses that follow a default event within the next 12-months - will be applied;
- Stage 2: when it is deemed there has been a significant increase in credit risk since initial recognition, but no credit impairment has materialised, a loss allowance equal to the lifetime ECL – i.e. lifetime expected loss resulting from all possible defaults throughout the residual life of a facility – will be applied; and
- Stage 3: when the facility is considered credit impaired, a loss allowance equal to the lifetime ECL will be applied. Similar to incurred losses under IAS 39, objective evidence of credit impairment is required.

Probability of default (PD)

PD represents the likelihood of a borrower defaulting on their financial obligation in the following month, assuming it has not closed or defaulted since the reporting date. For each month in the forecast period, the monthly PD is estimated from a range of factors. These include the current risk grade for the exposure, which become less relevant further into the forecast period, as well as the expected evolution of the account risk with maturity and factors for changing economics. This is supported by historical data analysis.

Exposure at default (EAD)

EAD is based on the amount we expect to be owed if a default event was to occur. The EAD for each month of the forecast period is determined by the expected payment profile, which varies by product type:

- For amortising products, this is based on the borrower's contractual repayments over the forecast period. This is adjusted for any expected overpayments the borrower may make and for any arrears expected if the account was to default.
- For revolving products, or amortising products with an undrawn element, the EAD is determined by the balance at default and the contractual limit of the exposure. These assumptions vary by product type and are based on analysis of recent default data

Loss given default (LGD)

LGD represents our expected loss if a default event were to occur. The LGD is expressed as a percentage and is calculated as the expected loss divided by EAD for each month of the forecast period.

LGD is based on factors that impact the likelihood and value of any subsequent write-offs, which vary according to whether the product is secured, in which case it takes into account collateral values as well as the historical discounts to market/book values due to forced sales type, or unsecured.

Survival rate (SR)

SR is the probability that the exposure has not closed or defaulted since the reporting date and is estimated for each month of the forecast period.

Life of a facility

The forecast period for amortising facilities is based on the remaining contractual term. For revolving facilities, we have an analytical approach based on the behavioural, rather than contractual, characteristics of the facility type. The life of each facility type is defined as the point when the monthly increase in ECL becomes zero (or falls below some de minimis amount).

3.3 Forward-looking information

The assessment of a significant increase in credit risk (SICR) and the calculation of ECL both incorporate forward-looking information. We have performed historical analysis and identified the key economic variables impacting credit risk and ECLs for each portfolio, e.g. GDP, house prices, unemployment etc. Where applicable, these economic variables, and their associated impacts, have been incorporated into the individual models described above. Forward-looking information is considered an area of key management judgement (see section 5.2 for more details).

3.4 Significant increase in credit risk (SICR)

We consider exposures to have experienced a SICR due to quantitative, qualitative or backstop reasons.

Quantitative criteria

The lifetime PD at the reporting date exceeds - compared to the value anticipated when the exposure was first recognised - both a relative increase and absolute increase threshold.

The lifetime PD for each exposure is produced using the values described in section 3.2 "Measuring ECL". The value anticipated from the initial recognition is based on a similar set of values calculated at this point, adjusted to reflect the account surviving to the reporting date. The comparison uses an annualised lifetime PD, where the lifetime PD is divided by the forecast period.

For revolving retail products, the lifetime period for the purposes of the SICR determination is taken as 5 years. This is different to the lifetime period applied in the ECL calculation detailed above.

A relative threshold of 100% (doubling the PD) has been applied across all portfolios, while absolute increase thresholds have been tailored to each portfolio. These have been chosen with consideration given to the characteristics of the accounts identified as having deteriorated and their subsequent performance.

Qualitative criteria

For each portfolio, there are specific criteria that indicate an exposure has increased in credit risk, independent of any changes in PD. These criteria are selected in consultation with portfolio management practices and the performance of the exposures they identify.

Backstop criteria

We are not rebutting the presumptions made in IFRS 9 relating to either a significant increase in credit risk or default. Therefore, all exposures greater than 30 or 90 days past due (DPD) will be placed in at least stages 2 and 3 respectively.

3.5 Governance around ECL impairment allowances

The Risk Methodology team has developed our IFRS 9 ECL impairment models (with the exception of the Oxford Economics model), with all material models independently reviewed by the Internal Validation Team. As model owners, Credit Risk teams run the IFRS 9 models monthly to calculate ECL impairment allowances.

These models are sensitive to changes in credit conditions, and reflect various management judgements that give rise to measurement uncertainty in our reportable ECL (see section 5 for details). The following fora review provision drivers and ensure that management judgements remain appropriate:

- The *Model Risk Control Forum* reviews and approves required model changes;
- The *Asset and Liability Committee* is responsible for reviewing and approving the economic scenarios and probability weights used to calculate forward-looking scenarios;
- The *Credit Provisions Forum* reviews management judgements and approves IFRS 9 ECL impairment allowances; and
- The *Board Audit Committee* reviews and challenges the appropriateness of the estimates and judgements made by management.

4. Loss allowance movements analysis

4.1 Comparison of loss allowance methodology concepts

The methodologies for the calculation of incurred losses under IAS 39 and ECLs under IFRS 9 are fundamentally different. For this reason, we did not seek to leverage models of the former for the design and build of the latter. Notwithstanding, certain key existing impairment concepts can be compared to the ECL methodology and estimate, across the three ECL stages:

- In section 4.2 below, we illustrate how we allocate the accounts at transition from the IAS 39 impairment loss allowance categories to the three IFRS 9 ECL stages. The impairment provisions and drawn balances are allocated accordingly; and
- All non-performing loans (NPLs) are in stage 3 with all forborne accounts at least stage 2. Refer to Appendix A for an analysis of the stage distribution of IFRS 9 exposures, in particular the split of stage 2 exposures by less than and equal to, and greater than 30 DPD.

4.2 Movement in loss allowance

Our loss allowance has increased by £211m from a £940m incurred loss impairment provision under IAS 39 to a £1,151m ECL impairment provision under IFRS 9. This movement has been driven by the need to:

- Report a 12-month ECL against exposures that have not suffered a significant increase in credit risk since origination or acquisition (Stage 1);
- Report a lifetime ECL on certain exposures for which an IAS 39 emergence period IBNO loss allowance was applied. These are the accounts that are performing, show no specific evidence of loss but which have experienced a significant increase in credit risk since origination (Stage 2);
- Account for differences in the way an ECL and an incurred loss provision are calculated on facilities treated as non-performing under IAS 39 (Stage 3);
- Bring off-balance sheet exposures into the scope of impairment provision assessment; and
- Factor in the effects of multiple economic scenarios.

To analyse this movement, we assess where our exposures have been allocated to on transition to IFRS 9, with reference to each of the following categories against which we assessed our exposures under IAS 39:

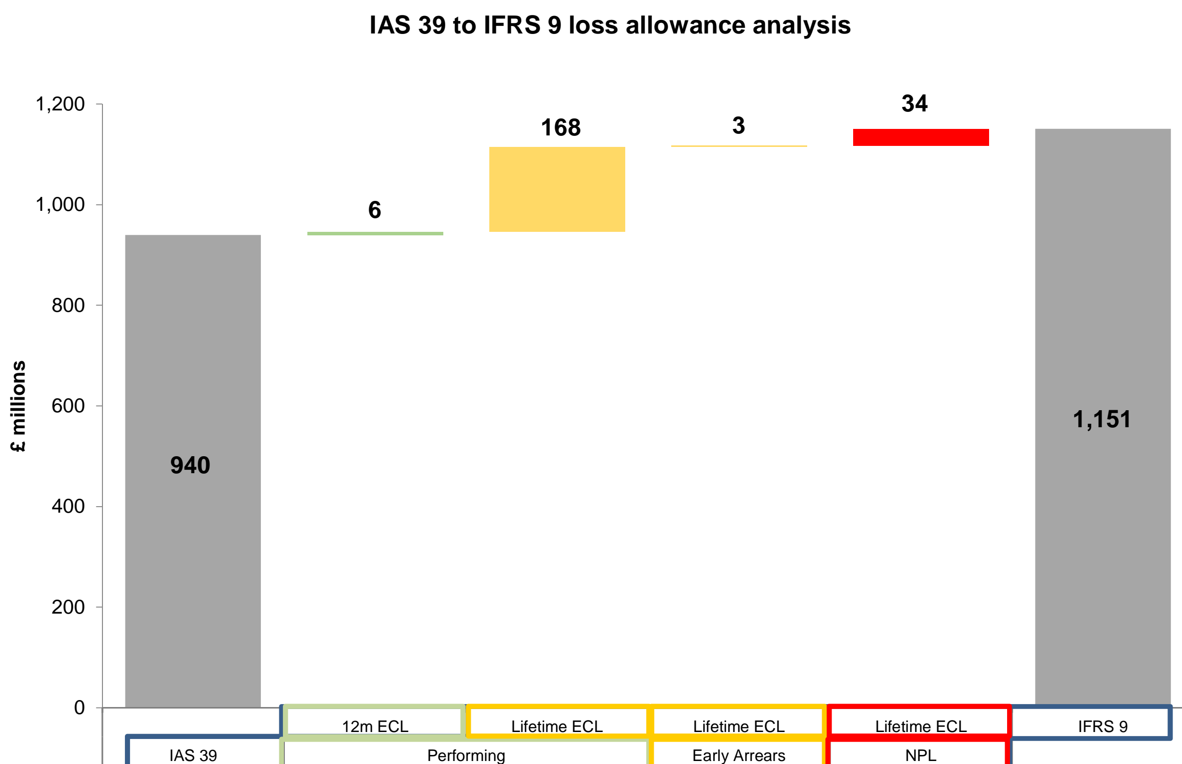
Performing (with no specific evidence of loss): under IAS 39, accounts that are performing and show no specific evidence of loss have an IBNO provision calculated. This provision is the estimated loss that would arise from cases missing a payment in the appropriate emergence period and which will ultimately be written off.

- For accounts that have not deteriorated since origination, a 12-month ECL is calculated. This estimates the losses that would arise on the accounts that default in the next 12 months. This is different to the various emergence period definitions but has a similar impact across all the portfolios.
- For accounts that have deteriorated or are credit-impaired, a lifetime ECL is calculated. This estimates all future losses arising on these accounts. As this is a wider definition than the IBNO emergence period this results in higher provisions.

Early Arrears: under IAS 39, accounts that are performing and in arrears have an IBNO provision calculated. This provision is the estimated loss that would arise from cases that will ultimately be written-off. Under IFRS 9, these accounts have been assessed against the 30 DPD backstop criteria and other quantitative and qualitative criterion. This resulted in the majority of accounts being treated as stage 2, and attracting a lifetime ECL.

NPLs: under IAS 39, NPLs have an observed provision calculated. This provision is the estimated loss that would arise from cases that will ultimately be written-off. Under IFRS 9, these accounts have been assessed as being credit impaired, and as such have been treated as stage 3 and allocated a lifetime ECL.

The below waterfall chart illustrates these high-level movements between incurred loss under IAS 39 at 31 December 2017 and ECL under IFRS 9 on 1 January 2018. Inherent within this analysis, the impact of multiple economic scenarios contributes an additional £195m to loss allowances, which is derived as the difference between the base case ECL and the reportable, probability-weighted ECLs.



5. Areas of significant management judgement

5.1 Classification and measurement

IFRS 9 requires that all financial assets are subsequently measured at AC, FVOCI or FVTPL based on the business model (see Appendix C) for managing the financial assets and their contractual cash flow characteristics. The business model assessment is an area of significant judgement as it depends upon facts and circumstances and the intentions of an entity in relation to particular investments.

5.2 ECL impairment methodology

We have made a number of management judgements around subjective elements and inputs in order to implement ECL capabilities in the organisation. Some of these judgements pertain to decisions made throughout the design and build of ECL methodology, and others to the application of ECL methodology. Whilst only the latter category will be subject to periodic monitoring and review at subsequent reporting intervals, all of these judgements – to varying degrees – give rise to inherent measurement uncertainty in our reportable ECL.

The main design and build judgements – subject to ad-hoc review

- The definition of default: for IFRS 9 purposes, we use the same default criteria as for the regulatory capital models, or a similar definition if not an IRB portfolio (refer section 3.2);
- SICR – PD at origination: where we have experienced limitations on the availability of origination data, we have made certain proxy assumptions. In these cases, we make adjustments to the PD at the proxy origination date to account for the possibility of the PD already being increased since the actual origination. We consider such adjustments immaterial;
- Lifetime periods: to mitigate the computational overhead of running all portfolios out to their natural lifetime, we apply restrictions to certain portfolios with a high volume of accounts (e.g. mortgages and overdrafts on bank accounts). As set out in section 3.2, the life of each facility type is the point when the monthly increase in ECL becomes zero or de minimis; and
- Effective Interest Rate (EIR): for the majority of our portfolios, the income recognition EIRs that are calculated under IAS 39 are used as the discount factor in the IFRS 9 ECL calculations. Retail EIRs are based on behavioural cash flows, whereas Corporate EIRs use contractual cash flows with an adjustment factor to take account of prepayments.

The main application judgements – subject to quarterly review

- Forward-looking multiple economic scenarios: we use five scenarios, consisting of a central base case, two upside scenarios and two downside scenarios except for our SGCB portfolio, where we use a central and a single upside and downside scenario. This symmetry meets the "unbiased" requirement and we consider these scenarios sufficient to account for any non-linear relationships. We create our macroeconomic scenarios by imposing the chosen paths for Gross Domestic Product (GDP) on the Oxford Economic model in order to generate other macroeconomic variables, e.g. House Price Index (HPI), unemployment;
- Probability weights: in determining our initial scenario probability weightings, we award the highest probability to the base case, whilst the extreme cases typically attract lower probabilities than the more moderate ones. In addition, due to the current economic position and policy concerns evidenced by the Prudential Regulatory Authority (PRA) and Financial Policy Committee (FPC), we have applied a higher weighting to the downside scenarios. We consider this appropriate in light of the consensus view of future performance of the UK economy, including projections for UK GDP growth;
- SICR – Stage 2 thresholds: a combination of quantitative (both absolute and relative), qualitative and backstop criteria are employed (see section 3.4); and
- Post Model Adjustments (PMAs): these relate to adjustments which we deem necessary to account for identified model limitations – most notably those that have arisen due to challenges in obtaining historical data. We expect these to gradually become redundant as we build up sufficient comparative data over future reporting periods. Additionally, we apply certain temporary adjustments for immaterial portfolio exposures still requiring ECL models.

We will further assess our measurement uncertainty and sensitivity to changes in economic credit conditions throughout the course of 2018, and anticipate providing our expected inherent quantitative impacts of such management judgements in our 2018 Annual Report and Accounts. The form and content of such disclosure will be guided by the outcomes of the PRA Taskforce on Disclosures about ECL in which we participate.

Appendix A: Credit Risk Exposures, Loss Allowances and Coverage

IFRS 9 On Balance Sheet Exposures [1]

	Stage 1	Stage 2	Stage 2: Of which	Stage 2: Of which	Stage 3 [2]	Total
	£m	£m	<=30DPD	>30DPD	£m	£m
Retail Banking	156,118	10,657	9,537	1,120	2,222	168,997
- of which mortgages	143,208	9,756	8,765	991	1,986	154,950
Commercial Banking	18,362	646	575	71	383	19,391
Global Corporate Banking	11,553	93	93	-	340	11,986
Corporate Centre	55,943	210	172	38	20	56,173
Total	**241,976**	**11,606**	**10,377**	**1,229**	**2,965**	**256,547**

Exposures subject to IFRS 9 ECL assessment [3]

	Stage 1	Stage 2	Stage 2: Of which	Stage 2: Of which	Stage 3	Total
	£m	£m	<=30DPD	>30DPD	£m	£m
Retail Banking	170,785	10,885	9,760	1,125	2,263	183,933
- of which mortgages	149,310	9,884	8,891	993	2,004	161,198
Commercial Banking	22,651	866	786	80	388	23,905
Global Corporate Banking	23,001	109	109	-	372	23,482
Corporate Centre	56,819	250	212	38	20	57,089
Total	**273,256**	**12,110**	**10,867**	**1,243**	**3,043**	**288,409**

IFRS 9 ECL

	Stage 1	Stage 2	Stage 2: Of which	Stage 2: Of which	Stage 3	Total
	£m	£m	<=30DPD	>30DPD	£m	£m
Retail Banking	110	247	219	28	268	625
- of which mortgages	20	131	115	16	121	272
Commercial Banking	43	33	25	8	173	249
Global Corporate Banking	16	-	-	-	242	258
Corporate Centre	7	4	2	2	8	19
Total	**176**	**284**	**246**	**38**	**691**	**1,151**

ECL / IFRS 9 Exposure % (Loss Rate)

	Stage 1	Stage 2	Stage 2: Of which	Stage 2: Of which	Stage 3	Total
	%	%	<=30DPD	>30DPD	%	%
Retail Banking	*0.06*	*2.27*	*2.24*	*2.49*	*11.84*	*0.34*
- of which mortgages	*0.01*	*1.33*	*1.29*	*1.61*	*6.04*	*0.17*
Commercial Banking	*0.19*	*3.81*	*3.18*	*10.00*	*44.59*	*1.04*
Global Corporate Banking	*0.07*	-	-	-	*65.05*	*1.10*
Corporate Centre	*0.01*	*1.60*	*0.94*	*5.26*	*40.00*	*0.03*
Total	***0.06***	***2.35***	***2.26***	***3.06***	***22.71***	***0.40***

1. All on-balance sheet exposures measured at Amortised Cost and FVOCI.
2. Our Stage 3 exposures under IFRS 9 and our non-performing loans used in our NPL ratio metric are subject to different criteria. These criteria are under review given the ongoing regulatory changes to the default definition.
3. Includes off-balance sheet exposures amounting to £32bn.

Appendix B: IFRS 7 statutory reporting and disclosures

Schedule 1: Statutory balance sheet reconciliation under IAS 39 and IFRS 9

The measurement categories and carrying amounts of financial assets determined in accordance with IAS 39 and IFRS 9 are compared below, illustrating a total net assets decrease of £192m as a result of the application of IFRS 9:

Assets	IAS 39		Reclassifications (1)	Remeasurement (2)	IFRS 9	
	Measurement category	Carrying Amount (at 31/12/17) £m			Measurement category	Carrying Amount (at 01/01/18) £m
Cash and balances with central banks	Loans & receivables	32,771			Amortised Cost	32,771
Trading assets	FVTPL	30,536			FVTPL (Mandatory)	30,536
	FVTPL	19			FVOCI	19
Derivative financial instruments	FVTPL (Trading)	19,942			FVTPL (Mandatory)	19,942
Financial assets designated at fair value	**FVTPL (Designated)**	**1,022**	**(45)**		**Amortised Cost**	**977**
	FVTPL (Designated)	836			FVTPL (Designated)	836
	FVTPL (Designated)	238			FVTPL (Mandatory)	238
Loans and advances to banks	Loans & receivables	5,930			Amortised Cost	5,930
Loans and advances to customers [3]	**Loans & receivables**	**199,210**		**(211)**	**Amortised Cost**	**198,999**
	Loans & receivables	**181**	**(1)**		**FVOCI**	**180**
	Loans & receivables	91			FVTPL (Mandatory)	91
Financial investments	Loans & receivables	1,198			Amortised Cost	1,198
	Loans & receivables	**982**	**(2)**		**FVTPL (Mandatory)**	**980**
	Available-for-sale financial assets	8,743			FVOCI	8,743
	Available-for-sale financial assets	29			FVTPL (Mandatory)	29
	Held-to-maturity investments	6,578			Amortised Cost	6,578
	Available-for-sale financial assets	81			FVTPL (Mandatory)	81
Other assets	**Other assets**	**6,373**	**(1)**		**Other assets**	**6,372**
Total assets (pre-DTA) (4)		**314,760**	**(49)**	**(211)**		**314,500**

1. **Reclassifications**: this column captures the gross (pre-tax) and net (post-tax) impacts on assets resulting from facilities impacted by the new IFRS 9 C&M rules.
2. **Remeasurement (of loss allowance)**: this column captures the gross (pre-tax) and net (post-tax) impact of facilities that had an incurred loss under IAS 39, and now have an ECL under IFRS 9; and facilities that have been reclassified from a non-amortised cost basis to an amortised cost basis. Note, there is no loss allowance movement attributable to held-to-maturity investments or available-for-sale financial assets reclassified to amortised cost.
3. **Financial guarantee contracts**: of the £211m of increase in loss allowance, £6m relates to ECL on financial guarantee contracts, which for presentation purposes have been aggregated in the assets section. See schedule 2 below.
4. **DTA:** the impact of transition to IFRS 9 gives rise to a DTA of £68m, of which £14m is attributable to Reclassifications, and £54m to Remeasurement. This DTA will be offset against our Deferred Tax Liabilities.

Schedule 2: Loss allowance reconciliation

	Loss allowance under IAS 39/ provisions under IAS 37 £m	Reclassifications £m	Remeasurement £m	Loss allowance under IFRS 9 £m
Loans & receivables (IAS 39)/ Financial assets at amortised cost (IFRS 9) [(1)]				
Loans and advances to customers	940	-	**205**	1,145
Provisions for off-balance-sheet exposures (IAS 37/ IFRS 9) [(2)]				
Financial guarantees	-	-	6	6
Total	**940**	**-**	**211**	**1,151**

1. For financial instruments subject to incurred loss assessment under IAS 39, and amortised cost under IFRS 9. Note, there are no loss allowance movement attributable to held-to-maturity investments or available-for-sale financial assets reclassified to amortised cost.
2. The ECL on off-balance sheet commitments which are both identifiable from ECL on total exposures, and for which were previously within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and now within the scope of IFRS 9.

Schedule 3: Reserves and retained earnings

	Impact at 1 January 2018 £m
Closing retained earnings and reserves under IAS 39	**6,700**
Other reserves	
Closing balance under IAS 39 [(1)]	301
Reclassification of investment securities (debt and equity) from AFS to FVTPL [(2)]	(5)
Opening balance under IFRS 9	296
Retained earnings	
Closing balance under IAS 39	6,399
Reclassifications under IFRS 9	(44)
Recognition of expected credit losses under IFRS 9 [(3)]	(211)
Deferred tax asset	68
Opening balance under IFRS 9	6,212
Opening retained earnings and reserves under IFRS 9	**6,508**

1. Other reserves is made up the following components under IAS 39: of £68m of available-for-sale reserve, £228m of cash flow hedging reserve, and £5m of foreign currency translation reserves. The available-for-sale reserve becomes the fair value reserve under IFRS 9.
2. Consists of loans and receivables which have transferred to FVOCI, and equity instruments which have transferred from available-for-sale financial assets to non-trading financial assets held mandatorily at FVTPL.
3. Analysed in section 4.2.

Appendix C: Provisional accounting policy changes for IFRS 9

Revenue recognition

Interest income and expense

Interest income on financial assets that are classified as amortised cost and interest expense on financial liabilities other than those at FVTPL are determined using the effective interest rate method.

The effective interest rate is the rate that discounts the estimated future cash payments or receipts over the expected life of the instrument or, when appropriate, a shorter period, to the gross carrying amount of the financial asset (i.e. its amortised cost before any impairment allowance) or to the amortised cost of a financial liability. When calculating the effective interest rate, the future cash flows are estimated after considering all the contractual terms of the instrument excluding expected credit losses. The calculation includes all amounts paid or received by the Santander UK group that are an integral part of the overall return, direct incremental transaction costs related to the acquisition, issue or disposal of the financial instrument and all other premiums or discounts.

Interest income is calculated by applying the effective interest rate to the gross carrying amount of financial assets, except for financial assets that have subsequently become credit-impaired (or 'stage 3'), for which interest revenue is calculated by applying the effective interest rate to their amortised cost (i.e. net of the expected credit loss provision).

Interest income on assets classified as amortised cost, interest expense on liabilities classified at amortised cost, and interest income and expense on hedging derivatives are recognised in 'Interest and similar income' and 'Interest expense and similar charges' in the income statement, as appropriate.

Financial assets and liabilities

(A) Initial recognition and measurement

Financial assets and liabilities are initially recognised when the Santander UK group becomes a party to the contractual terms of the instrument. The Santander UK group determines the classification of its financial assets and liabilities at initial recognition and measures a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss (FVTPL), transaction costs that are incremental and directly attributable to the acquisition or issue of the financial asset or financial liability. Transaction costs of financial assets and financial liabilities carried at fair value through profit or loss are expensed in profit or loss. Immediately after initial recognition, an expected credit loss (ECL) allowance is recognised for financial assets measured at amortised cost and investments in debt instruments measured at fair value through other comprehensive income (FVOCI).

A regular way purchase is a purchase of a financial asset under a contract whose terms require delivery of the asset within the timeframe established generally by regulation or convention in the market place concerned. Regular way purchases of financial assets classified as loans and receivables, issues of equity or financial liabilities measured at amortised cost are recognised on settlement date; all other regular way purchases and issues are recognised on trade date. For this purpose, assets that are mandatorily measured at FVTPL form a separate classification from assets designated as measured at FVTPL.

(B) Financial assets

(i) Classification and subsequent measurement

From 1 January 2018, the Santander UK group has applied IFRS 9 *Financial Instruments* and classifies its financial assets in the following measurement categories:

- Amortised cost;
- FVOCI; or
- FVTPL.

Financial assets and financial liabilities are classified as FVTPL if they are either held for trading or otherwise designated at FVTPL on initial recognition.

Financial assets and financial liabilities are classified as held for trading if they are derivatives or if they are acquired or incurred principally for the purpose of selling or repurchasing in the near-term, or form part of a portfolio of financial instruments that are managed together and for which there is evidence of short-term profit taking.

In certain circumstances financial assets and financial liabilities other than those that are held for trading are designated at FVTPL where this results in more relevant information because it significantly reduces a measurement inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains or losses on them on a different basis, or where the assets or liabilities are managed and their performance evaluated on a fair value basis.

The classification requirements for debt and equity instruments are set out below.

(a) Debt instruments

Debt instruments are those instruments that meet the definition of a financial liability from the issuer's perspective, such as loans and government and corporate bonds.

Classification and subsequent measurement of debt instruments depend on:

- the Santander UK group's business model for managing the asset; and
- the cash flow characteristics of the asset.

Based on these factors, the Santander UK group classifies its debt instruments into one of the following three measurement categories:

- **Amortised cost** – Financial assets that are held for collection of contractual cash flows where those cash flows represent solely payments of principal and interest (SPPI), and that are not designated at FVTPL, are measured at amortised cost. The carrying amount of these assets is adjusted by any ECL recognised and measured as presented in Appendix A. Interest income from these financial assets is included in 'Interest and similar income' using the effective interest rate method.
- **FVOCI** - Financial assets that are held for collection of contractual cash flows and for selling the assets, where the assets' cash flows represent SPPI, and that are not designated at FVTPL, are measured at FVOCI. Movements in the carrying amount are recognised in OCI, except for the recognition of impairment gains or losses, interest revenue and foreign exchange gains and losses on the instrument's amortised cost which are recognised in profit or loss. When the financial asset is derecognised, the cumulative gain or loss previously recognised in OCI is reclassified from equity to profit or loss and recognised in 'Net trading and other income'. Interest income from these financial assets is included in 'Interest and similar income' using the effective interest rate method.
- **FVTPL** – Financial assets that do not meet the criteria for amortised cost or FVOCI are measured at FVTPL. A gain or loss on a debt instrument that is subsequently measured at FVTPL, including any debt instruments designated at fair value, and is not part of a hedging relationship is recognised in profit or loss and presented in the income statement in 'Net trading and other income' in the period in which it arises. Interest income from these financial assets is included in 'Interest and similar income' using the effective interest rate method.

Business model

The business model reflects how the Santander UK group manages the assets in order to generate cash flows and, specifically, whether the Santander UK group's objective is solely to collect the contractual cash flows from the assets or is to collect both the contractual cash flows and cash flows arising from the sale of assets. If neither of these is applicable such as where the financial assets are held for trading purposes, then the financial assets are classified as part of 'Other' business model and measured at FVTPL.

Factors considered by the Santander UK group in determining the business model for a group of assets include past experience on how the cash flows for these assets were collected, how the assets' performance is evaluated and reported to key management personnel and how risks are assessed and managed.

SPPI

Where the business model is to hold assets to collect contractual cash flows or to collect contractual cash flows and sell, the Santander UK group assesses whether the assets' cash flows represent solely payments of principal and interest (the SPPI test). In making this assessment, the Santander UK group considers whether the contractual cash flows are consistent with a basic lending arrangement (i.e. interest includes only consideration for the time value of money, credit risk, other basic lending risks and a profit margin that is consistent with a basic lending arrangement). Where the contractual terms introduce exposure to risk or volatility that are inconsistent with a basic lending arrangement, the related asset is classified and measured at FVTPL.

Financial assets with embedded derivatives are considered in their entirety when determining whether their cash flows are solely payments of principal and interest.

The Santander UK group reclassifies financial assets when and only when its business model for managing those assets changes. The reclassification takes place from the start of the first reporting period following the change. Such changes are expected to be very infrequent.

(b) Equity instruments

Equity instruments are instruments that meet the definition of equity from the issuer's perspective being instruments that do not contain a contractual obligation to pay and that evidence a residual interest in the issuer's net assets. The Santander UK group subsequently measures all equity investments at FVTPL, except where management has elected, at initial recognition, to irrevocably designate an equity investment at FVOCI. When this election is used, fair value gains and losses are recognised in OCI and are not subsequently reclassified to profit or loss, including on disposal. ECLs (and reversal of ECLs) are not reported separately from other changes in fair value. Dividends, when representing a return on such investments, continue to be recognised in profit or loss as other income when Santander UK group's right to receive payments is established. Gains and losses on equity investments at FVTPL are included in the 'Net trading and other income' line in the income statement.

(ii) Impairment

The Santander UK group assesses on a forward-looking basis the ECL associated with its debt instrument assets carried at amortised cost and FVOCI and with the exposure arising from financial guarantee contracts and loan commitments. The Santander UK group recognises a loss allowance for such losses at each reporting date. The measurement of ECL reflects:

- An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- The time value of money; and
- Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

(iii) Modifications

The treatment of a renegotiation or modification of the contractual cash flows of a financial asset depends upon whether the renegotiation or modification is done for commercial reasons or because of financial difficulties of the borrower.

- Contractual modifications for commercial reasons: such modifications are treated as a new transaction resulting in the derecognition of the original financial asset, and the recognition of a "new" financial asset. Any difference between the carrying amount of the derecognised asset and the fair value of the new asset is recognised in the income statement as a gain or loss on derecognition.
- Contractual modifications due to financial difficulties of the borrower: where Santander UK modifies the contractual conditions to enable the borrower to fulfil their payment obligations, the asset is not derecognised. The gross carrying amount of the financial asset is recalculated as the present value of the renegotiated/modified contractual cash flows that are discounted at the financial asset's original EIR and any gain or loss arising from the modification is recognised in the income statement.

Other contractual modifications not being of the types described above are assessed on a case-by-case basis to establish whether or not the financial asset should be derecognised.

(iv) Derecognition other than on a modification

Financial assets are derecognised when the rights to receive cash flows have expired or the Santander UK group has transferred its contractual right to receive the cash flows from the assets and either: (1) substantially all the risks and rewards of ownership have been transferred; or (2) the Santander UK group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

(C) Financial liabilities

(i) Classification and subsequent measurement

Financial liabilities are classified as subsequently measured at amortised cost, except for:

- Financial liabilities at fair value through profit or loss: this classification is applied to derivatives, financial liabilities held for trading and other financial liabilities designated as such at initial recognition. Gains or losses on financial liabilities designated at fair value through profit or loss are presented partially in other comprehensive income (the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability) and partially in profit or loss (the remaining amount of change in the fair value of the liability);
- Financial liabilities arising from the transfer of financial assets which did not qualify for derecognition, whereby a financial liability is recognised for the consideration received for the transfer. In subsequent periods, the Santander UK group recognises any expense incurred on the financial liability; and
- Financial guarantee contracts and loan commitments.

(ii) Derecognition

Financial liabilities are derecognised when extinguished, cancelled or expired.

(D) Financial guarantee contracts and loan commitments

Financial guarantee contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due, in accordance with the terms of a debt instrument. Such financial guarantees are given to banks, financial institutions and others on behalf of customers to secure loans, overdrafts and other banking facilities.

Financial guarantee contracts are initially measured at fair value and subsequently measured at the higher of:

- The amount of the loss allowance; and
- The premium received on initial recognition less income recognised in accordance with the principles of IFRS 15 *Revenue from Contracts with Customers.*

Loan commitments are measured as the amount of the loss allowance. The Santander UK group has not provided any commitment to provide loans at a below-market interest rate, or that can be settled net in cash or by delivering or issuing another financial instrument.

For financial guarantee contracts and loan commitments, the loss allowance is recognised as a provision.

Additional information about Santander UK and Banco Santander

Banco Santander (SAN SM, STD US, BNC LN) is a leading retail and commercial bank, based in Spain, with a meaningful market share in 10 core countries in Europe and the Americas. Banco Santander is among the world's top banks by market capitalisation. Founded in 1857, Banco Santander has 133 million customers, 13,697 branches and 202,000 employees at the close of December 2017. In 2017,Banco Santander made attributable profit of EUR 6,619 million.

Santander UK is a financial services provider in the UK that offers a wide range of personal and commercial financial products and services. At 31 December 2017, the bank serves around 14 million active customers with c19,500 employees and operates through 806 branches (which includes 61 university branches) and 64 regional Corporate Business Centres. Santander UK is subject to the full supervision of the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) in the UK. Santander UK plc customers are protected by the Financial Services Compensation Scheme (FSCS) in the UK.

Banco Santander has a standard listing of its ordinary shares on the London Stock Exchange and Santander UK Group Holdings plc and Santander UK plc have preference shares listed on the London Stock Exchange.

Nothing in this announcement constitutes or should be construed as constituting a profit forecast.

Further information about Santander UK is available at our website: www.aboutsantander.co.uk.

Disclaimer

Santander UK Group Holdings plc (Santander UK) and Banco Santander both caution that this announcement may contain forward-looking statements. Such forward-looking statements are found in various places throughout this announcement. Words such as "believes", "anticipates", "expects", "intends", "aims" and "plans" and other similar expressions are intended to identify forward-looking statements, but they are not the exclusive means of identifying such statements. Forward-looking statements include, without limitation, statements concerning our future business development and economic performance. These forward-looking statements are based on management's current expectations, estimates and projections and both Santander UK and Banco Santander caution that these statements are not guarantees of future performance. We also caution readers that a number of important factors could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements. We have identified certain of these factors in the forward looking statements on page [269] of the Santander UK Group Holdings plc 2017 Annual Report & Accounts. Investors and others should carefully consider the foregoing factors and other uncertainties and events. Undue reliance should not be placed on forward-looking statements when making decisions with respect to Santander UK, Santander UK plc, Banco Santander and/or their securities. Such forward-looking statements speak only as of the date on which they are made, and we do not undertake any obligation to update or revise any of them, whether as a result of new information, future events or otherwise. Statements as to historical performance, historical share price or financial accretion are not intended to mean that future performance, future share price or future earnings for any period will necessarily match or exceed those of any prior quarter. Nothing in this announcement should be construed as profit forecast.

Santander UK is a frequent issuer in the debt capital markets and regularly meets with investors via formal roadshows and other ad hoc meetings. In line with Santander UK's usual practice, it expects to discuss this announcement with investors and other matters relating to Santander UK.