

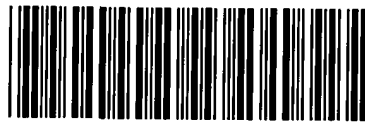
HOLMES MASTER ISSUER plc

Registered in England and Wales  
No: 05953811

ANNUAL REPORT AND FINANCIAL  
STATEMENTS

FOR THE YEAR ENDED  
31 DECEMBER 2016

TUESDAY



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## STRATEGIC REPORT

The Directors submit the Strategic Report together with their Report of the Directors and the audited financial statements for the year ended 31 December 2016.

### Principal activity

Holmes Master Issuer Plc (the 'Company') was established as a special purpose company for the purposes of issuing debt securities (the "notes") in the international capital markets and lending the proceeds thereof to a group company Holmes Funding Limited on a limited recourse basis. In turn Holmes Funding Limited made such funds available to the Santander UK Group Holdings plc group by purchasing a beneficial interest in a UK residential mortgage loan portfolio held by Holmes Trustees Limited (the 'Holmes Master Trust'). The sale of the underlying assets under the securitisation arrangement fails the de-recognition criteria and are therefore deemed loans.

The principal activities of the Company as defined in the Securitisation Transaction document which can be found at [www.santander.co.uk/uk/about-santander-uk/investor-relations/holmes-master-trust](http://www.santander.co.uk/uk/about-santander-uk/investor-relations/holmes-master-trust) include holding loans under intercompany loan agreement to Holmes Funding Limited, entering into financial instruments, issuing the notes and other activities reasonably incidental thereto.

### The programme

The mortgage backed programme was established on 28 November 2006. Notes issued under the programme have been and will be issued in series. Each series will normally: (a) be issued on a single date; (b) be subject to the terms and conditions of the notes; and (c) consist of one or more classes (or sub-classes) of notes. Notes of the same class rank *pari passu* and pro rata among themselves. Each series of the same class will not, however, be subject to identical terms in all respects (for example, interest rates, interest calculations, expected maturity and final maturity dates may differ).

The Company's obligations to pay principal and interest on the notes are funded primarily from the payments of principal and interest received by it from Holmes Funding Limited under the intercompany loan. The Company's primary asset will be its rights to mortgages under the intercompany loan agreement. Holmes Funding Limited uses the amounts received from its share in the trust property to meet its obligations to pay interest and principal due to the Company under the intercompany loan. Under the documents governing the transaction, Santander UK plc and its subsidiaries (the 'Group') are not obliged to support any losses that may be suffered by holders of the debt securities in issue.

The loans included within the underlying portfolio include repayment loans and interest only loans with balances of less than £750,000.

The loans within the portfolio are monitored and assessed for impairment on a regular basis as, under International Accounting Standard (IAS) 39 – 'Financial Instruments: Recognition and Measurement,' the beneficial interest in a mortgage portfolio fails the criteria for recognition within the Company's financial statements as the loans fail derecognition at Santander UK plc level.

The only asset held by the Company that is at risk of material impairment is the loan to Holmes Funding Limited, the repayment of which is dependent upon the performance of the residential mortgage portfolio. The risk of impairment is mitigated by the collateral and credit enhancements within the Holmes securitisation structure.

The performance of the mortgage portfolio is continually assessed by Santander UK plc and external credit rating agencies. It follows that the impairment policies of Santander UK plc are applied by the Company.

The directors believe that the performance of the portfolio has been in line with management's expectations.

### Key performance

During the year the Company received interest income of £95m (2015: £123m) from Holmes Funding Limited. The Company used those cash resources to pay interest expense of £95m (2015: £123m) on the debt securities in issue. During the year, the Company issued debt securities of £1,179m (2015: none), made net draw-downs of intercompany loans of £3,661m (2015: £2,664m) and made payments of principal of £3,661m (2015: £2,664m). All amounts were paid in full and on time.

The key performance indicators used by management are predominantly consideration of whether there have been breaches of the transaction documents. However there are certain measures (triggers) set out in the transaction documents which are relevant to the Company including assessing whether all counterparties involved in the transaction have a rating that remains adequate to support their on-going roles in the programme, and arrears related events. There were no triggers breached in the year.

### Fair review of the Company's Business

The Santander UK plc Group (the "Group") manages its operations on a divisional basis. For this reason, the Company's Directors believe that further key performance indicators for the Company are not necessary or appropriate for an understanding of the development, performance or position of the business. The performance of the divisions of Santander UK plc, which include the Company, are discussed in the Group's Annual Report which does not form part of this Report.

The purpose of this Report is to provide information to the members of the Company and as such it is only addressed to those members. The Report may contain certain forward-looking statements with respect to the operations, performance and financial condition of the Company. By their nature, these statements involve inherent risks and uncertainties since future events, circumstances and other factors can cause results and developments to differ materially from the plans, objectives, expectations and intentions expressed in such forward-looking statements. Members should consider this when relying on any forward-looking statements. The forward-looking statements reflect knowledge and information available at the date of preparation of this Report and the Company undertakes no obligation to update any forward-looking statement during the year. Nothing in this Report should be construed as a profit forecast.

## STRATEGIC REPORT (CONTINUED)

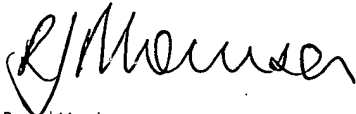
### Principal risks and uncertainties facing the Company

The Company's principal risks and uncertainties together with the processes that are in place to monitor and mitigate those risks where possible can be found in Notes 3 and 20.

### Likely Future Developments

The Directors do not expect any significant change in the level of business in the foreseeable future.

By Order of the Board

A handwritten signature in black ink, appearing to read 'R Morrison', is written over the printed name and title.

Rachel Morrison  
Director

11 April 2017

Registered Office Address: 2 Triton Square, Regent's Place, London, NW1 3AN

## REPORT OF THE DIRECTORS

The Directors submit their report together with the Strategic Report and the audited financial statements for the year ended 31 December 2016.

### Principal activity

The Company was established as a special purpose company for the purposes of issuing notes in the international capital markets and lending the proceeds thereof to a group company Holmes Funding Limited on a limited recourse basis. In turn Holmes Funding Limited made such funds available to the Santander UK Group Holdings plc group by purchasing a beneficial interest in a UK residential mortgage loan portfolio held by the Holmes Master Trust.

The principal activities of the Company includes holding loans under intercompany loan agreement to Holmes Funding Limited, entering into financial instruments, issuing the notes and other activities reasonably incidental thereto.

### Results and dividends

The profit after tax for the year ended 31 December 2016 amounted to £1.3m (2015: £4.7m). The Directors do not recommend the payment of a final dividend (2015: £nil).

### Subsequent events

There are no subsequent events.

### Directors

The Directors who served throughout the year and to the date of this report (except as noted) were as follows:

Mr M H Filer	
Mrs R J Morrison	(appointed 7 April 2016)
Wilmington Trust SP Services (London) Limited	

Wilmington Trust SP Services (London) Limited and Mr Martin McDermott jointly held one share in the holding company, Holmes Holdings Limited at 31 December 2016. The other share in Holmes Holdings Limited was held by Wilmington Trust SP Services (London) Limited. On 24 January 2017 the share held jointly was transferred to Wilmington Trust SP Services (London) Limited.

Mr M H Filer is also a director of Wilmington Trust SP Services (London) Limited.

None of the other Directors had a beneficial interest in the shares of the Company, or of the holding company, Holmes Holding Limited or its subsidiaries, at the year-end.

### Directors' Responsibilities Statement

The Directors are responsible for preparing the Strategic Report, Report of the Directors and the financial statements in accordance with applicable law and regulations.

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 International Financial Reporting Standards (IFRSs) as adopted by the European Union. 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 these financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether applicable International Financial Reporting Standards (IFRSs) as adopted by the European Union have been followed, subject to any material departures disclosed and explained in the financial statements; 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 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. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

### Corporate governance

Due to the nature of the securities which have been issued, the Company is largely exempt from the requirements of the Financial Conduct Authority Disclosure and Transparency Rules (DTR) which would otherwise require the Company to have an audit committee in place and include a corporate governance statement in the Report of the Directors. The directors are therefore satisfied that there is no requirement for an audit committee or to publish a corporate governance statement.

## REPORT OF THE DIRECTORS (CONTINUED)

### Statement of Going Concern

The Company's business activities, together with the factors likely to affect its future development, performance and position are set out in the Strategic Report. The financial position of the Company, its cash flows, liquidity position and borrowing facilities are set out in the financial statements. In addition, Notes 3 and 20 to the financial statements include the Company's financial risk management objectives; its exposures to credit risk and liquidity risk objectives; and its policies and processes for managing its capital.

The Company has adequate financial resources. As a consequence, the Directors believe that the Company is well placed to manage its business risks successfully despite the current uncertain economic outlook.

The Directors have a reasonable expectation that the Company has adequate resources to continue in operational existence for at least the period of 12 months from the date the financial statements are authorised for issue. Accordingly, they continue to adopt the going concern basis of accounting in preparing the Annual Report and Financial Statements.

### Financial Instruments

The Company's financial instruments, other than derivatives, comprise loans to group companies, borrowings, cash and liquid resources, and various items, such as other assets and liabilities that arise directly from its operations. The main purpose of these financial instruments is to raise finance for the Group's operations.

The Company also enters into derivatives transactions (principally cross currency and interest rate swaps). The purpose of such transactions is to manage the currency risks and interest rate risks arising from the Company's operations and its sources of finance.

It is, and has been throughout the year under review, the Company's policy that no trading in financial instruments shall be undertaken.

The main risk arising from the Company's financial instruments is currency risk and interest rate risk. The Company has debt securities in issue denominated in US Dollars and Euros. The Company's Board reviews and agrees policies for managing this risk. The Company's policy is to eliminate all exposures arising from movements in exchange and interest rates by the use of cross currency swaps or interest rate swaps to hedge payments of interest and principal on the securities.

All other assets, liabilities and transactions are denominated in Sterling.

Further disclosures regarding financial risk management objectives and policies and the Company's exposure to principal risks can be found in Note 3.

### Qualifying third party indemnities

Enhanced indemnities are provided to certain Directors of the Company by Santander UK plc (where such person has been nominated in writing by Santander UK plc as its representative on the board) against liabilities and associated costs which they could incur in the course of their duties to the Company. All of the indemnities remain in force as at the date of the Report and Financial Statements. A copy of each of the indemnities is kept at the registered office address of Santander UK plc.

### Independent Auditors

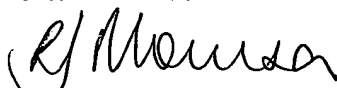
Each of the Directors as at the date of approval of this report confirms that:

- so far as the Director is aware, there is no relevant audit information of which the Company's auditors are unaware; and
- the Director has taken all steps that he/she ought to have taken as a Director to make himself/herself 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 Companies Act 2006.

PricewaterhouseCoopers LLP have expressed their willingness to continue in office as auditor and a resolution to reappoint them will be proposed at the Company's forthcoming Annual General Meeting.

On behalf of the Board



Rachel Morrison  
Director

11 April 2017

Registered Office Address: 2 Triton Square, Regent's Place, London, NW1 3AN.

## INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF HOLMES MASTER ISSUER PLC

### Report on the financial statements

#### Our opinion

In our opinion, Holmes Master Issuer plc's financial statements (the "financial statements"):

- give a true and fair view of the state of the company's affairs as at 31 December 2016 and of its profit and cash flows for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards ("IFRSs") as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

#### What we have audited

The financial statements, included within the Annual Report and Financial Statements (the "Annual Report"), comprise:

- the Balance Sheet as at 31 December 2016;
- the Statement of Comprehensive Income for the year then ended;
- the Cash Flow Statement for the year then ended;
- the Statement of Changes in Equity for the year then ended; and
- the notes to the financial statements, which include a summary of significant accounting policies and other explanatory information.

The financial reporting framework that has been applied in the preparation of the financial statements is IFRSs as adopted by the European Union, and applicable law.

In applying the financial reporting framework, the directors have made a number of subjective judgements, for example in respect of significant accounting estimates. In making such estimates, they have made assumptions and considered future events.

#### Opinions on other matters prescribed by the Companies Act 2006

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the Strategic Report and the Report of the Directors for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the Strategic Report and the Report of the Directors have been prepared in accordance with applicable legal requirements.

In addition, in light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we are required to report if we have identified any material misstatements in the Strategic Report and the Report of the Directors. We have nothing to report in this respect.

#### Other matters on which we are required to report by exception

##### Adequacy of accounting records and information and explanations received

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

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

##### Directors' remuneration

Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law are not made. We have no exceptions to report arising from this responsibility.

## INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF HOLMES MASTER ISSUER PLC (CONTINUED)

### Responsibilities for the financial statements and the audit

#### Our responsibilities and those of the directors

As explained more fully in the Directors' Responsibilities Statement set out on page 3, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view.

Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland) ("ISAs (UK & Ireland)"). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

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.

#### What an audit of financial statements involves

We conducted our audit in accordance with ISAs (UK & Ireland). An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

- whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed;
- the reasonableness of significant accounting estimates made by the directors; and
- the overall presentation of the financial statements.

We primarily focus our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

We test and examine information, using sampling and other auditing techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report. With respect to the Strategic Report and Report of the Directors, we consider whether those reports include the disclosures required by applicable legal requirements.



Jessica Miller (Senior Statutory Auditor)  
for and on behalf of PricewaterhouseCoopers LLP  
Chartered Accountants and Statutory Auditors  
London

12 April 2017

## STATEMENT OF COMPREHENSIVE INCOME

For the years ended 31 December

		2016 £000	2015 £000
Continuing operations	Notes		
Interest and similar income	5	95,306	123,208
Interest expense and similar charges	6	(94,816)	(123,416)
Net interest income / (expense)		490	(208)
Net other operating income	7	884	5,028
Administrative expenses		(120)	(120)
Profit before tax	8	1,254	4,700
Tax charge on profit for the year	9	(1)	(1)
Profit for the year		1,253	4,699
Other comprehensive income that may be reclassified to profit or loss subsequently:			
Cash flow hedges:			
- Gains on cash flow hedges (net of tax - £nil)		81,069	29,402
- Losses on cash flow hedges transferred to profit or loss (net of tax - £nil)		(81,002)	(29,252)
Total other comprehensive income for the year		67	150
Total net comprehensive income for the year attributable to the equity holders of the Company		1,320	4,849

The accompanying notes form an integral part of the financial statements.

## STATEMENT OF CHANGES IN EQUITY

For the years ended 31 December

	Share capital £000	Retained earnings £000	Hedging reserve £000	Total equity £000
At 1 January 2015	50	(3,999)	292	(3,657)
Profit for the year	-	4,699	-	4,699
Other comprehensive income for the year	-	-	150	150
At 31 December 2015 and 1 January 2016	50	700	442	1,192
Profit for the year	-	1,253	-	1,253
Other comprehensive income for the year	-	-	67	67
At 31 December 2016	50	1,953	509	2,512

The accompanying notes form an integral part of the financial statements.



## BALANCE SHEET

As at 31 December

	Notes	2016 £000	2015 £000
<b>Assets</b>			
Cash and cash equivalents	10	530	84
Derivative financial instruments – assets	11 & 12	380,890	112,490
Loans and advances to group companies	13	3,214,437	5,697,135
Other assets	14	11,243	22,872
<b>Total assets</b>		<b>3,607,100</b>	<b>5,832,581</b>
<b>Liabilities</b>			
Debt securities in issue	15	(3,584,706)	(5,713,859)
Derivative financial instruments - liabilities	11 & 12	-	(90,883)
Other liabilities	16	(19,882)	(26,647)
<b>Total liabilities</b>		<b>(3,604,588)</b>	<b>(5,831,389)</b>
<b>Equity</b>			
Share capital	17	(50)	(50)
Hedging reserve	18	(509)	(442)
Retained earnings		(1,953)	(700)
<b>Total equity</b>		<b>(2,512)</b>	<b>(1,192)</b>
<b>Total liabilities and equity</b>		<b>(3,607,100)</b>	<b>(5,832,581)</b>

The accompanying notes form an integral part of the financial statements.

The financial statements were approved by the Board of Directors, authorised for issue, and signed on its behalf by:



Rachel Morrison  
Director

11 April 2017

## CASH FLOW STATEMENT

For the years ended 31 December

	Notes	2016 £000	2015 £000
<b>Cash flows from operating activities</b>			
Profit before tax		1,254	4,700
Adjustments for:			
Gains on hedged items attributable to hedged risks		(4,826)	(3,665)
Loss on foreign exchange on retranslation of debt securities in issue		358,372	144,269
<b>Operating cash flows before movements in working capital</b>		<b>354,800</b>	<b>145,304</b>
Change in operating assets		(256,772)	(29,577)
Change in operating liabilities		(97,581)	(99,639)
Corporation taxes paid		(1)	(1)
<b>Net cash generated by operating activities</b>		<b>446</b>	<b>16,087</b>
<b>Investing activities</b>			
Loans repaid to group companies		-	(16,083)
Loans advanced to group companies		(1,178,814)	-
Loans repaid by group companies		3,661,424	2,663,744
<b>Net cash generated by investing activities</b>		<b>2,482,610</b>	<b>2,647,661</b>
<b>Financing activities</b>			
Issue of debt securities		1,178,814	-
Redemption of debt securities		(3,661,424)	(2,663,744)
<b>Net cash used in financing activities</b>		<b>(2,482,610)</b>	<b>(2,663,744)</b>
<b>Net increase in cash and cash equivalents</b>		<b>446</b>	<b>4</b>
Cash and cash equivalents at beginning of year		84	80
<b>Cash and cash equivalents at end of year</b>	10	<b>530</b>	<b>84</b>

The accompanying notes form an integral part of the financial statements.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016

### 1. ACCOUNTING POLICIES

The principal accounting policies adopted in the presentation of the financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

#### General information

The Company is a limited liability company, domiciled and incorporated in the United Kingdom and is part of a European listed group whose ultimate parent is Banco Santander SA. The registered office address of the Company is 2 Triton Square, Regent's Place, London NW1 3AN.

#### Basis of preparation

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) and IFRS Interpretations Committee (IFRS IC) interpretations as adopted by the European Union and the Companies Act 2006 applicable to companies reporting under IFRS.

The functional and presentation currency of the Company is sterling.

The financial statements have been prepared on the going concern basis using the historical cost convention, as modified by financial assets and financial liabilities held at fair value through profit or loss and all derivative contracts. An assessment of the appropriateness of the adoption of the going concern basis of accounting is disclosed in the statement of going concern set out in the Report of the Directors.

#### Foreign currency translation

Items included in the financial statements of the entity are measured using the currency that best reflects the economic substance of the underlying events and circumstances relevant to that entity ("the functional currency"). The functional and presentation currency of the Company is Sterling.

Foreign currency transactions are translated into the functional currency at the exchange rates prevailing at the dates of the transactions. Monetary assets and liabilities that are denominated in foreign currencies are translated into the functional currency of the Company at the rates in effect at the balance sheet date. Non-monetary items carried at fair value that are denominated in foreign currencies are translated at the rates prevailing at the date when the fair value was determined. Foreign currency translation differences are recognised in profit or loss and are included in the Statement of Comprehensive Income.

#### Interest income and expense

Interest income on financial assets that are classified as loans and receivables and interest expense on financial liabilities other than those at fair value through profit and loss are determined using the effective interest 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 net carrying amount of the financial asset or financial liability.

When calculating the effective interest rate, the future cash flows are estimated after considering all the contractual terms of the instrument excluding future 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 and expense is shown gross in the Statement of Comprehensive Income.

#### Financial assets and liabilities

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 financial liabilities at initial recognition. Financial assets are classified as financial assets at fair value through profit or loss, loans and receivables, available-for-sale and held to maturity financial assets. The Company does not hold available-for-sale and held to maturity financial assets.

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 expire.

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 are recognised on settlement date; all other regular way purchases are recognised on trade date.

#### *a) Financial assets and liabilities at fair value through profit or loss*

Financial assets and financial liabilities are classified as fair value through profit or loss if they are designated at fair value through profit or loss on initial recognition. Financial assets and financial liabilities classified as fair value through profit or loss are initially recognised at fair value and transaction costs are taken directly to the Statement of Comprehensive Income. Gains and losses arising from changes in fair value are included directly in the Statement of Comprehensive Income. The Company's financial assets that are classified as fair value through profit or loss are derivatives that are not designated in a hedging relationship.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016

### 1. ACCOUNTING POLICIES (CONTINUED)

#### *b) Loans and receivables*

Loans and receivables are non-derivative financial assets with fixed or determinable payments, that are not quoted in an active market and which are not classified as available-for-sale or fair value through profit or loss. They arise when the Company provides money or services direct to another entity with no intention of trading the loan. Loans and receivables are initially recognised at fair value including direct and incremental transaction costs. They are subsequently valued at amortised cost, using the effective interest method. Loans and receivables consist of loans and advances to group companies shown in the Balance Sheet and accrued interest shown within other assets.

#### *c) Borrowings*

Borrowings (which include debt securities in issue shown in the Balance Sheet and accrued interest shown within other liabilities) are recognised initially at fair value, being their issue proceeds (fair value of consideration received) net of transactions costs incurred. Borrowings are subsequently valued at amortised cost, using the effective interest method, or fair value through profit or loss depends on designation at initial recognition.

The exception to this are financial liabilities which are designated in fair value hedge accounting relationships and are re-measured to fair value at each reporting period.

For each class of assets and liabilities not measured at fair value in the statement of financial position but for which the fair value is disclosed, an entity discloses the information required by paragraph 93(b), (d) and (i) of IFRS 13. However, an entity is not required to provide the quantitative disclosures about significant unobservable inputs used in fair value measurements categorised within Level 3 of the fair value hierarchy required by paragraph 93(d) of IFRS 13. For such assets and liabilities, an entity does not need to provide the other disclosures required by this IFRS.

#### **Derivative financial instruments**

Derivative financial instruments ('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.

The Company holds cross currency swaps in order to manage foreign currency risk arising on the foreign denominated loans due to related parties. The Company also holds interest rate swaps to hedge significant future transactions and cash flows dependent on movement in interest rates.

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 over-the-counter derivatives are obtained using valuation techniques, including discounted cash flow and option pricing models. The Company holds no exchange traded derivatives.

Derivatives are contracted with Santander UK plc or counterparties that meet standards set out in the relevant Prospectus. If subsequently there is a ratings downgrade of the counterparty credit rating, remedial measures include provision of collateral for obligations under the relevant swap.

#### **Hedge accounting**

In order to economically hedge against interest and exchange rate risks, derivatives are entered into as a part of the securitisation transaction to manage risk.

The Company applies hedge accounting to represent, to the maximum possible extent permitted under accounting standards, the economic effects of its risk management strategies. Derivatives are used to hedge exposures to interest rates and exchange rates.

At the time a financial instrument is designated as a hedge (i.e., at the inception of the hedge), the Company formally documents the relationship between the hedging instrument(s) and hedged item(s), its risk management objective and strategy for undertaking the hedge. The documentation includes the identification of each hedging instrument and respective hedged item, the nature of the risk being hedged (including the benchmark interest rate being hedged in a hedge of interest rate risk) and how the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value attributable to the hedged risk is to be assessed. Accordingly, the Company formally assesses, both at the inception of the hedge and on an on-going basis, whether the hedging derivatives have been and will be highly effective in offsetting changes in the fair value attributable to the hedged risk during the period that the hedge is designated. A hedge is normally regarded as highly effective if, at inception and throughout its life, the Company can expect, and actual results indicate, that changes in the fair value or cash flow of the hedged items are effectively offset by changes in the fair value or cash flow of the hedging instrument. If at any point it is concluded that it is no longer highly effective in achieving its documented objective, hedge accounting is discontinued.

Where derivatives are held for risk management purposes, and when transactions meet the required criteria for documentation and hedge effectiveness, the derivatives may be designated as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedges'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedges'); or (iii) a hedge of a net investment in a foreign operation ('net investment hedges'). The Company applies fair value hedge accounting and cash flow hedge accounting but not hedging of a net investment in a foreign operation.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016 (CONTINUED)

### 1. ACCOUNTING POLICIES (CONTINUED)

#### Hedge accounting (continued)

##### *a) Fair value hedge accounting*

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the Statement of Comprehensive Income, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

If the hedge no longer meets the criteria for hedge accounting, changes in the fair value of the hedged item attributable to the hedged risk are no longer recognised in the Statement of Comprehensive Income. For fair value hedges of interest rate risk, the cumulative adjustment that has been made to the carrying amount of the hedged item is amortised to the Statement of Comprehensive Income using the effective interest method over the period to maturity.

##### *b) Cash flow hedge accounting*

The effective portion of changes in the fair value of qualifying cash flow hedges is recognised in other comprehensive income in the cash flow hedging reserve. The gain or loss relating to the ineffective portion is recognised immediately in the Statement of Comprehensive Income. Amounts accumulated in equity are reclassified to the Statement of Comprehensive Income in the periods in which the hedged item affects profit or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised in the Statement of Comprehensive Income when the forecast transaction is ultimately recognised in the Statement of Comprehensive Income. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to Statement of Comprehensive Income.

The Company is exposed foreign currency risks on its debt issuances denominated in foreign currency. Cash flow hedging is used to hedge the variability in cash flows arising from this foreign currency risk.

#### Impairment of financial assets

A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of events that occurred after the initial recognition of the asset (a 'loss event') and that loss event has an impact on the estimated future cash flows of the financial asset or group of financial assets.

The Company first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If there is no objective evidence of impairment for an individually assessed financial asset it is included in a group of financial assets with similar credit risk characteristics and collectively assessed for impairment.

Impairment for collectively assessed loans are calculated based on the probability of default, exposure at default and the loss given default, using historical data adjusted as considered appropriate to reflect current market conditions. An adjustment is made for the effect of discounting cash flows.

The only asset held by the Company that is at risk of material impairment is the loan to Holmes Funding Limited, the repayment of which is dependent upon the performance of the residential mortgage portfolio. The risk of impairment is mitigated by the collateral within the Holmes securitisation structure.

The performance of the mortgage portfolio is continually assessed by Santander UK plc and external credit rating agencies. It follows that the impairment policies of Santander UK plc are applied by the Company.

#### Income taxes

The directors are satisfied that the Company meets the definition of a 'securitisation company' as defined by both the Finance Act 2005 and the subsequent secondary legislation and that no incremental unfunded tax liabilities will arise. As a result, no deferred tax amounts are recognised.

Under the powers conferred by the Act, secondary legislation was enacted in 2006 which ensures that, subject to certain conditions being met and an election being made, for periods commencing on or after 1 January 2007, corporation tax for a 'securitisation company' will be calculated by reference to the profit of the securitisation company required to be retained in accordance with the relevant capital market arrangement.

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 Statement of Comprehensive Income 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.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016 (CONTINUED)

### 1. ACCOUNTING POLICIES (CONTINUED)

#### Cash and cash equivalents

For the purposes of the Cash Flow Statement, cash and cash equivalents comprise assets with less than three months' maturity from the date of acquisition, including cash, restricted balances and non restricted balances with central banks, loans and advances to banks and amounts due from other banks.

#### Future accounting developments

The Company has not yet adopted the following significant new or revised standards and interpretations, and amendments thereto, which have been issued but which are not yet effective for the Company:

- a) IFRS 9 'Financial Instruments' (IFRS 9) – In July 2014, the International Accounting Standards Board (IASB) approved IFRS 9 to replace IAS 39 'Financial Instruments: Recognition and Measurement'.

IFRS 9 sets out the requirements for recognition and measurement of financial instruments. The main new developments of the standard are discussed below.

*Classification and measurement of financial assets and financial liabilities:* Under IFRS 9, financial assets are classified on the basis of the business model within which they are held and their contractual cash flow characteristics. These factors determine whether the financial assets are measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss. For many financial assets, the classification and measurement outcomes will be similar to IAS 39. However, under IFRS 9, embedded derivatives are not separated from host financial assets and equity securities are measured at fair value either through profit or loss or, in certain circumstances, an irrevocable election may be made to present fair value movements in other comprehensive income. The requirements for the classification and measurement of financial liabilities were carried forward unchanged from IAS 39, however, the requirements relating to the fair value option for financial liabilities were changed to address own credit risk and, in particular, the presentation of gains and losses within other comprehensive income.

*Impairment:* IFRS 9 introduces fundamental changes to the impairment of financial assets measured at amortised cost or at fair value through other comprehensive income, lease receivables and certain commitments to extend credit and financial guarantee contracts. It is no longer necessary for losses to be incurred before credit losses are recognised. Instead, under IFRS 9, an entity always accounts for expected credit losses (ECLs), and any changes in those ECLs. The ECL approach must reflect both current and forecast changes in macroeconomic data over a horizon that extends from 12 months to the remaining life of the asset if a borrower's credit risk is deemed to have deteriorated significantly at the reporting date compared to the origination date. The estimate of ECLs should reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes and considering reasonable and supportable information at the reporting date. Similar to the current incurred credit loss provisioning approach, management will exercise judgement as to whether additional adjustments are required in order to adequately reflect possible events or current conditions that could affect credit risk.

For financial assets, an ECL is the current value of the difference between the contractual cash flows owed to the entity according to the contract and the cash flows which the entity expects to receive. For undrawn loan commitments, an ECL is the current value of the difference between the contractual cash flows owed to the entity and the cash flows which the entity expects to receive if the loan is drawn.

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

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

The assessment of whether a significant increase in credit risk has occurred since initial recognition involves the application of both quantitative measures and qualitative factors, requires management judgement and is a key aspect of the IFRS 9 methodology.

*Hedge accounting:* The general hedge accounting requirements align more closely with risk management practices and establish a more principle-based approach thereby allowing hedge accounting to be applied to a wider variety of hedging instruments and risks. Macro hedge accounting is being dealt with as a separate project. Until such time as that project is complete, and to remove any potential conflict between any existing macro hedge accounting undertaken under IAS 39 and the new general hedge accounting requirements of IFRS 9, entities can choose to continue to apply the existing hedge accounting requirements in IAS 39. Based on the analysis performed to date, the Company expects to continue IAS 39 hedge accounting. No changes are currently being implemented to hedge accounting policies and practices.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016 (CONTINUED)

### 1. ACCOUNTING POLICIES (CONTINUED)

#### Future accounting developments (continued)

*Transition:* IFRS 9 has been endorsed for use in the European Union. The mandatory effective date of IFRS 9 is 1 January 2018. The classification and measurement and impairment requirements will be applied retrospectively by adjusting the opening balance sheet at the date of initial application. There is no requirement to restate comparative information. The Company is assessing the likely impacts of the new financial asset classification & measurement and impairment requirements. Upon the satisfactory completion of this work, including formal testing of the ECL models during 2017, the Company will quantify the indicative impact when that information is known or reasonably estimable, and by no later than the end of 2017. It is not yet practicable to quantify the effect of IFRS 9 in these Financial Statements.

A number of new standards and amendments to standards and interpretations have been issued but are not yet effective for the current accounting period. None of these are expected to have a material impact on the financial statements of the Company.

### 2. CRITICAL ACCOUNTING POLICIES AND AREAS OF SIGNIFICANT MANAGEMENT JUDGEMENT

The preparation of the Company's financial statements requires management to make estimates and judgements 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 estimates and judgements on an on-going basis. Management bases its estimates and judgements on historical experience and on other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

The following accounting estimates and judgements are considered important to the portrayal of the Company's financial results and financial condition because: (i) they are highly susceptible to change from period to period as assumptions are made to calculate the estimates, and (ii) any significant difference between the estimated amounts and actual amounts could have a material impact on the Company's future financial results and financial condition.

In calculating each estimate, a range of outcomes was calculated based principally on management's conclusions regarding the input assumptions relative to historic experience. The actual estimates were based on what management concluded to be the most probable assumptions within the range of reasonably possible assumptions. There were no changes in the year.

#### *Valuation of financial instruments*

When estimating the value of its derivative assets and liabilities management considers a range of interest rates, exchange rates, counterparty credit ratings and other similar inputs, all of which vary across maturity bands. These are chosen to best reflect the particular characteristics of each transaction based on observable inputs and adjustments to these inputs for Level 2 instruments. Detailed disclosures on financial instruments can be found in note 1 and 12.

#### *Impairment losses*

The Company assesses its financial assets for objective evidence of impairment at the Balance Sheet date. An impairment loss is recognised if, and only if, there is a loss event that has occurred after initial recognition and before the Balance Sheet date and that has a reliably measurable impact on the estimated future cash flows of the financial assets.

#### *Effective interest rate*

Certain financial instruments are accounted for at amortised cost on an effective interest rate basis, under which the income or expenses associated with the instrument is spread over the instrument's expected life. Periodically, models are reviewed to re-assess expected life of the mortgages underlying the deemed loans.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016 (CONTINUED)

### 3. FINANCIAL RISK MANAGEMENT

The Company's risk management focuses on the major areas of credit risk, market risk and liquidity risk. Risk management is carried out by the central risk management function of the Santander UK group. Authority flows from the Santander UK plc Board to the Chief Executive Officer and from him to his direct reports. Delegation of authority is to individuals. Formal standing committees are maintained for effective management of oversight.

#### Credit risk

Credit risk is the risk that counterparties will not meet their financial obligations and may result in the Company losing the principal amount lent, the interest accrued and any unrealised gains, less any security held. The main source of credit risk is in the loans and advances to group companies, derivative financial instruments assets and other assets.

The maximum exposure to credit risk without taking into account collateral or credit enhancements is the carrying amount of the loans and other debts due from members of £3.21bn (2015: £5.70bn), the fair value of derivative financial assets of £0.38bn (2015: £0.11bn) and the carrying amount of other assets of £0.01bn (2015: £0.02bn).

At the balance sheet date all financial assets subject to credit risk were neither past due nor impaired.

As at 31 December 2016, the book value of residential mortgage loans that Santander UK plc had assigned legal title to the Holmes securitisation structure was £5.56bn (2015: £7.05bn). The Holmes securitisation structure comprising fellow subsidiaries is over collateralised by £2.58bn (2015: £1.66bn). The Holmes securitisation structure acquired interest in a portfolio of mortgage loans (Funder share) was £2.98bn (2015: £5.39bn) and the Santander UK plc seller share was £2.58bn (2015: £1.66bn).

The Holmes securitisation structure has cash balances and reserves of £0.66bn (2015: £0.87bn) which also acts as a credit enhancement feature.

Derivatives are contracted with Santander UK plc or counterparties that meet standards set out in the relevant Transaction documents. If subsequently there is a ratings downgrade of the counterparty credit rating, remedial measures include provision of collateral for obligations under the relevant swap.

The maximum LTV ratio of the securitised mortgages within the structure at origination is 95% with arrears rates, significantly below the rate that can be absorbed by the level of over collateralisation currently within the structure. There are no repurchase obligations on the underlying loans.

The loans within the portfolio are monitored and assessed for impairment on a regular basis at a group level. The impairment policy applied by Santander UK plc is equivalent to the impairment of financial assets policy of the Company.

Santander UK plc is rated periodically by credit rating agencies Standard & Poor's, Moody's Investors Service and Fitch Ratings, Ltd.

Santander UK plc's credit ratings are disclosed below as the financial assets of the Holmes securitisation structure are secured on mortgage assets within Santander UK plc.

Further details can be found in the notes to the Group financial statements of Santander UK plc's Annual Report and Financial Statements and monthly investor reports of Holmes Master Trust.

Santander UK plc's current credit ratings were:

	S & P	Moody's	Fitch
Long-term rating	A	Aa3	A
Long-term rating outlook	Negative	Negative	Stable
Short term rating	A-1	P-1	F1

#### Liquidity risk

Liquidity risk is the potential that, although remaining solvent, the Company does not have sufficient liquid financial resources to enable it to meet its obligations as they fall due, or can secure them only at excessive cost.

Liquidity is managed by the Company by matching the terms of the financial instruments so that cash inflows meet cash outflows. The receipts from the related party loan asset and the payments in respect of the derivative financial instruments described in the Annual Report and Financial Statements are matched. The receipts from the derivative financial instruments and the payments required in respect of the debt securities in issue described above are also matched.



## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016 (CONTINUED)

### 3. FINANCIAL RISK MANAGEMENT (CONTINUED)

#### *Maturities of financial liabilities*

The table below analyses the maturities of the undiscounted cash flows relating to the financial liabilities of the Company based on the remaining period to the contractual maturity date at the Balance Sheet date. There are no significant financial liabilities related to financial guarantee contracts.

At 31 December 2016	Within one month £000	1-3 months £000	3-12 months £000	1-5 years £000	Over 5 years £000	2016 Total £000
Debt securities in issue	-	-	(256,814)	-	(2,957,712)	(3,214,526)
Interest payable on debt securities in issue	(19,882)	-	(74,706)	(325,990)	(2,675,833)	(3,096,411)
<b>Total</b>	<b>(19,882)</b>	<b>-</b>	<b>(331,520)</b>	<b>(325,990)</b>	<b>(5,633,545)</b>	<b>(6,310,937)</b>

At 31 December 2015	Within one month £000	1-3 months £000	3-12 months £000	1-5 years £000	Over 5 years £000	2015 Total £000
Debt securities in issue	-	-	-	-	(5,713,859)	(5,713,859)
Derivative financial liabilities	(85,975)	-	(31,145)	-	-	(117,120)
Interest payable on debt securities in issue	(26,646)	-	(102,214)	(446,023)	(3,772,607)	(4,347,490)
<b>Total</b>	<b>(112,621)</b>	<b>-</b>	<b>(133,359)</b>	<b>(446,023)</b>	<b>(9,486,466)</b>	<b>(10,178,469)</b>

The maturity analyses above for derivative financial liabilities include the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of the cash flows. The undiscounted cash flows for the derivative financial instruments comprise only the amounts payable under the contract. Under the terms of the contract these cash outflows are accompanied by related cash inflows.

Collateral calls on derivative positions can pose a significant liquidity risk. Collateral calls may arise at times of market stress and when asset liquidity may be tightening. The timing of the cash flows on a derivative hedging an asset may be different to the timing of the cash flows of the asset being held, even if they are similar in all other respects. Collateral calls may be triggered by a credit downgrading. The Company manages these risks by including collateral calls in stress tests on liquidity, and by maintaining a portfolio of assets held for managing liquidity risk. As at 31 December 2016, the Company held no cash collateral (2015: £16.1m which is recorded in other assets in the balance sheet as disclosed in note 14).

#### Market risk

Market risk is potential for loss of income or decrease in the value of net assets caused by movements in the levels and prices of financial instruments. The Company is subject to market risk in the form of interest rate risk and currency risks from the fluctuations in the US Dollar and Euro currencies.

In order to hedge against currency risks, the Company enters into cross currency swaps and as a result of this, the Company's total interest income and expense on financial assets and liabilities is based on the same rate of sterling LIBOR; it therefore has no material cash flow sensitivity to changes in currency rates in either 2016 or 2015. As a result, no sensitivity analysis is presented for currency risk as the changes to the two instruments will be equal and offsetting.

The Company also enters into interest rate swap contracts with Santander UK plc, a related party, and counterparties that meet standards set out in the relevant Transaction documents to manage basis risk between interest flows on the cross currency swaps and on interest payments received from Santander UK plc. Hedge accounting is adopted for that funding so that the Company is hedged against the exposure to interest rate volatility from the movement in fair value of those interest rate swap contracts.

A 50bp adverse or positive movement in interest rates would have an immaterial impact on profit for the year and on net assets.

During the year, the Company generated fair value gains on derivative financial instruments of £363m (2015: gains of £148m). These gains were substantially offset by foreign exchange losses on re-translation of debt securities in issue of £358m (2015: losses of £144m), losses on fair value hedging ineffectiveness of £2.5m (2015: losses of £0.7m) and losses on cash flow ineffectiveness of £1.6m (2015: gains of £1.5m). This volatility is expected to even out over the long term.

#### Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This includes regulatory, legal and compliance risk. Operational risk is monitored and managed within the Group. An independent central operational risk function has responsibility for establishing the framework within which these risks are managed and is aligned to operational risk professionals within business areas to ensure consistent approaches are applied across the Group. The primary purpose of the framework is to define and articulate the Group-wide policy, processes, roles and responsibilities.

The day-to-day management of operational risk is the responsibility of business managers who identify, assess and monitor the risks, in line with the processes described in the framework. The operational risk function ensures that all key risks are regularly reported to the Group's risk committee and board of directors.

# NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016 (CONTINUED)

## 4. BUSINESS AND GEOGRAPHICAL SEGMENTS

All of the Company's income is derived from activities in the same business and geographical segment, within the UK.

## 5. INTEREST AND SIMILAR INCOME

	Year ended 31 December 2016 £000	Year ended 31 December 2015 £000
Interest income from Holmes Funding Limited	77,492	123,207
Interest income from Santander UK plc	1	1
Swap interest income	17,813	-
	95,306	123,208

## 6. INTEREST EXPENSE AND SIMILAR CHARGES

	Year ended 31 December 2016 £000	Year ended 31 December 2015 £000
Interest payable on debt securities in issue	94,816	120,603
Swap interest expense	-	2,813
	94,816	123,416

## 7. NET OTHER OPERATING INCOME

	Year ended 31 December 2016 £000	Year ended 31 December 2015 £000
Fair value hedging:		
- Losses on hedging instruments	(7,341)	(4,340)
- Gains on hedged items attributable to hedged risks	4,826	3,665
Fair value hedging ineffectiveness	(2,515)	(675)
Cash flow hedging ineffectiveness	(1,555)	1,487
Fair value gains on derivative financial instruments	363,326	148,485
Loss on foreign exchange on re-translation of debt securities in issue	(358,372)	(144,269)
	884	5,028

The Company hedges its exposures to various risks, including interest rate risk and foreign currency risk, in connection with the Company's operations and its sources of finance.

The Company applies cash flow hedge accounting in line with IAS 39 in relation to the foreign currency risk of the cash flows of *class A6 of the Series 2011-3* and *class A1 of series 2016-1* USD floating rate notes (refer to note 11) and fair value hedge accounting with regards to the interest rate risk of *class A5 of series 2010-1* and *class A5 of series 2011-3* fixed rate notes (refer to Note 15 for details).

In line with the transaction documents, swaps are also in place to economically hedge FV or interest rate risk on the remaining fixed rate or foreign currency notes and fair value movements of those swaps are accounted in Profit and Loss within the Statement of Comprehensive income.

The gains or losses arising on these assets and liabilities are presented in the table above on a combined basis.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016 (CONTINUED)

### 8. PROFIT BEFORE TAX

#### Directors' emoluments

The Directors' services to the Company are an incidental part of their duties. No Directors were remunerated for their services to the Company. Directors' emoluments are borne by Santander UK plc and corporate service fees, which include the provision of Directors, are borne by Holmes Funding Limited. No emoluments were paid by the Company to the Directors during the year (2015: £nil).

#### Staff costs

The Company had no employees in the current or previous financial year.

#### Auditors remuneration

The audit fee for the current and prior year has been paid on the Company's behalf by Santander UK plc, in accordance with Company policy, for which no recharge has been made. The audit fee for the current year is £11,000 (2015: £11,996).

### 9. TAX

	Year ended 31 December 2016 £000	Year ended 31 December 2015 £000
<b>Current tax:</b>		
UK corporation tax on profit for the year	1	1
Tax charge on profit for the year	1	1

For UK corporation tax purposes, the Company has been considered as a Securitisation Company under the 'Taxation of Securitisation Companies Regulations (SI 2006/3296)'. Therefore the Company is not required to pay corporation tax on its accounting profit or loss. Instead, the Company is required to pay tax on its retained profits as specified in the documentation governing the Transaction.

UK corporation tax is calculated at 20% (2015: 20%) of the estimated assessable profits of the year.

The Finance (No. 2) Act 2015, which provides for reductions in the main rate of UK corporation tax to 19% effective from 1 April 2017 and to 18% from 1 April 2020 was enacted on 18 November 2015.

The Finance Act 2016, which was substantively enacted on 6 September 2016, introduced a further reduction in the corporation tax rate to 17% from 2020.

The tax on the Company's profit before tax differs from the theoretical amount that would arise using the basic tax rate of the Company as follows:

	Year ended 31 December 2016 £000	Year ended 31 December 2015 £000
<b>Profit before tax</b>	<b>1,254</b>	<b>4,700</b>
Tax calculated at a rate of 20% (2015: 20%)	251	940
Non-taxable income	(250)	(939)
<b>Tax charge for the year</b>	<b>1</b>	<b>1</b>

The Company meets the requirements of a securitisation company for tax purposes and is taxed on the margin that it receives in return for participating in the securitisation structure under the waterfall arrangement. Any other amounts that form part of its retained profit and all other amounts that it receives are disregarded for tax purposes.

### 10. CASH AND CASH EQUIVALENTS

	2016 £000	2015 £000
Due from Santander UK plc	530	84
	<b>530</b>	<b>84</b>

Cash and cash equivalent balances due from Santander UK plc, a related party was £530m (2015: £84m).

All cash balances held with Santander UK plc are held under a Guaranteed Investment Contract and are classified as restricted funds, as withdrawals are restricted by a priority of payments in accordance with the terms of the securitisation structure.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016 (CONTINUED)

### 11. DERIVATIVE FINANCIAL INSTRUMENTS

The Company holds derivatives to manage the currency risks and interest rate risks arising from the Company's operations and its sources of finance. The cross currency swaps require the Company to pay a rate linked to three-month sterling LIBOR and receive fixed rate payment in US Dollar and Euro currencies and the interest rate swaps require the Company to pay a rate linked to three-month Sterling LIBOR and receive fixed rate payment in Sterling.

These derivatives are recorded at fair value through profit or loss, except those which have been designated in effective cash flow hedging relationships where the effective portion of the change in fair value is recorded in other comprehensive income.

The use of derivatives is determined in the transaction documents at the time of issue of each series of debt securities in issue.

At 31 December 2016, the Company held derivative assets of £380.9m (2015: £112.5m) and derivative liabilities of £nil (2015: £90.9m).

#### Hedged cash flows

The following tables show when the Company's hedged cash flows are expected to occur and when they will affect income for designated cash flow hedges.

	0 - 1 years £000	1 - 2 years £000	2 - 3 years £000	3 - 4 years £000	4 - 5 years £000	5 - 10 years £000	Total £000
<b>31 December 2016</b>							
<b>Hedged forecast cash flows expected to occur:</b>							
Forecast payable cash flows	(311,000)	(7,000)	(204,000)	-	-	-	(522,000)
<b>Hedged forecast cash flows affect profit or loss:</b>							
Forecast payable cash flows	(311,000)	(7,000)	(203,000)	-	-	-	(521,000)

	0 - 1 years £000	1 - 2 years £000	2 - 3 years £000	3 - 4 years £000	4 - 5 years £000	5 - 10 years £000	Total £000
<b>31 December 2015</b>							
<b>Hedged forecast cash flows expected to occur:</b>							
Forecast payable cash flows	(4,000)	(5,000)	(6,000)	(170,000)	-	-	(185,000)
<b>Hedged forecast cash flows affect profit or loss:</b>							
Forecast payable cash flows	(4,000)	(6,000)	(6,000)	(169,000)	-	-	(185,000)

There were no transactions for which cash flow hedge accounting had to be ceased during the years ended 31 December 2016 and 2015 as a result of the highly probable cash flows no longer being expected to occur.

During the year, gains transferred from the cash flow hedging reserve to other operating income amounted to £81m (2015: £29m).

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016 (CONTINUED)

### 12. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following tables summarise the fair values of the financial asset and liability classes accounted for at fair value at 31 December 2016 and 2015, analysed by the valuation methodology used by the Company to determine their fair value, including their levels in the fair value hierarchy – level 1, level 2 and level 3.

31 December 2016		Internal models based on						Total £000	Valuation Technique	
Balance Sheet category		Level 1 £000 %		Level 2 £000 %		Level 3 £000 %				
Assets										
Derivative assets	Foreign exchange contracts	-	-	-	-	373,426	98	373,426	98	A
	Interest rate swaps	-	-	-	-	7,464	2	7,464	2	
Total assets at fair value		-	-	-	-	380,890	100	380,890	100	
Liabilities										
Derivative liabilities	Foreign exchange contracts	-	-	-	-	-	-	-	-	A
Financial liabilities at FVTPL	Debt securities in issue in fair value hedge relationships	-	-	-	-	(788,991)	100	(788,991)	100	
Total liabilities at fair value		-	-	-	-	(788,991)	100	(788,991)	100	
31 December 2015		Internal models based on						Total £000	Valuation Technique	
Balance Sheet category		Level 1 £000 %		Level 2 £000 %		Level 3 £000 %				
Assets										
Derivative assets	Foreign exchange contracts	-	-	-	-	101,425	90	101,425	90	A
	Interest rate swaps	-	-	-	-	11,065	10	11,065	10	
Total assets at fair value		-	-	-	-	112,490	100	112,490	100	
Liabilities										
Derivative liabilities	Foreign exchange contracts	-	-	-	-	(90,883)	11	(90,883)	11	A
Financial liabilities at FVTPL	Debt securities in issue in fair value hedge relationships	-	-	-	-	(725,644)	89	(725,644)	89	
Total liabilities at fair value		-	-	-	-	(816,527)	100	(816,527)	100	

During the year ended 31 December 2016 and 2015 there were no transfers of financial instruments between levels.

#### Valuation of financial instruments

Financial instruments that are classified or designated at fair value through profit or loss and all derivatives are stated at fair value. The fair value of such 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.

Changes in the valuation of such financial instruments, including derivatives, are included in the line item 'Net other operating income' or in 'Other comprehensive income' in the Statement of Comprehensive Income.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016 (CONTINUED)

### 12. FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED)

#### *(i) Initial measurement*

The best evidence of the fair value of a financial instrument at initial recognition is the transaction price unless the instrument is evidenced by comparison with other observable current market transactions in the same instrument or based on a valuation technique whose variables include significant data from observable markets. Any difference between the transaction price and the value based on a valuation technique where the inputs are not based on data from observable current markets is not recognised in the Statement of Comprehensive Income on initial recognition. Subsequent gains and losses are only recognised to the extent that they arise from a change in a factor that market participants would consider in setting a price.

#### *(ii) Subsequent measurement*

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 has the ability to access at the measurement date. The Company has no assets or liabilities measured at fair value that are classified as Level 1.
- Level 2: Quoted prices in non-active 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 2 positions include exchange rate derivatives and interest rate derivatives.
- Level 3: Inputs to the pricing or valuation techniques that are significant to the overall fair value measurement of the asset or liability are unobservable. The Company has no assets or liabilities measured at fair value that are classified as Level 3.

#### *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 did not make any material changes to the valuation techniques and internal models it used during the year ended 31 December 2016.

#### *Valuation techniques*

The main valuation techniques employed in the Company's internal models to measure the fair value of the financial instruments disclosed above at 31 December 2016 and 2015 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 during the years ended 31 December 2016 and 2015.

- A In the valuation of financial instruments requiring static hedging (for example interest rate and exchange derivatives), the 'present value' method is used. Expected future cash flows are discounted using the interest rate curves of the applicable currencies. 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.

#### *Internal models based on observable market data - derivative assets and liabilities*

These instruments consist of exchange rate contracts and interest rate contracts. The models used in estimating the fair value of these derivatives do not contain a high level of subjectivity as the methodologies used in the models do not require significant judgement, and the inputs used in the models are observable market data such as plain vanilla interest rate swaps and option contracts. As the inputs used in the valuation are based on observable market data, these derivatives are classified within level 2 of the valuation hierarchy.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016 (CONTINUED)

### 13. LOANS AND ADVANCES TO GROUP COMPANIES

	2016 £000	2015 £000
Receivable:		
Within one year	256,814	-
Greater than five years	2,957,623	5,697,135
	3,214,437	5,697,135

The loans are all denominated in Sterling and are at variable rates of interest, based on LIBOR for three-month sterling deposits. The carrying amount of loans and advances to group companies approximates to their fair value.

### 14. OTHER ASSETS

	2016 £000	2015 £000
Accrued interest due from group companies	11,206	22,835
Called up share capital not paid – due from Holmes Holdings Limited (see note 17)	37	37
	11,243	22,872

The carrying amount of other assets approximates to their fair value.

### 15. DEBT SECURITIES IN ISSUE

	2016 £000	2015 £000
Residential mortgage backed notes	3,584,706	5,713,859
These borrowings are repayable as follows:		
Within one year	303,862	-
Greater than five years	3,280,844	5,713,859
	3,584,706	5,713,859

The tables below disclose the list of debt securities in issue.

Issue: 2010-1	Currency	2016 £000	2016 Issued currency '000	2015 £000	2015 Issued currency '000
Series 1 Class A4 Floating Rate Notes 2054	EUR	-	-	286,236	389,066
Series 1 Class A5 Fixed Rate Notes 2054 <sup>(1)</sup>	GBP	380,887	375,000	384,685	384,685
Z Note 2054	GBP	-	-	600,000	600,000
		380,887		1,270,921	

Issue: 2011-1	Currency	2016 £000	2016 Issued currency '000	2015 £000	2015 Issued currency '000
Series 1 Class A4 Floating Rate Notes 2054	EUR	-	-	216,372	294,103
Series 1 Class A5 Floating Rate Notes 2054	GBP	-	-	191,167	195,167
Series 1 Class Z 2054	GBP	-	-	450,000	450,000
		-	-	857,539	

Issue: 2011-3	Currency	2016 £000	2016 Issued currency '000	2015 £000	2015 Issued currency '000
Series 1 Class A4 Floating Rate Notes 2054	GBP	-	-	120,686	120,686
Series 1 Class A5 Fixed Rate Notes 2054 <sup>(1)</sup>	USD	408,104	500,000	340,959	500,000
Series 1 Class A6 Floating Rate Notes 2054	USD	202,575	250,000	168,487	250,000
		610,679		630,132	

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016  
(CONTINUED)

## 15. DEBT SECURITIES IN ISSUE (CONTINUED)

Issue: 2012-1	Currency	2016 £000	2016 Issued currency '000	2015 £000	2015 Issued currency '000
Series 1 Class A6 Floating Rate Notes 2054	GBP	117,943	117,943	215,000	215,000
Series 1 Class Z 2054	GBP	-	-	610,000	610,000
		117,943		825,000	
Issue: 2012-2	Currency	2016 £000	2016 Issued currency '000	2015 £000	2015 Issued currency '000
Series 1 Class A1 Floating Rate Notes 2054	USD	702,762	867,286	842,437	1,250,000
Series 1 Class Z 2054	GBP	-	-	175,000	175,000
		702,762		1,017,437	
Issue: 2012-3	Currency	2016 £000	2016 Issued currency '000	2015 £000	2015 Issued currency '000
Series 1 Class A1 Floating Rate Notes 2054	GBP	365,845	365,845	515,000	515,000
Series 1 Class B1 Floating Rate Notes 2054	USD	113,442	140,000	94,354	140,000
Series 1 Class B2 Floating Rate Notes 2054	GBP	33,000	33,000	33,000	33,000
		512,287		642,354	
Issue: 2013-1	Currency	2016 £000	2016 Issued currency '000	2015 £000	2015 Issued currency '000
Series 1 Class A2 Floating Rate Notes 2054	GBP	-	-	385,714	385,714
Series 1 Class A3 Floating Rate Notes 2054	GBP	34,286	34,286	84,762	84,762
		34,286		470,476	
Issue: 2016-1	Currency	2016 £000	2016 Issued currency '000	2015 £000	2015 Issued currency '000
Series 1 Class A1 Floating Rate Notes 2017	USD	303,862	375,000	-	-
Series 1 Class A2 Floating Rate Notes 2054	GBP	340,000	340,000	-	-
Series 1 Class Z 2054	GBP	582,000	582,000	-	-
		1,225,862		-	
Total		3,584,706		5,713,859	

<sup>(1)</sup> Included in the carrying amount of debt securities in issue above are the following two debt securities in issue which are in a fair value hedging relationship. The fair value hedged accounting valuation adjustments arising for the two debt securities in issue are:

	2016 £000	2015 £000
Issue 2010 1 Series 1 Class A5	5,888	9,685
Issue 2011 3 Series 1 Class A5	2,954	3,984
	8,842	13,669

The debt securities in issue approximate to fair values except where shown in the table below:



## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016 (CONTINUED)

### 15. DEBT SECURITIES IN ISSUE (CONTINUED)

The fair value movements of the two debt securities in issue were:

	Issue 2010-1 Series 1 Class A5	Issue 2011-3 Series 1 Class A5	Total
	£000	£000	£000
At 31 December 2014	389,055	324,440	713,495
Foreign exchange movement	-	15,814	15,814
Fair value movement attributable to hedged risks	(4,370)	705	(3,665)
At 31 December 2015	384,685	340,959	725,644
Foreign exchange movement	-	68,173	68,173
Fair value movement attributable to hedged risks	(3,798)	(1,028)	(4,826)
At 31 December 2016	380,887	408,104	788,991

All the Class A notes of each series will rank in priority to each series of Class B notes.

Interest is payable on the debt securities in issue at variable rates based on the three-month US Dollar LIBOR, three-month EURIBOR and three-month Sterling LIBOR. The Series 1 Class A5 Fixed Rate Notes 2054 has a fixed rate of interest.

The Company's obligations to note-holders, and to other secured creditors, are secured under a deed of charge that grants security over all of its assets in favour of the security trustee. The principal assets of the Company are loans made to Holmes Funding Limited, a group company, whose obligations in respect of these loans, are secured under a deed of charge which grants security over all its assets, primarily comprising shares in a portfolio of residential mortgage loans, in favour of the security trustee. These mortgages fail the de-recognition criteria described in IAS 39 and as such are represented by a receivable on the balance sheet of Holmes Funding Limited, though legally Holmes Funding Limited is entitled to the income from these mortgages. The security trustee holds this security for the benefit of all secured creditors of Holmes Funding Limited, including the Company.

All the debt securities in issue are listed and are included in the amounts shown above.

The Company's debt securities in issue are denominated in US Dollar, Euros and Pounds Sterling. All currency borrowings are swapped at inception so that they have the effect of sterling borrowings. These swaps provide an effective hedge against exchange rate movements, but the requirement to carry them at fair value leads, when exchange rates have moved significantly since the issue of the debt securities in issue, to large balances for the swaps being carried in the balance sheet.

### 16. OTHER LIABILITIES

	2016 £000	2015 £000
Accrued interest payable	19,881	26,646
Corporation tax	1	1
	19,882	26,647

Other liabilities include £1.6m (2015: £5.9m) of accrued interest payable to Santander UK plc. Other liabilities are deemed repayable within one year. The Directors consider that the carrying amount of other liabilities approximates to their fair value.

### 17. SHARE CAPITAL

	2016 £000	2015 £000
Issued and called up:		
50,000 (2015: 50,000) Ordinary shares of £1 each	50	50

49,998 Ordinary shares are partly paid to 25 pence. Two ordinary shares are fully paid. The unpaid element is disclosed in note 14.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016 (CONTINUED)

### 18. HEDGING RESERVE

	2016 £000	2015 £000
Cross currency swaps	509	442
	509	442

The hedging reserve represents the cumulative effective portion of gains and losses arising on changes in fair value of hedging instruments entered into for cash flow hedges. The cumulative gain or loss arising on changes in fair value of the hedging instruments that are recognised and accumulated under the heading of hedging reserve will be reclassified to profit or loss only when the hedged transaction affects the profit or loss, or included as a basis adjustment to the non-financial hedged item, consistent with the Company's accounting policy.

### 19. RELATED PARTY TRANSACTIONS

During the year, the Company entered into the following transactions with related parties:

	Interest expense		Interest income		Cash and cash equivalents		Amounts due from / (to) related parties	
	2016 £000	2015 £000	2016 £000	2015 £000	2016 £000	2015 £000	2016 £000	2015 £000
Santander UK plc	16,329	29,370	1	1	530	84	(1,586)	(5,902)
Holmes Funding Limited	-	-	77,492	123,207	-	-	3,214,526	5,697,135
Holmes Holdings Limited	-	-	-	-	-	-	37	37

The following derivative balances were held with related party Abbey National Treasury Services plc:

	2016 £000	2015 £000
Derivative financial instruments – assets	380,890	112,490
Derivative financial instruments – liabilities	-	(90,883)
SWAP interest income / (expense)	17,813	(2,813)

In addition to the above, fees receivable from Holmes Funding Limited were £120,000 (2015: £120,000) and accrued interest receivable from Holmes Funding Limited was £11,348,000 (2015: £22,835,000).

There were no related party transactions during the year, or existing at the balance sheet date, with the Company's or parent company's key management personnel.

### 20. CAPITAL MANAGEMENT AND RESOURCES

Santander UK plc adopts a centralised capital management approach, based on an assessment of both regulatory requirements and the economic capital impacts of businesses in the Santander UK group. Disclosures relating to the Company's capital management can be found in the Santander UK Annual Report and Financial Statements.

Capital held by the Company and managed centrally as part of Santander UK plc, comprises share capital and reserves which can be found in the Balance Sheet on page 8. The Company's capital is not externally regulated.

Capital is managed by way of processes set up at inception of the Company and subsequently there is no active process for managing its own capital. The Company is designed to hold minimum reserves once all amounts due on the related party loans have been received and amounts owing, including deferred consideration, have been paid.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2016 (CONTINUED)

### 21. PARENT UNDERTAKING AND CONTROLLING PARTY

The Company's immediate parent company is Holmes Holdings Limited. Wilmington Trust SP Services (London) Limited, a company incorporated in Great Britain and registered in England and Wales, holds the entire share capital of Holmes Holdings Limited as trustee under a discretionary charitable trust, dated 17 February 1999, for the benefit of certain charities.

The administration, operations, accounting and financial reporting functions of the Company are performed by Santander UK plc, which is incorporated in Great Britain and registered in England and Wales.

Santander UK plc has been delegated administration and servicing functions in respect of the loans on behalf of the mortgages' trustee and the beneficiary as the service providers.

The Company is a Special Purpose Entity controlled by Santander UK plc and is therefore consolidated within the Santander UK Group Holdings plc group financial statements.

The Company's ultimate controlling party is Banco Santander SA, a company registered in Spain. Banco Santander SA is the parent undertaking of the largest group of undertakings for which group financial statements are drawn up and of which the Company is a member. Santander UK plc is the parent undertaking of the smallest group of undertakings for which the group financial statements are drawn up and of which the Company is a member.

Copies of all sets of group financial statements, which include the results of the Company, are available from Secretariat, Santander UK plc, 2 Triton Square, Regent's Place, London NW1 3AN.