Santander Financial Services plc

2021 Annual Report

PART OF THE BANCO SANTANDER GROUP

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Santander Financial Services plc
2021 Annual Report

Index

Important information for readers
Santander Financial Services plc (the Company or SFS) operates in the UK, the Isle of Man and Jersey, and is part of Banco Santander (comprising Banco Santander SA and its subsidiaries). Santander Financial Services plc is regulated by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The Isle of Man branch is regulated by the Isle of Man Financial Services Authority. The Jersey branch is regulated by the Jersey Financial Services Commission.

This Annual Report contains forward-looking statements that involve inherent risks and uncertainties. Actual results may differ materially from those contained in such forward-looking statements.

For more information see www.aboutsantander.co.uk.

Strategic report

Santander Financial Services plc (SFS or the Company) is a subsidiary of Santander UK Group Holdings plc (together with its subsidiaries, Santander UK or the Santander UK group). The Company is required to set out in this report a fair review of its business and a description of its principal risks and uncertainties, including a balanced and comprehensive analysis of the development and performance of the business in the year and of its position at the end of the year. This information can be found below and in the following sections of this Annual Report, which are incorporated into and form part of this Strategic report.

Under the UK Companies Act 2006, a safe harbour limits the liability of Directors in respect of statements in and omissions from the Directors' Report (for which see page 9 and the Strategic report). Under English law, the Directors would be liable to the Company, but not to any third party, if one or more of these reports contained errors as a result of recklessness or knowing misstatement or dishonest concealment of a material fact, but would otherwise not be liable. Pages 9 to 12 inclusive comprise the Directors' Report, pages 2 and 3 comprise the Strategic report, each of which have been drawn up and presented in accordance with and in reliance upon English company law and the liabilities of the Directors in connection with these reports shall be subject to the limitations and restrictions provided by such law.

The Directors, in preparing this Strategic report, have complied with Section 414C of the Companies Act 2006.

Principal activities

SFS is an operating company whose principal activity is to provide banking and financial services for clients and customers through its presence in the UK, Jersey and the Isle of Man, whilst also holding a pool of residual assets and liabilities, which is intended to be run down and/or managed for value.

Under Santander UK's ring-fencing plans, the assets and liabilities of SFS (except for a portfolio of residual assets and liabilities) were transferred to Santander UK plc (the principal ring-fenced bank of the Santander UK group) and to Banco Santander SA, London Branch and SFS became a direct wholly owed subsidiary of Santander UK Group Holdings plc. The businesses of Santander UK plc's Jersey and Isle of Man branches was also transferred to Jersey and Isle of Man branches of the Company.'

SFS is part of a core UK group with Santander UK Group Holdings plc and Santander Equity Investments Limited for capital ratio and large exposure purposes under the terms of the Non-RFB Capital Support Deed. For more on this agreement, see Note 18 to the Financial Statements.

SFS manages its own liquidity separately.

In October 2020, the Company purchased a £3.2bn portfolio of UK residential mortgages from Santander UK plc to allow it to efficiently deploy its excess liquidity and improve its balance sheet position by optimising the Company's funding to improve the return generated by the Company from deposits taken from its customers.

In January 2022 the Company acquired Abbey National International Limited, a Jersey registered entity.

Our performance and key performance indicators

The directors of the Company's ultimate UK parent, Santander UK Group Holdings plc, monitor the performance of the Santander UK group (which includes SFS) on a business division basis. Key performance indicators are not set, monitored or managed at the Company level. As a result, the Company's Directors believe that analysis using key performance indicators for the Company is not necessary or appropriate for an understanding of the development, performance or position of the Company.

Risk management overview

Information on our principal risks and uncertainties is set out in the Risk review by type of risk.

Broader geopolitical and social risks, including invasion by Russia of Ukraine
During the course of the past two years, since the onset of the Covid-19 pandemic, a number of broader risks have evolved and may present future headwinds. These include, geopolitical tensions between regions across the world, global supply chain pressures (which have already fuelled inflationary pressures), stretched household finances, and emerging social unrest. These factors are also likely to play into increased localised political risk, including in the UK. We are closely following these developments and the potential for any material impacts which may need to be taken into consideration in our future business plans.

Financial overview

Development and performance of our business in 2021
Information on the development and performance of our business in the year is set out in the 'Income statement review' section of the Financial review.

Our position at 31 December 2021
Information on our position at the end of the year is set out in the 'Balance sheet review' section of the Financial review.

Section 172 Statement

The Directors have acted in a way that they considered, in good faith, to be most likely to promote the long-term success of the Company for the benefit of its members, having regard to the following:

(a) Likely consequences of any decision in the long term: The Company is wholly owned by Santander UK Group Holdings plc and as such will operate to the standards set by the Santander UK group. Any decision taken is expected to align to the strategy of the wider Santander UK group and will take into account the interests of all relevant stakeholders. Impacts of any decisions will be determined through ongoing risk assessment conducted with all relevant stakeholders.

(b) Interests of the Company's employees: The Company's staff have employment contracts with the Company. The Company policies involve and inform employees on matters that affect them. For more on this, see 'Employees' in the Directors' report.

(c) Business relationships with suppliers, customers and others: The Board recognises the importance of building strong relationships with suppliers and customers and actively engages with representatives of contracting parties to ascertain their views and take them into account. In Jersey, we secured new premises for a new Santander Work Café which was opened in January 2021 offering an innovative space for clients and non-customers, which brings a bank, co-working area and coffee house together in a single place. The success of the Jersey Work Café in 2021 has lead management to agree plans to replicate the Work Café model in the Isle Of Man, premises have now been sourced with plans to open in 2023.

(d) Community and the environment: The Board encourages its employees to support community programmes and to factor the impact on the environment, both local and more extended, into decision-making processes. As part of our ongoing support of the local community the Jersey branch is focusing on supporting key sporting partnerships: Jersey Reds premiership rugby team, Jersey Reds minis and juniors, Strive Academy which provides health and fitness education to children and aspiring athletes and Team Jets netball. In addition, the Santander Work Café in Jersey is able to offer free meeting rooms, co-working space and host events for local charities, small business owners and entrepreneurs. The Isle of Man branch also supports local community sporting events and sponsors: Douglas Rugby Club, ManXtreme games and the New Year's Day Santander splash. Both branches also participate in Corporate Social Responsibility days to help make a difference in the community. As part of this, staff volunteered with National Trust Jersey and Curraghs Wildlife Park in the Isle of Man.

(e) Reputation for high standards of business conduct: The Company's reputation is fundamental to the long-term success of the Company and significant effort is expended to ensure that performance and processes attain and wherever possible exceed expectations. Santander UK (including SFS) is committed to maintaining high ethical standards – adhering to laws and regulations, conducting business in a responsible way and treating all stakeholders with honesty and integrity. These principles are further reflected in Santander UK's Ethical Code of Conduct. For more on this, see 'Ethical Code of Conduct' in the Directors' report.

(f) Need to act fairly as between members of the Company: The Company is wholly owned by Santander UK Group Holdings plc and that shareholder has oversight of key decisions of the Company on a periodic basis. Information is shared effectively to ensure that the shareholder is engaged.

This confirmation is given and should be interpreted in accordance with the provisions of Section 418 of the UK Companies Act 2006.

By Order of the Board

James Pountney
Director
10 March 2022

INCOME STATEMENT REVIEW

SUMMARISED INCOME STATEMENT

	2021	2020
	£m	£m
Net interest income/(expense)	**51.0**	(4.2)
Non-interest expense[(1)]	**(1.4)**	(2.8)
Total operating income/(expense)	**49.6**	(7.0)
Operating expenses before credit impairment losses, provisions and charges	**(23.1)**	(19.3)
Operating credit impairment losses, provisions and charges	**(2.2)**	(0.8)
Profit/(loss) before tax	**24.3**	(27.1)
Tax on profit/(loss)	**2.4**	15.5
Profit/(loss) after tax	**26.7**	(11.6)

(1) Comprises 'Net fee and commission income' and 'Other operating income'.

A more detailed income statement is contained in the Financial Statements.

2021 compared to 2020

Profit/(loss) before tax increased to £24.3m due to the factors outlined below. By income statement line item, the movements were:

– Net interest income/(expense) increased to net interest income of £51.0m in 2021 (2020: net interest expense of £4.2m), with higher interest income following the purchase of UK residential mortgages from Santander UK plc towards the end of 2020. Interest expense also decreased due to a reduced cost of funding in line with the Bank of England base rate decreases.

– Non-interest expense decreased to £1.4m in 2021 (2020: £2.8m), due to a gain on the Prudential receivables hedge and lower losses from FX movements, partially offset by additional fees paid to Santander UK plc associated with the portfolio of UK residential mortgages purchased from Santander UK plc.

– Operating expenses before credit impairment losses, provisions and charges increased to £23.1m in 2021 (2020: £19.3m), mainly due to an increase in the Santander UK service level agreement for services provided by Santander UK on behalf of SFS, and an increase in information technology costs, depreciation and staff costs to facilitate the Company's growth plan.

– Operating credit impairment losses, provisions and charges increased to £2.2m in 2021 (2020: £0.8m), due to the release in 2020 of an over provision relating to the closure in 2018 of our US branch which did not recur in 2021. The remaining charge consisted of the bank levy and a small amount of mortgage credit impairment loss provisioning.

– Tax on profit/(loss) was £2.4m in 2021 (2020: £15.5m) driven by an increase in the profit before tax in the year net of adjustment to provisions for taxation in prior periods.

Critical factors affecting results

The preparation of our Financial Statements requires management to make estimates and judgements that affect the reported amount of assets and liabilities at the balance sheet date and the reported amount of income and expenses during the reporting period. Management evaluates its estimates and judgements on an ongoing basis. Management bases its estimates and judgements on historical experience and other factors believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

In the course of preparing the financial statements, no significant judgements have been made in the process of applying the Company's accounting policies.

BALANCE SHEET REVIEW

SUMMARISED BALANCE SHEET

	2021	2020
	£m	£m
Assets		
Cash and balances at central banks	**2,355**	2,288
Financial assets at fair value through profit or loss	**468**	534
Financial assets at amortised cost	**3,748**	3,848
Property, plant and equipment	**7**	6
Tax, intangibles and other assets	**11**	13
Total assets	**6,589**	6,689
Liabilities		
Financial liabilities at fair value through profit or loss	**237**	308
Financial liabilities at amortised cost	**6,000**	6,049
Tax, other liabilities and provisions	**26**	25
Total liabilities	**6,263**	6,382
Equity		
Total shareholders' equity	**326**	307
Total equity	**326**	307
Total liabilities and equity	**6,589**	6,689

A more detailed balance sheet is contained in the Financial Statements.

2021 compared to 2020

Assets

Cash and balances at central banks
Cash and balances at central banks increased to £2,355m at 31 December 2021 (2020: £2,288m), due to excess liquidity being held at the Bank of England.

Financial assets at fair value through profit or loss
Financial assets at fair value through profit or loss decreased to £468m at 31 December 2021 (2020: £534m) due to a decrease in the value of Prudential Lifetime Mortgages and interest rate swaps.

Financial assets at amortised cost
Financial assets at amortised cost decreased to £3,748m at 31 December 2021 (2020: £3,848m), driven by a decrease in cash collateral placed with Banco Santander and repayments of the portfolio of UK residential mortgages transferred from Santander UK plc, partially offset by growth in the Jersey and Isle of Man mortgage portfolios.

Liabilities

Financial liabilities at fair value through profit or loss
Financial liabilities at fair value through profit or loss decreased to £237m at 31 December 2021 (2020: £308m) due to a decrease in the Prudential Lifetime Mortgage hedges.

Financial liabilities at amortised cost
Financial liabilities at amortised cost decreased to £6,000m at 31 December 2021 (2020: £6,049m), driven by a small decrease in customer deposits.

Equity

Total shareholders' equity increased to £326m at 31 December 2021 (2020: £307m) due to the profit for the year, partially offset by dividends paid of £8m (2020: £nil).

BOARD OF DIRECTORS

NON-EXECUTIVE DIRECTORS

Antonio Costa Ortuño

Chair

Antonio Costa was appointed as Chair of the Company on 25 November 2020, following his appointment as a Non-Executive Director of the Company on 9 October 2020. He has over 20 years of experience in the banking and financial industry, having joined Banco Santander in 1996. Since 2009 he has been the Chief Executive Officer of Banco Santander International, SA in Switzerland and and serves as a member of the Risk and Compliance Committees and is also a member of the Global Private Banking Committee of Santander Wealth Management and Insurance Division. Previously he held the position of Regional Director for the Mexican desk in Banco Santander International in Miami as an Executive Vice-President. He also served as Deputy Representative for Banco Santander in Peru and also worked in Banco Santander de Negocios in Spain.

Helen Hatton

Independent Non-Executive Director

Helen Hatton was appointed as an Independent Non-Executive Director on16 December 2020. She has over 17 years of experience working for the regulators across the Crown Dependencies, effecting organisational change across governance, accountability and risk management amongst other areas, to enhance the effectiveness of Jersey regulation. In the Isle of Man, she was part of the senior management group with responsibility for strategic development and operational control of the Enforcement division and covered a number of disciplines during her tenure such as Anti Money Laundering, Enforcement, Compliance, and Inter-Regulatory relations.

Jennifer Houghton

Independent Non-Executive Director

Jennifer Houghton was appointed as an Independent Non-Executive Director on 13 October 2020. She is an experienced qualified accountant and chartered director who has worked as a managing director, finance director, company secretary, and MLRO, with a successful career in California, Luxembourg, Sweden and the Isle of Man, both in practice and in industry. She also worked for Deloitte & Touche for 18 years in the banking, insurance and financial services sectors.

Victor Matarranz

Non-Executive Director

Victor Matarranz was appointed as Non-Executive Director of the Company on 7 March 2020. He is currently Group Senior Executive Vice-President and Global Head of Wealth Management and Insurance at Banco Santander. Victor brings an immense amount of experience to the role having previously held the positions of Director of Strategy (2014 – 2017) with Banco Santander and prior to this he held the position of Director of Strategy and Chief of Staff to the CEO in Santander UK (2012 – 2014), as well as a Partner during his employment at McKinsey & Company in Spain (2000 - 2012) where he worked in Strategy, mainly in Retail and Corporate Banking.

Charles Shepherd

Non-Executive Director

Charles Shepherd was appointed as Non-Executive Director of the Company on 7 March 2020. Charles is the current General Counsel, Head of Retail, Corporate, and Wholesale Banking Legal for the Santander UK group. He joined Santander UK in 2004 as a senior lawyer providing legal advice and guidance to the Global Banking & Markets division and has held several roles since then. Charles has played a key role in managing and successfully implementing Santander UK's ring-fencing programme. He has substantial experience of a range of financial products and services and financial services regulation from working with Santander UK's Retail Banking, Wealth Management, Corporate and Commercial Banking and Corporate and Investment Banking businesses and its Treasury function.

EXECUTIVE DIRECTORS

James Pountney

Chief Executive Officer, Chief Financial Officer and Chief Operating Officer

James Pountney was appointed as Executive Director, Chief Executive Officer, Chief Financial Officer and Chief Operating Officer of the Company on 9 October 2020. James joined Santander UK plc in July 2015 as Managing Director for its Jersey and Isle of Man branches. He has extensive knowledge of the retail banking and wealth management industry having previously worked for Lloyds Bank and Citibank before joining Standard Chartered (Jersey) Limited, during which time he was appointed as an Executive Director on the subsidiary board and was Head of Private and International Banking, serving the bank's customers across Asia, Africa and the Middle East. Following that, James spent a brief period with HSBC International plc as Head of Premier and Wealth Management before joining Santander.

Richard Settle

Chief Risk Officer

Richard Settle was appointed as Executive Director and Chief Risk Officer of the Company on 8 December 2020. Richard has over 25 years of risk and audit experience in financial institutions and joined from Euroclear UK & Ireland where he was CRO. He previously held CRO or senior risk positions in Deutsche Bank, Shanghai Pudong Development Bank and Citi in London.

Directors' report

INTRODUCTION

The Directors submit their report together with the financial statements for the year ended 31 December 2021. The information in the Directors' report is unaudited, except where marked.

HISTORY, CORPORATE STRUCTURE, SUBSIDIARIES AND BRANCHES

The Company's principal activity is to provide banking and financial services for clients and customers through its presence in the UK, Jersey and the Isle of Man, whilst also holding a pool of residual assets and liabilities, which is intended to be run down and/or managed for value.

The Company was established in 1989 for the purpose of managing the liquidity, risk management and wholesale banking needs of Abbey National plc (subsequently renamed Santander UK plc) and its subsidiaries.

On 12 November 2004, Banco Santander SA, a company incorporated in Spain, completed the acquisition of the entire issued ordinary share capital of the then parent company of the Company, Santander UK plc, at which point the Company became an indirect subsidiary of Banco Santander SA.

In 2018, as part of the implementation of ring-fencing in the Santander UK group, the assets and liabilities of the Company (except for a portfolio of residual assets and liabilities) were transferred to Santander UK plc (the principal ring-fenced bank of the Santander UK group) and to Banco Santander SA, London Branch and the Company became a direct wholly owned subsidiary of Santander UK Group Holdings plc. The businesses of Santander UK plc's Jersey and Isle of Man branches was also transferred to Jersey and Isle of Man branches of the Company.

On 30 September 2019, the Company changed its legal name to Santander Financial Services plc from Abbey National Treasury Services plc to better reflect its current business direction and strategy, and to align the Company's legal name to the Santander brand.

The Company remains a wholly owned direct subsidiary of Santander UK Group Holdings plc and a wholly owned indirect subsidiary of Banco Santander SA.

As noted above, the Company has branch offices in Jersey and the Isle of Man. In January 2022 the Company acquired Abbey National International Limited, a Jersey registered entity. For further information, see Note 13 to the Financial Statements.

RESULTS AND DIVIDENDS

The profit after tax for the year was £26.7m (2020: loss after tax £11.6m). The Directors do not recommend the payment of a final dividend for 2021 (2020: £nil) on the ordinary shares in issue. Interim dividends of £7m and £1m were paid during the year on the ordinary shares (2020: Interim dividend of £nil).

Details of the Company's activities and business performance during 2021 are set out in the Strategic report on pages 2 to 3, and the Financial review on pages 4 to 6.

EVENTS AFTER THE BALANCE SHEET DATE

There have been no material post balance sheet events, except as set out in Note 26.

DIRECTORS

Directors who served during the year and to the date of signing the financial statements were as follows:

Name of Director	Date of appointment
Antonio Costa Ortuno (Chair and Non-Executive)	9 October 2020
James Pountney (Chief Executive Officer and Chief Financial Officer)	9 October 2020
Richard Settle (Chief Risk Officer)	8 December 2020
Victor Matarranz (Non-Executive)	7 March 2020
Charles Shepherd (Non-Executive)	7 March 2020
Jennifer Houghton (Independent Non-Executive)	13 October 2020
Helen Hatton (Independent Non-Executive)	16 December 2020

During the year and to the date of signing the financial statements, the following Directors resigned:

Name of Director	Date of resignation
Simon Lloyd (Independent Non-Executive)	31 March 2021

Two INEDs have contracts for services. The CEO and CRO are employed by the Company. The remaining Directors are employed by companies within the Banco Santander and Santander UK groups. Directors may be paid instead of being required to work during their notice period. None of the Directors' employment contracts provide for benefits to be paid on termination of employment other than for redundancy.

All Directors are appointed and retired in accordance with the Company's Articles of Association and the UK Companies Act 2006. The Company does not require the Directors to offer themselves for re-election every year, or that new Directors appointed by the Board offer themselves for election at the next Annual General Meeting.

Details of aggregate remuneration received by the Directors of the Company in 2021 and 2020 are found in Note 22 to the Financial Statements. The remuneration, excluding pension contributions, of the highest paid Director and details of Director participation in defined benefit pension schemes are contained in Note 22 to the Financial Statements. For a description and details of related party transactions, see Note 23 to the Financial Statements.

Directors' indemnities
Enhanced indemnities are provided to the Directors of the Company by Santander UK Group Holdings plc against liabilities and associated costs which they could incur in the course of their duties to the Company. All of the indemnities were in force during the financial year and at the date of approval of the Annual Report. All of the indemnities were qualifying third party indemnities. A copy of each of the indemnities is kept at the registered office address of Santander UK Group Holdings plc.

EMPLOYEES

All staff in Jersey and the Isle of Man have employment contracts with the Company.

As part of the Santander UK group, we continue to ensure that our remuneration policies are consistent with our strategic objectives and are designed with the long-term success of the Company in mind. In doing so we aim to attract and retain the most talented and committed people.

Communication
The Company participates in Santander UK's policies and aims to involve and inform employees on matters that affect them. The intranet is a focal point for communications and the 'AskHR' website connects employees to all the information they need about working for Santander UK (including SFS) . We also use face-to-face communication, such as team meetings and roadshows for updates. Santander UK (including SFS) regularly considers employees' opinions and asks for their views on a range of issues through regular engagement and surveys.

Consultation
The Company has a successful history of working in partnership with its recognised trade union, Advance. The trade union is affiliated to the Trades Union Congress. We consult Advance on significant proposals including those relating to change across the business at both national and local levels.

Disability
The Company is committed to equality of employment, access and quality of service for disabled people and complies with the UK Equality Act 2010 throughout its business operations. Santander UK (including SFS) has processes in place to help train, develop, retain and promote employees with disabilities.

Santander UK is a Disability Confident Employer achieving the 'Leader' level. We are committed to giving full and fair consideration to employment applications by disabled people, having regard to their particular aptitudes and abilities, and for continuing the employment of employees who have become disabled by arranging appropriate training and making reasonable adjustment in the workplace.

STREAMLINED ENERGY AND CARBON REPORTING (SECR)

The Company meets the requirements under SECR reporting disclosures but in terms of our UK energy use we consider this to be negligible.

POLITICAL CONTRIBUTIONS

In 2021 and 2020, no contributions were made for political purposes and no political expenditure was incurred.

SHARE CAPITAL

Details of the structure of the Company's share capital, including the rights and obligations attaching apply to each class of share in the Company, can be found in Note 19 to the Financial Statements which are incorporated by reference into this report. The powers of the Directors in relation to share capital are set out in the Company's Articles of Association as determined by the Companies Act 2006.

FINANCIAL INSTRUMENTS

The Company's risks are managed on a group level by Santander UK Group Holdings plc, except for liquidity which is managed on a standalone basis. The financial risk management objectives and policies of the Company and the exposure of the Company to credit risk, market risk, liquidity risk and capital risk are outlined in the Risk review.

RESEARCH AND DEVELOPMENT

New products, campaigns and business initiatives are reviewed by the Company's Project Steering Forum.

SUPERVISION AND REGULATION

The Company is authorised by the PRA and regulated by the FCA and the PRA. The Isle of Man branch is regulated by the Isle of Man Financial Services Authority. The Jersey branch is regulated by the Jersey Financial Services Commission. While the Company is a UK registered entity, it is also subject to the laws and regulations of the other jurisdictions in which it operates.

BOARD COMMITTEES

The Company maintains a standing Board Audit Committee, Board Risk Committee and Board Nomination Committee. The Board Audit Committee and Board Risk Committee met regularly throughout the year. The Board Nomination Committee meets as required. The Board Audit Committee is chaired by Jennifer Houghton, the Board Risk Committee is chaired by Helen Hatton and the Board Nomination Committee is chaired by Antonio Costa.

INTERNAL CONTROLS

Risk management and internal controls
The Board and its Committees are responsible for reviewing and ensuring the effectiveness of management's system of risk management and internal controls. We have carried out a robust assessment of the principal risks facing the Company, including those that would threaten its business model, future performance, solvency or liquidity. For further details, see the Risk review.

Management's report on internal control over financial reporting
Internal control over financial reporting is a component of an overall system of internal control. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting, and the preparation and fair presentation of financial statements for external purposes in accordance with UK-adopted international accounting standards.

The Company's internal control over financial reporting includes:
- Policies and procedures that relate to the maintenance of records that fairly and accurately reflect the transactions and dispositions of assets
- Controls providing reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in accordance with UK-adopted international accounting standards, and that receipts and expenditures are being made only as authorised by management
- Controls providing reasonable assurance regarding prevention or timely detection of unauthorised acquisition and use or disposition of assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or because the degree of compliance with policies or procedures may deteriorate.

Management is responsible for establishing and maintaining adequate internal control over the financial reporting of the Company. Management assessed the effectiveness of the Company's internal control over financial reporting at 31 December 2021 based on the criteria established in the Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in May 2013 (the 2013 Framework).

Based on this assessment, management concluded, at 31 December 2021, that the Company's internal control over financial reporting was effective.

GOING CONCERN (audited)

The going concern of the Company is reliant on preserving a sufficient level of capital and adequately funding the balance sheet. The Company's business activities and financial position, together with the factors likely to affect its future development and performance, are set out in the Strategic report on pages 2 to 3, and the Financial review on pages 4 to 6. The Company's objectives, policies and processes for managing the financial and other risks to which it is exposed, including capital, funding and liquidity, are described in the Risk review.

In assessing going concern, the Directors take account of all information of which they are aware about the future, which is at least, but is not limited to, 12 months from the date that the financial statements are approved.

As described in the Strategic Report, the Company is a wholly owned direct subsidiary of Santander UK Group Holdings plc, and its principal activity is to provide banking and financial services for clients and customers through its presence in the UK, Jersey and the Isle of Man, whilst also holding a pool of residual assets and liabilities, which is intended to be run down and/or managed for value.

At 31 December 2021, the Company, Santander UK Group Holdings plc (the regulated entities) and Santander Equity Investments Limited were party to a capital support deed dated 13 November 2018 (the Non-RFB Sub-Group Capital Support Deed). These parties were permitted by the PRA to form a core UK group as defined in the PRA Rulebook, a permission which expired on 31 December 2021. Exposures of each of the regulated entities to other members of the core UK group were exempt from large exposure limits that would otherwise apply and intra-group exposures risk-weighted at 0% on a solo as well as consolidated basis. The purpose of the Non-RFB Sub-Group Capital Support Deed was to facilitate the prompt transfer of available capital resources from, or repayment of liabilities by, the members in the event that the Company breached or was at risk of breaching its capital resources. A new Non-RFB Sub-Group Capital Support Deed was entered into on 17 December 2021 and effective from 1 January 2022, reflecting the latest version of associated regulation. The parties to the Non-RFB Sub-Group Capital Support Deed remained unchanged with the PRA granting permission for a renewal of the Non-RFB core UK group from 1 January 2022 to 31 December 2024, following expiry of the previous permission on 31 December 2021.

The Company manages its own liquidity.

Having assessed the principal risks and the other matters discussed above, the Directors consider it appropriate to adopt the going concern basis of accounting in preparing the financial statements.

ETHICAL CODE OF CONDUCT

The Company is committed to ensuring we hold ourselves to high ethical standards. This means adhering to laws and regulations and also conducting business in a responsible way, and treating all stakeholders with fairness and respect. These principles are reflected in Santander UK's Ethical Code of Conduct, which sets the standards expected of all employees.

Maintaining high standards of professional and personal conduct helps the Company identify, manage and respond to risks, creates a positive, collaborative working environment and it ensures positive customer interactions and outcomes.

Among the requirements set out in the Ethical Code of Conduct we expect employees to:

- Act with integrity in all their business actions on behalf of the Company
- Not use their authority or position for personal gain
- Speak up and report risks
- Conduct business relationships in a transparent manner.

There are numerous policies which support employees to meet these expectations and to ensure Santander UK (including the Company) remains a Simple, Personal and Fair bank for its colleagues, customers, shareholders and the communities it serves. The Ethical Code of Conduct applies to all employees including permanent and temporary employees as well as Executive Directors and Non-Executive Directors.

STATEMENT OF DIRECTORS' RESPONSIBILITIES

The Directors are responsible for preparing the annual report and the financial statements in accordance with applicable law and regulation.

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared the financial statements in accordance with UK-adopted international accounting standards (IAS).

Under company law, the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing the financial statements, the Directors are required to:

- Select suitable accounting policies and then apply them consistently;
- State whether applicable UK-adopted IAS have been followed, subject to any material departures disclosed and explained in the financial statements;
- Make judgements and accounting estimates that are reasonable and prudent; and
- Prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The Directors are responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are also responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company, and enable them to ensure that the financial statements comply with the Companies Act 2006.

The Directors are responsible for the maintenance and integrity of the company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Directors' confirmations

The Directors consider that the Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's position and performance, business model and strategy.

Each of the Directors whose names and functions are listed in the Board of Directors section and the Chair's report on Corporate Governance confirms that, to the best of their knowledge:

- The financial statements, which have been prepared in accordance with UK-adopted IAS, give a true and fair view of the assets, liabilities, financial position and profit of the Company, and
- The management report, which is incorporated into the Directors' report, includes a fair review of the development and performance of the business and the position of the Company, together with a description of the principal risks and uncertainties it faces.

DISCLOSURE OF INFORMATION TO AUDITORS

In the case of each Director in office at the date the Directors' report is approved:

- So far as the Director is aware, there is no relevant audit information of which the company's auditor is unaware; and
- They have taken all steps that they ought to have taken as a Director in order to make themselves aware of any relevant audit information and to establish that the company's auditors are aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of Section 418 of the UK Companies Act 2006.

AUDITORS

PricewaterhouseCoopers LLP will continue in the office of auditor. A resolution to reappoint them will be proposed at the Company's forthcoming Annual General Meeting.

By Order of the Board

James Pountney
Director
10 March 2022
2 Triton Square, Regent's Place, London NW1 3AN

This Risk review consists of unaudited financial information unless otherwise stated. The audited financial information is an integral part of the Financial Statements.

RISK GOVERNANCE

RISK FRAMEWORK

Our risk governance structure

We are committed to the highest standards of corporate governance in every part of our business, including risk management. For details of our governance, including the Board and its Committees, see the 'Governance' section of this Annual Report. The Company maintains a Board Audit Committee and a Board Risk Committee. The Board delegates certain responsibilities to Board Level Committees as needed and where appropriate.

Our risk governance structure strengthens our ability to identify, assess, manage and report risks, as follows:
- **Committees**: A number of Board and Executive committees are responsible for specific parts of the Risk Framework. SFS has chosen to adopt the Santander UK Risk Framework
- **Key senior management roles**: A number of senior roles have specific responsibilities for risk management
- **Risk organisational structure**: We have the 'three lines of defence' model built into the way we run our business.

The Company operates within a standalone Risk Appetite Statement approved by the Board.

Committees

The Santander UK Risk Framework states that operating companies of Santander UK should have a sufficient committee structure in place to allow them to discharge their risk responsibilities and escalate issues. The structure should be proportionate to the company's size and complexity.

The Board Level Committee responsibilities for risk in 2021 were:

Board Level Committee	Main risk responsibilities
The Board	– Has overall responsibility for business execution and for managing risk – Reviews the Company's adherence to the Risk Framework and Risk Appetite.
Board Risk Committee (BRC)	– Assesses the Company's adherence to the Risk Framework and Risk Appetite – Advises the Board on our overall Risk Appetite, tolerance and strategy – Oversees our exposure to risk
Board Audit Committee	Monitors and reviews the financial statements integrity, and any formal announcements on financial performance – Reviews the adequacy and effectiveness of the internal financial controls and whistleblowing arrangements – Monitors and reviews the effectiveness of the internal audit function

The Executive Level Committee responsibilities for risk in 2021 were:

Executive Level Committee	Main risk responsibilities
Executive Committee	– Sets and monitors performance against the Company's annual plan and budget – Ensures that adequate and effective risk control processes and reporting systems are in place to identify, assess, manage and report all the relevant risks in the Company as detailed in the Risk Framework and Risk Appetite – Monitors the risk profile of the Company – Manages the structural balance sheet risks, capital, funding and liquidity, in line with the policies, strategies and plans set by the Company.

The Santander UK Corporate Governance Framework and Risk Framework have been adopted by its subsidiaries, including the Company, to ensure consistency of application. As Santander UK Group Holdings plc is the immediate parent company of the Company, its Executive and Board level committees consider the impact on the Company, as a subsidiary, as part of their decision-making process.

Key senior management roles

Senior roles with specific responsibilities for risk management are:

Role	Main risk responsibilities
Chief Executive Officer	The Board delegates responsibility for our business activities and managing risk on a day-to-day basis to the CEO. The CEO proposes our strategy and business plan, puts them into practice and manages the risks involved. The CEO must also ensure we have a suitable system of controls to manage risks and report to the Board on it.
Chief Risk Officer (CRO)	Oversees and challenges risk activities, and ensures new lending decisions are made within our Risk Appetite. Accountable for the control and oversight of credit, market, liquidity, capital, operational risk and risks associated with climate change.
Chief Financial Officer	Responsible for developing strategy and supporting our corporate goals within our risk appetite. The CFO is responsible for managing interest rate, liquidity and capital risks.

Risk organisational structure

We use the 'three lines of defence' model to manage risk. This model is widely used in the banking industry and has a clear set of principles to put in place a cohesive operating model across an organisation. It does this by separating risk management, risk control and risk assurance.

Line 1 - Risk management	Business Units and Business Support Units identify, assess and manage the risks which originate and exist in their area, within our Risk Appetite.
Line 2 - Risk control	Risk Control Units are independent monitoring and control functions. They are under the executive responsibility of the CEO, but responsible to the CRO or the CLRO for overseeing the first line of defence. They make sure Business Units and Business Support Units manage risks effectively and within our Risk Appetite.
Line 3 - Risk assurance	Internal Audit is an independent corporate function. It gives assurance on the design and effectiveness of our risk management and control processes.

RISK APPETITE

How we control the risks we are prepared to take

When our Board sets our strategic objectives, it is important that we are clear about the risks we are prepared to take to achieve them. We express this through our Risk Appetite Statement, which defines the amount and kind of risk we are willing to take. Our Risk Appetite and strategy are closely linked, and our strategy must be achievable within the limits set out in our Risk Appetite.

The principles of our Risk Appetite

Our Risk Appetite Statement lists eight principles that we use to set our Risk Appetite:

- We always aim to have enough financial resources to continue to do business in adverse but plausible stressed economic and business conditions, as well as to survive a very severe stress that would deplete our capital reserves
- We should be able to predict how our income and losses might vary – that is, how volatile they are. That applies to all our risks and lines of business
- We are an autonomous business, so we always aim to have strong capital and liquidity resources
- We set controls on large concentrations of risk, like single customers
- There are some key risks we take, but for which we do not actively seek any reward, like operational, conduct and regulatory, financial crime, legal and reputational risk. We take a risk-averse approach to these risks
- We comply with all regulations – and aim to exceed the standards they set
- Our pay and bonus schemes should support these principles and our risk culture
- We always aim to earn the trust of our people, customers, shareholders and communities.

How we describe the limits in our Risk Appetite

Our Risk Appetite sets out detailed limits across all types of risk, using metrics and qualitative statements.

Metrics

We use metrics to set limits on capital, liquidity and credit risk. We set:

- Capital limits, reflecting both the capital that regulators expect us to hold (regulatory capital)
- Liquidity limits according to a range of plausible stress scenarios for our business
- Credit limits, to control the credit quality of our mortgage and other loan portfolios.

These limits apply in normal business conditions, but also when we might be experiencing a far more difficult economic environment. We refer to conditions like this as being under stress. See more on stress scenarios on the next page.

Qualitative statements

For some types of risk we also use qualitative statements that describe in words the appetite we want to set.

How we set our Risk Appetite, and stay within it

We control our Risk Appetite through our Risk Appetite Framework. Our Board approves and oversees our Risk Appetite Statement every year. This ensures it is consistent with our strategy and reflects changes in the markets and economic environment in which we operate. Our Executive Committee is responsible for ensuring that our risk profile (the level of risk we are prepared to accept) is consistent with our Risk Appetite Statement. To do this they monitor our performance against our Risk Appetite regularly.

We also use stress testing to review how our business plan performs against our Risk Appetite Statement. This shows us if we would stay within our Risk Appetite under stress conditions. It also helps us to identify any adverse trends or inconsistencies.

We embed our Risk Appetite by setting more detailed risk limits for each business unit and key portfolios. These are set in a way so that if we stay within each detailed limit, we will stay within our overall Risk Appetite. When we use qualitative statements to describe our appetite for a risk, we link them to lower-level key risk indicators, so that we can monitor and report our performance against them.

STRESS TESTING

Stress testing is carried out as part of the Santander UK group stress testing exercises. The following sections therefore refer to the Santander UK group and the Company.

Stress testing helps us understand how different events and economic conditions could affect our business plan, earnings and risk profile. This helps us plan and manage our business.

Scenarios for stress testing

To see how we might cope with difficult conditions, we regularly develop challenging scenarios that we might face. We consult a broad range of internal stakeholders, including Board members, when we design and choose our most important scenarios. The scenarios cover a wide range of outcomes, risk factors, time horizons and market conditions. They are designed to test:

– The impact of shocks affecting the economy as a whole or the markets we operate in
– Key potential vulnerabilities of our business model, and the processes and systems which support it
– Potential impacts on specific risk types.

We describe each scenario using a narrative setting out how events might unfold, as well as a market and/or economic context. For example, the key economic factors we reflect in our ICAAP scenarios include house prices, interest rates, unemployment levels and the size of the UK economy. We also explore sensitivities around several macro variables where there may be concerns or levels of uncertainty. In 2021, the Company participated in the Santander UK group's completion of the Bank of England’s (BoE) Climate Biennial Exploratory Scenario (CBES). The purpose of this exercise was to investigate a range of risks that may not be directly linked to prevailing economic and financial conditions and helps us to prepare for possible future shocks. The CBES tested the resilience of the UK financial system to the physical and transition risks associated with three different climate pathways. The key climate factors included physical risks due to higher global temperatures, and transition risks as a consequence of the structural changes needed to transition towards a low-carbon economy. Where appropriate, we also capture the economics in Jersey and Isle of Man in our scenarios.

How we use stress testing

We use stress testing to estimate the effect of these scenarios on our business and financial performance, including:

– Our business plan, and its assessment against our Risk Appetite
– Our capital strength, through our ICAAP
– Our liquidity position, through our ILAAP
– Our long term impacts of climate change, through the CBES
– Impacts on other risk types.

We use a wide range of models, approaches and assumptions. These help us interpret the links between factors in markets and the economy, and our financial performance. For example, one model looks at how changes to key macroeconomic variables like unemployment rates might affect the number of customers who might fall into arrears on their mortgage or other loans.

Our stress testing models are subject to a formal review, independent validation and approval process. We highlight the key weaknesses and related model assumptions in the approval process for each stress test. In some cases, we overlay expert judgement onto the results of our models. Where this is material to the outcome of the stress test, the approving governance committee reviews it. We take a multi-layered approach to stress testing to capture risks at various levels. This ranges from sensitivity analysis of a single factor to a portfolio, to wider exercises that cover all risks across our entire business. We use stress test outputs to design plans that aim to mitigate damaging effects.

We also conduct reverse stress tests. These are tests in which we identify and assess scenarios that are most likely to cause our business model to fail.

Board oversight of stress testing

The Santander UK ERCC approves the design of the scenarios in our ICAAP and ILAAP. The SFS Board Risk Committee ratifies the approach, stress testing framework and results of the ICAAP and ILAAP after ensuring there is proper and appropriate second line of defence oversight of the process. Scenarios are appropriately challenged and debated before Board approval is given.

Regulatory stress tests

We take part in a number of external stress testing exercises. These can include stress tests of the UK banking system conducted by the PRA and the BoE. We also contribute to stress tests of Banco Santander SA conducted by the European Banking Authority (EBA).

For more on capital and liquidity stress testing, see the ‘Capital risk’ and ‘Liquidity risk’ sections.

CREDIT RISK

Overview

Credit risk management
In this section, we set out how our exposures arise and our approach to credit risk across the credit risk lifecycle. We also discuss our expected credit losses (ECL) approach and the key inputs to our ECL model.

Credit risk review
In this section, we analyse our maximum and net exposures to credit risk, including their credit quality and concentrations of risk.

CREDIT RISK MANAGEMENT

Exposures (audited)

Exposures to credit risk arise in our business from:

- Loans and advances to customers (mainly UK and Crown Dependency residential mortgages to individuals)
- Loans and advances to banks and other financial institutions

Our approach to credit risk

We manage our portfolios across the credit risk lifecycle, from drawing up our risk strategy, plans, budgets and limits to making sure the actual risk profile of our exposures stays in line with our business plans and within our Risk Appetite. We further tailor the way we manage risk across the lifecycle to the type of product.

1. Risk strategy and planning (audited)

All relevant areas of the business work together to create our business plans. We aim to balance our strategy, goals, and financial and technical resources with our Risk Appetite. To do this, we focus on economic and market conditions and forecasts, regulations, conduct matters, profitability, returns and market share. The result is an agreed set of targets and limits that help us direct our business.

2. Assessment and origination (audited)

Managing credit risk begins with lending responsibly. That means only lending to customers who can afford to pay us back, even if things get tighter for them, and are committed to paying us back. We perform (or in the case of UK residential mortgages purchased from Santander UK plc, it performed) a thorough risk assessment to make sure customers can meet their obligations before a credit application is approved. These decisions are made with authority from the Board and consider:

- The credit quality of the customer
- The underlying risk and how we can mitigate it, such as through netting or collateral
- Our risk policy, limits and appetite
- Whether we can balance the amount of risk we face with the returns we expect, and
- Assessment of customer affordability.

Affordability
For Crown Dependency residential mortgages, we take proportionate steps to assess whether the customer will be able to make all the repayments on the loan over its full term. As part of this, we assess the risk that they will not pay us back. We do this by a series of initial affordability and credit risk assessments. We assess affordability by reviewing the customer's income and spending, their other credit commitments, and what would happen if interest rates went up. We regularly review the way we calculate affordability and refine it when we need to. This can be due to changes in regulations, the economy or our risk profile. For UK residential mortgages purchased from Santander UK plc, Santander UK plc makes the affordability assessments in accordance with its policies and procedures.

Credit profile
For Crown Dependency residential mortgages, we look at each customer's credit profile and signs of how reliable they are at repaying credit. When they apply, we use the data they give us, and:

- **Credit policy:** these are our rules and guidelines. We review them regularly to make sure our decisions are consistent and fair and align to the risk profile we want. We look at the property and the LTV as well as the borrower
- **Credit scores:** based on statistics about the reasons people fail to pay off debt. We use them to build models of what is likely to happen in the future. These models give a credit score to the customer for the loan they want, to show how likely it is to be repaid. We regularly review them
- **Credit reference agencies:** data from credit reference agencies about how the borrower has handled credit in the past
- **Other Santander accounts:** we look at how the customer is using their other accounts with us.

For UK residential mortgages purchased from Santander UK plc, it undertakes a similar assessment of the credit profile of the customer.

How we make the decision
For UK residential mortgages, Santander UK plc has originated the loan using its policies and process and the Company has subsequently acquired the loan and its associated credit risk. For Crown Dependencies mortgages, loans below a certain LTV and size are underwritten within delegated authorities by the mortgage underwriting team; any exceptions to policy or amounts above that are approved by the Company's Credit committee.

Credit risk mitigation

The types of credit risk mitigation, including collateral, across each of our portfolios is:

Portfolio	Description
Residential mortgages	Collateral is in the form of a first legal charge over the property. Before we or Santander UK plc grant a mortgage, the property is valued. We have our own guidelines for surveyor valuations, which build on guidance from the Royal Institution of Chartered Surveyors (RICS). But we also make use of automated valuation methodologies where our confidence in the accuracy of this method is high.
Loans and advances to banks and other financial institutions	We use the Credit Support Annex with the ISDA Master Agreement and other similar arrangements in relation to our derivatives and some of our loans and advances to banks and other financial institutions. This gives us collateral for our net exposures.

3. Monitoring (audited)

We measure and monitor changes in our credit risk profile on a regular and systematic basis against our budgets, limits and benchmarks. We monitor credit performance by portfolio, segment, customer or transaction. If our portfolios do not perform as we expect, we investigate to understand the reasons. Then we take action to mitigate it as far as possible and bring performance back on track. We monitor and review our risk profile through formal governance forums and committees across our business. These agree and track any steps we need to take to manage our portfolios, to make sure the impact is prompt and effective. This structure is a vital feedback tool to coordinate issues, trends and developments across each part of the credit risk lifecycle. In the case of UK residential mortgages purchased from Santander UK plc, we rely on Santander UK to monitor the portfolio in accordance with the servicing agreement with us.

Credit concentrations

Credit exposure metrics in line with the Board approved risk appetite are presented to the SFS Board Risk Committee, Board Audit Committee and ERCC as appropriate.

For residential mortgages, our risk assessment does not end once we have made the decision to lend or acquire a UK residential mortgage from Santander UK plc. We continue to monitor credit risk across the credit risk lifecycle, ensuring that early arrears are highlighted, and customers contacted to discuss potential problems. For residential mortgages, our monitoring also takes account of changes in property prices. We (or, in the case of UK residential mortgages, Santander UK plc) estimate the property's value every three months. In most cases, statistical models based on recent sales prices and valuations in that local area are used. Use of this model is subject to Model Risk Governance. Where a lack of data means the model's valuation is not available, the original surveyor valuation with a House Price Index (HPI) adjustment as appropriate is used.

Our Watchlist

For loans and advances to banks and other financial institutions, we use a Watchlist to help us identify potential problem debt early. Just because a customer is on our Watchlist does not mean they have defaulted. It just means that something has happened that has increased the probability of default. There are several reasons we might put customers on this list. For example, if they suffer a downturn in trade, breach a covenant, lose a major contract, slip into early arrears, or their key management resign. Whatever the trigger, we review the case to assess the potential financial impact.

We classify Watchlist cases as:

- **Enhanced monitoring**: for less urgent cases. If they are significant, we monitor them more often and where appropriate may consider more collateral.
- **Proactive management:** for more urgent or serious cases. We may take steps to restructure debt including extending the term, taking more collateral, agreeing a lower credit limit or seeking repayment of the loan through refinancing or other means.

We assess cases on the Watchlist for impairment as explained in 'Significant Increase in Credit Risk (SICR)' in the 'Credit risk management' section.

When a customer is included in enhanced monitoring, we do not consider that it has suffered a SICR for ECL purposes, so it remains in Stage 1 for purposes of our loss allowance calculations. When a customer is included in proactive management, we consider that it has suffered a SICR. This means we transfer it to Stage 2 and subject it to a lifetime ECL assessment to calculate the new loss allowance. We take into account any forbearance we offer. This includes whether any extra security or guarantees are available, the likelihood of more equity and the potential to enhance value through asset management.

4. Arrears management (audited)

Sometimes our customers face financial difficulty and may fall into payment arrears or breach the conditions of their credit facility. If this happens, we work with them to get their account back on track. We aim to support our customers and keep our relationship with them. To do this, we:

- Find affordable and sustainable ways of repaying to fit their circumstances
- Monitor their finances and use models to predict how they will cope. This helps us put in place the right strategy to manage their debt
- Work with them to get their account back on track as soon as possible in a way that works for them and us
- Monitor agreements we make to manage their debt, so we know they are working.

For residential mortgages, we have several strategies to manage arrears that we can use as early as the day after a missed payment. We assess the problems a customer is having, so we can offer them the right help to bring their account up to date as soon as possible. The most common way to bring an account up to date is to agree an affordable repayment plan with the customer. The strategy we use depends on the risk and the customer's circumstances. We have a range of tools to help customers to reach an affordable and acceptable solution. This could mean visiting the customer or offering debt counselling by a third party.

For loans and advances to banks and other financial institutions, we identify problem debt by close monitoring, supported by our Watchlist process. When there is a problem, we take a collaborative approach, led by the relevant credit risk expert with our Finance team and the relationship managers.

We aim to act before a customer defaults, to prevent it, if possible. The strategy we use depends on the type of customer, their circumstances and the level of risk. We use restructuring and rehabilitation tools to try to help our customers find their own way out of financial difficulty and agree on a plan that works for both of us. We aim to identify warning signs early by monitoring customers' financial and trading data, checking to make sure they are not breaching any covenants, and by having regular dialogue with them. We hold regular Watchlist meetings to agree a strategy for each portfolio.

Our Credit Risk team are engaged as appropriate on Watchlist cases and we may hand over more serious cases to them.

5. Debt recovery (audited)

Sometimes, even when we have taken all reasonable and responsible steps we can to manage arrears, they are not effective. If this happens, we have to end our agreement with the customer and try to recover the whole debt, or as much of it as we can.

For residential mortgages, when a customer cannot or will not keep to an agreement for paying off their arrears, we consider recovery options. We only do this once we have tried to get the account back in order. To recover what we are owed, we may initiate legal action that could ultimately lead to the customer facing court action for possession of the property. For retail mortgage loans we can delay legal action. That can happen if the customer shows that they will be able to pay off the loan or the arrears. We aim to repossess only as a last resort or, if necessary, to protect the property from damage or third-party claims. We make sure our estimated losses from repossessed properties are realistic by getting two independent valuations on each property, as well as the estimated cost of selling it. These form the basis of our loss allowances calculations. Where we do enforce the possession of properties held as collateral, we use external agents to realise the value and settle the debt. During this process we do not own the property, but we do administer the sale process. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with insolvency regulations.

For loans and advances to banks, where we cannot find a way forward or reach a consensual arrangement, we consider recovery options. This can be through:

- The insolvency process
- Enforcing over any collateral
- Selling debt on the secondary market
- Considering other legal action available to recover what we are owed from debtors and guarantors.

If there is a shortfall, we write it off against loss allowances we hold. In certain very rare instances, we may act as mortgagee in possession of assets held as collateral against non-performing loans. In such cases the assets are carried on our balance sheet and are classified according to our accounting policies.

Santander UK plc undertakes the activities described above on our behalf in relation to residential mortgages we have purchased from it.

Risk measurement and control

We measure and control credit risk at all stages across the credit risk lifecycle. We have a range of tools, processes and approaches, but we rely mainly on:

- **Credit control:** as a core part of risk management we generate, extract and store accurate, comprehensive and timely data to track credit limits. We do this using internal data
- **Review:** we use formal and informal forums to approve, validate, review and challenge our risk management. We do this to help predict if our credit risk will worsen.

The Crown Dependency residential mortgage portfolio involves managing approximately 2,800 mortgages. This allows us to analyse the portfolio in detail at an individual account level in order to measure the risk. We assess and review our loss allowances regularly. We look at a number of factors, including the cash flow available to service debt. We also use an agency to value the collateral. We risk manage the UK residential mortgage portfolio purchased via a risk transfer from Santander UK plc.

Key metrics (audited)

We use a number of key metrics to measure and control credit risk, as follows:

Metric	Description
Expected Credit Loss (ECL)	ECL tells us what credit risk is likely to cost us either over the next 12 months on qualifying exposures, or defaults over the lifetime of the exposure where there is evidence of a significant increase in credit risk (SICR) since origination. We explain how we calculate ECL below.
Stages 1, 2 and 3	We assess each facility's credit risk profile to determine which stage to allocate them to, and we monitor where there is a SICR and transfers between the stages. We explain how we allocate a facility to Stage 1, 2 or 3 below.
Stage 3 ratio	The Stage 3 ratio is the sum of Stage 3 drawn and Stage 3 undrawn assets divided by the sum of total drawn assets and Stage 3 undrawn assets. The Stage 3 ratio is the main indicator of credit quality performance.
Expected Loss (EL)	EL is based on the regulatory capital rules of CRD IV and gives us another view of credit risk. It is the product of the probability of default (PD), exposure at default and loss given default. We calculate each factor in accordance with CRD IV and include direct and indirect costs. We base them on our risk models and our assessment of each customer's credit quality. There are differences between regulatory EL and IFRS 9 ECL, which we set out below. For the rest of our Risk review, impairments, losses and loss allowances refer to calculations in accordance with IFRS, unless we specifically say they relate to CRD IV. For our IFRS accounting policy on impairment, see Note1 to the Financial Statements.

We also assess risks from other perspectives, such as geography, business area, product and process to identify areas we need to focus on. We also use stress testing to establish vulnerabilities to economic deterioration. Our business segments tailor their approach to credit risk to their own customers, as we explain later on.

Recognising ECL (audited)

The ECL approach estimates the credit losses arising from defaults in the next 12 months on qualifying exposures, or defaults over the lifetime of the exposure where there is evidence of a SICR since the origination date. The ECL approach takes into account forward-looking data, including a range of possible outcomes, which should be unbiased and probability-weighted in order to reflect the risk of a loss being incurred even when it is considered unlikely.

Multiple economic scenarios and probability weights (audited)
This work is led by Santander UK plc and approved by the Company as part of the modelling on the Company's mortgage book.

We use five forward-looking economic scenarios. For 2021, they consist of a central base case, one upside scenario and three downside scenarios. We use five scenarios to reflect a wide range of possible outcomes for the UK economy. Both the UK and Crown Dependency residential mortgages have similar profiles to the wider UK portfolio and therefore the UK economic scenarios are appropriate to apply, with small adjustments on HPI made to reflect the Crown Dependency market conditions.

Our forecasting approach
We derive our scenarios in part by using a set of parameters in GDP fan charts published by the Office for Budget Responsibility (OBR). To avoid major changes to the scenarios due to changes in the OBR fan charts, we place more weight on the long-run outlook of the fan charts rather than relying solely on each individual release as this can create large swings in the scenarios which may not be appropriate. We use the OBR fan charts to calculate our GDP paths for each scenario. For 2021 this applied to the Upside 1, Downside 1 and Downside 2 scenarios. These fan charts reflect the probability distribution of a deviation from the OBR's central forecast to illustrate the uncertainty regarding the outcome of a variable, in this case GDP.

We use the 0.6 fan chart path for our Upside 1 scenario and the 0.3 path for Downside 1. For Downside 2 we use a blend of the Downside 1 scenario and the base case rather than the 2008/09 recession, which is used under BAU. This is because the fall in GDP in the base case is markedly higher than the one seen in 2008/09, due to the lockdown restrictions imposed due to Covid-19. To ensure that Downside 2 is kept consistent with any changes to the OBR fan charts, we calculate the Downside 2 GDP by taking the percentage difference between Downside 2 and Downside 1 GDP in the original forecast and applying this difference to the new Downside 1.

Once we have established the GDP paths for each scenario, we run them through the Oxford Global Economic Model (OGEM) to derive the other macroeconomic variables, such as unemployment and house prices. These variables are the product of the GDP growth paths we have forecast and the output of the OGEM for these growth paths. We then impose a Bank Rate profile for each scenario using expert judgement. We determine the Bank of England Bank Rate (Bank Rate) by using the base case Bank Rate profile and adjusting this for each of the four other scenarios. To do this, we firstly consider what each of the scenarios is trying to achieve.

For the upside scenario, which has a higher growth path and rising productivity growth, we allow for a managed tightening of the monetary stance, so we assume small increases in Bank Rate. In contrast, for Downside 2 the scenario shows monetary policy forced into a reactive stance to contain CPI inflation at a time of weakening output growth, so we assume the Bank of England would raise rates in this scenario to bring inflation back to its target rate. The rising Bank Rate profiles are based on forward guidance from the Bank of England, where increases are assumed to be gradual and incremental. For the Downside 1 scenario, this is aligned to the base case forecast for the majority of the 5 year forecast as inflation is similar to that of the base case, and for Downside 3, this shows a negative interest rate profile which the Bank of England follows to try and boost growth with inflation remaining low. In this way, our scenarios reflect a range of possible outcomes that the Bank of England may follow for different growth paths.

Our use of five scenarios is designed to reflect different possible outcomes to the base case forecast highlighting the upside and downside risks associated with the central scenario. The downside risks for the UK economy include further waves of Covid-19 leading to restrictions on economic activity, a further and sharper downturn in global growth, a substantial increase in inflation which raises the cost of living, a continuation of the very low productivity growth seen in the UK, and a move to a more protectionist agenda for trade. The upside risks are more muted at present and include a stronger recovery in global growth, coupled with a move to more open trade and further trade agreements with other countries.

We update the baseline in our economic scenarios at least twice a year in line with our annual budgeting and three-year planning processes, or sooner if there is a material change in current or expected economic conditions. For instance, in 2021 the base case has been updated every quarter. We refresh all our economic scenarios each quarter to reflect the latest data and OBR fan charts if these have changed, which are then reviewed and approved by the Credit Risk Provisions Forum (CRPF). The CRPF also assesses the probability weights at least once a quarter.

We do not use consensus forecasts as inputs to our models, but we do compare the outputs of our models against consensus views for the base case, to make sure that we understand any significant differences and address them where needed. At the end of 2021, there were no significant differences between our base case forecasts and the consensus views.

In 2021, we were also able to do further peer benchmarking analysis of the economic scenarios using the data the PRA provided, which for Q4 2021 included the mean weighted analysis for a selection of economic variables, including GDP, unemployment rate and HPI. This meant that we could compare our weighted scenarios against the average of our peers to understand what differences there may be. The conclusion of this analysis demonstrated that our economic scenarios were in line with our peers, although on a weighted basis house price inflation reflected a more conservative view.

In 2021, we also considered any likely impact from climate change risk on our forecasting approach and concluded that no adjustment to the multiple economic scenarios for climate change risk was required. This is because climate change effects are generally regarded to be relevant over a longer timeframe than our forecast period of five years.

Key changes to our forecasting approach in 2021
In 2021, there were no specific changes to our forecasting approach. The OBR have not published fan charts since March 2020. However, in order to ensure that the error bands remain reasonable, they have been cross-checked against other forecasters views on downside and upside scenarios to make sure they remain a reasonable proxy and we are considering using our own fan chart error bands going forward to mitigate this issue.

Base case

For our base case, the forecasts are based on the following assumptions: that there are no further lockdowns due to rising Covid-19 infections; that the majority of overseas travel restrictions have been removed; that supply constraints continue into 2022; that in Q4 further self-imposed social distancing restrictions are re-enacted to deal with increased infection rates slowing growth further; and that GDP 2019 levels are returned to in H1 2022. It is normal practice to review the scenarios and associated weights every quarter to ensure they appropriately reflect the current economic circumstances, and we will continue to follow that approach particularly as the advice the UK Government issues is subject to change in this fluid environment.

Base case key macroeconomic assumptions
– House price growth: The stamp duty holiday ceased at the end of September 2021. However, there has not appeared to be a marked slowdown in house price growth, although it was expected to fall back further in Q4 2021 as more normal demand patterns for housing emerge. With unemployment continuing to remain low, conditions for buying still favourable, albeit with mortgage rates increasing in line with Bank Rate hikes, and with the supply side remaining weak this will help keep house prices from falling. On this basis we were projecting an increase of 5% by the end of 2021, although this will vary across the UK regions with London seeing much smaller rises.
– GDP: The outlook assumes the recovery peaked in Q2 2021 with slowing quarterly growth rates thereafter. Growth in 2021 and 2022 will be hampered by the changes to the trading conditions brought about by the UK's exit from the EU and with supply constraints continuing to dominate, raising prices which along with the jump in prices for gas and oil result in inflation peaking in H1 2022. Growth continues in 2022, but with rates starting to return to pre-Covid levels as catch-up consumption begins to dissipate and the economy moves towards average growth rates. Key to growth is ensuring rising prices remain under control and that the cost of living spike remains that.
– Unemployment rate: Unemployment was expected to peak in Q4 2021 at 4.7% as the UK Government's job support schemes come to an end. However, with the majority of UK businesses wanting to retain staff for when trading conditions return to more 'normal' patterns, unemployment continues to fall back over the forecast period. Given the reduced size of the UK workforce, unemployment by the end of the forecast period is only slightly higher than pre-pandemic.
– Bank Rate: For the Bank Rate forecast, the base case had Bank Rate at 25bps at the end of 2021, in line with the increase in rates implemented by the Monetary Policy Committee (MPC) on 16 December 2021. In 2022 it assumes two further rate hikes of 25bps, each to end 2022 at 75bps. These further increases are designed to bring CPI inflation back towards target in 2023 given a peak of circa 6% in H1 2022. The base case remains flat from beginning of 2023 over the rest of the forecast period as inflation starts to drop back with rates now at pre-pandemic levels. The Bank of England look to bed in these new rates and to understand its effects on businesses.

In the medium-term, the projections assume that current demographic and productivity trends will continue, causing a reduction in the UK's growth potential. For instance, it is likely that the reduction in the UK workforce continues and that this will have a knock on impact for the economy, particularly if there are shortages of skilled workers in particular sectors. This is reflected in an average annual growth expectation of 1.6%, the OBR's latest estimate of the UK's long run average growth rate. CPI inflation is forecast to be significantly above the 2% target rate in the initial forecast period but then fall to target by the end. With higher levels of savings, consumers use a proportion of these to help support household spending power through 2022.

In summary, the base case assumes that the outlook improves as the successful vaccination programme continues, which ends the need for further national lockdowns.

Key changes to our base case in 2021

The key changes to our base case assumptions in 2021 were: (i) stronger GDP growth in 2021 and weaker expansion in 2022 to reflect the faster recovery followed by a return to slower, pre-pandemic growth rates; (ii) the unemployment rate, whilst lower than expected given the government furlough scheme, rises a little and peaks in Q4 2021. Thereafter it falls back very gradually over the forecast horizon; (iii) there is much faster house price growth in 2021 as the ending of the stamp duty holiday only has a limited effect on reducing demand and supply remains constrained; and (iv) the Bank Rate profile increases to 75bps by 2022 and thereafter is held flat at its pre-pandemic level of 0.75%. This had the effect of increasing the weighted average of the Bank Rate across the five scenarios to 1.25%.

Other scenarios

Based on this revised base case, we have reviewed our suite of scenarios to ensure that they capture the wide range of potential outcomes for the UK economy. These include (i) a significant rise in Covid-19 cases and further lockdown measures being imposed as variants continue to appear; (ii) a slower recovery that is more akin to the 'U' shape of past recessions; (iii) higher inflation; (iv) labour market frictions due to skills mismatches and a shrinking workforce as some discouraged workers leave altogether (for example EU workers returning to their native countries and older UK born workers retiring early); and (v) the global economy bouncing back more strongly than expected.

In order to reflect these potential outcomes, we decided to continue to use the base case and four additional scenarios, which management considers to provide a range wide enough to reflect all of the above potential outcomes. However, as the risks remain skewed to the downside, to reflect these outcomes sufficiently, we concluded that only one upside scenario would be needed to reflect the upside risks to the base case. As with the base case, the scenarios are forecast over a five-year period and then mean revert over the next three years to the OBR's latest estimate of the UK's long run average growth rate.

The four scenarios are as follows:

One upside scenario
Our modest upside scenario remains appropriate based on vaccines and boosters continuing to be distributed quickly and effectively to the population, which in turn creates a more resilient workforce. It also assumes a faster global recovery and the UK continuing to agree to trade agreements with a number of countries outside the EU. It is also based on productivity growth recovering. HPI for Upside 1 is less positive than for the base case and is based on the HPI equations built into the Oxford Global Economic Model (OGEM) and the particular GDP profile used, whereas our base case reflects our planning view which allows for flexibility to align what is currently seen in the market to the outlook of the economic variable forecast.

Three downside scenarios
Downside 1 assumes further local/regional restrictions were implemented as we moved through 2021 and into 2022 than in the base case as a means of controlling increases in infection rates, which in turn impact economic growth as vaccines are not as effective in combating new variants as hoped. The scenario also reflects a fall in demand for housing leading to downward price corrections over the next five years with a peak to trough of negative 5%. It assumes trade agreements with other countries being negotiated over the forecast period, but fewer than in the base case.

Downside 2 reflects a severe downturn with a longer recovery needed (U shape) capturing even more conservatism and lack of confidence in terms of spending by consumers with higher levels of unemployment. For businesses, it reflects a slower return to profitability and more insolvencies as vaccines are unable to keep infection rates from new variants under control. Companies also struggle to adapt to the new trading conditions with the EU, which create supply bottlenecks and push up manufacturing costs that businesses can no longer absorb, forcing them to pass this burden onto consumers. With business confidence weak and investment contracting, a reduction in investor appetite for UK assets causes a sharp depreciation in sterling which pushes up imported inflation and causes the MPC to raise rates significantly. It also assumes that the incidence of major risk events, for example those caused by climate change, continue to occur exposing risks to countries' fiscal position and the means to respond to such events which results in growth taking far longer to recover.

There is a substantial rise in interest rates of up to 3%, which results in a large increase in debt-service costs to households and a rapid undermining of demand in the housing market. House values fall sharply and the combination of rising interest rates and unemployment with falling house prices results in a rising profile of credit impairment losses.

Downside 3 features a double dip in economic activity (W shape) lasting three quarters, with higher unemployment and a sharper fall in house prices compared to the four other scenarios. The fall in GDP of circa 7% between Q4 2020 and Q2 2022 is less than half the fall of circa 22% in H1 2020, as this assumes businesses have contingency plans to be able to stay open whilst practising social distancing. The peak in the unemployment rate is similar to that seen in the early 1980s recession peaking at 11.9% in 2022 and remaining in double digits until early 2023, before falling back very gradually. The long-term effects of high unemployment result in a permanent hit to potential output, as persistent and elevated uncertainty leads to more job losses and corporate bankruptcies. Sharp falls in house prices (circa 27%) combined with persistently higher unemployment have particularly adverse consequences for credit impairment charges.

Key changes to our alternative scenarios in 2021
The key changes to our alternative scenarios in 2021 related to changes to the base case, historical data for each variable, and the OGEM. We also rolled forward the GDP path in Downside 3 but kept the overall shape of the profile the same. We did not make any other methodological changes to the scenarios. The combination of these different inputs will mean differences across the variables for each of the alternative scenarios when we update them each quarter. As such, it is not possible to pin-point a specific reason for each change as we do not run the inputs in isolation. However, we compare the variables between each quarter and review any large changes to ensure they are not erroneous.

The table below sets out our macroeconomic assumptions for each of the five scenarios at 31 December 2021:

		Upside 1	Base case	Downside 1	Downside 2	Downside 3
		%	%	%	%	%
GDP[1]	2020 (actual)	(9.7)	(9.7)	(9.7)	(9.7)	(9.7)
	2021	7.0	6.9	6.8	6.2	5.6
	2022	4.8	4.6	4.1	(0.7)	(7.5)
	2023	2.2	1.7	0.9	0.5	3.1
	2024	1.9	1.5	0.5	1.6	1.5
	2025	2.1	1.6	0.5	1.7	1.5
Bank Rate[1]	2020 (actual)	0.10	0.10	0.10	0.10	0.10
	2021	0.25	0.25	0.25	0.25	0.25
	2022	0.75	0.75	0.75	1.00	(0.50)
	2023	0.75	0.75	0.75	2.00	0.00
	2024	1.25	0.75	1.00	3.00	0.00
	2025	1.75	0.75	1.00	2.75	0.00
HPI[1]	2020 (actual)	6.9	6.9	6.9	6.9	6.9
	2021	5.4	5.0	5.4	5.4	(2.5)
	2022	(0.8)	2.0	(1.8)	(8.3)	(19.6)
	2023	(2.0)	2.0	(4.6)	(13.1)	(9.3)
	2024	1.0	2.0	(3.1)	(4.8)	2.4
	2025	3.8	2.0	(0.7)	4.3	3.3
Unemployment[1]	2020 (actual)	5.2	5.2	5.2	5.2	5.2
	2021	4.4	4.7	4.4	4.4	6.8
	2022	4.4	4.5	4.8	6.9	11.4
	2023	4.2	4.4	5.0	6.9	8.7
	2024	3.9	4.3	5.1	6.4	8.0
	2025	3.7	4.3	5.4	6.1	7.4

The table below sets out our macroeconomic assumptions for each of the five scenarios at 31 December 2020:

		Upside 1	Base case	Downside 1	Downside 2	Downside 3
		%	%	%	%	%
GDP[1]	2020	(10.5)	(11.5)	(10.5)	(11.1)	(11.5)
	2021	4.8	4.5	4.0	(0.8)	(8.0)
	2022	4.9	6.1	3.6	3.2	3.1
	2023	3.0	2.2	1.5	2.7	1.5
	2024	2.0	1.5	0.4	1.5	1.5
Bank Rate[1]	2020	0.10	0.10	0.10	0.10	0.10
	2021	0.25	0.10	0.10	0.75	(0.50)
	2022	0.75	0.10	0.10	1.75	0.00
	2023	1.25	0.10	0.10	3.00	0.00
	2024	1.75	0.25	0.25	2.75	0.00
HPI[1]	2020	3.7	3.5	3.7	3.7	3.5
	2021	(4.6)	(2.0)	(5.4)	(11.3)	(19.7)
	2022	(4.1)	1.5	(6.6)	(14.5)	(8.2)
	2023	2.4	2.0	(1.8)	(3.8)	1.3
	2024	5.5	2.0	0.5	4.9	3.1
Unemployment[1]	2020	6.3	6.8	6.3	6.3	6.8
	2021	6.1	7.5	6.5	8.5	11.4
	2022	5.3	6.2	6.1	7.9	8.7
	2023	4.4	5.6	5.7	6.9	8.0
	2024	4.1	5.5	5.8	6.5	7.4

(1) GDP is the calendar year annual growth rate, HPI is Q4 annual growth rate and all other data points are at 31 December in the year indicated.

Our macroeconomic assumptions and their evolution throughout the forecast period
Our macroeconomic assumptions and their evolution throughout the forecast period for 2021 and 2020 were:

		Upside 1	Base case	Downside 1	Downside 2	Downside 3
2021		**%**	**%**	**%**	**%**	**%**
House price growth	5-year average increase/decrease	**1.30**	**2.00**	**(1.78)**	**(3.27)**	**(6.00)**
	Peak/(trough) at (1)	**(3.07)**	**0.00**	**(9.87)**	**(24.03)**	**(32.12)**
GDP	5-year average increase/decrease	**2.33**	**1.89**	**0.93**	**0.49**	**(0.58)**
	Cumulative growth/(fall) to peak/(trough) (2)	**12.19**	**9.83**	**4.75**	**2.48**	**(2.85)**
Unemployment rate	5-year end period	**3.60**	**4.30**	**5.65**	**5.95**	**6.80**
	Peak/(trough) at (1)	**4.45**	**4.70**	**5.65**	**7.27**	**11.90**
Bank of England bank rate	5-year end period	**2.00**	**0.75**	**1.00**	**2.25**	**0.25**
	Peak/(trough) at (1)	**2.00**	**0.75**	**1.00**	**3.00**	**(0.50)**

		Upside 1	Base case	Downside 1	Downside 2	Downside 3
2020		%	%	%	%	%
House price growth	5-year average increase/decrease	0.49	1.38	(2.01)	(4.54)	(4.44)
	Peak/(trough) at (1)	2.45	7.11	(9.65)	(20.72)	(20.32)
GDP	5-year average increase/decrease	0.75	0.39	(0.38)	(0.98)	(2.82)
	Cumulative growth/(fall) to peak/(trough) (2)	3.82	1.96	(1.88)	(4.80)	(13.33)
Unemployment rate	5-year end period	4.14	5.50	5.84	6.52	7.40
	Peak/(trough) at (1)	6.28	7.90	6.51	8.78	11.90
Bank of England bank rate	5-year end period	1.75	0.25	0.25	2.75	0.00
	Peak/(trough) at (1)	1.75	0.25	0.25	3.00	(0.50)

(1) For GDP and house price growth it is the peak to trough change within the 5 year period; for the unemployment rate it is the peak; and for Bank Rate it is the peak or trough.
(2) This is the cumulative growth for the 5 year period.

Scenario weights
Given the change to the base case in Q4 2021, we undertook a full review of the probability weights applied to all the scenarios. The setting of probability weights needs to consider both the probability of the economic scenarios occurring while ensuring that the scenarios capture the non-linear distribution of losses across a reasonable range. To support the initial assessment of how likely a scenario is to occur, we typically undertake a Monte Carlo analysis which would ascertain the likelihood of a five-year average GDP forecast growth rate occurring based on the long run historically observed average. Creating a standard distribution bell curve around this long run average allows us to estimate the probability of a given GDP scenario occurring and therefore assign a probability weight to that scenario. However, a key challenge with this approach in a stressed environment like the one seen in 2020 is that extreme GDP forecasts occur.

Due to the extreme falls in growth, in 2020 we changed the time period that we looked at for the Monte Carlo analysis to 2007-2012 in order to capture the very low period of growth, similar to those seen in 2020. However, this time period is no longer appropriate as the economy recovers resulting in large upswings in growth. As such, we have assessed various periods of growth, similar to the action we took in 2020, and the most relevant period would be to include the entire data set given that the number of growth periods since 1948 far outweighs the downswings. In this case, the base case sits at the 10th percentile with such a growth rate occurring, historically, nearly half the time (43%) implying that a weight of between 40-50% remains appropriate. Under the longer period, the Downside 3 scenario now sits in the 50th percentile since the number of significant quarterly growth periods is increasing as we move through 2021. However, this still suggests that a low weight remains appropriate.

We also need to consider the UK economic and political environment when applying weights. Although the economic recovery has started, it is clear that the roadmap will need to be altered in order to deal with any increasing infection rates caused by new variants, particularly as they are appearing regularly and vaccines may need to evolve further to deal with potential resistance to them. As such, we remain of the view that the risks are still biased to the downside and include: emergence of further variants that are resistant to existing vaccines leading to further lockdowns - at present the Omicron variant is an example of where uncertainty is affecting the UK economy via self-imposed restrictions as well as those mandated by the UK Government; a substantial increase in inflation; continuing weak investment; a larger negative impact from the EU trade deal than assumed; and the increasing possibility of a second Scottish referendum which may bring disruption to any recovery in the latter years of the forecast. As such, it remains appropriate to reflect this with a 50% weight for the downside scenarios.

The scenario weights we applied for 2021 and 2020 were:

	Upside 1	Base case	Downside 1	Downside 2	Downside 3
Scenario weights	**%**	**%**	**%**	**%**	**%**
2021	5	45	25	20	5

	Upside 1	Base case	Downside 1	Downside 2	Downside 3
Scenario weights	**%**	**%**	**%**	**%**	**%**
2020	5	45	15	25	10

Significant Increase in Credit Risk (SICR) (audited)

Loans which have suffered a SICR since origination are subject to a lifetime ECL assessment which extends to a maximum of the contractual term of the loan, or the behavioural term for a revolving facility. Loans which have not experienced a SICR are subject to 12-month ECL. We assess the credit risk profile of each facility to determine which of three stages to allocate them to:

- Stage 1: when there has been no SICR since initial recognition. We apply a loss allowance equal to a 12-month ECL i.e. the proportion of lifetime expected losses that relate to that default event expected in the next 12 months
- Stage 2: when there has been a SICR since initial recognition, but no credit impairment has materialised. We apply 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
- Stage 3: when the exposure is considered credit impaired. We apply a loss allowance equal to the lifetime ECL. Objective evidence of credit impairment is required. For more, see the section 'Definition of default (Credit impaired)' above.

We use a range of quantitative, qualitative and backstop criteria to identify exposures that have experienced a SICR. The Santander UK Credit Risk Provisions Forum (CRPF) reviews and approves our SICR thresholds periodically. The Santander UK Board Audit Committee reviews and challenges the appropriateness of them each year, or more often if we change them. Santander UK Board Audit Committee reviews definition of default for mortgages purchased by SFS from Santander UK plc and SFS Board Audit Committee reviews definition of default for SFS originated mortgages.

Quantitative criteria

We use quantitative criteria to identify where an exposure has increased in credit risk. The criteria we apply are based on whether any increase in the lifetime PD since the recognition date exceeds a set threshold both in relative and absolute terms. We base the value anticipated from the initial recognition on a similar set of assumptions and data to the ones we used at the reporting date, adjusted to reflect the account surviving to that date. The comparison uses either an annualised lifetime PD, where the lifetime PD is divided by the forecast period, or the absolute change in lifetime PD since initial recognition.

For each portfolio, the quantitative criteria we used for 2021 and 2020 were:

Residential mortgages	Loans and advances to banks[(1)]
30bps	400bps

(1) Loans and advances to banks use the comparison of lifetime PDs to determine Stage allocation, unlike other products which first turn the lifetime PD into an average yearly PD (annualised) and then do the comparison.

Qualitative criteria

We also use qualitative criteria to identify where an exposure has increased in credit risk, independent of any changes in PD. For each portfolio, the criteria we used for 2021 and 2020 were:

Residential mortgages	Loans and advances to banks
In forbearance	In forbearance
Default in last 24m	Watchlist – proactive management
£100+ arrears	>30 Days past due (DPD) in last 12m
Bankrupt	Default at proxy origination

Backstop criteria

As a backstop, we classify all exposures more than 30 or 90 DPD in at least Stage 2 or in Stage 3, respectively. This means that we do not rebut the backstop presumptions in IFRS 9 (i.e. credit risk has significantly increased if contractual payments are more than 30 DPD) relating to either a SICR or default.

Definition of default (Credit impaired) (audited)

We define a financial instrument as in default (i.e. credit impaired) for purposes of calculating ECL if it is more than three months past due, or if we have data to make us doubt the customer can keep up with their payments i.e. they are unlikely to pay. The data we have on customers varies across our business segments. It typically includes where:

Residential mortgages
– They have been reported bankrupt or insolvent. This excludes accounts which are up to date and are not defaulted
– Their loan term has ended, but they still owe us money more than three months later
– They have had forbearance while in default, but have not caught up with the payments they had missed before that, or they have had multiple forbearance
– We have suspended their fees and interest because they are in financial difficulties
– We have repossessed the property
Loans and advances to banks
– They have had a winding up notice issued, or something happens that is likely to trigger insolvency – such as another lender calls in a loan
– Something happens that makes them less likely to be able to pay us – such as they lose an important client or contract
– They have regularly missed or delayed payments, even though they have not gone over the three-month limit for default
– Their loan is unlikely to be refinanced or repaid in full on maturity
– Their loan has an excessive LTV that is unlikely to be resolved, such as by a change in planning policy, pay-downs, or increase in market value

Where we use the advanced internal ratings-based basis for a portfolio in our capital calculations, we use the same default definitions for ECL purposes. The CRPF reviews and approves the definition of default at least annually. The Santander UK Board Audit Committee reviews and challenges the appropriateness of the definition each year, or more often if we change it.

Measuring ECL (audited)

For accounts not in default at the reporting date, we estimate a monthly ECL for each exposure and for each month over the forecast period. 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. We calculate each monthly ECL as the discounted value for the relevant forecast month of the product of the following factors:

Factor	Description
Survival rate (SR)	The probability that the exposure has not closed or defaulted since the reporting date.
Probability of default (PD)	The likelihood of a borrower defaulting in the following month, assuming it has not closed or defaulted since the reporting date. For each month in the forecast period, we estimate the monthly PD from a range of factors. These include the current risk grade for the exposure, which becomes less relevant further into the forecast period, as well as the expected evolution of the account risk with maturity and factors for changing economics. We support this with historical data analysis.
Exposure at default (EAD)	The amount we expect to be owed if a default event was to occur. We determine EAD for each month of the forecast period by the expected payment profile, which varies by product type. For amortising products, we base it on the borrower's contractual repayments over the forecast period. We adjust this for any expected overpayments on Stage 1 accounts that the borrower may make and for any arrears we expect if the account was to default. For revolving products, or amortising products with an off-balance sheet element, we determine EAD using the balance at default and the contractual exposure limit. We vary these assumptions by product type and base them on analysis of recent default data.
Loss given default (LGD)	Our expected loss if a default event were to occur. We express it as a percentage and calculate it based on factors that we have observed to affect the likelihood and/or value of any subsequent write-offs, which vary according to whether the product is secured or unsecured. If the product is secured, we take into account collateral values as well as the historical discounts to market/book values due to forced sales type.

We use the original effective interest rate as the discount rate. For accounts in default, we use the EAD as the reporting date balance. We also calculate an LGD to reflect the default status of the account, considering the current DPD and loan to value. PD and SR are not required for accounts in default.

Forecast period

We base the forecast period for amortising facilities on the remaining contract term. For revolving facilities, we use an analytical approach based on the behavioural, rather than contractual, characteristics of the facility type. In some cases, we shorten the period to simplify the calculation. If we do this, we apply a post model adjustment to reflect our view of the full lifetime ECL.

Forward-looking information

Our assessments of a SICR and the calculation of ECL both incorporate forward-looking data. We perform historical analysis and identify the key economic variables that impact credit risk and ECL for each portfolio. These can include the house price growth, GDP, unemployment rate and Bank of England bank rate. Where applicable, we incorporate these economic variables and their associated impacts into our models.

Grouping of instruments for losses measured on a collective basis

We measure ECL at the individual financial instrument level. However, where we have used internal capital or similar models as the basis for our ECL models, this typically results in a large number of relatively small homogenous groups. We typically group instruments where they share risk characteristics using one or more statistical models and assess them for impairment collectively. We use this approach for the Crown Dependencies and UK residential mortgage portfolios.

We calculate separate collective provisions for instruments in Stages 1, 2 and 3 where the instrument is not individually assessed. As described above, for all our other portfolios (whether we assess them for impairment individually or collectively) we use five forward-looking economic scenarios.

Management judgements and accounting estimates applied in calculating ECL (audited)
IFRS 9 recognises that management judgements and accounting estimates are an essential part of calculating ECL. Specifically, where the historical data that we use in our models does not reflect current or future expected conditions, or the data we have does not cover a sufficient period or is not robust enough. We consider the accounting estimates in calculating ECL to be:

- Definition of default;
- Forward-looking multiple economic scenarios;
- Probability weights applied to multiple economic scenarios; and
- Significant Increase in Credit Risk (SICR) thresholds.

Governance around ECL impairment allowances (audited)
Santander UK Risk Methodology team developed our ECL impairment models (except for the external models we use, such as OGEM which we described earlier in 'Our forecasting approach'), and our Independent Validations Team independently reviews all material models. As model owners, the Santander UK Risk Provisioning & Forecasting team run the models to calculate our ECL impairment allowances each month. The models are sensitive to changes in credit conditions and reflect various management judgements that give rise to measurement uncertainty in our reportable ECL as set out above. The following Santander UK committees and forums review the provision drivers and ensure that the management judgements we apply remain appropriate:

- **Model Risk Control Forum** (MRCF) reviews and approves new models and required model changes. It also reviews the use of OGEM as a reliable model on which to base our other forecast macroeconomic variables. It is used across all stress testing and planning so it is subject to model risk criteria. MRCF will delegate responsibility of approvals to Model Risk Management Forum (MRMF) for changes of low risk materiality or less complex changes.
- **ALCO** reviews and approves the base case used in the economic scenarios we use to calculate forward-looking scenarios.
- **CRPF** reviews and approves the economic scenarios and probability weights we use to calculate forward-looking scenarios. It also reviews management judgements and approves ECL impairment allowances.
- **Board Audit Committee** reviews and challenges the appropriateness of the estimates and judgements made by management.

After the above governance process at Santander UK level is concluded, SFS accountable executives are engaged to approve the methodologies and outputs, which SFS have the oversight and accountability on. SFS ECL impairment allowances are then reviewed and approved by SFS committees and forums, including ALCO, ERCC, Broad Risk and Audit Committee and Executive Committee.

For more on the governance around specific elements of the ECL impairment allowances, including the frequency of, and thresholds for, reviews, including by these committees and forums, see the detailed sections above.

How we assess the performance of our ECL estimation process
We assess the reasonableness of our ECL provisions and the results of our Staging analysis using a range of methods. These include:

- **Benchmarking:** we compare our coverage levels with our peers.
- **Stand-back testing:** we monitor the level of our coverage against actual write-offs.
- **Back-testing:** we compare key drivers periodically as part of model monitoring practices.
- **Monitoring trends:** we track ECL and Staged assets over time and against our internal budgets and forecasts, with triggers set accordingly.

CREDIT RISK REVIEW

Our maximum and net exposure to credit risk (audited)

The tables below show the main differences between our maximum and net exposure to credit risk. The tables only show the financial assets that credit risk affects and to which the impairment requirements in IFRS 9 are applied.

For balance sheet assets, the maximum exposure to credit risk is the carrying value after impairment loss allowances. Off-balance sheet exposures are mortgage offers, guarantees, formal standby facilities, credit lines and other commitments. For off-balance sheet guarantees, the maximum exposure is the maximum amount that we would have to pay if the guarantees were called on. For formal standby facilities, credit lines and other commitments that are irrevocable over the life of the facility, the maximum exposure is the total amount of the commitment.

	Maximum exposure				
	Balance sheet asset				
	Gross amounts	Loss allowances	Net amounts	Off-balance sheet	Net exposure
2021	**£bn**	**£bn**	**£bn**	**£bn**	**£bn**
Cash and balances at central banks	**2.4**	**—**	**2.4**	**—**	**2.4**
Financial assets at amortised cost:					
– Loans and advances to customers[1]	**3.5**	**—**	**3.5**	**—**	**3.5**
– Crown dependencies	**0.7**	**—**	**0.7**	**—**	**0.7**
– UK residential mortgages	**2.6**	**—**	**2.6**	**—**	**2.6**
– Other	**0.2**	**—**	**0.2**	**—**	**0.2**
– Loans and advances to banks	**0.2**	**—**	**0.2**	**—**	**0.2**
Total financial assets at amortised cost	**3.7**	**—**	**3.7**	**—**	**3.7**
Total	**6.1**	**—**	**6.1**	**—**	**6.1**
2020					
Cash and balances at central banks	2.3	—	2.3	—	2.3
Financial assets at amortised cost:					
– Loans and advances to customers[1]	3.6	—	3.6	—	3.6
– Crown dependencies	0.3	—	0.3	—	0.3
– UK residential mortgages	3.1	—	3.1	—	3.1
– Other	0.2	—	0.2	—	0.2
– Loans and advances to banks	0.3	—	0.3	—	0.3
Total financial assets at amortised cost	3.9	—	3.9	—	3.9
Total	6.2	—	6.2	—	6.2

(1) Balances include interest we have charged to the customer's account and accrued interest that we have not charged to the account yet.

The tables below show the main differences between our maximum and net exposure to credit risk on the financial assets that credit risk affects and to which the impairment requirements in IFRS 9 are not applied.

	Maximum exposure				
	Balance sheet asset				
	Gross amounts	Loss allowances	Net amounts	Off-balance sheet	Net Exposure
2021	**£bn**	**£bn**	**£bn**	**£bn**	**£bn**
Financial assets at FVTPL:					
– Other financial assets at FVTPL	**0.5**	**—**	**0.5**	**—**	**0.5**
Total	**0.5**	**—**	**0.5**	**—**	**0.5**
2020					
Financial assets at FVTPL:					
– Other financial assets at FVTPL	0.5	—	0.5	—	0.5
Total	0.5	—	0.5	—	0.5

Single credit rating scale

In the table below, we have used a single rating scale to ensure we are consistent across all our credit risk portfolios in how we report the risk of default. It has eight grades for non–defaulted exposures, from 9 (lowest risk) to 2 (highest risk). We define each grade by an upper and lower PD value and we scale the grades so that the default risk increases by a factor of ten every time the grade number drops by two steps. For example, grade 9 has an average PD of 0.010%, and grade 7 has an average PD of 0.100%. We give defaulted exposures a grade 1 and a PD value of 100%. In the final column of the table we show the approximate equivalent credit rating grade used by Standard & Poor's Ratings Services (S&P).

	PD range			
	Mid	Lower	Upper	S&P equivalent
Santander UK risk grade	%	%	%	
9	0.010	—	0.021	AAA to AA+
8	0.032	0.021	0.066	AA to AA-
7	0.100	0.066	0.208	A+ to BBB
6	0.316	0.208	0.658	BBB- to BB
5	1.000	0.658	2.081	BB-
4	3.162	2.081	6.581	B+ to B
3	10.000	6.581	20.811	B-
2	31.623	20.811	99.999	CCC to C
1 (Default)	100.000	100.000	100.000	D

The PDs in the table above are based on Economic Capital (EC) PD mappings which are calculated based on the average probability of default over an economic cycle. This is different to the IFRS 9 PDs which are calculated at a point in time using forward looking economic scenarios. Where possible, the EC PD values are largely aligned to the regulatory capital models however any regulatory floors are removed and PDs are defined at every possible rating rather than categorised into rating buckets.

Rating distribution (audited)
The tables below show the credit rating of our financial assets to which the impairment requirements in IFRS 9 apply.

	SFS risk grade								
	9	8	7	6	5	4	1 to 3	Other[1]	Total
2021	**£bn**	**£bn**	**£bn**	**£bn**	**£bn**	**£bn**	**£bn**	**£bn**	**£bn**
Cash and balances at central banks	**2.4**	**—**	**—**	**—**	**—**	**—**	**—**	**—**	**2.4**
Financial assets at amortised cost:									
Loans and advances to customers:[2]	**—**	**0.5**	**1.5**	**0.6**	**0.1**	**0.1**	**—**	**0.7**	**3.5**
– Crown dependencies	**—**	**—**	**—**	**—**	**—**	**—**	**—**	**0.7**	**0.7**
– UK residential mortgages	**—**	**0.5**	**1.3**	**0.6**	**0.1**	**0.1**	**—**	**—**	**2.6**
– Other	**—**	**—**	**0.2**	**—**	**—**	**—**	**—**	**—**	**0.2**
Loans and advances to banks	**—**	**—**	**0.2**	**—**	**—**	**—**	**—**	**—**	**0.2**
Total on balance sheet exposures	**2.4**	**0.5**	**1.7**	**0.6**	**0.1**	**0.1**	**—**	**0.7**	**6.1**
Off-balance sheet exposures	**—**	**—**	**—**	**—**	**—**	**—**	**—**	**—**	**—**
Total	**2.4**	**0.5**	**1.7**	**0.6**	**0.1**	**0.1**	**—**	**0.7**	**6.1**
2020									
Cash and balances at central banks	2.3	—	—	—	—	—	—	—	2.3
Financial assets at amortised cost:									
Loans and advances to customers:[2]	—	0.5	1.6	0.7	0.1	0.4	—	0.3	3.6
– Crown dependencies	—	—	—	—	—	—	—	0.3	0.3
– UK residential mortgages	—	0.5	1.4	0.7	0.1	0.4	—	—	3.1
– Other	—	—	0.2	—	—	—	—	—	0.2
Loans and advances to banks	—	—	0.3	—	—	—	—	—	0.3
Total on balance sheet exposures	2.3	0.5	1.9	0.7	0.1	0.4	—	0.3	6.2
Off-balance sheet exposures	—	—	—	—	—	—	—	—	—
Total	2.3	0.5	1.9	0.7	0.1	0.4	—	0.3	6.2

(1) We use scorecards for these items, rather than rating models.
(2) Includes interest we have charged to the customer's account and accrued interest we have not charged to the account yet

Credit quality (audited)
The following tables analyse the credit risk exposure of financial instruments for which an ECL allowance is recognised, and the corresponding ECL at 31 December 2021 and 2020:

	Stage 1	Stage 2	Stage 3	Total
2021	**£m**	**£m**	**£m**	**£m**
Exposures				
Loans and advances to customers	**3,469**	**49**	**3**	**3,521**
– Crown dependencies	**738**	**2**	**1**	**741**
– UK residential mortgages	**2,536**	**47**	**2**	**2,585**
– Other	**195**	**—**	**—**	**195**
Total ECL	**—**	**—**	**—**	**—**
2020				
Exposures				
Loans and advances to customers	3,534	43	1	3,578
– Crown dependencies	287	—	1	288
– UK residential mortgages	3,028	43	—	3,071
– Other	219	—	—	219
Total ECL	—	—	—	—

Reconciliation of exposures, loss allowance and net carrying amounts (audited)

The table below shows the relationships between disclosures in this Credit risk review section which refer to drawn exposures and the associated ECL, and the total assets as presented in the Consolidated Balance Sheet.

	On-Balance Sheet			Off-Balance Sheet	
	Exposures	Loss allowance	Net carrying amount	Exposures(1)	Loss allowance
2021	**£m**	**£m**	**£m**	**£m**	**£m**
Cash and balances at central banks	**2,355**	**—**	**2,355**	**—**	**—**
Loans and advances to customers	**3,521**	**—**	**3,521**	**39**	**—**
– Crown dependencies	**741**	**—**	**741**	**39**	**—**
– UK residential mortgages	**2,585**	**—**	**2,585**	**—**	**—**
– Other	**195**	**—**	**195**	**—**	**—**
Loans and advances to banks	**227**	**—**	**227**	**—**	**—**
Total exposures	**6,103**	**—**	**6,103**	**39**	**—**
Assets classified at FVTPL			**468**		
Non-financial assets			**18**		
Total assets per the Balance Sheet			**6,589**		
2020					
Cash and balances at central banks	2,288	—	2,288	—	—
Loans and advances to customers	3,578	—	3,578	10	—
– Crown dependencies	288	—	288	10	—
– UK residential mortgages	3,071	—	3,071	—	—
– Other	219	—	219	—	—
Loans and advances to banks	270	—	270	—	—
Total exposures	6,136	—	6,136	10	—
Assets classified at FVTPL			534		
Non-financial assets			19		
Total assets per the Balance Sheet			6,689		

(1) Prior year off-balance sheet exposures restated to include £10m that were previously omitted.

Concentrations of credit risk exposures

Country risk exposures (audited)

We manage our country risk exposure under our global limits framework. Within this framework we set our Risk Appetite for each country, taking into account factors that may affect its risk profile. These can include political events, macroeconomics and the nature of the risk. We actively manage exposures if we think we need to. We consider Banco Santander SA related risk separately.

The tables below show our total exposures, which are the total of balance sheet and off–balance sheet values. We calculate balance sheet values in accordance with IFRS (i.e. after netting allowed under IAS 32) except for credit provisions which we add back. Off–balance sheet values are undrawn facilities. We classify location by country of risk – the country where each client has its main business or assets. That is unless there is a full risk transfer guarantee in place, in which case we use the guarantor's country of domicile. If a client has operations in many countries, we use their country of incorporation. The tables below exclude balances with other Banco Santander group members. We show them separately in the 'Balances with other Banco Santander group members' section.

	2021						2020					
		Financial Institutions						Financial Institutions				
Country:	**Governments**	**Banks(1)**	**Other**	**Retail**	**Corporate**	**Total(2)**	**Governments**	**Banks(1)**	**Other**	**Retail**	**Corporate**	**Total(2)**
	£bn	**£bn**	**£bn**	**£bn**	**£bn**	**£bn**	£bn	£bn	£bn	£bn	£bn	£bn
UK	**2.4**	**—**	**0.6**	**2.7**	**—**	**5.7**	2.3	—	0.7	3.1	—	6.1
Jersey	**—**	**—**	**—**	**0.4**	**—**	**0.4**	—	—	—	—	—	—
Isle of Man	**—**	**—**	**—**	**0.3**	**—**	**0.3**	—	—	—	0.3	—	0.3
	2.4	**—**	**0.6**	**3.4**	**—**	**6.4**	2.3	—	0.7	3.4	—	6.4
Total	**2.4**	**—**	**0.6**	**3.4**	**—**	**6.4**	2.3	—	0.7	3.4	—	6.4

(1) Excludes balances with central banks. Such balances are reported under Governments.
(2) Excludes cash at hand, interests in other entities, intangible assets, property, plant and equipment, tax assets, retirement benefit assets and other assets. Loans are included gross of credit provisions.

Balances with other Banco Santander companies (audited)
We deal with other Banco Santander group members in the ordinary course of business. We do this where we have a particular business advantage or expertise and where they can offer us commercial opportunities. These transactions also arise where we support the activities of, or with, larger multinational clients and financial institutions which may deal with other Banco Santander group members. We conduct these activities on the same terms as for similar transactions with third parties, and in a way that manages the credit risk within limits acceptable to the Board and the PRA.

At 31 December 2021 and 2020, we had gross balances with other Banco Santander group members as follows:

	2021	2020
	£bn	£bn
Assets:		
Spain	**0.2**	0.3
Liabilities:		
Spain	**0.2**	0.3

Credit performance (audited)

The customer loans in the table below are presented differently from the balances in the Balance Sheet. The main difference is that the customer loans below exclude inter-company balances. We disclose inter-company balances separately in the Notes to the Financial Statements. In addition, customer loans below are presented on an amortised cost basis.

	Customer Loans					
	Total	**Stage 1**	**Stage 2**	**Stage 3**	**Gross write-offs**	**Loan loss allowances**
2021	**£bn**	**£bn**	**£bn**	**£bn**	**£m**	**£m**
Drawn Balances	**3.5**	**3.5**	—	—	—	—
– Crown dependencies	**0.7**	**0.7**	—	—	—	—
– UK residential mortgages	**2.6**	**2.6**	—	—	—	—
– Other	**0.2**	**0.2**	—	—	—	—
Undrawn Balances		—	—	—		
– Crown dependencies		—	—	—		
– UK residential mortgages		—	—	—		
– Other		—	—	—		
Stage 1, Stage 2, and Stage 3 ratios (%)		**100**	—	—		
2020						
Drawn Balances	3.6	3.6	—	—	—	—
– Crown dependencies	0.3	0.3	—	—	—	—
– UK residential mortgages	3.1	3.1	—	—	—	—
– Other	0.2	0.2	—	—	—	—
Undrawn Balances		—	—	—		
– Crown dependencies		—	—	—		
– UK residential mortgages		—	—	—		
– Other		—	—	—		
Stage 1, Stage 2, and Stage 3 ratios (%)		100	—	—		

Credit risk review - UK residential mortgages

The portfolio of UK residential mortgages is broadly representative of the wider UK mortgage book originated by Santander UK plc.

Borrower profile (audited)

In this table, 'Home movers' include both existing customers moving house and taking out a new mortgage with Santander UK plc, and customers who switch their mortgage to Santander UK plc when they move house. 'Remortgagers' are new customers who are taking a new mortgage with Santander UK plc.

		2021		2020
	£m	%	£m	%
Home movers	**1,222**	**47.3**	1,431	46.6
Remortgagers	**691**	**26.7**	862	28.1
First-time buyers	**672**	**26.0**	778	25.3
Buy-to-let	**—**	**—**	—	—
	2,585	**100.0**	3,071	100.0

Interest rate profile (audited)

The interest rate profile of our mortgage asset stock was:

		2021		2020
	£m	%	£m	%
Fixed rate	**2,370**	**91.7**	2,814	91.6
Variable rate	**114**	**4.4**	166	5.4
Standard variable rate	**40**	**1.5**	55	1.8
Follow on rate	**61**	**2.4**	36	1.2
	2,585	**100.0**	3,071	100.0

Geographical distribution (audited)

The geographical distribution of our mortgage asset stock was:

	2021	2020
	£bn	£bn
London	**0.7**	0.8
Midlands and East Anglia	**0.4**	0.4
North	**0.4**	0.4
Northern Ireland	**—**	—
Scotland	**—**	—
South East excluding London	**0.8**	1.2
South West, Wales and other	**0.3**	0.3
	2.6	3.1

Loan-to-value analysis (audited)

This table shows the LTV distribution for the gross carrying amount and the related ECL of our UK residential mortgage portfolio. We also show the collateral value and simple average LTV for our mortgage stock. We use our estimate of the property value at the balance sheet date. We include fees that have been added to the loan in the LTV calculation. For flexible products, we only include the drawn amount, not undrawn limits.

		2021		2020
	Total	ECL	Total	ECL
LTV	£m	£m	£m	£m
Up to 50%	**1,147**	**—**	1,131	—
>50-75%	**1,246**	**—**	1,447	—
>75-85%	**169**	**—**	395	—
>85-100%	**20**	**—**	95	—
>100%	**3**	**—**	3	—
	2,585	**—**	3,071	—
Collateral value of residential properties(1)	**2,585**		3,071	
	%		%	
Simple average LTV (indexed)(2)	**42**		47	

(1) Collateral value shown is limited to the balance of each related loan. Excludes the impact of over-collateralisation, where the collateral is higher than the loan. Includes collateral against loans in negative equity of nil (2020: nil).
(2) Total of all LTV% divided by the total of all accounts.

UK residential mortgages - portfolios of particular interest

Introduction

All our UK residential mortgages are residential prime lending and we do not acquire or hold sub-prime or second charge mortgages. Despite that, some types of mortgages have higher risks and others stand out for different reasons. These are:

Product	Description
Interest-only loans and part interest-only, part repayment loans	With an interest-only mortgage, the customer pays interest every month but the principal balance may remain outstanding until the end of the mortgage term. Some mortgages have a part that is interest-only, with the rest being a normal repayment mortgage. Customers with part interest-only, part repayment mortgages still have to pay back a lump sum at the end of their mortgage for the interest-only part. This means there is a higher credit risk on these loans as we depend on the customers to pay back a lump sum. We design new account LTV maximums to mitigate this credit risk. We also make sure the customer has a plausible repayment plan before we lend to them and remains on track for the life of the loan. Customers with interest-only mortgages have to make arrangements to repay the principal at the end of the mortgage. We have a strategy to make sure that we tell these customers that they have to do this. We send them messages with their annual mortgage statements, and we run contact campaigns to encourage them to tell us how they plan to repay. We undertake these contact campaigns periodically throughout the customers' interest-only mortgage term and increase the frequency of contact as customers approach term maturity. If customers know they will not be able to repay their mortgage in full when it ends, or if their mortgage has already passed the date when it should have ended, we talk to them. If we think it is in the customer's interests and they can afford it, we look at other ways of managing it. That can mean turning the mortgage into a standard repayment one and extending it. Or, if the customer is waiting for their means of repaying it, such as an investment plan or bonds, to mature, an extension may be permitted.
Loans with an LTV >100%	Where the mortgage balance is more than the property is now worth, we cannot recover the full value of the loan by repossessing and selling the property. This means there is a higher credit risk on these loans. In some cases, property prices have fallen, so mortgages we gave in the past with lower LTVs now have LTVs greater than 100%. We monitor existing accounts with LTVs >100% as part of our assessment of ongoing portfolio performance.

Credit performance (audited)

		Portfolio of particular interest[1]			
	Total	Interest-only	Part interest-only, part repayment[2]	LTV>100%	Other portfolio
2021	**£m**	**£m**	**£m**	**£m**	**£m**
Mortgage portfolio	**2,585**	**252**	**227**	**3**	**2,107**
- Stage 1	**2,536**	**247**	**223**	**3**	**2,069**
- Stage 2	**47**	**4**	**4**	**—**	**37**
- Stage 3	**2**	**1**	**—**	**—**	**1**
Stage 3 ratio	**—%**	**—%**	**—%**	**—%**	**—%**
Simple average LTV (indexed)	**42%**	**35%**	**45%**	**108%**	**43%**
2020					
Mortgage portfolio	3,071	281	265	3	2,524
- Stage 1	3,028	279	259	3	2,489
- Stage 2	43	2	6	—	35
- Stage 3	—	—	—	—	—
Stage 3 ratio	—%	—%	—%	—%	—%
Simple average LTV (indexed)	47%	37%	48%	117%	48%

(1) Where a loan falls into more than one category, we include it in all the categories that apply. As a result, the sum of the mortgages in the segments of particular interest and the other portfolio does not agree to the total mortgage portfolio.
(2) Mortgage balance includes both the interest-only part of £164m (2020: £190m) and the non-interest-only part of the loan.

MARKET RISK

Market risk comprises non-traded market risk and traded market risk. The Company has no traded market risk exposures.

NON-TRADED MARKET RISK MANAGEMENT

Risk appetite

Our framework for dealing with market risk is part of the overall Santander UK Risk Framework. Our Structural and Market Risk framework sets out our high-level arrangements and standards to manage, control and oversee non-traded market risk. The Santander UK Risk Appetite sets the controls, risk limits and key risk metrics for non-traded market risk. We articulate risk appetite by the income and value sensitivity limits we set in the Santander UK Risk Appetite, at both Santander UK and Banco Santander group levels.

EVE sensitivity

We calculate EVE sensitivity as the change in the net present value of all the interest rate sensitive items in the banking book balance sheet for a defined set of instantaneous parallel and non-parallel shifts in the yield curve. We use a static balance sheet. This means that all balance sheet items run-off according to their contractual, behavioural or assumed run-off behaviour (whichever is appropriate), and there is no retained or new business.

NON-TRADED MARKET RISK REVIEW

Interest rate risk

Yield curve risk

The table below shows how our base case income and valuation would be affected by a 25 basis points (bps) and a 50 bps parallel shift (both up and down) applied instantaneously to the yield curve at 31 December 2021 and 2020. Sensitivity to parallel shifts represents the amount of risk in a way that we think is both simple and scalable. From 2021, we have typically focused on a 25bps stress for non-traded market risk controls that reflects a more plausible yield curve stress in the current low rate environment. We continue to monitor sensitivities to other parallel and non-parallel shifts as well as scenarios. Sensitivities to a 50bps shift are also provided this year as a bridge to previous year's disclosures.

				2021				2020
	+25bps	**-25bps**	**+50bps**	**-50bps**	+25bps	-25bps	+50bps	-50bps
	£m	**£m**	**£m**	**£m**	£m	£m	£m	£m
Net interest margin sensitivity (audited)	**4**	**(4)**	**8**	**(8)**	3	(1)	6	(1)
EVE sensitivity	**1**	**(2)**	**2**	**(5)**	(2)	(3)	(4)	(7)

Managing IBOR transition

In 2021, we made good progress in the IBOR transition as substantial parts of the process began to come to an end. New reference rate products have been deployed to support the transition off IBOR rates and, in 2021, the majority of affected legacy contracts were transitioned from the LIBOR rates ceasing at the end of the year. We continue to work with our customers to agree the transition of the relatively small number of agreements that remain to be transitioned at the end of 2021. For more, see Note 27 to the financial statements.

LIQUIDITY RISK

Overview
SFS oversees and manages liquidity separately but this is included as part of the ILAAP process driven by Santander UK Group Holdings plc, and we are considered as part of the overall UK framework. Under this model, SFS meets its regulatory requirements for the purpose of managing liquidity risk on an individual basis.

LIQUIDITY RISK MANAGEMENT

Risk appetite
Separate Liquidity Risk Appetites (LRAs) for Santander UK plc and for the Company are in place. These are appropriate to their individual business models and consistent with the strategy of Santander UK Group Holdings plc.

Our LRA statement is based on the principles of liquidity management we use to manage our balance sheet. It also supports our need to meet or exceed the rules of our regulators.

The Company has adopted the Santander UK Risk Management framework and the CFO and Risk Divisions within Santander UK, and through the respective service level agreements, provide information for the Company to manage and control liquidity risk on behalf of the Company. The relevant policy frameworks and procedures within Santander UK Group Holdings plc therefore also apply to the Company.

Our LRA is proposed to the Risk division, and reviewed and approved by the Board each year, or more often if needed.

The Company’s Board approved the Internal Liquidity Adequacy Assessment Process (ILAAP) in November 2021.

Risk measurement
We use a number of metrics to manage liquidity risk. These include metrics that show the difference between cash and collateral inflows and outflows in different periods. We have a liquidity stress testing framework in place which is central to our LRA measurement and monitoring. It includes three severe but plausible stress test scenarios. To fit with our risk appetite, the liquidity outflows that come from these stress tests must be fully covered with high-quality liquid assets, other liquid assets and management actions sanctioned at the right level of governance.

Our Risk division runs a range of stress tests. Our LRA stress test is a combination of three tests that cover idiosyncratic, market-wide and combined scenarios.

We monitor our Liquidity Coverage Ratio (LCR) to ensure we continue to meet the requirements. We also monitor the Net Stable Funding Ratio (NSFR), which was implemented on 1 January 2022. We exceed the requirements for both LCR and NSFR.

Risk mitigation (audited)
The Board aims to make our balance sheet resilient at all times and for it to be perceived as such by stakeholders. This preserves our short and long-term viability. The Board recognises that as we are involved in maturity transformation, we cannot hold enough liquidity to cover all possible stress scenarios. The Board requires us to hold enough liquidity to make sure we will survive three plausible but severe stress scenarios (our LRA stress). We do this by maintaining a prudent balance sheet structure and approved liquid resources.

Risk monitoring and reporting (audited)
We monitor liquidity risk daily, weekly and monthly. We do this through different committees and levels of management, including the SFS ALCO and the Board Risk Committee.

LIQUIDITY RISK REVIEW

Liquidity risk for the Company is monitored and managed separately from the rest of the Santander UK group.

Liquidity Coverage Ratio
This table shows our LCR and LRA at 31 December 2021 and 2020. The LRA data reflect the stress testing methodology in place at that time.

	LCR		LRA	
	2021	2020	**2021**	2020
	£m	£m	**£m**	£m
Eligible liquidity pool (liquidity value)	**2.8**	2.8	**2.8**	2.8
Net stress outflows	**(1.4)**	(1.7)	**(1.5)**	(1.7)
Surplus	**1.4**	1.1	**1.3**	1.1
Eligible liquidity pool as a percentage of anticipated net cash flows	**206%**	165%	**184%**	168%

We also monitor the Net Stable Funding Ratio (NSFR), which has been implemented on 1 January 2022 and we exceed the requirements. At 31 December 2021, the SFS NSFR was 137%.

LCR eligible liquidity pool
This table shows the carrying value of our eligible liquidity pool assets at 31 December 2021 and 2020. It also shows the weighted average carrying value in the year.

	Carrying value						Weighted average carrying value in the year	
	2021			2020			**2021**	2020
	Level 1	**Level 2**	**Total**	Level 1	Level 2	Total	**Total**	Total
	£bn	**£bn**	**£bn**	£bn	£bn	£bn	**£bn**	£bn
Cash and balances at central banks	**2.3**	**—**	**2.3**	2.3	—	2.3	**2.0**	4.7
Government bonds	**0.5**	**—**	**0.5**	0.5	—	0.5	**0.5**	0.5
	2.8	**—**	**2.8**	2.8	—	2.8	**2.5**	5.2

Currency analysis
The carrying value of our eligible liquidity pool was in Sterling only at £2.8bn (2020: £2.8bn). The composition of the pool is consistent with the currency profile of our net liquidity outflows.

FUNDING RISK MANAGEMENT

Deposit funding

The Company is primarily funded through Crown Dependency deposits from Santander UK Group Holdings plc.

Wholesale funding

Wholesale funding from Santander UK Group Holdings plc was £31m at 31 December 2021 (2020: £8m), all of which was classified as Deposits by banks.

CAPITAL RISK

THE SCOPE OF OUR CAPITAL ADEQUACY

Regulatory supervision

For capital purposes, we are subject to prudential supervision by the PRA, as a UK bank, and by the European Central Bank (ECB) as part of the Banco Santander group. The ECB supervises Banco Santander as part of the Single Supervisory Mechanism (SSM). Although we are part of the Banco Santander group, we do not have a guarantee from our ultimate parent Banco Santander SA. As we are regulated by the PRA, we have to meet the PRA capital requirements on a standalone basis. We also have to show the PRA that we can withstand capital stress tests without the support of our ultimate parent. Reinforcing our corporate governance framework, the PRA exercises oversight through its rules and regulations on the Board and senior management appointments.

Santander UK Group Holdings plc is the holding company of Santander Financial Services plc and is the head of the Santander UK group (including SFS) for regulatory capital and leverage purposes.

CAPITAL RISK MANAGEMENT

The Board is responsible for capital management strategy and policy and ensuring that we monitor and control our capital resources within regulatory and internal limits. We operate within the capital risk framework and appetite approved by SFS and Santander UK Boards. This reflects the business environment we operate in, our strategy for each material risk and the potential impact of any adverse scenarios or stresses on our capital position.

Management of capital requirements (audited)

Our capital risk appetite aims to maintain capital levels appropriate to the level of stress applied, and the expected regulatory response. In:
- An adverse economic stress, which we might expect to occur once in 20 years, the firm should remain profitable and exceed all regulatory capital minimums at all times.
- A very severe economic stress, which we might expect to occur once in 100 years, and which has been designed to test any specific weaknesses of a firm's business model, the firm should meet all regulatory capital minimums at all times. This is subject to the use of regulatory buffers designed to absorb losses in such a stress.

Management of capital resources (audited)

We use a mix of regulatory and Economic Capital (EC) ratios and limits, internal buffers and restrictions to manage our capital resources. We also take account of the costs of differing capital instruments and capital management techniques. We also use these to shape the best structure for our capital needs. We decide how to allocate our capital resources as part of our strategic planning process. We base this in part on the relative returns on capital using both EC and regulatory capital measures. We plan for severe stresses and we set out what action we would take if an extremely severe stress threatened our viability and solvency. This could include not paying dividends, selling assets, reducing our business and issuing more capital.

Risk measurement

We apply Banco Santander's approach to capital measurement and risk management for CRD IV. For more on the CRD IV risk measurement of our exposures, see Banco Santander's Pillar 3 report.

The main metrics we use to measure capital risk are CET1 capital and total regulatory capital.

Risk mitigation

Santander UK has designed its capital risk framework, policies and procedures to ensure that we operate within our Risk Appetite. Santander UK manages capital transferability between its subsidiaries in line with its business strategy, its risk and capital management policies, and UK laws and regulations. There are no legal restrictions on Santander UK moving capital resources promptly, or repaying liabilities, between Santander UK and its subsidiaries except for loans and distributions between Santander UK entities in the ring-fenced bank sub-group and Santander UK entities that are not members of the ring-fenced bank sub-group (such as the Company), where the PRA is required to assess the impact of proposed distribution prior to payment.

At 31 December 2021, Santander UK Group Holdings plc, the Company and Santander Equity Investments Limited were party to the Non-RFB Sub-Group Capital Support Deed dated 13 November 2018. These parties were permitted by the PRA to form a core UK group as defined in the PRA Rulebook. Exposures of each of the regulated entities to other members of the core UK group were exempt from large exposure limits that would otherwise apply and intra-group exposures risk-weighted at 0% on a solo as well as consolidated basis. The purpose of the 2018 Deed was to facilitate the prompt transfer of available capital resources from, or repayment of liabilities by, the non-regulated parties to any of the regulated parties in the Non-RFB Sub-Group in the event that one of the regulated parties breached or was at risk of breaching its capital resources or risk concentrations requirements. Santander UK Group Holdings plc became a PRA-regulated firm from 12 December 2021.

A new Non-RFB Sub-Group Capital Support Deed was entered into on 17 December 2021 and effective from 1 January 2022, reflecting the latest version of associated regulation. The parties to the Non-RFB Sub-Group Capital Support Deed 2021 remained unchanged with the PRA granting permission for a renewal of the Non-RFB core UK group from 1 January 2022 to 31 December 2024, following expiry of the previous permission on 31 December 2021.

Risk monitoring and reporting

We monitor and report regularly against our capital plan. We do this to identify any change in our business performance that might affect our capital. Each month, we also review the economic assumptions we use to create and stress test our capital plan. We do this to identify any potential reduction in our capital.

CAPITAL RISK REVIEW

Regulatory capital resources (audited)

This table shows our regulatory capital.

	2021	2020
	£m	£m
CET1 capital before regulatory adjustments	**326**	307
CET1 regulatory adjustments	**(33)**	(8)
CET1 capital	**293**	299
Total regulatory capital	**293**	299

CET1 regulatory adjustments

These are adjustments required by CRD IV.

Independent auditors' report to the members of Santander Financial Services plc

Report on the audit of the financial statements

Opinion

In our opinion, Santander Financial Services plc's financial statements:

- give a true and fair view of the state of the Company's affairs as at 31 December 2021 and of its profit and cash flows for the year then ended;
- have been properly prepared in accordance with UK-adopted international accounting standards; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

We have audited the financial statements, included within the Annual Report, which comprise: the balance sheet as at 31 December 2021; the income statement, the statement of comprehensive income, the cash flow statement, the statement of changes in equity for the year then ended; and the notes to the financial statements, which include a description of the significant accounting policies.

Our opinion is consistent with our reporting to the Board Audit Committee.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We remained independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

To the best of our knowledge and belief, we declare that non-audit services prohibited by the FRC's Ethical Standard were not provided.

Other than those disclosed in Note 6 to the financial statements, we have provided no non-audit services to the Company in the period under audit.

Our audit approach

Context

Our 2021 audit was conducted semi-remotely, and we considered the impact of COVID-19 on the nature and extent of our work throughout the audit process. With some restrictions still in place we have continued to use technology effectively to coordinate with and oversee the work of overseas component teams and to exchange information between PwC and the Company. The improved use of technology has allowed us to further mitigate any risks that may arise from a remote working environment.

As part of our audit we also considered the continued impact of remote working on the Company's processes and controls. We evaluated the design and tested the operating effectiveness of relevant controls over financial reporting. In this regard, we did not identify any significant audit issues arising from the impact of remote working.

We continue to monitor the UK mortgage portfolio which was transferred from the ring-fenced bank (Santander UK plc) to the Company in 2020. We have performed audit work over the expected credit losses of the UK portfolio and the impact due to COVID-19 on the creditworthiness of borrowers. We have set out our response to this audit risk as a Key Audit Matter below.

Overview

Audit scope
- The scope of our audit and the nature, timing and extent of audit procedures performed were determined by our risk assessment and other qualitative factors (including history of misstatement through fraud or error).
- We performed audit procedures over components considered to be financially significant in the context of the Company.
- Our audit plan was discussed with the Board Audit Committee in October 2021. We discussed the key audit matters with the Committee at the conclusion of the audit.

Key audit matters
- Expected credit loss allowance on acquired mortgage portfolio from Santander UK plc

Materiality
- Overall materiality: £31.2m (2020: £33.5m) based on approximately 0.5% of total assets.
- Performance materiality: £23.4m (2020: £25.1m).

The scope of our audit

As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the financial statements.

Key audit matters

Key audit matters are those matters that, in the auditors' professional judgement, were of most significance in the audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditors, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. These matters, and any comments we make on the results of our procedures thereon, were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

This is not a complete list of all risks identified by our audit.

Accounting for acquisition of mortgage portfolio from Santander UK plc and Impact of COVID-19, which were key audit matters last year, are no longer included because of the fact that no further transfers took place during 2021 and the impact of COVID-19 is no longer deemed to be a key audit matter. Otherwise, the key audit matters below are consistent with last year.

Key audit matter	How our audit addressed the key audit matter
<u>*Expected credit loss allowance on acquired mortgage portfolio from Santander UK plc*</u>	
The determination of credit loss ('ECL') allowances can be subjective and judgemental. As at 31 December 2021, the Company has recognised credit impairment loss allowances on loans and advances to customers of less than £1m against loans and advances to customers of £2.6bn on the residential mortgages acquired from the RFB in October 2020. The majority (>98%) of loans are classified as Stage 1 at 31 December 2021. This is referenced in the SFS Annual Report in the Credit Risk Review section of the front half disclosures as well as Note 7 (Credit Impairment Losses and Provisions) and Note 12 (Loans and Advances to Customers). The identification and determination of expected credit loss provisions is inherently judgemental as it involves the use of unobservable inputs such as forward-looking economic assumptions. This increases the estimation uncertainty and risk of material error related to the reported expected credit losses. Management have not identified ECL as a critical accounting estimate given the low level of ECL recognised in the entity. However, given the judgements involved in calculating ECL and considering the current economic environment, we considered the valuation of ECL at 31 December 2021 to be a key audit matter.	Our testing procedures included the following: We understood and tested the controls around ECL, including: - Model performance monitoring controls, including testing model estimates against actual outcomes; and - The review and approval of significant judgements, estimates and the assessment of ECL modelled outputs at senior governance forums. We determined we could rely on these controls for the purposes of our audit, and supplemented this with test of details in the following areas: - We assessed whether the IFRS 9 ECL model methodologies used by management were appropriate, making use of our credit risk modelling experts and our industry knowledge. This included an evaluation of the ability of the models to appropriately reflect the impact of the COVID-19 pandemic as well as rising inflation on certain model assumptions, as well as the criteria set by management for determining whether there had been a significant increase in credit risk; - We have assessed the key assumptions relating to staging criteria and probability weighted forward looking information; - We independently recalculated critical model components and re-performed the calculation of ECL in the model. We ensured that the ECL calculations were consistent with the approved model methodologies; - We independently re-performed key aspects of model monitoring performed by management relating to model performance, segmentation and stability. We critically assessed the monitoring results; - We used our economics and credit risk modelling experts to critically assess the reasonableness of the multiple economic scenarios and scenario probability weightings adopted by management. We considered external economic data and consensus forecasts and whether management's forecasts appropriately reflected the possible economic consequences of the pandemic, including different possible paths that the pandemic could take. In particular, we challenged the appropriateness of the scenario probability weightings and COVID-19 stress downside scenario; - We assessed the completeness and ongoing appropriateness of overlays and post model adjustments ('PMAs') recognised by management to mitigate data and model limitations or emerging risk not captured by existing models; and - We considered whether any of these PMAs were required to address relevant risks that are not captured in the modelled provisions. We did not identify any material PMAs which we considered appropriate given >98% of the book is classified as Stage 1.Based on the procedures performed and the evidence obtained, we found management's judgements used in the determination of the ECLs, and the ECL provision recognised in the financial statements at 31 December 2021 to be reasonable.

How we tailored the audit scope

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the structure of the Company, the accounting processes and controls, and the industry in which it operates.

At the beginning of the year we identified the Jersey and Isle of Man branches of the Company to contain balances that, in our view, require an audit of specific financial statement line items based on their size or their risk characteristics, in the context to the Company's financial statements. We instructed PwC Channel Islands who are familiar with the relevant businesses to audit these balances. In addition, due to the magnitude of the new London deposits business launched in Q3 of 2021, the related deposits balance has also been brought into scope.

As part of the planning and execution of the audit, we worked closely with the PwC Channel Islands auditors throughout the year to ensure that the procedures performed on our behalf were sufficient for our purposes and, while physical site visits were not possible due to COVID-19, we held regular discussions and reviewed the results of their work via desktop review.

Processes and controls supporting the Company's operations are also undertaken by Banco Santander S.A. in Spain, including the hosting and monitoring of certain IT systems. We engaged PwC Spain to gain an understanding and to test the design and effectiveness of these IT controls. We held regular discussions with PwC Spain as well as our own IT specialist team and reviewed the results of their work.

The procedures which we performed accounted for 95% of interest and similar income, 99% of interest expense and similar charges, 99% of net trading and other income and 99% of total assets of the Company.

Materiality

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating the effect of misstatements, both individually and in aggregate on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

Overall Company materiality	£31,200,000 (2020: £33,500,000).
How we determined it	Approximately 0.5% of total assets
Rationale for benchmark applied	Asset-based measures are generally appropriate for entities whose performance is assessed on asset growth. We have discussed the Company's strategy to grow its deposit business and further utilise this form of funding to support growth. This, paired with the launch of its Jersey mortgage business and the proposed future transfer of additional mortgages from Santander UK plc, shows an asset-based focus. Considering also that the Company is 100% owned by Santander UK Group Holdings plc, an assets based benchmark for the current year is considered the most appropriate.

We use performance materiality to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds overall materiality. Specifically, we use performance materiality in determining the scope of our audit and the nature and extent of our testing of account balances, classes of transactions and disclosures, for example in determining sample sizes. Our performance materiality was 75% (2020: 75%) of overall materiality, amounting to £23,400,000 (2020: £25,100,000) for the Company financial statements.

In determining the performance materiality, we considered a number of factors - the history of misstatements, risk assessment and aggregation risk and the effectiveness of controls - and concluded that an amount at the upper end of our normal range was appropriate.

We agreed with the Board Audit Committee that we would report to them misstatements identified during our audit above £1,600,000 (2020: £1,700,000) as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

Conclusions relating to going concern

Our evaluation of the directors' assessment of the Company's ability to continue to adopt the going concern basis of accounting included:

- A risk assessment to identify factors that could impact the going concern basis of accounting, including the current and forecast financial performance, regulatory metrics and the sector in which the Company operates;
- Inspection of the Capital Support Deed issued by Santander UK Group Holdings plc to the Company and another affiliate and review of the Santander UK Group Holdings plc's going concern and viability statements presented by management to its Board Audit Committee to assess that support can be provided to the Company;
- Evaluation of the reasonableness of the Company's latest management forecasts, including testing the mathematical accuracy of the forecasts, testing key assumptions and a sensitivity analysis using our understanding of the Company and its financial and operating performance obtained during the course of our audit;
- Review of the Company's ILAAP, regulatory correspondence and reports provided to governance forums, and audit of the total capital resources; and
- Reviewing the appropriateness of the disclosures in the Annual Report.

Based on the work we have performed, we have not identified any material uncertainties relating to events or conditions that, individually or collectively, may cast significant doubt on the Company's ability to continue as a going concern for a period of at least twelve months from when the financial statements are authorised for issue.

In auditing the financial statements, we have concluded that the directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate. However, because not all future events or conditions can be predicted, this conclusion is not a guarantee as to the Company's ability to continue as a going concern.

Our responsibilities and the responsibilities of the directors with respect to going concern are described in the relevant sections of this report.

Reporting on other information

The other information comprises all of the information in the Annual Report other than the financial statements and our auditors' report thereon. The directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except to the extent otherwise explicitly stated in this report, any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify an apparent material inconsistency or material misstatement, we are required to perform procedures to conclude whether there is a material misstatement of the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

With respect to the Strategic report and Directors' report, we also considered whether the disclosures required by the UK Companies Act 2006 have been included.

Based on our work undertaken in the course of the audit, the Companies Act 2006 requires us also to report certain opinions and matters as described below.

Strategic report and Directors' report

In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic report and Directors' report for the year ended 31 December 2021 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

In light of the knowledge and understanding of the Company and its environment obtained in the course of the audit, we did not identify any material misstatements in the Strategic report and Directors' report.

Responsibilities for the financial statements and the audit

Responsibilities of the directors for the financial statements

As explained more fully in the Statement of Directors' Responsibilities, the directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The directors are also responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

Auditors' responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Irregularities, including fraud, are instances of non-compliance with laws and regulations. We design procedures in line with our responsibilities, outlined above, to detect material misstatements in respect of irregularities, including fraud. The extent to which our procedures are capable of detecting irregularities, including fraud, is detailed below.

Based on our understanding of the Company and industry, we identified that the principal risks of non-compliance with laws and regulations related to breaches of the rules of the Financial Conduct Authority, Prudential Regulation Authority, Jersey Financial Services Commission and Isle of Man Financial Services Authority, and we considered the extent to which non-compliance might have a material effect on the financial statements. We also considered those laws and regulations that have a direct impact on the financial statements such as the Companies Act 2006. We evaluated management's incentives and opportunities for fraudulent manipulation of the financial statements (including the risk of override of controls), and determined that the principal risks were related to management bias through judgements and assumptions in accounting estimates (e.g. expected credit losses).

The engagement team shared this risk assessment with the component auditors so that they could include appropriate audit procedures in response to such risks in their work. Audit procedures performed by the engagement team included:

- Discussions with management and those charged with governance in relation to known or suspected instances of non-compliance with laws and regulation and fraud;
- Evaluation and testing of the operating effectiveness of management's controls designed to prevent and detect fraud and errors in financial reporting;
- Attendance at key governance forums and reviewing management information presented at these meetings;
- Challenging assumptions and judgements made by management in their accounting estimates, in particular in relation to the impairment of loans and advances (as set out in our Key Audit Matters);
- Identifying and testing journal entries, in particular any journal entries posted by senior management (in particular incoming and outgoing board members), unusual account combinations and period end adjustments; and
- Incorporated unpredictability into the nature, timing and/or extent of our testing.

There are inherent limitations in the audit procedures described above. We are less likely to become aware of instances of non-compliance with laws and regulations that are not closely related to events and transactions reflected in the financial statements. Also, the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion.

Our audit testing might include testing complete populations of certain transactions and balances, possibly using data auditing techniques. However, it typically involves selecting a limited number of items for testing, rather than testing complete populations. We will often seek to target particular items for testing based on their size or risk characteristics. In other cases, we will use audit sampling to enable us to draw a conclusion about the population from which the sample is selected.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditors' report.

Use of this report

This report, including the opinions, has been prepared for and only for the Company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Other required reporting

Companies Act 2006 exception reporting

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not obtained all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the Company, or returns adequate for our audit have not been received from branches not visited by us; or
- certain disclosures of directors' remuneration specified by law are not made; or
- the financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Appointment

Following the recommendation of the Board Audit Committee, we were appointed by the members on 31 March 2016 to audit the financial statements for the year ended 31 December 2016 and subsequent financial periods. The period of total uninterrupted engagement is 6 years, covering the years ended 31 December 2016 to 31 December 2021.

Steven Linnegar (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
10 March 2022

INCOME STATEMENT

For the years ended 31 December

	Notes	2021 £m	2020 £m
Interest and similar income		**67.4**	40.1
Interest expense and similar charges		**(16.4)**	(44.3)
Net interest income/(expense)	2	**51.0**	(4.2)
Net fee and commission expense	3	**(6.9)**	(2.6)
Other operating income/(expense)	4	**5.5**	(0.2)
Total operating income/(expense)		**49.6**	(7.0)
Operating expenses before credit impairment losses, provisions and charges	5	**(23.1)**	(19.3)
Credit impairment losses	7	**(0.1)**	(0.1)
Provisions for other liabilities and charges		**(2.1)**	(0.7)
Total operating credit impairment losses, provisions and charges		**(2.2)**	(0.8)
Profit/(loss) before tax		**24.3**	(27.1)
Tax on profit/(loss)	8	**2.4**	15.5
Profit/(loss) after tax		**26.7**	(11.6)
Attributable to:			
Equity holders of the parent		**26.7**	(11.6)
Profit/(loss) after tax		**26.7**	(11.6)

STATEMENT OF COMPREHENSIVE INCOME

For the years ended 31 December

	2021 £m	2020 £m
Profit/(loss) after tax	**26.7**	(11.6)
Total comprehensive income/(expense)	**26.7**	(11.6)
Attributable to:		
Equity holders of the parent	**26.7**	(11.6)
Total comprehensive income/(expense)	**26.7**	(11.6)

The accompanying Notes to the Financial Statements form an integral part of these Financial Statements.

BALANCE SHEET

At 31 December

	Notes	2021 £m	2020 £m
Assets			
Cash and balances at central banks		**2,355**	2,288
Financial assets at fair value through profit or loss:			
– Derivative financial instruments	10	**27**	39
– Other financial assets at fair value through profit or loss	11	**441**	495
Financial assets at amortised cost:			
– Loans and advances to customers	12	**3,521**	3,578
– Loans and advances to banks		**227**	270
Intangible assets		**—**	1
Property, plant and equipment		**7**	6
Deferred tax assets	8	**6**	7
Other assets		**5**	5
Total assets		**6,589**	6,689
Liabilities			
Financial liabilities at fair value through profit or loss:			
– Derivative financial instruments	10	**237**	308
Financial liabilities at amortised cost:			
– Deposits by customers	14	**5,969**	6,041
– Deposits by banks	15	**31**	8
Other liabilities	16	**10**	11
Provisions	17	**2**	5
Current tax liabilities	8	**14**	9
Total liabilities		**6,263**	6,382
Equity			
Share capital	19	**250**	250
Retained earnings		**76**	57
Total shareholders' equity		**326**	307
Total liabilities and equity		**6,589**	6,689

The accompanying Notes to the Financial Statements form an integral part of these Financial Statements.

The Financial Statements were approved and authorised for issue by the Board on 10 March 2022 and signed on its behalf by:

James Pountney
Director

Company Registered Number: 2338548

CASH FLOW STATEMENT

For the years ended 31 December

	2021	2020
	£m	£m
Cash flows from operating activities		
Profit/(loss) after tax	**27**	(12)
Adjustments for:		
Non-cash items included in profit:		
– Depreciation and amortisation	**3**	2
– Provisions for other liabilities and charges	**2**	1
– Corporation tax credit	**(2)**	(16)
	3	(13)
Net change in operating assets and liabilities		
– Cash and balances held at central banks	**1**	(5)
– Derivative assets	**12**	(1)
– Other financial assets at fair value through profit or loss	**54**	(42)
– Loans and advances to banks and customers	**40**	(2,788)
– Other assets	**—**	(6)
– Deposits by banks and customers	**(40)**	(74)
– Derivative liabilities	**(71)**	57
– Other liabilities[1]	**1**	1
	(3)	(2,858)
Corporation taxes paid	**(7)**	(2)
Net cash flows from operating activities[2]	**20**	(2,885)
Cash flows from investing activities		
Purchase of property, plant and equipment and Intangible assets	**(3)**	(4)
Net cash flows from investing activities	**(3)**	(4)
Cash flows from financing activities		
Dividends paid on ordinary shares	**(8)**	—
Principal elements of lease payments[1]	**(1)**	(1)
Net cash flows from financing activities	**(9)**	(1)
Change in cash and cash equivalents	**8**	(2,890)
Cash and cash equivalents at beginning of the year	**2,524**	5,414
Cash and cash equivalents at the end of the year	**2,532**	2,524
Cash and cash equivalents consist of:		
Cash and balances at central banks	**2,355**	2,288
Less: regulatory minimum cash balances	**(17)**	(18)
	2,338	2,270
Other cash equivalents[3]	**194**	254
Cash and cash equivalents at the end of the year	**2,532**	2,524

(1)For 2021, Principal elements of lease payments are included as a separate line item in the Consolidated Cash Flow Statement. As a result, cash flows of £1m for 2020 have been reclassified from 'Other liabilities' within operating activities to 'Principal elements of lease payments' within financing activities. Total cash outflow for leases was £1m (2020: £1m).
(2)Net cash flows from operating activities includes interest received of £67.4m (2020: £37.1m) and interest paid of £25.4m (2020: £45.3m).
(3) Other cash equivalents is an intercompany loan to the ultimate parent which is classed as on demand.

The accompanying Notes to the Financial Statements form an integral part of these Financial Statements.

STATEMENT OF CHANGES IN EQUITY

For the years ended 31 December

	Share capital	Retained earnings	Total
	£m	£m	£m
At 1 January 2021	**250**	**57**	**307**
Profit after tax	**—**	**27**	**27**
Total comprehensive income	**—**	**27**	**27**
Dividends on ordinary shares	**—**	**(8)**	**(8)**
At 31 December 2021	**250**	**76**	**326**
At 1 January 2020	250	69	319
Loss after tax	—	(12)	(12)
Total comprehensive expense	—	(12)	(12)
At 31 December 2020	250	57	307

The accompanying Notes to the Financial Statements form an integral part of these Financial Statements.

1. ACCOUNTING POLICIES

These financial statements are prepared for Santander Financial Services plc (the Company or SFS) under the Companies Act 2006. Santander Financial Services plc is a public company, limited by shares and incorporated in England and Wales having a registered office at 2 Triton Square, Regent's Place, London, NW1 3AN. The Company is an operating company whose principal activity is to provide banking and financial services for clients and customers through its presence in the UK, Jersey and the Isle of Man, whilst also holding a pool of residual assets and liabilities, which is intended to be run down and/or managed for value.

Basis of Preparation

These financial statements have been prepared on the going concern basis using the historical cost convention, except for financial assets and liabilities that have been measured at fair value. An assessment of the appropriateness of the adoption of the going concern basis of accounting is disclosed in the statement of going concern in the Directors' Report.

Compliance with International Financial Reporting Standards

The financial statements comply with UK-adopted international accounting standards.

Disclosures required by IFRS 7 'Financial Instruments: Disclosure' relating to the nature and extent of risks arising from financial instruments, and IAS 1 'Presentation of Financial Statements' relating to objectives, policies and processes for managing capital, can be found in the Risk review. Those disclosures form an integral part of these financial statements.

Accounting developments

Interest Rate Benchmark Reform

In 2019, the IASB issued 'Interest Rate Benchmark Reform: Amendments to IFRS 9, IAS 39 and IFRS 7'. The Company applies IAS 39 hedge accounting so the amendments to IFRS 9 do not apply. Although the IAS 39 and IFRS 7 amendments, which apply to all hedging relationships directly affected by uncertainties related to interbank offered rate (IBOR) reform, became effective from 1 January 2020, following their endorsement , the Company early adopted those amendments in the preparation of the financial statements for the year ended 31 December 2019. The exceptions given by the IAS 39 amendments meant that IBOR reform had no impact on hedge relationships for affected hedges.

In 2020, the IASB issued 'Interest Rate Benchmark Reform – Phase 2 - Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16'. These amendments apply only to changes required by IBOR reform to financial instruments and hedging relationships. Although the amendments became effective from 1 January 2021 and are applied retrospectively without restating comparative information, following their endorsement, the Company early adopted the amendments in the preparation of the financial statements for the year ended 31 December 2020. The amendments address the accounting issues for financial instruments when IBOR reform is implemented including providing a practical expedient for changes to contractual cash flows, giving relief from specific hedge accounting requirements, and specifying a number of additional disclosures to enable users of financial statements to understand the effect of IBOR reform on an entity's financial instruments and risk management strategy.

Further details of the impact of these amendments on the financial statements for the year ended 31 December 2021 and the additional disclosures required are provided in Note 27.

Future developments

At 31 December 2021, there were no significant new or revised standards and interpretations, and amendments thereto, which have been issued but which are not yet effective or which have otherwise not been early adopted where permitted.

Revenue recognition

a) Interest income and expense

Interest and similar income comprises interest income on financial assets measured at amortised cost and interest income on hedging derivatives. Interest expense and similar charges comprises interest expense on financial liabilities measured at amortised cost, and interest expense on hedging derivatives. Interest income on financial assets measured at amortised cost and interest expense on financial liabilities other than those at fair value through profit or loss (FVTPL) is 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 Company 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 ECL provision). For more information on stage allocations of credit risk exposures, see 'Significant increase in credit risk' in the 'Credit risk management' section of the Risk review.

b) Fee and commission income and expense

Fees and commissions that are not an integral part of the effective interest rate are recognised when the service is performed. Most fee and commission income is recognised at a point in time. Certain commitment, upfront and management fees are recognised over time but are not material. Fee and commission income which forms an integral part of the effective interest rate of a financial instrument (for example certain loan commitment fees) is recognised as an adjustment to the effective interest rate and recorded in 'Interest income'.

c) Dividend income

Except for equity securities classified as trading assets or financial assets held at fair value through profit or loss, described below, dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for equity securities.

d) Other operating income

Other operating income includes all gains and losses from changes in the fair value of financial assets and liabilities held at fair value through profit or loss (comprising financial assets and liabilities held for trading, trading derivatives and other financial assets and liabilities at fair value through profit or loss), together with related interest income, expense, dividends and changes in fair value of any derivatives managed in conjunction with these assets and liabilities. Changes in fair value of derivatives in a fair value hedging relationship are also recognised in other operating income. Other operating income also includes income from operating lease assets, and profits and losses arising on the sales of property, plant and equipment and subsidiary undertakings.

Property, plant and equipment

Property, plant and equipment include owner-occupied properties (including leasehold properties), office fixtures and equipment and computer software. Property, plant and equipment also includes right-of-use assets where the Company is the lessee, as described further in the 'Leases' accounting policy below. Property, plant and equipment are carried at cost less accumulated depreciation and accumulated impairment losses. A review for indications of impairment is carried out at each reporting date. Gains and losses on disposal are determined by reference to the carrying amount and are reported in other operating income. Repairs and renewals are charged to the income statement when the expenditure is incurred. Internally developed software, meeting the capitalisation criteria of having reliably measurable direct costs associated with the identifiable and unique software product that is expected to provide future economic benefits, and externally purchased software are classified in property, plant and equipment where the software is an integral part of the related computer hardware (for example, the operating system of a computer). Classes of property, plant and equipment are depreciated on a straight-line basis over their useful life, as follows:

Owner-occupied properties	Not exceeding 50 years
Office fixtures and equipment	5 to 8 years
Computer software	3 years
Right-of-use assets (see 'Leases – SFS as lessee' below)	Shorter of the lease term or the useful life of the underlying asset

Depreciation is not charged on freehold land and assets under construction.

Financial Instruments

a) Initial recognition and measurement

Financial assets and liabilities are initially recognised when the Company becomes a party to the contractual terms of the instrument. The Company 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 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 FVTPL 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. The Company does not hold any held to maturity financial assets.

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.

b) Financial assets and liabilities

i) Classification and subsequent measurement
The Company classifies its financial assets in the measurement categories of amortised cost and FVTPL.

Financial assets and financial liabilities are classified as FVTPL where there is a requirement to do so or where they are otherwise designated at FVTPL on initial recognition. Financial assets and financial liabilities which are required to be held at FVTPL include:

- Financial assets and financial liabilities held for trading
- Debt instruments that do not have solely payments of principal and interest (SPPI) characteristics. Otherwise, such instruments are measured at amortised cost.

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, other financial assets and financial liabilities are designated at FVTPL where this results in more relevant information. This may arise 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, where the assets and liabilities are managed and their performance evaluated on a fair value basis or, in the case of financial liabilities, where it contains one or more embedded derivatives which are not closely related to the host contract.

The classification and measurement requirements for financial assets and financial liabilities are set out below. All the Company's financial assets are debt instruments.

Financial assets: 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 Company's business model for managing the asset, and the cash flow characteristics of the asset.

Business model
The business model reflects how the Company manages the assets in order to generate cash flows and, specifically, whether the Company'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 the 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 an 'other' business model and measured at FVTPL. Factors considered 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 Company assesses whether the assets' cash flows represent SPPI. In making this assessment, the Company 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 is 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 SPPI.

Based on these factors, the Company classifies its debt instruments into one of the following measurement categories:

- Amortised cost – Financial assets that are held for collection of contractual cash flows where those cash flows represent 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 Note 12. Interest income from these financial assets is included in 'Interest and similar income' using the effective interest rate method. When estimates of future cash flows are revised, the carrying amount of the respective financial assets or financial liabilities is adjusted to reflect the new estimate discounted using the original effective interest rate. Any changes are recognised in the income statement.
- FVTPL – Financial assets that do not meet the criteria for amortised cost 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, is recognised in profit or loss and presented in the income statement in 'Other operating income' in the period in which it arises.

The Company 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.

Financial liabilities
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 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); and
- Financial guarantee contracts and loan commitments.

ii) Impairment of debt instrument financial assets
The Company assesses on a forward-looking basis the ECL associated with its debt instrument assets carried at amortised cost and with the exposure arising from financial guarantee contracts and loan commitments. The Company 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.

For more on how ECL is calculated see the Credit risk section of the Risk review.

- **Write-off**

  For secured loans, a write-off is only made when all collection procedures have been exhausted and the security has been sold and/or a claim made on any mortgage indemnity guarantee or other insurance. There may be occasions where a write-off occurs for other reasons, such as following a consensual restructure or refinancing of the debt or where the debt is sold for strategic reasons into the secondary market at a value lower than its face value.

  There is no threshold based on past due status beyond which all secured loans are written off as there can be significant variations in the time needed to enforce possession and sale of the security, especially due to the different legal frameworks that apply in different regions of the UK. For unsecured loans, a write-off is only made when all internal avenues of collecting the debt have been exhausted. Where appropriate the debt is passed over to external collection agencies. A past due threshold is applied to unsecured debt where accounts that are 180 days past due are written off unless there is a dispute awaiting resolution. Contact is made with customers with the aim to achieve a realistic and sustainable repayment arrangement. Litigation and/or enforcement of security is usually carried out only when the steps described above have been undertaken without success.

  All write-offs are assessed / made on a case-by-case basis, taking account of the exposure at the date of write-off, after accounting for the value from any collateral or insurance held against the loan. The exception to this is in cases where fraud has occurred, where the exposure is written off once investigations have been completed and the probability of recovery is minimal. The time span between discovery and write-off will be short and may not result in an impairment loss allowance being raised. The write-off policy is regularly reviewed. Write-offs are charged against previously established loss allowances.

- **Recoveries**

  Recoveries of credit impairment losses are not included in the impairment loss allowance but are taken to income and offset against credit impairment losses. Recoveries of credit impairment losses are classified in the income statement as 'Credit impairment losses'.

iii) Modifications of financial assets
The treatment of a renegotiation or modification of the contractual cash flows of a financial asset normally depends upon whether the renegotiation or modification is due to financial difficulties of the borrower or for other commercial reasons.

- *Contractual modifications due to financial difficulties of the borrower*: where the Company 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.
- *Contractual modifications for other commercial reasons*: an assessment is performed to determine whether the terms of the new agreement are substantially different from the terms of the existing agreement, after considering changes in the cash flows arising from the modified terms and the overall instrument risk profile. Where terms are substantially different, such modifications are treated as a new transaction resulting in derecognition of the original financial asset, and the recognition of a 'new' financial asset with 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. Where terms are not substantially different, the carrying value of the financial asset is adjusted to reflect the present value of modified cash flows discounted at the original EIR with any gain or loss arising from modification recognised immediately in the income statement.

Any other contractual modifications, such as where a regulatory authority imposes a change in certain contractual terms or due to legal reasons, 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 Company 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 Company has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

Financial liabilities are derecognised when extinguished, cancelled or expired.

c) 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.

Loan commitments are measured as the amount of the loss allowance. The Company 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 and charged to credit impairment losses in the income statement. The loss allowance in respect of revolving facilities is classified in loans and advances to customers to the extent of any drawn balances. The loss allowance in respect of undrawn amounts is classified in provisions. When amounts are drawn, any related loss allowance is transferred from provisions to loans and advances to customers.

Derivative financial instruments (derivatives)

Derivatives are contracts or agreements whose value is derived from one or more underlying indices or asset values inherent in the contract or agreement, which require no or little initial net investment and are settled at a future date. Transactions are undertaken in interest rate, cross currency, equity, residential property and other index-related swaps, forwards, caps, floors, swaptions, as well as credit default and total return swaps, equity index contracts and exchange traded interest rate futures, and equity index options.

Derivatives are held for risk management purposes and classified as fair value through profit or loss.

Derivatives are recognised initially (on the date on which a derivative contract is entered into), and are subsequently remeasured, at their fair value. Fair values of exchange-traded derivatives are obtained from quoted market prices. Fair values of over-the-counter derivatives are estimated using valuation techniques, including discounted cash flow and option pricing models.

All derivatives are carried as assets when their fair value is positive and as liabilities when their fair value is negative, except where netting is permitted. Gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement and included within other operating income.

Offsetting financial assets and liabilities

Financial assets and liabilities including derivatives are offset and the net amount reported in the balance sheet when there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis or realise the asset and settle the liability simultaneously. The Company is party to a number of arrangements, including master netting arrangements under industry standard agreements which facilitate netting of transactions in jurisdictions where netting agreements are recognised and have legal force. The netting arrangements do not generally result in an offset of balance sheet assets and liabilities for accounting purposes, as transactions are usually settled on a gross basis.

Impairment of non-financial assets

At each balance sheet date, or more frequently when events or changes in circumstances dictate, property plant and equipment (including operating lease assets) and intangible assets are assessed for indicators of impairment. If indications are present, these assets are subject to an impairment review. The impairment review comprises a comparison of the carrying amount of the asset with its recoverable amount: the higher of the asset's fair value less costs to sell and its value in use.

The fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Value in use is calculated by discounting management's expected future cash flows obtainable as a result of the asset's continued use, including those resulting from its ultimate disposal, at a market based discount rate on a pre-tax basis.

The carrying values of property, plant and equipment, and intangible assets are written down by the amount of any impairment and the loss is recognised in the income statement in the period in which it occurs. A previously recognised impairment loss relating to property, plant and equipment may be reversed in part or in full when a change in circumstances leads to a change in the estimates used to determine the property, plant and equipment's recoverable amount. The carrying amount of the property, plant and equipment will only be increased up to the amount that would have been had the original impairment not been recognised.

Leases - SFS as lessee

The Company assesses whether a contract is or contains a lease at the inception of the contract and recognises a right-of-use (ROU) asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments for all leases, except for leases with a term of 12 months or less which are expensed in the income statement on a straight-line basis over the lease terms. Lease payments exclude irrecoverable VAT which is expensed in the income statement as lease payments are made.

The lease liability, which is included in Other liabilities on the balance sheet, is initially measured at the present value of the lease payments that are not paid at the commencement date, discounted using the incremental borrowing rate appropriate to the lease term. The lease liability is subsequently measured at amortised cost using the effective interest rate method. Remeasurement of the lease liability occurs if there is a change in the lease payments (when a corresponding adjustment is made to the ROU asset), the lease term or in the assessment of an option to purchase the underlying asset.

At inception, the ROU asset, which is included in Property, plant and equipment on the balance sheet, comprises the lease liability, initial direct costs and the obligations to restore the asset, less any incentives granted by the lessor. The ROU asset is depreciated over the shorter of the lease term or the useful life of the underlying asset and is reviewed for indications of impairment as for owned assets. The obligation to restore the asset is included in Provisions on the balance sheet.

Income taxes, including deferred taxes
The tax expense represents the sum of the income tax currently payable and deferred income tax.

Income tax payable on profits, based on the applicable tax law in each jurisdiction, is recognised as an expense in the period in which profits arise. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date. A current tax liability for the current or prior period is measured at the amount expected to be paid to the tax authorities. Where the amount of the final tax liability is uncertain or where a position is challenged by a taxation authority, the liability recognised is the most likely outcome. Where a most likely outcome cannot be determined, a weighted average basis is applied.

Deferred income tax is the tax expected to be payable or recoverable on income tax losses available to carry forward and on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which the assets may be utilised as they reverse. Such deferred tax liabilities are not recognised if the temporary difference arises from the initial recognition of goodwill. Deferred tax assets and liabilities are not recognised from the initial recognition of other assets (other than in a business combination) and liabilities in a transaction that affects neither the taxable profit nor the accounting profit.

Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised based on rates enacted or substantively enacted at the balance sheet date. Deferred tax is charged or credited in the income statement, except when it relates to items recognised in other comprehensive income or directly in equity, in which case the deferred tax is also recognised in other comprehensive income or directly in equity. Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries except where the Company is able to control reversal of the temporary difference and it is probable that it will not reverse in the foreseeable future. The Company reviews the carrying amount of deferred tax assets at each balance sheet date and reduces it to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred and current tax assets and liabilities are only offset when they arise in the same tax reporting group and where there is both the legal right and the intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

Cash and cash equivalents
For the purposes of the cash flow statement, cash and cash equivalents comprise balances with less than three months maturity from the date of acquisition, including cash and non-restricted balances with central banks, treasury bills and other eligible bills, loans and advances to banks and short-term investments in securities.

Provisions
Provisions are recognised for present obligations arising as consequences of past events where it is more likely than not that a transfer of economic benefits will be necessary to settle the obligation, and it can be reliably estimated.

Provision is made for the anticipated cost of restructuring, including redundancy costs, when an obligation exists. An obligation exists when the Company has a detailed formal plan for restructuring a business, has raised valid expectations in those affected by the restructuring, and has started to implement the plan or announce its main features.

When a leasehold property ceases to be used in the business, provision is made where the unavoidable costs of the future obligations relating to the lease are expected to exceed anticipated rental income. The net costs are discounted using market rates of interest to reflect the long-term nature of the cash flows.

Loan commitments are measured as the amount of the loss allowance (determined in accordance with IFRS 9 as described in Credit risk section of the Risk review).

Contingent liabilities are possible obligations whose existence will be confirmed only by certain future events or present obligations where the transfer of economic benefit is uncertain or cannot be reliably measured. Contingent liabilities are not recognised but are disclosed unless they are remote.

Share capital
a) Share issue costs
Incremental external costs directly attributable to the issue of new shares are deducted from equity net of related income taxes.

b) Dividends
Dividends on ordinary shares are recognised in equity in the period in which the right to receive payment is established.

CRITICAL JUDGEMENTS AND ACCOUNTING ESTIMATES

The preparation of the financial statements requires management to make judgements and accounting estimates that affect the reported amount of assets and liabilities at the date of the financial statements and the reported amount of income and expenses during the reporting period. Management evaluates its judgements and accounting estimates, which are based on historical experience and on various other factors that are believed to be reasonable under the circumstances, on an ongoing basis. Actual results may differ from these accounting estimates under different assumptions or conditions.

In the course of preparing the financial statements, no significant judgements have been made in the process of applying the Company's accounting policies.

2. NET INTEREST INCOME / (EXPENSE)

	2021	2020
	£m	£m
Interest and similar income:		
Loans and advances to Santander UK group undertakings	**2.2**	0.1
UK residential mortgages	**55.4**	15.8
Other loans and advances	**9.8**	24.2
Total interest and similar income:	**67.4**	40.1
Interest expense and similar charges:		
Deposits by Santander UK group undertakings	**(16.0)**	(0.1)
Other deposits and borrowings	**(0.4)**	(44.2)
Total interest expense and similar charges	**(16.4)**	(44.3)
Net interest income/(expense)	**51.0**	(4.2)

3. NET FEE AND COMMISSION EXPENSE

	2021	2020
	£m	£m
Fee and commission income:		
Current account and debit card fee income	**1.2**	—
Non-banking and other fees	**—**	1.3
Total fee and commission income	**1.2**	1.3
Total fee and commission expense	**(8.1)**	(3.9)
Net fee and commission expense	**(6.9)**	(2.6)

Total fee and commission expense includes £nil (2020: £1.3m) fees paid to Santander UK plc associated with a portfolio of mortgages transferred from Santander UK plc to the Company, other commissions of £8.0m (2020: £2.4m) and other fee expenses of £0.1m (2020: £0.2m).

4. OTHER OPERATING INCOME / (EXPENSE)

	2021	2020
	£m	£m
Net gains/(losses) on financial instruments designated at fair value through profit or loss	**(44.0)**	51.4
Net gains/(losses) on financial instruments mandatorily at fair value through profit or loss	**49.5**	(51.6)
	5.5	(0.2)

5. OPERATING EXPENSES BEFORE CREDIT IMPAIRMENT LOSSES, PROVISIONS AND CHARGES

	2021	2020
	£m	£m
Staff costs:		
Wages and salaries	**7.0**	5.6
Performance-related payments	**1.9**	1.6
Social security costs	**0.6**	0.4
Pensions costs – defined contribution plans	**0.6**	0.4
Other personnel costs	**0.4**	0.4
	10.5	8.4
Other administration expenses	**9.9**	8.7
Depreciation, amortisation and impairment	**2.7**	2.2
	23.1	19.3

The Company uses staff who have employment contracts with Santander UK. The cost of their services is recharged by Santander UK to the Company. These recharges are classified as other administrative expenses and are excluded from the average number of full-time equivalent staff.

All staff in Jersey and the Isle of Man now have employment contracts with the Company. In June 2020, the staff at the Isle of Man branch had their service contracts transferred from ALIL Services Limited, part of Santander UK, to the Company. From June 2020, these employees have been included in the average number of full-time equivalent staff.

The average number of full-time equivalent staff in 2021 was 141 (2020: 103).

Other administration expenses
'Other administration expenses' includes £nil (2020: £nil) expenses related to short-term leases.

Depreciation, amortisation and impairment
SFS has no operating lease assets as lessor. In 2021, depreciation, amortisation and impairment included depreciation of £0.7m (2020: £0.6m) on right-of-use assets with a net book value of £2m at 31 December 2021 (2020: £3m).

6. AUDIT AND OTHER SERVICES

	2021	2020
	£m	£m
Audit fees:		
Fees payable to the Company's auditors and its associates for the audit of the annual accounts	**0.3**	0.3
Total audit fees	**0.3**	0.3
Non-audit fees:		
Audit-related assurance services	**0.1**	0.1
Other assurance services	**—**	—
Other non-audit services	**—**	—
Total non-audit fees(1)	**0.1**	0.1

(1) Total non-audit fees comprised audit-related assurance services of £68,000 (2020: £50,350) and other assurance services of £nil (2020: £nil).

7. CREDIT IMPAIRMENT LOSSES

There were no material credit impairment losses on loans and advances to banks or loans and advances to customers.

8. TAXATION

	2021 £m	2020 £m
Current tax:		
UK corporation tax on profit/(loss) for the year	**2.9**	(9.4)
Adjustments in respect of prior years	**(5.8)**	(5.0)
Total current tax	**(2.9)**	(14.4)
Deferred tax:		
Charge/(credit) for the year	**0.5**	(0.2)
Adjustments in respect of prior years	**—**	(0.9)
Total deferred tax	**0.5**	(1.1)
Tax on profit/(loss)	**(2.4)**	(15.5)

The standard rate of UK corporation tax was 27.0% for banking entities (2020: 27%) including an 8% surcharge applied to banking companies from 1 January 2016. Taxation for other jurisdictions is calculated at the rates prevailing in the relevant jurisdictions.

The effective tax rate for 2021, based on profit/(loss) before tax, was (9.9%) (2020: 57.2%). The tax on profit/(loss) before tax differs from the theoretical amount that would arise using the basic corporation tax rate of the Company as follows:

	2021 £m	2020 £m
Profit/(loss) before tax	**24.3**	(27.1)
Tax calculated at a tax rate of 19% (2020: 19%)	**4.6**	(5.1)
Bank surcharge on profits	**1.9**	(2.1)
Effect of different tax rates in other jurisdictions	**(3.9)**	(3.3)
Other disallowable items	**0.8**	0.9
Adjustment to prior year provisions	**(5.8)**	(5.9)
Tax credit	**(2.4)**	(15.5)

The UK government announced in its budget on 3 March 2021 that it would increase the main rate of corporation tax by 6% to 25% with effect from 1 April 2023. This change was substantively enacted on 24 May 2021 and, as a result, the effect has been reflected in the closing deferred tax position included in these financial statements. The comparative 2020 results reflected an increase in tax rates by 2% following an announcement in the 2020 budget to reverse a previously planned rate reduction from April 2020.

A reduction in the Bank Surcharge rate from 8% to 3% was announced in October 2021 to be effective from 1 April 2023. This change in rate was substantively enacted on 2 February 2022 and as a result, the effects of this change have not been reflected in the closing balance sheet position for deferred tax. The effect of the change, had it been substantively enacted by the balance sheet date, would be to increase both the deferred tax expense for the period and reduce the deferred tax asset by less than £1m.

Current tax assets and liabilities
Movements in current tax assets and liabilities during the year were as follows:

	2021 £m	2020 £m
Liabilities at 1 January	**(9)**	(26)
Income statement credit	**3**	14
Corporate income tax (paid)/received	**(7)**	2
Other movements	**(1)**	1
Liabilities at 31 December	**(14)**	(9)

The amount of corporation income tax paid differs from the tax charge for the period as a result of the timing of payments due to the tax authorities together with the effects of movements in deferred tax and adjustments to prior period current tax provisions.

The Company proactively engages with HM Revenue & Customs to resolve tax matters relating to prior years. The accounting policy for recognising provisions for such matters are described in Note 1 to the Financial Statements. It is not expected that there will be any material movement in such provisions within the next 12 months. The Company adopted the Code of Practice on Taxation for Banks in 2010.

Deferred tax
The table below shows the deferred tax assets and liabilities including the movement in the deferred tax account during the year. Deferred tax balances are presented in the balance sheet after offsetting assets and liabilities where the Company has the legal right to offset and intends to settle on a net basis.

	Accelerated tax depreciation	Other temporary differences	Total
	£m	£m	£m
At 1 January 2021	**1**	**6**	**7**
Income statement charge	**(1)**	**—**	**(1)**
At 31 December 2021	**—**	**6**	**6**
At 1 January 2020	1	5	6
Income statement charge	—	1	1
At 31 December 2020	1	6	7

The deferred tax assets above have been recognised on the basis that sufficient future taxable profits are forecast within the foreseeable future, in excess of the profits arising from the reversal of existing taxable temporary differences, to allow for the utilisation of the assets within the Santander UK group as they reverse.

9. DIVIDENDS ON ORDINARY SHARES

Dividends on ordinary shares declared and paid in the year were as follows:

	2021	2020	**2021**	2020
	Pence per share	Pence per share	**£m**	£m
In respect of current year	**2.80**	—	**7**	—
	0.40	—	**1**	—
	3.20	—	**8**	—

10. DERIVATIVE FINANCIAL INSTRUMENTS

a) Use of derivatives

The Company undertakes derivative activities primarily to manage its own risks.

The Company's derivative activities do not give rise to significant open positions in portfolios of derivatives. Any residual position is managed to ensure that it remains within acceptable risk levels, with matching deals being used to achieve this where necessary. When entering into derivative transactions, the Company employs the same credit risk management procedures to assess and approve potential credit exposures that are used for traditional lending.

b) Analysis of derivatives

The table below includes the notional amounts of transactions outstanding at the balance sheet date; they do not represent actual exposures.

			2021			2020
		Fair value			Fair value	
	Notional amount	**Assets**	**Liabilities**	Notional amount	Assets	Liabilities
	£m	**£m**	**£m**	£m	£m	£m
Derivatives held for trading:						
Exchange rate contracts	**735**	**—**	**15**	601	—	13
Interest rate contracts	**469**	**27**	**222**	471	39	295
	1,204	**27**	**237**	1,072	39	308
Netting	**—**	**—**	**—**	—	—	—
Total derivatives financial instruments	**1,204**	**27**	**237**	1,072	39	308

For information about the impact of netting arrangements on derivative assets and liabilities in the table above, see Note 25.

11. OTHER FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS

	2021	2020
	£m	£m
Loans and advances to customers	440	492
Debt securities	1	3
	441	495

At 31 December 2021 and 2020, all other financial assets at fair value through profit or loss were designated as such.

Loans and advances to customers principally represent other loans, being deferred consideration that is managed, and has its performance evaluated, on a fair value basis in accordance with a documented investment strategy, and information about it is provided on that basis to management. Since 2009, the Company's policy has been not to designate similar new loans at fair value through profit or loss.

12. LOANS AND ADVANCES TO CUSTOMERS

	2021	2020
	£m	£m
Loans and advances to customers	3,521	3,578
Credit impairment loss allowances on loans and advances to customers	—	—
Net loans and advances to customers	**3,521**	3,578

13. INTERESTS IN OTHER ENTITIES

The Company is incorporated and domiciled in the UK and had no subsidiaries, associates or joint ventures at 31 December 2021. The Company has branch offices in Jersey and the Isle of Man. In January 2022, the Company acquired Abbey National International Limited, a Jersey registered entity.

14. DEPOSITS BY CUSTOMERS

	2021	2020
	£m	£m
Demand and time deposits	5,967	6,039
Amounts due to Santander UK subsidiaries and joint ventures	2	2
	5,969	6,041

15. DEPOSITS BY BANKS

	2021	2020
	£m	£m
Amounts due to Santander UK subsidiaries	31	1
Other deposits	—	7
	31	8

16. OTHER LIABILITIES

	2021	2020
	£m	£m
Lease liabilities	**2**	3
Other	**8**	8
	10	11

17. PROVISIONS

	2021	2020
	£m	£m
At 1 January	**5**	5
Additional provisions	**2**	3
Provisions released	**—**	(2)
Utilisation	**(5)**	(1)
At 31 December	**2**	5
To be settled:		
- Within 12 months	**2**	5
	2	5

Isle of Man and Jersey Bank Depositor Compensation Schemes (DCSs)

The Isle of Man branch of the Company is a participant in the Isle of Man Depositors' Compensation Scheme and the Jersey branch of the Company is a participant in the Jersey Bank Depositors Compensation Scheme. These DCSs are independent statutory compensation funds for customers of Isle of Man and Jersey banks and pay compensation if a bank is unable to pay claims against it.

The DCSs are funded, if and when required, by contributions from covered banks in the Isle of Man or Jersey that are participants in the DCSs. The cost to the Company in respect of the DCSs for 2021 was £nil (2020: £nil).

UK Bank Levy

In 2021 the Bank Levy charge was £1.6m (2020: £2.2m) at a rate of 0.10% (2020: 0.14%).

Other

Other provisions consisted of £nil (2020: £0.2m) in respect of vacant property and restructuring charges relating to the US branch of the Company which closed in 2018.

18. CONTINGENT LIABILITIES AND COMMITMENTS

	2021	2020
	£m	£m
Formal standby facilities, credit lines and other commitments	39	10
	39	10

At 31 December 2021, the Company had no significant credit impairment loss provisions relating to guarantees given to third parties and undrawn loan commitments. Where the items set out below can be reliably estimated, they are disclosed in the table above.

Formal standby facilities, credit lines and other commitments

Standby facilities, credit lines and other commitments are also granted as part of normal product facilities which are offered to customers. Corporate facilities can comprise standby and revolving facilities which are subject to ongoing compliance with covenants and the provision of agreed security. Failure to comply with these terms can result in the withdrawal of the unutilised facility headroom.

Capital Support Deed

At 31 December 2021, the Company, Santander UK Group Holdings plc (the regulated entities) and Santander Equity Investments Limited were party to a capital support deed dated 13 November 2018 (the Non-RFB Sub-Group Capital Support Deed). These parties were permitted by the PRA to form a core UK group as defined in the PRA Rulebook, a permission which expired on 31 December 2021. Exposures of each of the regulated entities to other members of the core UK group were exempt from large exposure limits that would otherwise apply and intra-group exposures risk-weighted at 0% on a solo as well as consolidated basis. The purpose of the Non-RFB Sub-Group Capital Support Deed was to facilitate the prompt transfer of available capital resources from, or repayment of liabilities by, the members in the event that the Company breached or was at risk of breaching its capital resources. A new Non-RFB Sub-Group Capital Support Deed was entered into on 17 December 2021 and effective from 1 January 2022, reflecting the latest version of associated regulation. The parties to the Non-RFB Sub-Group Capital Support Deed remained unchanged with the PRA granting permission for a renewal of the Non-RFB core UK group from 1 January 2022 to 31 December 2024, following expiry of the previous permission on 31 December 2021.

Isle of Man and Jersey DCSs and FSCS

As described in Note 17, the Company participates in the Isle of Man and Jersey DCSs, and the UK's national resolution scheme, the FSCS, and is thus subject to levies to fund the DCSs and the FSCS. In the event that the DCSs or the FSCS significantly increases the levies to be paid by firms, the associated costs to the Company would rise.

Other legal actions and regulatory matters

The Company engages in discussion, and co-operates, with the FCA, PRA, CMA and other regulators and government agencies in various jurisdictions in their supervision and review of Company including reviews exercised under statutory powers, regarding its interaction with past and present customers, both as part of general thematic work and in relation to specific products, services and activities. During the ordinary course of business, the Company is also subject to complaints and threatened legal proceedings brought by or on behalf of current or former employees, customers, investors or other third parties, in addition to legal and regulatory reviews, challenges and tax or enforcement investigations or proceedings in various jurisdictions. All such matters are assessed periodically to determine the likelihood of the Company incurring a liability.

In those instances where it is concluded that it is not yet probable that a quantifiable payment will be made, for example because the facts are unclear or further time is required to fully assess the merits of the case or to reasonably quantify the expected payment, no provision is made. In addition, where it is not currently practicable to estimate the possible financial effect of these matters, no provision is made.

German dividend tax arbitrage transactions

In June 2018 the Cologne Criminal Prosecution Office and the German Federal Tax Office commenced an investigation in relation to the historical involvement of Santander UK plc, Santander Financial Services plc and Cater Allen International Limited (all subsidiaries of Santander UK Group Holdings plc) in German dividend tax arbitrage transactions (known as cum/ex transactions). These transactions allegedly exploited a loophole of a specific German settlement mechanism through short-selling and complex derivative structuring which resulted in the German government either refunding withholding tax where such tax had not been paid or refunding it more than once. The German authorities are investigating numerous institutions and individuals in connection with alleged transactions and practices which may be found to be illegal under German law.

During 2021 we continued to cooperate with the German authorities and, with the assistance of external experts, to progress an internal investigation into the matters in question. The investigation is focused principally on the period 2009-2011 and remains on-going. There remain factual issues to be resolved which may have legal consequences including potentially material financial penalties. These issues create uncertainties which mean that it is difficult to predict the resolution of the matter including timing or the significance of the possible impact. Any potential losses, claims or expenses suffered or incurred by the Company in respect of these matters have been fully indemnified by Santander UK plc, as part of the ring-fencing transfer scheme between Santander UK plc, the Company and Banco Santander SA.

Taxation

The Company engages in discussion, and co-operates, with HM Revenue & Customs in their oversight of the Company's tax matters. The Company adopted the UK's Code of Practice on Taxation for Banks in 2010.

Other

As part of the sale of subsidiaries, businesses and other entities, and as is normal in such circumstances, the Company has given warranties and indemnities to the purchasers.

Other off-balance sheet commitments

The Company has commitments to lend at fixed interest rates which expose it to interest rate risk. For further information, see the Risk review.

19. SHARE CAPITAL

	Ordinary shares of £1 each		Tracker shares of £1 each		B Tracker shares of £1 each		Total
Issued and fully paid share capital	No.	£m	No.	£m	No.	£m	£m
At 1 January 2020, 31 December 2020, 1 January 2021 and 31 December 2021	**249,998,000**	**250**	**1,000**	**—**	**1,000**	**—**	**250**

In 2008, the Company issued 1,000 Tracker Shares of £1 each at par to its parent company for £1,000. The Tracker Shares entitled the holders to dividends related to certain cash flows that were received by the Company in the period up to 7 April 2010. The Tracker Shares are not redeemable and do not confer any rights to participate in the assets of the Company on winding up (beyond the amount subscribed). The Tracker Shares carry no voting rights.

In 2010, the Company issued 1,000 B Tracker Shares of £1 each at par to its parent company for £1,000. The B Tracker Shares entitled the holders to dividends related to certain cash flows that were received by the Company in the year up to 31 December 2011. The B Tracker Shares are not redeemable and do not confer any rights to participate in the assets of the Company on a winding up (beyond the amount subscribed). The B Tracker Shares carry no voting rights.

20. CHANGES IN LIABILITIES ARISING FROM FINANCING ACTIVITIES

The table below shows the changes in liabilities arising from financing activities:

			2021			2020
	Balance sheet item			Balance sheet item		
	Lease liabilities	**Dividends paid**	**Total**	Lease liabilities(1)	Dividends paid	Total(1)
	£m	**£m**	**£m**	£m	£m	£m
At 1 January	**3**	**—**	**3**	1	—	1
Payment of lease liability	**(1)**	**—**	**(1)**	(1)	—	(1)
Dividends paid	**—**	**(8)**	**(8)**	—	—	—
Liability-related other charges	**—**	**—**	**—**	3	—	3
Non-cash changes:						
– Other changes	**—**	**8**	**8**	—	—	—
At 31 December	**2**	**—**	**2**	3	—	3

(1) For 2021, changes in liabilities arising from financing activities relating to lease liabilities are disclosed separately. As a result, £1m of lease liability payments and £3m of Lease liability related other charges have been separately disclosed in 2020.

21. ASSETS CHARGED AS SECURITY FOR LIABILITIES AND COLLATERAL ACCEPTED AS SECURITY FOR ASSETS

The following transactions are conducted under terms that are usual and customary to collateralised transactions, including, where relevant, standard securities lending and repurchase agreements.

a) Assets charged as security for liabilities

The financial assets below are analysed between those assets accounted for on-balance sheet and off-balance sheet.

	2021	2020
	£m	£m
On-balance sheet:		
Loans and advances to customers	**85**	107
Loans and advances to banks	**194**	254
Total on-balance sheet	**279**	361
Total off-balance sheet	**—**	—

The Company provides assets as collateral in the following areas of the business.

Stock borrowing and lending agreements

Asset balances under stock borrowing and lending agreements represent stock lent by the Company. These balances amounted to £71m at 31 December 2021 (2020: £96m) and are offset by contractual commitments to return stock borrowed or cash received.

Derivatives business

In addition to the arrangements described above, collateral is also provided in the normal course of derivative business to counterparties. At 31 December 2021, £208m (2020: £265m) of such collateral in the form of cash had been provided by the Company and is included in the table above.

b) Collateral accepted as security for assets

The collateral held as security for assets below are analysed between those liabilities accounted for on the balance sheet and off-balance sheet, was:

	2021	2020
	£m	£m
Total on-balance sheet	**—**	—
Total off-balance sheet	**441**	514

Stock borrowing and lending agreements
Obligations under stock borrowing and lending agreements represent contractual commitments to return stock borrowed. These obligations totalled £441m at 31 December 2021 (2020: £514m) and are offset by a contractual right to receive stock lent by the Company. This off-balance sheet collateral is in relation to the loans and advances to customers at fair value through profit or loss.

Lending activities
In addition to the collateral held as security for assets, the Company may obtain a charge over a customer's property in connection with its lending activities. Details of these arrangements are set out in the 'Credit risk' section of the Risk review.

22. TRANSACTIONS WITH DIRECTORS AND OTHER KEY MANAGEMENT PERSONNEL

a) Remuneration of Directors and Other Key Management Personnel

The remuneration of the Directors and Other Key Management Personnel is set out in aggregate below.

	2021	2020
Directors' remuneration	£	£
Salaries and fees	**565,066**	211,681
Performance-related payments	**455,455**	101,829
Other fixed remuneration (pension and other allowances & non-cash pension benefits)	**45,918**	39,954
Total remuneration(1)	**1,066,439**	353,464

	2021	2020
Directors' and Other Key Management Personnel compensation	£	£
Short-term employee benefits	**2,046,061**	1,389,461
Post-employment benefits	**105,481**	82,040
Total compensation(1)	**2,151,542**	1,471,501

(1) No termination payments (2020: £11,093) were paid in 2021 to (2020: one) Directors or Key Management Personnel.

Of the Directors and Key Management Persons that served during the year, nine (2020: eight) were remunerated in relation to their services to this Company.

The Company ensures that it is compliant with the mandatory deferral requirements of the PRA's Rulebook (Remuneration Part) and FCA Remuneration Code for staff who meet the relevant criteria and the amount of bonus to be deferred is based on the total variable pay received. The PRA Remuneration Rules and Remuneration Code prescribes that at least 40% of variable pay must be made over a period of at least four, five or seven years and, for staff earning more than £500,000 in variable remuneration, at least 60% must be deferred over the same period.

In 2021, the remuneration, excluding pension contributions and compensation for loss of office, of the highest paid Director was £543,943 (2020: £96,345) of which £310,330 (2020: £41,785) was performance-related. In 2021 and 2020, no contributions were made to a defined contribution scheme on behalf of the highest paid Director.

At 31 December 2021 and 2020, there was no accrued pension benefit for the highest paid Director and there was no lump sum accrued by the highest paid Director.

b) Retirement benefits

In 2021 no Director received benefits under a defined benefit scheme (2020: none) and two Directors (2020: two) received benefits under a defined contribution scheme (employee funded).

c) Transactions with Directors, Other Key Management Personnel and each of their connected persons

Directors, Other Key Management Personnel who served during the year and their connected persons have undertaken the following transactions with the Company in the ordinary course of business.

	2021		2020	
	No.	**£**	No.	£
Secured loans, unsecured loans and overdrafts				
At 1 January	**3**	**2,105,199**	—	—
Net movements	**3**	**5,054,899**	3	2,105,199
At 31 December	**6**	**7,160,098**	3	2,105,199
Deposit, bank and instant access accounts and investments				
At 1 January	**6**	**478,526**	10	104,524
Net movements	**—**	**480,890**	(4)	374,002
At 31 December	**6**	**959,416**	6	478,526

In 2021 and 2020, no Director held any interest in, nor exercised or was granted any rights to subscribe for, shares of the Company. In addition, in 2021 and 2020, no Directors exercised share options over shares in Banco Santander SA, the ultimate parent company of the Company.

Secured loans, unsecured loans and overdrafts are made to Directors, Other Key Management Personnel and their connected persons, in the ordinary course of business, with terms prevailing for comparable transactions and on the same terms and conditions as applicable to other employees in the Company. Such loans do not involve more than the normal risk of collectability or present any unfavourable features. Amounts deposited by Directors, Other Key Management Personnel and their connected persons earn interest at the same rates as those offered to the market or on the same terms and conditions applicable to other employees in the Company. Deposits, bank and instant access accounts and investments are entered into by Directors, Other Key Management Personnel and their connected persons on normal market terms and conditions, or on the same terms and conditions as applicable to other employees in the Company.

In 2021, loans were made to two Directors (2020: none), with a principle amount of £3,360,000 outstanding at 31 December 2021. In 2021, loans were made to four Other Key Management Personnel (2020: three), with a principle amount of £3,800,098 outstanding at 31 December 2021 (2020: £2,105,199).

In 2021 and 2020, there were no other transactions, arrangements or agreements with the Company in which Directors, Other Key Management Personnel or their connected persons had a material interest. In addition, in 2021 and 2020, no Director had a material interest in any contract of significance with the Company other than a service contract.

23. RELATED PARTY DISCLOSURES

a) Parent undertaking and controlling party

The Company's immediate parent is Santander UK Group Holdings plc, a company incorporated in England and Wales. The ultimate parent and controlling party is Banco Santander SA, a company incorporated in Spain. The smallest and largest groups into which the Company's results are included are the group accounts of Santander UK Group Holdings plc and Banco Santander SA, respectively, copies of which may be obtained from Shareholder Relations, 2 Triton Square, Regent's Place, London NW1 3AN, on the corporate website (www.aboutsantander.co.uk) or on the Banco Santander corporate website (www.santander.com).

b) Transactions with related parties

Transactions with related parties during the year and balances outstanding at the year-end:

	Interest, fees and other income received		Interest, fees and other expense paid		Amounts owed by related parties		Amounts owed to related parties	
	2021	2020	**2021**	2020	**2021**	2020	**2021**	2020
	£m	£m	**£m**	£m	**£m**	£m	**£m**	£m
Ultimate parent company	**(48)**	—	**—**	53	**221**	293	**(222)**	(295)
Fellow subsidiaries	**—**	(6)	**8**	5	**3**	2	**(32)**	(5)
	(48)	(6)	**8**	58	**224**	295	**(254)**	(300)

Further information on balances due from/(to) other Banco Santander companies is set out in the section 'Balances with other Banco Santander companies' in the Risk review. In addition, details of the Capital Support Deed are described in Note 18.

In October 2020, the Company purchased a portfolio of mortgage assets with a book value of £3,163m from Santander UK plc for a cash consideration of £3,174m.

The above transactions were made in the ordinary course of business, on substantially the same terms as for comparable transactions with third party counterparties, and within limits acceptable to the PRA. Such transactions do not involve more than the normal risk of collectability or present any unfavourable features.

24. FINANCIAL INSTRUMENTS

a) Measurement basis of financial assets and liabilities

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. Note 1 describes how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised.

b) Fair value measurement and hierarchy

(i) Fair value measurement

The fair value of financial instruments is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal, or in its absence, the most advantageous market to which the Company has access at that date. The fair value of a liability reflects its non-performance risk.

Financial instruments valued using observable market prices

If a quoted market price in an active market is available for an instrument, the fair value is calculated as the current bid price multiplied by the number of units of the instrument held.

Financial instruments valued using a valuation technique

In the absence of a quoted market price in an active market, management uses internal models to make its best estimate of the price that the market would set for that financial instrument. In order to make these estimations, various techniques are employed, including extrapolation from observable market data and observation of similar financial instruments with similar characteristics. Wherever possible, valuation parameters for each product are based on prices directly observable in active markets or that can be derived from directly observable market prices. Chosen valuation techniques incorporate all the factors that market participants would take into account in pricing transactions.

The Company manages certain groups of financial assets and liabilities on the basis of its net exposure to either market risks or credit risk. As a result it has elected to use the exception under IFRS 13 which permits the fair value measurement of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position for a particular risk exposure or paid to transfer a net short position for a particular risk exposure in an orderly transaction between market participants at the measurement date under current market conditions.

(ii) Fair value hierarchy

The Company applies the following fair value hierarchy that prioritises the inputs to valuation techniques used in measuring fair value. The hierarchy establishes three categories for valuing financial instruments, giving the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The three categories are: quoted prices in active markets (Level 1), internal models based on observable market data (Level 2) and internal models based on other than observable market data (Level 3). If the inputs used to measure an asset or a liability fall to different levels within the hierarchy, the classification of the entire asset or liability will be based on the lowest level input that is significant to the overall fair value measurement of the asset or liability.

The Company categorises assets and liabilities measured at fair value within the fair value hierarchy based on the inputs to the valuation techniques as follows:

Level 1 Unadjusted quoted prices for identical assets or liabilities in an active market that the Company can access at the measurement date.

Level 2 Quoted prices in inactive markets, quoted prices for similar assets or liabilities, recent market transactions, inputs other than quoted market prices for the asset or liability that are observable either directly or indirectly for substantially the full term, and inputs to valuation techniques that are derived principally from or corroborated by observable market data through correlation or other statistical means for substantially the full term of the asset or liability.

Level 3 Significant inputs to the pricing or valuation techniques are unobservable.

Changes in the observability of significant valuation inputs during the reporting period may result in a transfer of assets and liabilities within the fair value hierarchy. The Company recognises transfers between levels of the fair value hierarchy when there is a significant change in either its principal market or the level of observability of the inputs to the valuation techniques as at the end of the reporting period.

c) Valuation techniques

The main valuation techniques employed in internal models to measure the fair value of the financial instruments at 31 December 2021 and 2020 are set out below. In substantially all cases, the principal inputs into these models are derived from observable market data. The Company did not make any material changes to the valuation techniques and internal models it used in 2021 and 2020. During 2021, the Company updated the interest rate market data valuation inputs to reflect the cessation of LIBOR at the end of 2021, using risk-free rates in line with market practice.

A In the valuation of financial instruments requiring static hedging (for example interest rate derivatives) and in the valuation of loans and advances and deposits, the 'present value' method is used. Expected future cash flows are discounted using the interest rate curves of the applicable currencies, as well as credit spreads. The interest rate curves are generally observable market data and reference yield curves derived from quoted interest rates in appropriate time bandings, which match the timings of the cash flows and maturities of the instruments.

B In the valuation of equity financial instruments requiring dynamic hedging (principally equity securities, options and other structured instruments), proprietary local volatility and stochastic volatility models are used. These types of models are widely accepted in the financial services industry. Observable market inputs used in these models include the bid-offer spread, foreign currency exchange rates, volatility and correlation between indices. In limited circumstances, other inputs may be used in these models that are based on unobservable market data, such as the Halifax's UK HPI volatility, HPI forward growth, HPI spot rate, mortality and, mean reversion and contingent litigation risk.

C In the valuation of financial instruments exposed to interest rate risk that require either static or dynamic hedging (such as interest rate futures, caps and floors, and options), the present value method (futures), Black's model (caps/floors) and the Hull/White and Markov functional models (Bermudan options) are used. These types of models are widely accepted in the financial services industry. The significant inputs used in these models are observable market data, including appropriate interest rate curves, volatilities, correlations and exchange rates. In limited circumstances, other inputs may be used in these models that are based on unobservable market data, such as HPI volatility, HPI forward growth, HPI spot rate and mortality.

The fair values of the financial instruments arising from the Company's internal models take into account, among other things, contract terms and observable market data, which include such factors as bid-offer spread, interest rates, credit risk and exchange rates. In all cases, when it is not possible to derive a valuation for a particular feature of an instrument, management uses judgement to determine the fair value of the particular feature. In exercising this judgement, a variety of tools are used including proxy observable data, historical data and extrapolation techniques. Extrapolation techniques take into account behavioural characteristics of equity markets that have been observed over time, and for which there is a strong case to support an expectation of a continuing trend in the future. Estimates are calibrated to observable market prices when they become available.

The Company believes its valuation methods are appropriate and consistent with other market participants. Nevertheless, the use of different valuation methods or assumptions, including imprecision in estimating unobservable market inputs, to determine the fair value of certain financial instruments could result in different estimates of fair value at the reporting date and the amount of gain or loss recorded for a particular instrument. Most of the valuation models are not significantly subjective, because they can be tested and, if necessary, recalibrated by the internal calculation of and subsequent comparison to market prices of actively traded securities, where available.

d) Control framework

Fair values are subject to a control framework designed to ensure that they are either determined or validated by a function independent of the risk-taker. To this end, ultimate responsibility for the determination of fair values lies with the Risk Department. For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or verification is utilised. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the Company will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable.

The factors that are considered in this regard include:

- The extent to which prices may be expected to represent genuine traded or tradeable prices
- The degree of similarity between financial instruments
- The degree of consistency between different sources
- The process followed by the pricing provider to derive the data
- The elapsed time between the date to which the market data relates and the balance sheet date
- The manner in which the data was sourced.

The source of pricing data is considered as part of the process that determines the classification of the level of a financial instrument. Consideration is given to the quality of the information available that provides the current mark-to-model valuation and estimates of how different these valuations could be on an actual trade, taking into consideration how active the market is. For spot assets that cannot be sold due to illiquidity, forward estimates are discounted to estimate a realisable value over time. Adjustments for illiquid positions are regularly reviewed to reflect changing market conditions.

For fair values determined using a valuation model, the control framework may include, as applicable, independent development and / or validation of: (i) the logic within the models; (ii) the inputs to those models; and (iii) any adjustments required outside the models. Internal valuation models are validated independently within the Risk Department. A validation report is produced for each model-derived valuation that assesses the mathematical assumptions behind the model, the implementation of the model and its integration within the trading system.

e) Fair values of financial instruments carried at amortised cost

The following tables analyse the fair value of the financial instruments carried at amortised cost at 31 December 2021 and 2020, including their levels in the fair value hierarchy – Level 1, Level 2 and Level 3. It does not include fair value information for financial assets and financial liabilities carried at amortised cost if the carrying amount is a reasonable approximation of fair value. Cash and balances at central banks which consist of demand deposits with the Bank of England. There were no financial instruments carried at amortised cost whose fair values would be classified in Level 1.

				2021				2020
	Fair value				Fair value			
	Level 2	Level 3	Total	Carrying value	Level 2	Level 3	Total	Carrying value
	£m	£m	£m	£m	£m	£m	£m	£m
Assets								
Loans and advances to customers	—	3,560	3,560	3,521	—	3,601	3,601	3,578
Loans and advances to banks	227	—	227	227	270	—	270	270
	227	3,560	3,787	3,748	270	3,601	3,871	3,848
Liabilities								
Deposits by customers	3	5,971	5,974	5,969	1	6,056	6,057	6,041
Deposits by banks	—	30	30	31	7	1	8	8
	3	6,001	6,004	6,000	8	6,057	6,065	6,049

Valuation methodology for financial instruments carried at amortised cost

The valuation approach to specific categories of financial instruments is described below.

Assets:

Loans and advances to customers

The approach to estimating the fair value of loans and advances to customers has been determined by discounting expected cash flows to reflect either current market rates or credit spreads relevant to the specific industry of the borrower. The determination of their fair values is an area of considerable estimation and uncertainty as there is no observable market and values are significantly affected by customer behaviour.

The fair value of the mortgage portfolio is calculated by discounting contractual cash flows by different spreads for each LTV band, after taking account of expected customer prepayment rates. The spread is based on new business interest rates derived from competitor market information.

Loans and advances to banks

These comprise secured loans, short-term placements with banks including collateral and unsettled financial transactions. The secured loans have been valued based on a discounted spread for the term of the loans using valuation technique A as described above. The carrying amount of the other items is deemed a reasonable approximation of their fair value, as the transactions are very short-term in duration.

Liabilities:

Deposits by customers

The majority of deposit liabilities are payable on demand and therefore can be deemed short-term in nature with the fair value equal to the carrying value. Certain of the deposit liabilities are at a fixed rate until maturity. The deficit/surplus of fair value over carrying value of these liabilities has been estimated by reference to the market rates available at the balance sheet date for similar deposit liabilities of similar maturities. The fair value of such deposit liabilities has been estimated using valuation technique A as described above.

Deposits by banks

The fair value of deposits by banks, including repos, has been estimated using valuation technique A as described above, discounted at the appropriate credit spread.

f) Fair values of financial instruments measured at fair value

The following tables summarise the fair values of the financial assets and liabilities accounted for at fair value at 31 December 2021 and 2020, analysed by their levels in the fair value hierarchy – Level 1, Level 2 and Level 3.

					2021				2020	
		Level 1	**Level 2**	**Level 3**	**Total**	Level 1	Level 2	Level 3	Total	Valuation technique
		£m	**£m**	**£m**	**£m**	£m	£m	£m	£m	
Assets										
Derivative financial instruments	Exchange rate contracts	**—**	**—**	**—**	**—**	—	—	—	—	A
	Interest rate contracts	**—**	**27**	**—**	**27**	—	39	—	39	A & C
		—	**27**	**—**	**27**	—	39	—	39	
Other financial assets at FVTPL	Loans and advances to customers	**—**	**440**	**—**	**440**	—	492	—	492	A
	Debt securities	**—**	**1**	**—**	**1**	—	3	—	3	A & B
		—	**441**	**—**	**441**	—	495	—	495	
Total assets at fair value		**—**	**468**	**—**	**468**	—	534	—	534	
Liabilities										
Derivative financial instruments	Exchange rate contracts	**—**	**15**	**—**	**15**	—	13	—	13	A
	Interest rate contracts	**—**	**222**	**—**	**222**	—	295	—	295	A & C
Total liabilities at fair value		**—**	**237**	**—**	**237**	—	308	—	308	

Transfers between levels of the fair value hierarchy

In 2021, there were no significant (2020: no significant) transfers of financial instruments between levels of the fair value hierarchy.

g) Fair value adjustments

The internal models incorporate assumptions that the Company believes would be made by a market participant to establish fair value. Fair value adjustments are adopted when the Company considers that there are additional factors that would be considered by a market participant that are not incorporated in the valuation model.

The Company classifies fair value adjustments as either ‘risk-related’ or ‘model-related’. The fair value adjustments form part of the portfolio fair value and are included in the balance sheet values of the product types to which they have been applied. The magnitude and types of fair value adjustment are listed in the following table:

	2021	2020
	£m	£m
Risk-related:		
- Uncertainty	**19**	22
	19	22

Risk-related adjustments

Risk-related adjustments are driven, in part, by the magnitude of the Company’s market or credit risk exposure, and by external market factors, such as the size of market spreads.

Uncertainty

Certain model inputs may be less readily determinable from market data, and/or the choice of model itself may be more subjective. In these circumstances, a range of possible values exists that the financial instrument or market parameter may assume, and an adjustment may be needed to reflect the likelihood that in estimating the fair value of the financial instrument, market participants would adopt more conservative values for uncertain parameters and/or model assumptions than those used in the valuation model.

h) Internal models based on information other than market data (Level 3)

At 31 December 2021 and 31 December 2020, there were no financial instruments classified as Level 3.

i) Maturities of financial liabilities and off-balance sheet commitments

The table below analyses the maturities of the undiscounted cash flows relating to financial liabilities and off-balance sheet commitments of the Company based on the remaining period to the contractual maturity date at the balance sheet date. Deposits by customers largely consist of retail deposits. This table is not intended to show the liquidity of the Company.

	On demand	Not later than 3 months	Later than 3 months and not later than 1 year	Later than 1 year and not later than 5 years	Later than 5 years	Total
2021	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Financial liabilities						
Derivative financial instruments	**—**	**19**	**3**	**2**	**230**	**254**
Deposits by customers	**3,087**	**1,357**	**1,440**	**88**	**—**	**5,972**
Deposits by banks	**31**	**—**	**—**	**—**	**—**	**31**
Lease liabilities	**—**	**—**	**—**	**1**	**1**	**2**
Total financial liabilities	**3,118**	**1,376**	**1,443**	**91**	**231**	**6,259**
Off-balance sheet commitments given	**39**	**—**	**—**	**—**	**—**	**39**
2020						
Financial liabilities						
Derivative financial instruments	—	13	—	2	312	327
Deposits by customers	2,648	1,571	1,719	108	—	6,046
Deposits by banks	7	1	—	—	—	8
Lease liabilities	—	—	1	1	1	3
Total financial liabilities	2,655	1,585	1,720	111	313	6,384
Off-balance sheet commitments given(1)	10	—	—	—	—	10

(1) For 2021, Off-balance sheet commitments are included as 'On demand'. As a result, £9m of off-balance sheet commitments previously included in 'Later than 3 months and not later than 1 year' for 2020 have been reclassified as 'On demand'.

25. OFFSETTING FINANCIAL ASSETS AND LIABILITIES

Financial assets and financial liabilities are reported on a net basis on the balance sheet only if there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously. The following table shows the impact of netting arrangements on:

- All financial assets and liabilities that are reported net on the balance sheet
- All derivative financial instruments and repurchase agreements and other similar secured lending and borrowing agreements that are subject to enforceable master netting arrangements or similar agreements, but do not qualify for balance sheet netting.

The table identifies the amounts that have been offset in the balance sheet and also those amounts that are covered by enforceable netting arrangements (offsetting arrangements and financial collateral) but do not qualify for netting under the requirements described above.

For derivative contracts, the ‘Financial instruments’ column identifies financial assets and liabilities that are subject to set off under netting agreements, such as the ISDA Master Agreement or derivative exchange or clearing counterparty agreements, whereby all outstanding transactions with the same counterparty can be offset and close-out netting applied across all outstanding transactions covered by the agreements if an event of default or other predetermined events occur. Financial collateral refers to cash and non-cash collateral obtained, typically daily or weekly, to cover the net exposure between counterparties by enabling the collateral to be realised in an event of default or if other predetermined events occur.

The Company engages in a variety of counterparty credit mitigation strategies in addition to netting and collateral arrangements. Therefore, the net amounts presented in the tables below do not purport to represent the Company’s actual credit exposure.

	Amounts subject to enforceable netting arrangements							
	Effects of offsetting on-balance sheet			Related amounts not offset				
	Gross amounts	Amounts offset	Net amounts on the balance sheet	Financial instruments	Financial collateral (1)	Net amount	Assets not subject to enforceable netting arrangements (2)	Balance sheet total (3)
2021	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Assets								
Derivative financial instruments	**27**	**—**	**27**	**—**	**—**	**27**	**—**	**27**
Loans and advances to customers and banks (4)	**197**	**—**	**197**	**—**	**—**	**197**	**3,551**	**3,748**
Total assets	**224**	**—**	**224**	**—**	**—**	**224**	**3,551**	**3,775**
Liabilities								
Derivative financial instruments	**237**	**—**	**237**	**—**	**—**	**237**	**—**	**237**
Deposits by customers and banks (4)	**32**	**—**	**32**	**—**	**—**	**32**	**5,968**	**6,000**
Total liabilities	**269**	**—**	**269**	**—**	**—**	**269**	**5,968**	**6,237**
2020								
Assets								
Derivative financial instruments	39	—	39	(38)	—	1	—	39
Loans and advances to customers and banks (4)	256	—	256	—	—	256	3,592	3,848
Total assets	295	—	295	(38)	—	257	3,592	3,887
Liabilities								
Derivative financial instruments	308	—	308	(38)	(264)	6	—	308
Deposits by customers and banks (4)	3	—	3	—	—	3	6,046	6,049
Total liabilities	311	—	311	(38)	(264)	9	6,046	6,357

(1) Financial collateral is reflected at its fair value but has been limited to the net balance sheet exposure so as not to include any over-collateralisation.
(2) This column includes contractual rights of set-off that are subject to uncertainty under the laws of the relevant jurisdiction.
(3) The balance sheet total is the sum of ‘Net amounts reported on the balance sheet’ that are subject to enforceable netting arrangements and ‘Amounts not subject to enforceable netting arrangements’.
(4) The amounts offset within loans and advances to customers/banks or deposits by customers/banks relate to intercompany balances that are subject to netting.

26. EVENTS AFTER THE BALANCE SHEET DATE

There have been no significant events between 31 December 2021 and the date of approval of these financial statements which would require a change to or additional disclosure in the financial statements.

27. INTEREST RATE BENCHMARK REFORM

In September 2019, the IASB amended IFRS 9 'Financial Instruments', IAS 39 'Financial Instruments: Recognition and Measurement' and IFRS 7 'Financial Instruments: Disclosures' to address issues affecting financial reporting in the period before the reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate (the Phase 1 amendments). These Phase 1 amendments provided temporary exceptions to specific hedge accounting requirements because of the uncertainty arising from the reform. After issuing the Phase 1 amendments, in August 2020, the IASB issued further amendments to various IFRSs to address issues that might affect financial reporting during the reform of an interest rate benchmark, including the effects of changes to contractual cash flows arising from the replacement of an interest rate benchmark with an alternative benchmark rate (the Phase 2 amendments). The Phase 2 amendments do not supersede the Phase 1 amendments.

Phase 1 amendments

The amendments apply to all hedging relationships directly affected by uncertainties related to IBOR reform, however, as the Company has not entered into any hedging relationships, the amendments had no impact.

Phase 2 amendments

These amendments apply only to changes required by IBOR reform to financial instruments. Changes are directly required by IBOR reform if, and only if, the change is necessary as a direct consequent of interest rate benchmark reform, and the new basis for determining the contractual cash flow is economically equivalent to the previous basis.

The amendments address the accounting issues for financial instruments when IBOR reform is implemented as described below.

Practical expedient for changes to contractual cash flows

For instruments to which the amortised cost measurement applies, the amendments require entities, as a practical expedient, to account for a change in the basis for determining the contractual cash flows by updating the effective interest rate using the guidance in IFRS 9 resulting in no immediate gain or loss being recognised, provided that, the change is directly required by IBOR reform and takes place on an economically equivalent basis. All instruments referencing GBP LIBOR transitioned to alternative benchmark interest rates during 2021. The Company has no lease contracts which are indexed to LIBOR or other IBORs. The practical expedient was applied to all instruments or contracts that transitioned to alternative benchmark interest rates during 2021 and had no material impact for the Company.

The following tables show the notional amounts of assets, liabilities and off-balance sheet commitments at 31 December 2021 and 31 December 2020 affected by IBOR reform that have yet to transition to an alternative benchmark interest rate as provided internally to key management personnel.

				2021
	GBP LIBOR	**USD LIBOR**	**Other**	**Total**
	£m	**£m**	**£m**	**£m**
Assets				
Financial assets at amortised cost	—	168	—	168
	—	**168**	**—**	**168**
Liabilities	**—**	**—**	**—**	**—**
Off-balance sheet commitments given	**—**	**—**	**—**	**—**

				2020
	GBP LIBOR	**USD LIBOR**	**Other**	**Total**
	£m	**£m**	**£m**	**£m**
Assets				
Derivatives	371	—	—	371
Financial assets at amortised cost(1)	—	176	—	176
	371	**176**	**—**	**547**
Liabilities				
Derivatives(2)	95	—	—	95
	95	**—**	**—**	**95**
Off-balance sheet commitments given	**5**	**—**	**—**	**5**

(1) £176m of asset USD LIBOR exposure previously included in Derivatives in 2020 has been reclassified as 'Financial assets at amortised cost'.
(2) The Company does not have any liability USD LIBOR exposure. As a result, £176m of liability USD LIBOR exposure previously included in 2020 has been removed.