

Marks and Spencer Financial Services Plc

Registered No: 1772585

Annual Report and Financial Statements for the year
ended 31 December 2019



Annual Report and Financial Statements for the year ended 31 December 2019

Contents

| | Page |
|---|-------------|
| Strategic Report | 1 |
| Report of the Directors | 6 |
| Independent auditors' report to the members of Marks and Spencer Financial Services Plc | 9 |
| Income statement | 16 |
| Statement of comprehensive income | 17 |
| Balance sheet | 18 |
| Statement of cash flows | 19 |
| Statement of changes in equity | 20 |
| Notes on the financial statements | 21 |

Strategic Report

Principal activities

Marks and Spencer Financial Services Plc ('the Entity') is a private company incorporated in England and Wales. Its trading address is Kings Meadow, Chester Business Park, Chester CH99 9FB. The Entity is limited by shares.

Marks and Spencer Financial Services Plc, trading as M&S Bank, is an authorised bank under the Financial Services and Markets Act 2000, authorised by the Prudential Regulation Authority ('PRA') and regulated by the Financial Conduct Authority ('FCA'). The Entity's principal activity is the provision of retail banking financial services to both Marks and Spencer plc (M&S plc) and non M&S plc customers.

The main products provided by the Entity are credit cards, unsecured personal loans, mortgages, general insurance, savings accounts, travel money, no monthly fee current accounts and fee based premium club and premium current account products.

A relationship agreement is in place with M&S plc which provides financial incentives to M&S plc for ongoing profitable development of the entity.

Review of the Entity's business

The Entity continues to show a profitable adjusted business performance against a backdrop of increasing regulatory and compliance requirements.

During 2019, the Entity recorded a loss due to high levels of customer remediation. The entity continued to deliver on its strategy of developing its product and service propositions, whilst maintaining a sound cost efficiency ratio.

The strategy was delivered by:

- Continuing to drive acquisition in our core product operating lines (e.g. credit card, personal loans, current account, mortgages, general insurance and travel money).
- Continued development of distribution channels (in store and on-line), including launch of a Click & Collect service for the purchase of travel money which is being expanded out to 117 stores by the end of Q1 2020.
- Providing high levels of service across all operations.
- Improving efficiency of processes and well controlled operating costs.
- Further development of digital banking capability to improve efficiency and customer experience. The card account opening process has been streamlined during 2019 and the number of digitally registered customers has continued to increase.

The Customer Recommendation Index (CRI) is a key customer metric, specifically in the current account market, where we were ranked 2nd/3rd in our competitor set for the majority of the year.

The entity continues to work closely with M&S plc to develop and drive forward an aligned strategy, leveraging the strengths and capabilities of both businesses.

Performance

The Entity's results for the year under review are as detailed in the income statement shown on page 16 of these financial statements.

The table below illustrates the differences in actual loss before tax to adjusted profit.

| | 2019 | 2018 |
|---|-------------|-----------|
| | £m | £m |
| (Loss)/profit before tax | (86) | 45 |
| PPI Remediation | 212 | 63 |
| NOSIA Remediation | 13 | — |
| Skilled person review Remediation | 15 | — |
| Profit Share impact of additional remediation | (78) | (23) |
| Adjusted profit | 76 | 85 |

The Entity reported a loss before tax for the year in 2019 of £86m compared with a profit of £45m in 2018.

The year on year movement reflects a £42m increase in net operating income before impairment charges, a £20m increase in loan impairment charge and a £153m increase in operating expenses. The increase in operating income reflects an increase in profit share recoverable from M&S plc (comparable to prior year) as a result of the increased PPI remediation charge recognised in 2019 within operating expenses. This is offset by lower interest income due to the impact of customer remediation. The customer remediation arises from a failure to send Notice of Sums in Arrears (NOSIA) letters and from customer detriment identified following a Skilled Person review of HSBC Collections and Recoveries activities, with a proportion of the remediation requiring refund of interest and fees.

The business generated an adjusted profit of £76m (2018 : £85m), excluding the impact of customer remediation programmes (note 22).

Adjusted operating income (adjusted for the impact of customer remediation) was £6m higher compared with 2018, with lower card and general insurance income offset by higher personal loan income and lower profit share payable to M&S plc. The lower cards income reflects updated estimates of future revenue likely to be generated from customers identified as in persistent debt who must now be offered solutions to rehabilitate their account.

Marks and Spencer Financial Services Plc

The lower general insurance income reflects the non-recurrence of one off items reported in 2018 and lower new business volumes and margins. Higher loan income reflects higher drawdowns and balance growth achieved during the year as a result of competitively priced offers.

The movement in profit share reflects the impact of the lower adjusted business performance, mainly driven by higher loan impairment charges.

The £20m higher loan impairment charge reflects higher expected credit losses for both cards and loans. This is driven by loan balance growth and adjusted performance of the portfolios, in particular updated Probability of Default and Loss Given Default parameters, offset by a favourable movement in the UK Economic Uncertainty adjustment compared to 2018. Adjusted operating expenses (adjusted for the impact of customer remediation) are £5m favourable compared with prior year, reflecting efficiency savings and release of aged accruals no longer expected to be required.

During 2019, the Entity issued an aggregate £167m of ordinary shares, £9m additional tier 1 instruments, and £16m tier 2 instruments. The capital injections were to replace capital used to fund reportable losses during the year and to strengthen the regulatory capital base in order to support lending growth. The ordinary shares and capital instruments were issued to HSBC UK Bank plc.

Key performance indicators

The Directors use Key Performance Indicators (KPIs) to monitor the business. As well as the income statement and the balance sheet, these indicators include measures to identify the returns on different categories of assets and the risks to which the Entity is exposed.

Financial KPIs

| | 2019 | 2018 |
|---|-----------|-----------|
| (Loss)/Profit Before Tax | (85,901) | 45,020 |
| Adjusted profit before tax (£'000) | 76,256 | 84,961 |
| Total risk-weighted assets (£'000) | 3,025,192 | 2,503,277 |
| Pre-tax return on risk-weighted assets (%) | 2.7 | 3.5 |
| Common equity tier 1 (%) | 12.3 | 11.3 |
| Cost efficiency ratio (%) | 48.0 | 50.0 |
| Return on tangible equity (Adjusted) (%) | 16.3 | 22.0 |
| Ratio of customer advances to customer deposits (%) | 194.9 | 167.7 |

Pre-tax return on average risk-weighted assets is measured as adjusted pre-tax profit divided by average risk-weighted assets.

Adjusted profit and adjusted operating expenses exclude customer remediation.

Common equity tier 1 capital comprises shareholders' equity less regulatory deductions and adjustments. The Entity seeks to maintain a strong capital base to support the development of its business and meet regulatory capital requirements at all times.

Cost efficiency is measured as total adjusted operating expenses divided by adjusted operating income before loan impairment and other credit risk provisions.

Return on tangible equity (RoTE) is defined as the adjusted profit attributable to ordinary shareholders, adjusted for Additional Tier 1 coupons, divided by average ordinary shareholders' equity, adjusted for other intangibles. The fall year on year reflects its higher average capital in force and lower adjusted business performance.

Ratio of customer advances to customer deposits comprises loans and advances to customers as a ratio of the total core customer deposits. This has risen year on year due to asset growth and lower customer liabilities.

Non-financial KPIs monitored include employee engagement which measures employees' emotional and intellectual commitment to the Entity and customer satisfaction.

Significant accounting judgements

The following are the key areas of accounting judgements affecting the Entity:

- Customer Remediation - this is covered in Note 22;
- Effective interest rate - this is covered in Note 14; and
- Loan impairment - this is covered in Note 28.

Key judgements underpinning these have been considered by the Board and Audit and Risk Committee.

Principal risks and uncertainties

An established risk governance framework and ownership structure ensures oversight of, and accountability for, the effective management of risk. The Entity's Audit and Risk Committee is a committee of the Board and focuses on risk governance and provides a forward looking view of risks and their mitigation. The Audit and Risk Committee meets four times a year and, as well as having oversight of the risk function, also oversees the assurance activities of both internal and external audit.

In carrying out its responsibilities the Audit and Risk Committee is closely supported by the Chief Risk Officer, the Chief Financial Officer, the Head of Internal Audit and Compliance, together with other business functions on risks within their respective areas of responsibility.

Principal financial risks and uncertainties facing the Entity are credit risk, market risk and liquidity risk. These risks, the exposure to such risks and management of risk are set out in Note 28 of the financial statements.

The most important non-financial types of risk are operational risk, conduct and regulatory risk, including financial crime compliance, reputational risk and cyber risk. The Directors have put in place procedures to monitor and manage these risks.

Operational risk is relevant to every aspect of the Entity's business and covers a wide spectrum of issues. Losses arising from fraud, unauthorised activities, errors, omission, inefficiency, systems failure or from external events all fall within the definition of operational risk. The objective of the Entity's operational risk management is to manage and control operational risk in a cost effective manner within targeted levels of operational risk consistent with the Entity's risk appetite, as proposed by the Risk Management Committee set by the Board.

Top and Emerging Risks

Information Security and Cyber Crime

The entity and other organisations continue to operate in an increasingly hostile cyber threat environment, which requires ongoing investment in business and technical controls to defend against these threats. Key threats include unauthorised access to online customers, advanced malware attacks and distributed denial of service attacks. We continually evaluate threat levels for the most prevalent attack types and their potential outcomes. To further protect the Entity and our customers we strengthened our controls to reduce the likelihood and impact of advanced malware, data leakage, infiltration of payment systems and denial of service attacks. We continued to enhance our cybersecurity capabilities, including threat detection, access control as well as back-up and recovery. An important part of our defence strategy is ensuring our people remain aware of cybersecurity issues and know how to report incidents.

Financial Crime and Fraud Risk

Throughout 2019, the entity continued to implement the final elements of the Global Standards programme to integrate our anti money laundering and sanctions capabilities into our day-to-day operations. We continue to enhance our financial crime risk management capabilities and the effectiveness of our financial crime controls, with the HSBC Group maintaining its investment in the next generation of tools to fight financial crime through the application of advanced analytics and artificial intelligence.

Conduct and customer detriment

Financial institutions remain under considerable scrutiny regarding conduct of business, particularly in relation to fair outcomes for customers and orderly and transparent operations in financial markets. Regulators, prosecutors, the media and the public all have heightened expectations as to the behaviour and conduct of financial institutions, any shortcomings or failure to demonstrate adequate controls are in place to mitigate such risks could result in regulatory sanctions, fines or an increase in civil litigation.

We have continued to enhance our management of conduct in areas including our governance of product arrangements, the treatment of potentially vulnerable customers and encouragement of a 'Speak Up' culture and management of related third party risks.

People Risk

Our colleagues are critical to our success and it is important that we identify, manage and mitigate any risks that might have an impact on our colleagues feeling empowered and able to thrive in their careers, as well as being able to support our customers and the communities they serve. We aim to foster a culture that proactively promotes the right colleague behaviours and conduct and that we have the right number of people with the right skills, knowledge and capabilities to be able to do the right thing for customers.

We continue to increase our focus on resource planning and employee retention to ensure we mitigate any risks around capacity and capability, as well as equipping line managers with the skills to both manage change and support their colleagues to ensure we engender a strong positive culture.

We have processes in place to identify where behaviours and conduct give us cause for concern and can mitigate the risk accordingly. HSBC University is focused on the development of our colleagues and supporting our leaders to create an environment for success. This is critical to retaining high-calibre individuals with the values, skills and experience for current and future roles.

Data Management

The Entity uses a large number of systems and applications to support key business processes and operations. As a result, we often need to reconcile multiple data sources, including customer data sources, to reduce the risk of error. We, along with other organisations, also need to meet external/ regulatory obligations such as the General Data Protection Regulation ('GDPR'), Basel Committee for Banking Supervision ('BCBS') 239 and Basel III. We are progressively improving data quality across a large number of systems. Our data management, aggregation and oversight continues to strengthen and enhance the effectiveness of internal systems and processes.

Marks and Spencer Financial Services Plc

Climate Risk

Climate change can impact a number of our risk types, including:

- Transition Risk, arising from the move to a low-carbon economy through policy, regulatory and technological changes.
- Physical Risk, through increasing severity and/or frequency of severe weather events or other climatic events (e.g. sea level rise, flooding).

These have potential to cause both idiosyncratic and systemic risks, resulting, over time, in potential financial impacts for the entity.

Process of UK withdrawal from the European Union

The UK left the EU on 31 January 2020, with a period of transition until 31st December 2020 agreed between the UK and the EU. We will continue to work with regulators, governments, customers and employees to manage the risks resulting from the UK's exit from the EU as they arise. The Entity is a UK based business with no EU passporting requirements and no need for legal entity restructuring. Our existing product offering is to UK resident customers. No significant change is required to our operating model, and the key area of risk is therefore associated with general market risk and the UK economy.

In spite of this significant external uncertainty however, we remain confident in our strategy, and will continue to build on positive progress, and our strong UK foundations, to deliver our ambition of making banking simple, safe and sustainable.

HBUK (including the Entity) is actively monitoring the outbreak of Novel Coronavirus in China and Hong Kong to assess any potential economic impact on our clients, our staff or our businesses. Business continuity plans have been reviewed following the outbreak to ensure the safety and well-being of our staff and customers and to ensure our ability to maintain our business operations is upheld.

Corporate Governance Statement

The Entity is, together with the wider HSBC Group, committed to high standards of corporate governance. The HSBC Group has a comprehensive range of principles, policies and procedures influenced by the UK Corporate Governance Code with requirements in respect of Board independence, composition and effectiveness to ensure that the Group is well managed, with appropriate oversight and control. These governance requirements surpass those of the alternative governance codes, as such the Company did not apply any specific corporate governance code during the financial year.

The Entity performed procedures to align with HSBC's corporate governance principles, policies and procedures.

Section 172 Statement

As set out in section 172 of the Companies Act 2006, the Directors must act in good faith to promote the success of the company for the benefit of its members as a whole. In performing their duty, under the Act, the Board is required to have full regard to: the interests of our employees; the impact of our operations on the community and environment; and the need to foster the Company's business relationships with key stakeholders in order to maintain a reputation for high standards of business conduct and enhance the sustainable long term success of the business.

The Directors are supported in the discharge of their duties by:

- An induction programme and ongoing training to provide an understanding of our business and financial performance and prospects;
- Management who present to Board and Committee meetings ensure that proposals contain all information relevant to determine the action that would most likely promote the success of the bank; and
- Carefully planned agendas for Board and Committee meetings, which provide sufficient time for the consideration and discussion of key matters.

Stakeholder Engagement

Building strong relationships with our stakeholders will help achieve our ambition in line with our purpose and values and promote the long term success of the bank. Our key stakeholders we consider in this regard are the people who work for us, bank with us, own us, supply us and regulate us. Due to the nature of our relationship with them, we also consider Marks and Spencer plc a key stakeholder in this regard.

Employees

We have a structured communications approach that uses leadership communications, campaigns and a regular flow of news to help colleagues to serve our customers better, make sense of our strategy, focus on our commercial priorities and provide clarity on issues. We build a sense of pride and purpose by recognising our colleagues' contributions to our business and celebrating our achievements.

Understanding how our colleagues feel is vital. It helps us ensure that we are giving them the right support to fulfil their potential and do the right thing for our customers. Colleagues are asked for feedback and encouraged to speak up. We continue to test the views of a representative sample of our people on a range of topics via our employee survey, 'Snapshot', which runs twice yearly. Snapshot results are presented to the Executive Committee, the Board, and other relevant committees of the functions. This ensures the attitudes and sentiments of our people inform decision-making at all levels of the business and action can then be taken to tackle areas of concern. Additionally, we also participate in the external Banking Standards Board Annual Assessment, comprising an employee survey and focus groups where our people can also have their say.

Feedback from 'Exchanges' is also an important way of listening to our people; Exchange sessions are safe forum meetings, without agendas, attended by colleagues from across the organisation. They can discuss what matters to them, share views and suggest ideas, while managers and leaders attend to listen. Our insight shows us that where our people participate in Exchange they are generally more positive about their experience with us. They feel better able to speak up, are more trusting of managers and leaders, and report higher levels of wellbeing. We provide the opportunity for people to take part in an Exchange meeting each quarter.

The Chief Executive Officer is actively involved in the engagement of employees through monthly open forums and bi-annual all employee web-casts to keep the workforce up-to-date on business developments and answer submitted questions. The Board

Marks and Spencer Financial Services Plc

receives regular updates from the Chief Executive Officer on employee matters, including feedback received through our regular external and internal employee surveys such as the Banking Standards Board and Snapshot.

Suppliers

The ethical and environmental code of conduct for suppliers of goods and services, which can be found on the HSBC public website, sets out how we work with our suppliers on ethical and environmental performance. The code of conduct for suppliers of goods and services raises conduct requirements related to the economic, environmental and social impacts associated with the supply of goods or services.

Customers

Ensuring customer feedback is actioned and communicated back to our customers has also been a big priority in 2019. Dedicated members of staff have been focussed on contacting customers who either flag issues through our feedback mechanisms to ensure a resolution is found, or who are promoters of the business to thank them for their feedback and to learn from these positive experiences.

HSBC UK

A strong relationship is maintained with HSBC UK through cross-directorships of the Chairman of the Board and one of the non-executive Directors. Matters to escalate to HSBC UK has been added as a standing agenda item to ensure that all key issues are reported to our sole shareholder in a timely manner. In addition to this, the Head of Retail Banking and Wealth Management (RBWM), HSBC UK is a member of the Board to ensure key business decisions are aligned with the HSBC UK strategy.

As a wholly owned subsidiary, we also benefit from certain engagement practices which take place at a HSBC Group level which allows us to have more efficient and effective engagement practices. For details on some of the engagement that takes place with stakeholders at a Group level, please see the HSBC Holdings plc 2019 Annual Report and HSBC Holdings plc Environmental, Social and Governance Update.

Marks and Spencer plc

We value our relationship with M&S plc and take appropriate steps to ensure that they are kept up to date on key business activities and decisions. A committee comprising membership from the Marks and Spencer Financial Services plc and Marks and Spencer plc to oversee the Bank's business and ensure that this is carried out and in accordance with the principles in the Relationship Agreement.

Consideration of Stakeholders in Principal Decisions

The Board delegates authority for day-to-day management of the Bank to the executive team and engages management in setting, approving and overseeing execution of the business strategy and related policies. Management conduct much of the Bank's primary engagement with both internal and external stakeholders, with the outputs of this engagement activity providing critical insight and perspective for the Board when taking decisions or challenging management in respect of decisions made on behalf of the bank.

Depending on the nature of the issue in question the relevance of each stakeholder group may differ. Board decisions will not necessarily result in a positive outcome for all of our stakeholders, but by considering our purpose, vision and values, and having due regard for stakeholder relationships, the Board aims to ensure that its decisions promote the long term success of the bank.

An example of principal decisions taken by the Company during the year include the appointments of Paul Spencer and David Lister as Chief Executive Officer and Chairman respectively. Prior to approving these appointments consideration was given to internal and external requirements such as HSBC UK endorsement and regulatory approval from the PRA. Due to the importance of these appointments, we also engaged with Marks and Spencer plc prior to their formal approval. Significant consideration was also given to the diversity of the Board with overriding consideration being the appointment of persons with requisite skills, knowledge and experience to help the bank meet its strategic objectives and promote the long term success of the Company.

On behalf of the Board



P W Scott
Director

26 February 2020

Kings Meadow
Chester Business Park
Chester CH99 9FB

Report of the Directors

Directors

The Directors of the Entity who were in office during the year and up to the date of signing the financial statements were as follows:

| Name | Appointed | Resigned |
|---------------------|-------------|-------------|
| S Fox | | 31 Jan 2019 |
| P M Spencer | 01 Feb 2019 | |
| J Coyle | | |
| S A Haire | | |
| M Handley | | |
| D M Holt | | 19 Sep 2019 |
| P W Scott | | |
| D Stewart | | |
| A D Van Den Aardweg | | |
| D Lister | 20 Sep 2019 | |

During the year Sue Fox resigned as a Director effective 31 January 2019, and Paul Spencer was appointed as a Director effective 1 February 2019.

The Articles of Association of the Entity provide that in certain circumstances the Directors are entitled to be indemnified out of the assets of the Entity against claims from third parties in respect of certain liabilities arising in connection with the performance of their functions, in accordance with the provisions of the UK Companies Act 2006. Indemnity provisions of this nature have been in place during the financial year but have not been utilised by the Directors. All Directors have the benefit of Directors' and officers' liability insurance.

Dividends

The Directors do not recommend the payment of an ordinary dividend in respect of the year ended 31 December 2019 (2018: Enil). Total distributions of £4.6m in respect of Additional Tier 1 capital were paid during 2019 (2018: £4.6m).

Significant events since the end of the financial year

No significant events affecting the Entity have occurred since the end of the financial year.

Future developments and Current Performance

The Entity will continue to seek to develop its product and service offerings for customers.

No change in the Entity's activities is expected.

Certain information that is required in the report of Directors under the Companies Act has been described in the Strategic Report on page 1.

Going concern basis

The financial statements are prepared on a going concern basis, as the Directors are satisfied that the Entity has the resources to continue in business for the foreseeable future. In making this assessment, the Directors have considered a wide range of information relating to present and future conditions, including future projections of profitability, cash flows and capital resources. This includes the level of funding and capital support expected to be required and to be available from the HSBC Group. The Entity is part of the Domestic Liquidity Sub-group ('Liquidity Group') of HSBC UK Bank plc and therefore part of the internal liquidity control and management structure of HSBC UK Bank plc. The Entity's liquidity position is managed as part of the HSBC Bank UK plc Liquidity Group, under which members agree to provide liquidity support when necessary.

Financial risk management

The financial risk management objectives and policies of the Entity, together with an analysis of the exposure to such risks, as required under Part 1 of Schedule 7 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, are set out in Note 28 of the Notes on the financial statements.

Diversity and inclusion

The Entity is committed to building a culture where individuals are valued, respected and supported; where different ideas, backgrounds, styles and perspectives are actively sought out to create business value; and where career advancement is based on objective criteria. Focus continues on the diversity profile of our workforce to help ensure it is reflective of the communities in which we operate and the customers we serve.

Diversity and Inclusion carries the highest level of executive support, and oversight of our diversity agenda and related activities resides with the Diversity and Inclusion Committee.

Employment of people with a disability

The Entity is committed to providing equal opportunities to employees. The employment of people with a disability is included in this commitment. The recruitment, training, career development and promotion of people with a disability are based on the aptitudes and abilities of the individual. Should employees become disabled during employment with us, efforts are made to continue their employment and, if necessary, appropriate training, reasonable equipment and facilities are provided.

Employment policy

The Entity continues to regard communication with its employees as a key aspect of its policies. Information is given to employees about employment matters and about the financial and economic factors affecting the Entity's performance through management channels, oral communication and by way of attendance at internal seminars and training programmes. Employees are encouraged to discuss operational and strategic issues with their line management and to make suggestions aimed at improving performance. The involvement of employees in the performance of the Entity is further encouraged through a profit participation scheme.

Capital management (audited)

The Entity defines capital as total shareholders' equity. It is the Entity's objective to maintain a strong capital base to support the business strategy and to meet regulatory capital requirements at all times. The PRA as the supervisor of the Entity, sets capital requirements and receives information on the capital adequacy of the Entity. The Entity complied with the PRA's capital adequacy requirements throughout 2019.

The Entity's policy and practice in capital measurement and allocation is underpinned by the Capital Requirements Regulation (CRR) and Capital Requirements Directive ('CRD IV') rules and any national discretions applied by the PRA. CRD IV legislation implemented Basel III in the EU, and in the UK, the 'PRA Rulebook' for CRR firms transposed the various discretions under CRD IV legislation into UK requirements. The Basel III framework is structured around three 'pillars': minimum capital requirements, supervisory review process and market discipline. Basel III also includes a number of capital buffers, including the Capital Conservation Buffer ('CCB'), Countercyclical Capital Buffer ('CCyB'), and other systemic buffers such as the Global/Other Systemically Important Institutions ('G-SII'/'O-SII') buffer.

Pillar 3 of the Basel regulatory framework is related to market discipline and aims to make firms more transparent by requiring them to publish specific details of their risks and capital, and how these are managed. Separate Pillar 3 disclosures are not required for the Entity as the Entity is included in the consolidated Pillar 3 disclosures of HSBC UK Bank plc. These disclosures are published as a separate document on HSBC UK Bank plc's website.

Regulatory capital

The Entity's capital base is divided into three main categories namely common equity tier 1, additional tier 1 and tier 2, depending on the degree of permanency and loss absorbency exhibited.

- Common equity tier 1 capital is the highest quality form of capital, comprising shareholders' equity adjusted for various regulatory deductions. These include deductions of the excess of expected loss amounts calculated under the Internal Ratings Based ('IRB') approach using the firm's own data, over and above the equivalent accounting provision and intangible assets and an IFRS 9 transitional add-back adjustment.
- Additional tier 1 capital comprises non-common equity capital securities which by nature of their terms are eligible for inclusion in the firm's capital base under CRD IV rules.
- Tier 2 comprises subordinated loans and any excess of accounting provision over equivalent IRB expected loss, subject to a cap of 0.6% of risk weighted assets.

Calculation of actual capital

| | 2019 £'000 | 2018 £'000 |
|---|------------------|------------------|
| Tier 1 capital | | |
| Shareholders' equity ¹ | 348,708 | 288,276 |
| Deductions | | |
| - Adjustment for intangible assets | (1,491) | (1,544) |
| - IFRS 9 transitional add-back | 23,227 | 11,836 |
| - Provision deduction | — | (14,667) |
| Common equity tier 1 capital (audited) | 370,444 | 283,901 |
| Issue of additional tier 1 instrument (note 25) | 69,000 | 60,000 |
| Tier 1 capital | 439,444 | 343,901 |
| Tier 2 capital | | |
| Total qualifying tier 2 capital before deductions | | |
| - Collective impairment allowances | 3,663 | 611 |
| - Term subordinated debt (Note 23) | 95,000 | 79,000 |
| Tier 2 capital (audited) | 98,663 | 79,611 |
| Total regulatory capital | 538,107 | 423,512 |
| Risk-weighted assets (Unaudited) | | |
| Credit and counterparty risk | 2,531,342 | 2,021,057 |
| Operational risk | 493,850 | 482,220 |
| Total | 3,025,192 | 2,503,277 |
| Capital ratios (%) (Unaudited) | | |
| Common equity tier 1 ratio | 12.25 | 11.34 |
| Tier 1 ratio | 14.53 | 13.74 |
| Total capital ratio (Unaudited) | 17.79 | 16.92 |

¹ Includes reported loss for 2019

During 2019, the Entity issued an aggregate £167m of ordinary shares, £9m additional tier 1 instruments, and £16m tier 2 instruments. The capital injections were to replace capital lost as a result of reportable losses during the year and to strengthen its

Marks and Spencer Financial Services Plc

regulatory capital base in order to support lending growth. The ordinary shares and capital instruments were issued to HSBC UK Bank plc.

Independent auditors

PricewaterhouseCoopers LLP ('PwC') is external auditor to the Entity. PwC has expressed its willingness to continue in office and the Board recommends that PwC be re-appointed as the Entity's auditor.

Directors' responsibility statement

The following statement, which should be read in conjunction with the auditor's statement of their responsibilities set out in their report on the next page, is made with a view to distinguish the respective responsibilities of the Directors and of the auditors in relation to the financial statements.

The Directors are responsible for preparing the *Annual Report and 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 International Financial Reporting Standards ('IFRSs') as adopted by the European Union ('EU').

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 Entity and of the profit or loss of the Entity 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 IFRS, as adopted by the EU have been followed, subject to any material departure disclosed and explained in the financial statements;
- make judgements and estimates that are reasonable and prudent; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the entity will continue in business.

The directors are also responsible for safeguarding the assets of the entity and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the entity's transactions and disclose with reasonable accuracy at any time the financial position of the entity 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 entity's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Directors' confirmations

The directors consider that the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the entity's position and performance, business model and strategy.

The Directors have responsibility for ensuring that sufficient accounting records are kept that disclose with reasonable accuracy at any time the financial position of the Entity and enable them to ensure that its financial statements comply with the Companies Act 2006. They are responsible for safeguarding the assets of the Entity and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Disclosure of Information to Auditors

In accordance with section 418 of the Companies Act 2006, the Directors' report includes a statement, in the case of each Director in office as at the date the Report of the Directors is approved, that:

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

On behalf of the Board



P W Scott
Director
26 February 2020

Kings Meadow
Chester Business Park
Chester CH99 9FB

Independent auditors' report to the members of Marks and Spencer Financial Services Plc

Report on the audit of the financial statements

Opinion

In our opinion, Marks and Spencer Financial Services Plc's financial statements:

- give a true and fair view of the state of the company's affairs as at 31 December 2019 and of its loss 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.

We have audited the financial statements, included within the Annual Report and Financial Statements (the "Annual Report"), which comprise: the balance sheet as at 31 December 2019; the income statement, the statement of comprehensive income, the statement of cash flows, 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 Audit and Risk 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

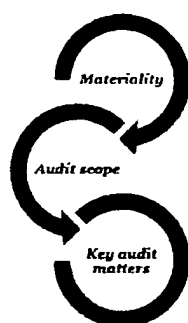
We remained independent of the company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to public interest entities, and we have fulfilled our other ethical responsibilities in accordance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

Other than those disclosed in note 7 to the financial statements, we have provided no non-audit services to the company in the period from 1 January 2019 to 31 December 2019.

Our audit approach

Overview



- Overall materiality: £5 million (2018: £5.9 million), based on 5% of average three year adjusted profit before tax.
- The majority of the accounting and financial reporting function is based at the company's principal office in Chester. The company's ultimate parent is HSBC Holdings plc. Certain control activities and processes are performed by other operating companies within the HSBC Group and some at shared service centres (for example, payroll processing). Therefore, certain audit procedures were performed by PwC teams in the relevant locations. This work was summarised in a Memorandum of Work Performed. We reviewed the Memorandum of Work Performed, and determined that the procedures performed were appropriate and therefore concluded that we could place reliance on the work performed by other PwC teams.

The following items were identified as key audit matters for the company:

- Recognition of revenue under Effective interest rate (EIR) accounting.
- Expected credit loss provisions for loans and advances to customers.
- Customer Redress - Payment Protection Insurance ('PPI').
- Provisions for conduct related matters other than PPI.
- IT access management.

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. In particular, we looked at where the directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain.

Capability of the audit in detecting irregularities, including fraud

Based on our understanding of the company and industry, we identified that the principal risks of non-compliance with laws and regulations include, but are not limited to, the Financial Conduct Authority's regulations, the Prudential Regulation Authority's regulations and the UK tax legislation. We considered the extent to which non-compliance might have a material effect on the

Marks and Spencer Financial Services Plc

financial statements. We also considered those laws and regulations that have a direct impact on the preparation of 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 posting inappropriate journal entries to increase revenue or reduce expenditure, and management bias in accounting estimates. Our audit procedures included challenging assumptions and judgements made by management in their significant accounting estimates, in particular in relation to the expected credit loss provisions of loans and advances to customers, EIR accounting, provisioning for PPI and other conduct related matters (see related key audit matters), and identifying and testing journal entries, in particular any journal entries posted with unusual account combinations or posted by senior management. Audit procedures performed by the engagement team included review of the financial statement disclosures to underlying supporting documentation, review of correspondence with and reports to the regulators, review of correspondence with legal advisors, enquiries of management, enquiries of legal counsel and review of internal audit reports in so far as they related to the financial statements.

There are inherent limitations in the audit procedures described above and the further removed non-compliance with laws and regulations is from the events and transactions reflected in the financial statements, the less likely we would become aware of it. 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.

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.

| Recognition of revenue under effective interest rate (EIR) accounting | Matters discussed with the Audit and Risk Committee |
|--|---|
| <p>Loans and advances to customers are recognised at amortised cost, and interest income recognised using the Effective Interest Rate (EIR) method. The majority of the Entity's interest income is calculated by automated systems and requires little or no management judgement. Therefore we have focused our work in relation to recognition of revenue under EIR accounting and specifically credit cards.</p> <p>EIR accounting is inherently subjective as it requires management to predict customer behaviour into the future, over the expected life of the products on which the EIR adjustment calculation is based. Changes in the key estimates and judgments could have a material impact on the EIR adjustments and hence the revenue recognised in any one accounting period.</p> <p>For credit cards there are significant judgments in calculating the EIR adjustment including setting estimates relating to the retention of customer balances over the expected life, the proportion that remain active following the end of the promotional period and the related interest income earned on those balances.</p> <p>Management has estimated the impact persistent debt regulations will have on customer behaviour and therefore on the accrued interest balance. This included assessing the proportion of customers who will take up each of the options offered by the bank, including increasing credit card repayments or switching to alternative products and considering those who may have cards suspended.</p> <p>See Notes 1.2.(e), 14 for the relevant disclosures including critical accounting estimate, accounting policies and analysis of effective interest rate.</p> | <p>Discussions with the Audit and Risk Committee focused on the key judgements and estimates including the level of expected customer balances and interest yield on significant promotional offers, the retention of balances after the end of the promotional period, and consideration as to how the entity's historic experience is consistent with that expected in the future.</p> <p>We also discussed key products where deviation from expected customer behaviour in the year has resulted in revenue adjustments taken.</p> <p>We discussed the impact on key estimates and judgements applied in response to the FCA's proposed changes to rules impacting customers in persistent debt.</p> <p>We also discussed the results of our audit work including testing of management controls, substantive testing and application of accounting standards</p> |

Procedures performed to support our discussions and conclusions

- Tested the controls over data input and checked the accuracy of model calculations.
- Observed management's governance meetings for the setting, challenge and approval of key estimates, including monitoring of actual trends compared to forecast estimates.
- Tested the governance over product pricing models and the use of that output to support the determination of EIR at origination.
- Tested the appropriateness of models used by management in EIR calculations and critically assessed and challenged the appropriateness of the key estimates, including expected life of customer accounts and assessing whether the use of customer balance and yield curves based on historic data were appropriately reflective of current behaviour and an appropriate indicator of the future.
- Performed sensitivity analyses of key estimates to understand the materiality of the impact that potential realistic changes in estimates may have, either individually or in combination, on the EIR asset.
- Performed testing over the adjustments taken to revenue during the year as a result of persistent debt regulations, considering the appropriateness of estimates made around the contact programme, customer responsiveness and resulting actions, and the completeness of the populations identified.
- Assessed the sufficiency of the disclosures in the financial statements relating to significant estimates made in the EIR calculation, including disclosure of sensitivities.

Expected credit loss provision for loans and advances to customers

The ECL provision for loans and advances to customers has a significant number of data inputs for all the retail portfolios, with material ECL arising on the credit card and personal loans portfolios.

In addition to the data inputs a number of key judgments are used to estimate the ECL provision, in particular the severity and likelihood of alternative downside economic scenarios that form part of the forward economic guidance and their impact on ECL.

Other key estimates include the determination of probabilities of default and loss rates, and their impact on the determination of significant increases in credit risk; and the appropriateness of post model adjustments made to reflect model and data limitations.

Whilst the credit environment has remained largely benign as a result of low interest rates and low unemployment, broader economic risks such as the impact of the UK departure from the EU remain which increase the estimation uncertainty in the ECL.

See Notes 1.2.(f), 28 for the relevant disclosures including critical accounting estimate, accounting policies and analysis of the impairment of loans and advances to customers.

Matters discussed with the Audit and Risk Committee

We discussed with the Audit and Risk Committee the changes to risk factors and other inputs within the models, such as the UK's planned and actual departure from the EU.

We discussed the more judgmental decisions made by management, in particular the application of forward economic guidance, including the severity and likelihood of alternative downside economic scenarios that form part of the forward economic guidance and their impact on ECL; and the threshold criteria for measurement of significant increase in credit risk; and consideration of required post model adjustments, including the impact of model and data limitations.

We discussed the observations made by our credit risk modelling experts with regard to the models and our assessment of the judgments applied by management within the modelling.

We also discussed how the control environment over the calculation of ECL evolved following initial adoption, reporting on areas of improvement and the results of our testing.

No material misstatements have been identified from our work.

Procedures performed to support our discussions and conclusions

- Tested model performance monitoring and validation controls, including periodic policy and independent model reviews and back testing of model performance and approval of model changes.
- Performed risk based substantive testing on models that we updated during the year, including independently rebuilding the modelling for certain estimates.
- Controls over the inputs of critical data into source system and the flow and transformation of data between source systems to the impairment calculation engine were tested. Substantive testing was performed over the critical data used in the year end ECL calculation.
- Tested controls over the inputs of critical data into source system and the flow and transformation of data between source systems to the impairment calculation engine. Substantive testing was performed over the critical data used in the year end ECL calculation.
- Tested the review and challenge of multiple economic scenarios by an expert panel and internal governance committee, and assessed the reasonableness and likelihood of these scenarios using our economic experts. Relevant economic, political and other events were considered in assessing the reasonableness of alternative downside scenarios. The severity and magnitude of the scenarios were compared to external forecasts and data from historical economic downturns, and the sensitivities of the scenarios on the ECL were considered.
- Observed management's review and challenge forums to assess the ECL output and approval of post model adjustments.

Marks and Spencer Financial Services Plc

| Customer Redress - Payment Protection Insurance ('PPI') | Matters discussed with the Audit and Risk Committee |
|---|--|
| <p>The provision for customer redress in respect of PPI incorporates a number of estimates that are highly judgemental.</p> <p>A high volume of information requests and complaints were received in the run up to the time bar on the 29 August 2019. As a result of the volumes received a significant number are yet to be assessed for mis-selling.</p> <p>The validity rate applied to the information requests and the average redress for these cases including those in respect of the complaints brought by the Official Receiver are the key estimates underlying the provision. The validity rate leads to the assessment of volumes of complaints yet to be worked.</p> <p>An estimate has also been made in relation to potential future legal claims where volumes are difficult to predict.</p> <p>See Notes 1.2.(a), 22 for the relevant disclosures including critical accounting estimate, accounting policies and analysis provisions for customer redress (PPI).</p> | <p>We discussed with the Audit and Risk Committee the appropriateness of applying historic validity rates and average redress to the remaining information requests.</p> <p>We discussed the adequacy of provisions for matters not impacted by timebar, including Official Receiver complaints and legal claims.</p> <p>We discussed the results of our controls and substantive testing. We also discussed alternative scenarios and the range of sensitivity in concluding on the adequacy of the provision held.</p> |
| Procedures performed to support our discussions and conclusions | |
| <ul style="list-style-type: none"> Evaluated the design and tested the operating effectiveness of key controls over the process of capturing key data used in the PPI provision calculation model. Examined the modelling process around the PPI provision calculation. We tested historical validity rates and redress amounts with worked cases and assessed whether the estimates underpinning the provision calculations, including future trends expected in respect of these inputs, were appropriate. Tested historic data relating to the number of legal claims received and assessed whether the estimates and judgements relating to future volumes were appropriate. Considered the sensitivity of the provision to possible variations in estimates. This could result in different amounts for some provisions to those calculated however these differences were within a reasonable range of outcomes. Evaluated whether the disclosures within the financial statements appropriately address the significant uncertainties that exist around determining the provisions and the sensitivity of the provisions to changes in the underlying estimates by comparing to the output of our audit work. | |
| Provision for conduct related matters other than PPI | Matters discussed with the Audit and Risk Committee |
| <p>A number of deficiencies have been identified in the Bank's internal processes that have resulted in customer detriment. The provision for these matters reflects the expected cost of repayment of historic fees and interest, distress and inconvenience payments and related operational remediation activities.</p> <p>Management grouped customers into cohorts based on the nature of the matter. The volume of customers impacted and expected redress amounts to be paid are the key estimates underlying the provision.</p> <p>Few customer redress payments have been made to date and the population of impacted customers is still being identified. The data available to support these estimates is limited, making them highly subjective.</p> <p>See Note 1.2.(a), 22 for the relevant disclosures including critical accounting estimate, accounting policies and analysis of provision for conduct related matters (other than PPI).</p> | <p>We discussed with the Audit and Risk Committee the process performed by management to estimate the impacted populations. We also discussed the estimates used in determining the expected redress for each cohort.</p> <p>We discussed the results of our controls and substantive testing. We also discussed alternative scenarios and the range of sensitivity in concluding on the adequacy of the provision held.</p> <p>No material misstatements have been identified from our work.</p> |
| Procedures performed to support our discussions and conclusions | |
| <ul style="list-style-type: none"> Evaluated the design and tested the operating effectiveness of key controls over key inputs to the calculated provision. Assessed the nature of process deficiencies and their consistency with cohorts of impacted customers identified by management. Evaluated the completeness of impacted cohorts identified by management. Examined the appropriateness of the provisioning model and underlying estimates used. We tested the appropriateness of customer populations identified for each cohort and the estimated redress per customer. Considered the sensitivity of the provision to possible changes in outcome. Considered the different amounts calculated to be within a reasonable range of outcomes. | |

Marks and Spencer Financial Services Plc

- Evaluated whether the disclosures within the financial statements appropriately address the uncertainties inherent to determining the provision and the sensitivity of the provision to changes in key estimates by comparing to the output of our audit work.

| Information technology ('IT') Access Management | Matters discussed with the Audit and Risk Committee |
|--|---|
| <p>Our audit approach relies extensively on automated controls and therefore on the effectiveness of controls over IT systems.</p> <p>In previous years, we identified and reported that controls over access to applications, operating systems and data in the financial reporting process required improvements. Access management controls are critical to ensure that changes to applications and underlying data are made in an appropriate manner. Appropriate access and change controls contribute to mitigating the risk of potential fraud or errors as a result of changes to applications and data. Management implemented remediation activities that have contributed to progress being made in reducing the risk over access management in the financial reporting process. Controls continue to require some improvement going forward.</p> | <p>The significance of IT controls to our audit and the status of the remediation was discussed at the Audit Committee meetings during the year.</p> <p>No material misstatements have been identified from our work.</p> |

Procedures performed to support our discussions and conclusions

- Tested access rights over applications, operating systems and databases relied upon for financial reporting. Specifically, the audit tested that:
 - new access requests for joiners were properly reviewed and authorised.
 - user access rights were removed on a timely basis when an individual left or moved role.
 - access rights to applications, operating systems and databases were periodically monitored for appropriateness.
 - highly privileged access was restricted to appropriate personnel.
- Other areas that were independently assessed included: password policies; security configurations; controls over changes to code, data and configuration; and that the ability to make such change via privileged operating system or databases access in the production environment was appropriately restricted.
- Where control deficiencies were identified, a range of additional procedures were performed:
 - where access outside of policy was identified, we understood the nature of the access, and, where required, obtained additional evidence on whether that access had been exploited.
 - testing of remediated controls to manage the monitoring of business access, including access that would allow a user to potentially override segregations of duty; and
 - substantive testing of whether user inappropriately hold access to key functionality underpinning financial reporting process, specific year-end reconciliations (i.e. custodian, bank account and suspense account reconciliations) and confirmation with external counterparties.

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 planning stage we updated our understanding of the entity and its environment, considering the company's operations, ownership and governance structures, accounting framework, selection of accounting policies and the company's objectives and strategies. We updated our understanding of the internal control environment, including in relation to IT. Industry level factors were also considered, including applicable laws and regulations.

Based on these initial audit planning procedures, we performed our risk assessment at the account balance and assertion level, considering risks of material misstatement through fraud or error.

The scope of our audit and the nature, timing and extent of our audit procedures were designed, planned and executed with consideration of our risk assessment, the financial significance of account balances, and other qualitative factors (e.g. history of error or misstatements). We performed audit procedures over all account balances and disclosures which we considered to be material and/or represent a risk of material misstatement to the financial statements.

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:

Marks and Spencer Financial Services Plc

| | |
|---------------------------------|---|
| Overall materiality | £5 million (2018: 5.9 million). |
| How we determined it | 5% of average three year adjusted profit before tax. |
| Rationale for benchmark applied | Adjusted profit before tax is the primary measure used by the company and the shareholder in assessing the performance of the company and removes the impact of significant items that distort the underlying results. Costs relating to customer redress programmes (such as PPI and other conduct related matters) are large, one-off items unrelated to the underlying performance of the company. The impact of the profit share is also adjusted. We considered a three year average of this adjusted benchmark due to relative volatility in the underlying results and this being considered to give a more representative position of underlying performance. |

We agreed with the Audit and Risk Committee that we would report to them misstatements identified during our audit above £250,000 (2018: £295,000) as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

Conclusions relating to going concern

ISAs (UK) require us to report to you when:

- the directors' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate; or
- the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

We have nothing to report in respect to the above matters.

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the company's ability to continue as a going concern. For example, the terms of the United Kingdom's withdrawal from the European Union are not clear, and it is difficult to evaluate all of the potential implications on the company's trade, customers, suppliers and the wider economy.

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 Report of the Directors, we also considered whether the disclosures required by the UK Companies Act 2006 have been included.

Based on the responsibilities described above and our work undertaken in the course of the audit, ISAs (UK) require us also to report certain opinions and matters as described below.

Strategic Report and Report of the Directors

In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic Report and Report of the Directors for the year ended 31 December 2019 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 Report of the Directors.

Responsibilities for the financial statements and the audit

Responsibilities of the directors for the financial statements

As explained more fully in the Directors' Responsibility Statement in respect of the financial statements set out on page 8, 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.

Marks and Spencer Financial Services Plc

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.

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

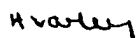
Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received 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 Audit and Risk Committee, we were appointed by the directors on 17 March 2015 to audit the financial statements for the year ended 31 December 2015 and subsequent financial periods. The period of total uninterrupted engagement is 5 years, covering the years ended 31 December 2015 to 31 December 2019.



Heather Varley (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Manchester
26 February 2020

Financial statements

Income statement for the year ended 31 December 2019

| | Notes | 2019 £'000 | 2018 £'000 |
|---|-------|------------------|------------------|
| Interest income | | 252,503 | 270,652 |
| Interest expense | | (47,638) | (42,059) |
| Net interest income | 2 | 204,865 | 228,593 |
| Fee and commission income | | 105,463 | 108,921 |
| Fee and commission expense | | (35,686) | (40,841) |
| Net fee income | 2 | 69,777 | 68,080 |
| Gains less losses from financial investments | | 53 | 1,788 |
| Other operating income ¹ | 3 | 66,265 | 426 |
| Net operating income before change in expected credit losses and other credit impairment charges | | 340,960 | 298,887 |
| Change in expected credit losses and other credit impairment charges | 2 | (70,289) | (50,137) |
| Net operating income | | 270,671 | 248,750 |
| Employee compensation and benefits | 4 | (45,865) | (46,135) |
| General and administrative expenses | 2 | (305,682) | (156,587) |
| Depreciation of property, plant and equipment | 16 | (737) | (706) |
| Amortisation of intangible assets | 17 | (330) | (302) |
| Depreciation of right-of-use assets ² | 27 | (3,958) | — |
| Total operating expenses¹ | | (356,572) | (203,730) |
| Operating (loss)/profit | | (85,901) | 45,020 |
| (Loss)/profit before tax | | (85,901) | 45,020 |
| Tax expense | 8 | (32,659) | (25,877) |
| (Loss)/profit for the year | | (118,560) | 19,043 |

¹ M&S plc profit share has been re-classified from Operating Expenses in 2018 (£0.9m) to Other Operating Income in 2019 (£66m) due to the nature of it being an intermediation fee between M&S plc and the Entity.

² Right-of-use assets have been recognised from January 2019 following the adoption of IFRS16. Comparatives have not been re-stated (see note 27).

Statement of comprehensive income for the year ended 31 December 2019

| | 2019 | 2018 |
|---|------------------|---------------|
| | £'000 | £'000 |
| (Loss)/profit for the year | (118,560) | 19,043 |
| Other comprehensive income | | |
| Items that will be reclassified subsequently to profit and loss when specific conditions are met: | | |
| Available-for-sale investments | | |
| - fair value gains | | |
| - income taxes | | |
| Other comprehensive income for the year, net of tax | | |
| Total comprehensive (expense)/income for the year | (118,560) | 19,043 |

All operations are continuing. There has been no comprehensive income or expense other than the (loss)/profit for the year as shown above (2018: nil).

Marks and Spencer Financial Services Plc

Balance sheet at 31 December 2019

Registered No: 1772585

| | | 2019 | 2018 |
|--|-------|------------------|------------------|
| | Note: | £'000 | £'000 |
| Assets | | | |
| Cash and balances at central banks | | 9,361 | 10,211 |
| Items in the course of collection from other banks | | 7,704 | 30,246 |
| Loans and advances to banks | 13 | 1,700,247 | 1,691,726 |
| Loans and advances to customers | 14 | 4,138,465 | 3,773,913 |
| Prepayments and accrued income | | 3,858 | 1,449 |
| Other assets ² | 18 | 135,602 | 44,578 |
| Property, plant and equipment | 16 | 1,546 | 1,601 |
| Right-of-use assets ¹ | 27 | 19,201 | — |
| Intangible assets | 17 | 1,491 | 1,544 |
| Deferred tax assets | 9 | 12,528 | 14,634 |
| Total assets | | 6,030,003 | 5,569,902 |
| Liabilities and equity | | | |
| Liabilities | | | |
| Deposits by banks | 19 | 3,055,000 | 2,627,092 |
| Customer accounts | 20 | 2,123,314 | 2,250,232 |
| Items in the course of transmission to other banks | | 6,589 | 2,660 |
| Accruals, deferred income and other liabilities ¹ | 21 | 105,617 | 107,232 |
| Current tax liabilities | | 31,066 | 24,244 |
| Provisions | 22 | 195,507 | 114,800 |
| Subordinated liabilities | 23 | 95,202 | 79,196 |
| Total liabilities | | 5,612,295 | 5,205,456 |
| Equity | | | |
| Called up share capital | 25 | 260,000 | 93,000 |
| Other equity instruments | 25 | 69,000 | 60,000 |
| Retained earnings | | 88,708 | 211,446 |
| Total equity | | 417,708 | 364,446 |
| Total liabilities and equity | | 6,030,003 | 5,569,902 |

1. Right-of-use assets have been recognised from January 2019 following the adoption of IFRS16. Comparatives have not been re-stated (see note 27).

2. Amounts due from M&S plc will be recovered in line with the relationship agreement, through offsetting future profit share charges as profits are earned

The accompanying notes on pages 21 to 58 form an integral part of these financial statements.

These financial statements were approved by the Board of Directors on 26 February 2020 and signed on its behalf by:



P W Scott
Director

Statement of cash flows for the year ended 31 December 2019

| | | 2019 | 2018 |
|---|-------|------------------|------------------|
| | Notes | £'000 | £'000 |
| Cash flows from operating activities | | | |
| (Loss)/profit before tax | | (85,901) | 45,020 |
| Adjustments for: | | | |
| Non-cash items included in profit before tax | 10 | 132,426 | (80,858) |
| Change in operating assets ^{1,3} | 10 | (435,396) | (90,095) |
| Change in operating liabilities ² | 10 | (151,246) | (316,273) |
| Tax paid | | (23,749) | (36,875) |
| Net cash used in operating activities | | (563,866) | (479,081) |
| Cash flows from investing activities | | | |
| Purchase of property, plant and equipment | | (682) | (520) |
| Purchase of intangible assets | | (276) | — |
| Proceeds from the sale and maturity of financial investments | | — | 672 |
| Net cash (used in)/generated from investing activities | | (958) | 152 |
| Cash flows from financing activities | | | |
| Proceeds from Borrowings | | 225,595 | 205,370 |
| Issue of ordinary share capital and other equity instruments | 25 | 176,000 | — |
| Subordinated loan capital issued | 23 | 16,000 | — |
| Dividends paid | | (4,559) | (4,572) |
| Net cash generated from financing activities | | 413,036 | 200,798 |
| Net decrease in cash and cash equivalents | | (151,788) | (278,131) |
| Cash and cash equivalents brought forward ^{1,2,3} | | 1,397,511 | 1,675,642 |
| Cash and cash equivalents carried forward | 10 | 1,245,723 | 1,397,511 |

1 Right-of use assets have been recognised from January 2019 following the adoption of IFRS16. Comparatives have not been re-stated (see note 27).

2 In 2019 the Entity excluded loans and advances to banks of less than 3 months but greater than 1 month from cash and cash equivalents. These were previously included due to being cancellable on demand. In addition in 2019 the Entity has included its cash ratio deposit account in cash and cash equivalents in line with the parent company accounting policy. Relevant comparatives have been re-presented and also include other cash equivalents not included in 2018 cash and cash equivalents. The net effect of this change was to decrease cash and cash equivalents by £340m in 2018 and by £640m in 2017.

3 At 31 December 2019 £5.4m (2018 £4.3m) was not available for use by the Entity as it relates to mandatory deposits at central banks.

Marks and Spencer Financial Services Plc

Statement of changes in equity for the year ended 31 December 2019

| | Called up share capital | Other equity instruments | Retained earnings | Other reserves Financial assets at FVOCI reserve | Total equity |
|---|-------------------------|--------------------------|-------------------|---|----------------|
| | £'000 | £'000 | £'000 | £'000 | £'000 |
| At 1 Jan 2019 | 93,000 | 60,000 | 211,446 | — | 364,446 |
| Loss for the year | — | — | (118,560) | — | (118,560) |
| Additional tier 1 instrument issued | — | 9,000 | — | — | 9,000 |
| New shares issued | 167,000 | — | — | — | 167,000 |
| Dividends to shareholders | — | — | (4,559) | — | (4,559) |
| Net impact of equity-settled share-based payments | — | — | 381 | — | 381 |
| At 31 Dec 2019 | 260,000 | 69,000 | 88,708 | — | 417,708 |

| | Called up share capital | Other equity instruments | Retained earnings | Other reserves Financial assets at FVOCI reserve | Total equity |
|---|-------------------------|--------------------------|-------------------|---|----------------|
| | £'000 | £'000 | £'000 | £'000 | £'000 |
| As at 31 Dec 2017 | 45,000 | 60,000 | 224,620 | 474 | 330,094 |
| Impact on transition to IFRS 9 (see Note 32) | — | — | (29,684) | (474) | (30,158) |
| At 1 Jan 2018 | 45,000 | 60,000 | 194,936 | — | 299,936 |
| Profit for the year | — | — | 19,043 | — | 19,043 |
| New shares issued | 48,000 | — | — | — | 48,000 |
| Dividends to shareholders | — | — | (4,572) | — | (4,572) |
| Net impact of equity-settled share-based payments | — | — | 38 | — | 38 |
| Other movements | — | — | 2,001 | — | 2,001 |
| At 31 Dec 2018 | 93,000 | 60,000 | 211,446 | — | 364,446 |

1. All new capital subscribed during 2018 and 2019 was issued to HSBC UK. For further details refer to note 25.
2. Other equity instruments - Additional Tier 1 Capital was issued to HSBC UK in 2019. For further details refer to note 25.
3. Equity is wholly attributable to equity shareholders of Marks and Spencer Financial Services Plc.

Notes on the financial statements

1. Basis of preparation and significant accounting policies

The financial statements of the Entity have been prepared in accordance with the Companies Act 2006 as applicable to companies using International Financial Reporting Standards ('IFRSs'). The principal accounting policies applied in the preparation of these financial statements have been consistently applied to all of the years presented, unless otherwise stated.

The financial statements have been prepared under the historic cost convention or historic cost modified by revaluation of financial assets and financial liabilities held at fair value through profit and loss (as applicable).

1.1. Basis of preparation

(a) Compliance with International Financial Reporting Standards

The financial statements of the Entity have been prepared in accordance with IFRSs as issued by the International Accounting Standards Board ('IASB'), including interpretations issued by the IFRS Interpretations Committee, and as endorsed by the European Union ('EU').

At 31 December 2019, there were no unendorsed standards effective for the year ended 31 December 2019 affecting these financial statements, and the Entity's application of IFRSs results in no differences between IFRSs as issued by the IASB and IFRSs as endorsed by the EU.

Standards adopted during the year ended 31 December 2019

IFRS 16 'Leases'

On 1 January 2019, Company adopted the requirements of IFRS 16. The adoption of the standard increased assets by £23m and increased financial liabilities by the same amount with no effect on net assets or retained earnings.

On adoption of IFRS 16, Company recognised lease liabilities in relation to leases that had previously been classified as 'operating leases' in accordance with IAS 17 'Leases'. These liabilities were recognised in 'other liabilities' and measured at the present value of the remaining lease payments, discounted at the lessee's incremental borrowing rate at 1 January 2019. The associated right of use ('ROU') assets were recognised in 'other assets' and measured at the amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments or provisions for onerous leases recognised on the balance sheet at 31 December 2018. In addition, the following practical expedients permitted by the standard were applied:

- reliance was placed on previous assessments on whether leases were onerous;
- operating leases with a remaining lease term of less than 12 months at 1 January 2019 were treated as short-term leases; and
- initial direct costs were not included in the measurement of ROU assets for leases previously accounted for as operating leases.

The differences between IAS 17 and IFRS 16 are summarised in the table below:

| | |
|--|--|
| Leases were classified as either finance or operating leases. Payments made under operating leases were charged to profit or loss on a straight-line basis over the period of the lease. | <p>Leases are recognised as an ROU asset and a corresponding liability at the date at which the leased asset is made available for use. Lease payments are allocated between the liability and finance cost. The finance cost is charged to profit or loss over the lease term so as to produce a constant period rate of interest on the remaining balance of the liability. The ROU asset is depreciated over the shorter of the ROU asset's useful economic life and the lease term on a straight-line basis.</p> <p>In determining the lease term, we consider all facts and circumstances that create an economic incentive to exercise an extension option or not exercise a termination option over the planning horizon of five years.</p> <p>In general, it is not expected that the discount rate implicit in the lease is available so the lessee's incremental borrowing rate is used. This is the rate that the lessee would have to pay to borrow the funds necessary to obtain an asset of a similar value in a similar economic environment with similar terms and conditions. The rates are determined for each economic environment in which we operate and for each term by adjusting swap rates with funding spreads (own credit spread) and cross-currency basis where appropriate.</p> |
|--|--|

No impact of IBOR amendments issued in 2019 as the Entity does not engage in any hedging activities.

Marks and Spencer Financial Services Plc

(b) Future accounting developments

Minor amendments to IFRSs

The IASB published a number of minor amendments to IFRSs which are effective from 1 January 2020, some of which have been endorsed for use in the EU. The Entity expects they will have an insignificant effect, when adopted, on the financial statements of the Entity.

Major new IFRSs

IFRS 17 'Insurance Contracts'

The IASB has published IFRS 17 'Insurance Contracts'. IFRS 17 has not yet been endorsed but is not expected to have a significant impact on the consolidated financial statements of the group and the separate financial statements of the bank.

(c) Changes to the presentation of the financial statements and Notes on the Financial Statements

In order to make the financial statements and notes thereon easier to understand, the Entity has changed the location and the wording used to describe certain accounting policies within the notes, removed certain immaterial disclosures and changed the order of certain sections.

In the current year the M&S plc profit share has been re-classified in Other Operating income due to it being a receivable from M&S plc (prior year £0.9m in Operating Expenses). By nature this reflects the income/expense arising from the profit share agreement between M&S plc and the Entity. Given its size in the year this has been separately disclosed.

(d) Presentation of information

The functional currency of the Entity is Sterling, which is also the presentational currency of the financial statements of the Entity.

The financial statements present information about the Entity as an individual undertaking and not about its group. The Entity is not required to prepare consolidated financial statements by virtue of the exemption conferred by section 400 of the Companies Act 2006.

Capital disclosures under IAS1 'Presentation of Financial Statements' ('IAS 1') have been included in the audited section of the 'Report of the Directors: Capital Management' on page 7.

(e) Critical accounting estimates and judgements

The preparation of financial information requires the use of estimates and judgements about future conditions. In view of the inherent uncertainties and the high level of subjectivity involved in the recognition or measurement of items, highlighted as the 'critical accounting estimates and judgements' in section 1.2 to follow, it is possible that the outcomes in the next financial year and beyond could differ from those on which management's estimates are based. This could result in materially different conclusions from those reached by management for the purposes of these financial statements. Management's selection of the Entity's accounting policies which contain critical estimates and judgements reflects the materiality of the items to which the policies are applied and the high degree of judgement and estimation uncertainty involved.

(f) Going concern

The financial statements are prepared on a going concern basis, as the Directors are satisfied that the Entity has the resources to continue in business for the foreseeable future. In making this assessment, the Directors have considered a wide range of information relating to present and future conditions, including future projections of profitability, cash flows and capital resources. This includes the level of funding and capital support expected to be required and to be available from the HSBC Group. The Entity is part of the Domestic Liquidity Sub-group ('Liquidity Group') of HSBC UK Bank plc and therefore part of the internal liquidity control and management structure of HSBC UK Bank plc. The Entity's liquidity position is managed as part of the HSBC Bank UK plc Liquidity Group, under which members agree to provide liquidity support when necessary.

Stress tests demonstrate that HBUK would be able to provide liquidity where required by the Entity.

1.2. Summary of significant accounting policies

(a) Provisions, contingent liabilities and guarantees

Provisions

Provisions are recognised when it is probable that an outflow of economic benefits will be required to settle a present legal or constructive obligation that has arisen as a result of past events and for which a reliable estimate can be made.

Critical accounting estimates and judgements

The recognition and measurement of provisions requires the Entity to make a number of judgements, assumptions and estimates. The most significant are set out below:

- Provisions for legal proceedings and regulatory matters typically require a higher degree of judgement than other types of provisions. When matters are at an early stage, accounting judgements can be difficult because of the high degree of uncertainty associated with determining whether a present obligation exists, and estimating the probability and amount of any outflows that may arise. As matters progress, management and legal advisers evaluate on an ongoing basis whether provisions should be recognised, revising previous estimates as appropriate. At more advanced stages, it is typically easier to make estimates around a better defined set of possible outcomes.
- Determining whether a present obligation exists. Professional advice is taken on the assessment of litigation, property (including onerous contracts) and similar obligations.
- Provisions for customer remediation also require significant levels of estimation. The amounts of provisions recognised depend on a number of different assumptions, such as the conversion of inbound contact and information requests into new complaints, the proportion of those new complaints which are to be upheld, and the redress to be paid to each upheld complaint. More information about these assumptions is included in Note 22.
- Provisions for legal proceedings and regulatory matters remain very sensitive to the assumptions used in the estimate. There could be a wider range of possible outcomes for any pending legal proceedings, investigations or inquiries. As a result it is often not practicable to quantify a range of possible outcomes for individual matters. It is also not practicable to meaningfully quantify ranges of potential outcomes in aggregate for these types of provisions because of the diverse nature and circumstances of such matters and the wide range of uncertainties involved.

Contingent liabilities, contractual commitments and guarantees

Contingent liabilities

Contingent liabilities related to legal proceedings or regulatory matters are not recognised in the financial statements but are disclosed unless the probability of settlement is remote.

Financial guarantee contracts

As at 31 December 2019 the Entity did not hold any financial guarantee contracts (2018: nil).

(b) Income and expense

Interest income and expense

Interest income and expense for all financial instruments, excluding those classified as held for trading or designated at fair value are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest method.

Interest on credit impaired financial assets is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Non-interest income and expense

Fee income is earned from a diverse range of services provided by the Entity to its customers. Fee income is accounted for as follows:

- Income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from sale of travel money); and
- Income earned from the provision of services is recognised as revenue as the services are provided (for example, interchange fee income).

Fee expense is recognised as services are received or liabilities are accrued.

Directly attributable acquisition costs are recognised over the estimated life of the relevant financial asset or financial liability. For credit cards this is 7 years, and for current accounts 5 years. These are reviewed annually to ensure they remain appropriate.

Other Operating Income

Profit share receivable/payable is recognised in accordance with the terms of the Relationship Agreement with M&S plc.

(c) Investments in subsidiaries

The Entity classifies investments in entities which it controls as subsidiaries. Where an entity is governed by voting rights, the entity consolidates when it holds, directly or indirectly, the necessary voting rights to pass resolutions by the governing body. In all other cases, the assessment of control is more complex and requires judgement of other factors, including having exposure to variability of returns, power to direct relevant activities and whether power is held as agent or principal.

The Entity's investments in subsidiaries are stated at cost less impairment losses.

(d) Valuation of financial instruments

All financial instruments are initially recognised at fair value. 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. The fair value of a financial instrument on initial recognition is generally its transaction price (that is, the fair value of the consideration given or received).

The fair value of financial instruments is generally measured on an individual basis.

(e) Financial instruments measured at amortised cost

Loans and advances

Financial assets that are held to collect the contractual cash flows and that contain contractual terms that give rise on specified dates to cash flows that are solely payments of principal and interest, are measured at amortised cost. Such financial assets include most loans and advances to banks and customers and some debt securities. In addition, most financial liabilities are measured at amortised cost. The carrying value of these financial assets and initial recognition includes any directly attributable transaction costs.

The Entity may commit to underwriting loans on fixed contractual terms for specified periods of time. When the Entity intends to hold the loan, a provision on the loan commitment is only recorded where it is probable that the Entity will incur a loss.

Critical accounting estimates and judgements

The measurement of loans and advances to customers at amortised cost requires management to estimate the effective interest rate for these loans, and results in the build-up of an asset during promotional periods as interest is accrued and recognised as it is earned but it is not charged to the customer.

(f) Impairment of amortised cost and FVOCI financial assets

Expected credit losses are recognised for loans and advances to banks and customers and other financial assets held at amortised cost. At initial recognition, allowance (or provision in the case of some loan commitments and financial guarantees) is required for ECL resulting from default events that are possible within the next 12 months (or less, where the remaining life is less than 12 months) ('12-month ECL'). In the event of a significant increase in credit risk, allowance (or provision) is required for ECL resulting from all possible default events over the expected life of the financial instrument ('lifetime ECL'). Financial assets where 12-month ECL is recognised are considered to be 'stage 1'; financial assets which are considered to have experienced a significant increase in credit risk are in 'stage 2'; and financial assets for which there is objective evidence of impairment so are considered to be in default or otherwise credit-impaired are in 'stage 3'.

Credit-impaired (stage 3)

The Entity determines that a financial instrument is credit-impaired and in stage 3 by considering relevant objective evidence, primarily whether:

- contractual payments of either principal or interest are past due for more than 90 days;
- there are other indications that the borrower is unlikely to pay, such as when a concession has been granted to the borrower for economic or legal reasons relating to the borrower's financial condition; and
- the loan is otherwise considered to be in default.

If such unlikelihood to pay is not identified at an earlier stage, it is deemed to occur when an exposure is 90 days past due, even where regulatory rules permit default to be defined based on 180 days past due. Therefore the definitions of credit-impaired and default are aligned as far as possible so that stage 3 represents all loans which are considered defaulted or otherwise credit-impaired.

Interest income is recognised by applying the effective interest rate to the amortised cost amount, i.e. gross carrying amount less Expected Credit Loss (ECL) allowance.

Write-off

Financial assets (and the related impairment allowances) are normally written off, either partially or in full, when there is no realistic prospect of recovery. Where loans are secured, this is generally after receipt of any proceeds from the realisation of security. In circumstances where the net realisable value of any collateral has been determined and there is no reasonable expectation of further recovery, write-off may be earlier.

Renegotiation

Loans are identified as renegotiated and classified as credit-impaired when we modify the contractual payment terms due to significant credit distress of the borrower. Renegotiated loans remain classified as credit-impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows and retain the designation of renegotiated until maturity or derecognition.

A loan that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement is made on substantially different terms or if the terms of an existing agreement are modified such that the renegotiated loan is a substantially different financial instrument.

All modified loans could be transferred out of stage 3 if they no longer exhibit any evidence of being credit-impaired and, in the case of renegotiated loans, there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, over the minimum observation period, and there are no other indicators of impairment. These loans could be transferred to stage 1 or 2 based on the mechanism as described below by comparing the risk of a default occurring at the reporting date (based on the modified contractual terms) and the risk of a default occurring at initial recognition (based on the original, unmodified contractual terms). Any amount written off as a result of the modification of contractual terms would not be reversed.

Significant increase in credit risk (stage 2)

An assessment of whether credit risk has increased significantly since initial recognition is performed at each reporting period by considering the change in the risk of default occurring over the remaining life of the financial instrument. The assessment explicitly or implicitly compares the risk of default occurring at the reporting date compared to that at initial recognition, taking into account reasonable and supportable information, including information about past events, current conditions and future economic conditions. The assessment is unbiased, probability-weighted, and to the extent relevant, uses forward-looking information consistent with that used in the measurement of ECL. The analysis of credit risk is multifactor. The determination of whether a specific factor is relevant and its weight compared with other factors depends on the type of product, the characteristics of the financial instrument and the borrower. Therefore, it is not possible to provide a single set of criteria that will determine what is considered to be a significant increase in credit risk and these criteria will differ for different types of lending. However, unless identified at an earlier stage, all financial assets are deemed to have suffered a significant increase in credit risk when 30 days past due.

For retail portfolios, default risk is assessed using a reporting date 12-month Probability of Default (PD) derived from credit scores, which incorporate all available information about the customer. This PD is adjusted for the effect of macroeconomic forecasts for periods longer than 12 months and is considered to be a reasonable approximation of a lifetime PD measure. Retail exposures are first segmented into homogeneous portfolios, generally by product. Within each portfolio, the stage 2 accounts are defined as accounts with an adjusted 12-month PD greater than the average 12-month PD of loans in that portfolio 12 months before they become 30 days past due. The expert credit risk judgement is that no prior increase in credit risk is significant. This portfolio-specific threshold identifies loans with a PD higher than would be expected from loans that are performing as originally expected, and higher than what would have been acceptable at origination. It therefore approximates a comparison of origination to reporting date PDs.

Unimpaired and without significant increase in credit risk - (stage 1)

ECL resulting from default events that are possible within the next 12 months ('12-month ECL') are recognised for financial instruments that remain in stage 1.

Movement between stages

Financial assets can be transferred between the different categories depending on their relative increase in credit risk since initial recognition. Financial instruments are transferred out of stage 2 if their credit risk is no longer considered to be significantly increased since initial recognition based on the assessments described above. Except for renegotiated loans, financial instruments are transferred out of stage 3 when they no longer exhibit any evidence of credit impairment as described above. Renegotiated loans will continue to be in stage 3 until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, observed over a minimum one-year period and there are no other indicators of impairment. For loans that are assessed for impairment on a portfolio basis, the evidence typically comprises a history of payment performance against the original or revised terms, as appropriate to the circumstances.

Measurement of ECL

The assessment of credit risk, and the estimation of ECL, are unbiased and probability-weighted, and incorporate all available information that is relevant to the assessment including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date. In addition, the estimation of ECL does take into account the time value of money.

In general, the entity calculates ECL using three main components, a probability of default, a loss given default ('LGD') and the exposure at default ('EAD').

The 12-month ECL is calculated by multiplying the 12-month PD, LGD and EAD. Lifetime ECL is calculated using the lifetime PD instead. The 12-month and lifetime PDs represent the probability of default occurring over the next 12 months and the remaining maturity of the instrument respectively.

The EAD represents the expected balance at default, taking into account the repayment of principal and interest from the balance sheet date to the default event together with any expected drawdowns of committed facilities. The LGD represents expected losses on the EAD given the event of default, taking into account, among other attributes, the mitigating effect of collateral value at the time it is expected to be realised and the time value of money.

The Entity leverages the Basel II IRB framework where possible, with recalibration to meet the differing IFRS 9 requirements set out in the following table:

| | | |
|-------|--|--|
| PD | <ul style="list-style-type: none"> Through the cycle (represents long-run average PD throughout a full economic cycle) The definition of default includes a backstop of 90+ days past due, although this has been modified to 180+ days past due for some portfolios, particularly UK mortgages. | <ul style="list-style-type: none"> Point in time (based on current conditions, adjusted to take into account estimates of future conditions that will impact PD) Default backstop of 90+ days past due for all portfolios |
| EAD | <ul style="list-style-type: none"> Cannot be lower than current balance Downturn LGD (consistent losses expected to be suffered during a severe but plausible economic downturn) | <ul style="list-style-type: none"> Amortisation captured for term products Expected LGD (based on estimate of loss given default including the expected impact of future economic conditions such as changes in value of collateral) |
| LGD | <ul style="list-style-type: none"> Regulatory floors may apply to mitigate risk of underestimating downturn LGD due to lack of historical data Discounted using cost of capital All collection costs included | <ul style="list-style-type: none"> No floors Discounted using the original effective interest rate of the loan Only costs associated with obtaining/selling collateral included |
| Other | | <ul style="list-style-type: none"> Discounted back from point of default to balance sheet date |

While 12-month PDs are recalibrated from Basel II models where possible, the lifetime PDs are determined by projecting the 12-month PD using a term structure.

Marks and Spencer Financial Services Plc

Period over which ECL is measured

Expected credit loss is measured from the initial recognition of the financial asset. The maximum period considered when measuring ECL (be it 12-month or lifetime ECL) is the maximum contractual period over which the Entity is exposed to credit risk.

Forward-looking economic inputs

M&S Bank follows a HSBC group wide methodology. The HSBC group generally apply three forward-looking global economic scenarios determined with reference to external forecast distributions representative of our view of forecast economic conditions, the consensus economic scenario approach. This approach is considered sufficient to calculate unbiased expected loss in most economic environments. They represent a 'most likely outcome' (the Central scenario) and two, less likely, 'outer' scenarios referred to as the Upside and Downside scenarios. The Central scenario is used by the annual operating planning process and, with regulatory modifications, will also be used in enterprise-wide stress tests. The Upside and Downside are constructed following a standard process supported by a scenario narrative reflecting the Group's current top and emerging risks and by consulting external and internal subject matter experts. The relationship between the outer scenarios and Central scenario will generally be fixed with the Central scenario being assigned a weighting of 80% and the Upside and Downside scenarios 10% each, with the difference between the Central and outer scenarios in terms of economic severity being informed by the spread of external forecast distributions among professional industry forecasts. The outer scenarios are economically plausible, internally consistent states of the world and will not necessarily be as severe as scenarios used in stress testing. The period of forecast is five years, after which the forecasts will revert to a view based on average past experience. The central forecast and spread between the Central and outer scenarios is grounded on the expected gross domestic product of the UK economy. The economic factors include, but are not limited to, gross domestic product, unemployment, interest rates and inflation.

In general, the consequences of the assessment of credit risk and the resulting ECL outputs will be probability-weighted using the standard probability weights. This probability weighting may be applied directly or the effect of the probability weighting determined on a periodic basis, at least annually, and then applied as an adjustment to the outcomes resulting from the Central economic forecast. The Central economic forecast is updated quarterly.

The group recognises that the consensus economic scenario approach using three scenarios will be insufficient in certain economic environments. Additional analysis may be requested at management's discretion, including the production of extra scenarios. If conditions warrant, this could result in a management overlay for economic uncertainty which is included in the ECL. This is the case for the UK and for M&S Bank (Note 28).

Critical accounting estimates and judgements

In determining ECL, management is required to exercise judgement in defining what is considered to be a significant increase in credit risk and in making assumptions and estimates to incorporate relevant information about past events, current conditions and forecasts of economic conditions. Judgement has been applied in determining the lifetime and point of initial recognition of revolving facilities.

The PD, LGD and EAD models which support these determinations are reviewed regularly in light of differences between loss estimates and actual loss experience, but given that IFRS 9 requirements have only just been applied, there has been little time available to make these comparisons. Therefore, the underlying models and their calibration, including how they react to forward-looking economic conditions, remain subject to review and refinement. This is particularly relevant for lifetime PDs, which have not been previously used in regulatory modelling and for the incorporation of 'Upside scenarios' which have not generally been subject to experience gained through stress testing.

The exercise of judgement in making estimations requires the use of assumptions which are highly subjective and very sensitive to the risk factors, in particular to changes in economic and credit conditions across a large number of geographical areas. Many of the factors have a high degree of interdependency; the judgement applied in respect of significant increases in credit risk for loan portfolios is the only standalone factor to which loan impairment allowances as a whole are sensitive. The section above sets out the assumptions underlying the Central scenario and information about how scenarios are developed in relation to the Group's top and emerging risks and its judgements, informed by consensus forecasts of professional industry forecasters. The adjustment from the ECL determined by using the Central scenario alone, which is used to calculate an unbiased expected loss, provides an indication of the overall sensitivity of ECL to different economic assumptions.

(g) Employee compensation and benefits

Share-based payments

The Entity enters into both equity-settled and cash-settled share-based payment arrangements with its employees as compensation for the provision of their services.

The vesting period for these schemes may commence before the grant date if the employees have started to render services in respect of the award before the grant date. Expenses are recognised when the employee starts to render service to which the award relates.

Cancellations result from the failure to meet a non-vesting condition during the vesting period, and are treated as an acceleration of vesting recognised immediately in the income statement. Failure to meet a vesting condition by the employee is not treated as a cancellation, and the amount of expense recognised for the award is adjusted to reflect the number of awards expected to vest.

Post-employment benefit plans

The HSBC group operates a number of pension schemes including defined benefit, defined contribution, and post-employment benefit schemes. Further details regarding these schemes is set out in Note 4.

Payments to defined contribution schemes are charged as an expense as the employees render service.

Defined benefit pension obligations are calculated using the projected unit credit method. The net charge to the income statement mainly comprises the service cost and the net interest on the net defined benefit asset or liability, and is presented in operating expenses.

Remeasurement of the net defined benefit asset or liability, which comprise actuarial gains and losses, return on plan assets excluding interest and the effect of the asset ceiling (if any, excluding interest), are recognised immediately in other comprehensive income. The net defined benefit asset or liability represents the present value of defined benefit obligations reduced by the fair value of plan assets, after applying the asset ceiling test, where the net defined benefit surplus is limited to the present value of available refunds and reductions in future contributions to the plan.

Marks and Spencer Financial Services Plc

The cost of obligations arising from other post-employment plans is accounted for on the same basis as defined benefit pension plans.

(h) Tax

Income tax comprises current tax and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised in other comprehensive income or directly in equity, in which case the tax is recognised in the same statement in which the related item appears.

Current tax is the tax expected to be payable on the taxable profit for the year and on any adjustment to tax payable in respect of previous years. The Entity provides for potential current tax liabilities that may arise on the basis of the amounts expected to be paid to the tax authorities.

Deferred tax is recognised on temporary differences between the carrying amounts of assets and liabilities in the balance sheet, and the amounts attributed to such assets and liabilities for tax purposes. Deferred tax is calculated using the tax rates expected to apply in the periods as the assets will be realised or the liabilities settled.

Current and deferred tax are calculated based on tax rates and laws enacted, or substantively enacted, by the balance sheet date.

(i) Property, plant and equipment

Equipment, fixtures and fittings are stated at cost less impairment losses and depreciation over their useful lives, which are generally between 2 years and 5 years. Property, plant and equipment is subject to an impairment review if their carrying amount may not be recoverable.

(j) Intangible assets

Intangible assets are stated at cost less amortisation and are amortised straight line over their estimated useful lives of 5 years. Expenditure on internally developed software is recognised as an asset when the Entity is able to demonstrate its intention and ability to complete the development and use the software in a manner that will generate future economic benefits and can reliably measure the cost to complete development. Borrowing costs are not included in the capitalised costs of intangible assets. Assets are subject to regular impairment reviews which compare the carrying value to the expected value in use. Any impairment losses are recognised in the Income Statement. Amortisation does not commence until the asset is brought into operational use.

(k) Called up share capital

Financial instruments issued are generally classified as equity when there is no contractual obligation to transfer cash or other financial assets. Incremental costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax.

(l) Cash and cash equivalents

Cash and cash equivalents include highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments are normally those with less than three months' maturity from the date of acquisition.

Marks and Spencer Financial Services Plc

2. Operating Profit

Operating profit is stated after the following items:

| | 2019 £'000 | 2018 £'000 |
|---|----------------|----------------|
| Interest income | | |
| Loans and advances to customers | 239,226 | 258,404 |
| Interest received from group undertakings | 13,273 | 12,238 |
| Other interest received | 4 | 10 |
| Total interest income | 252,503 | 270,652 |
| Interest expense | | |
| Customer accounts | 16,285 | 17,204 |
| Interest paid to group undertakings | 30,901 | 24,843 |
| Other interest paid | 452 | 12 |
| Total interest expense | 47,638 | 42,059 |
| Fee and commission income | | |
| Product fee income (restated) | 83,665 | 81,853 |
| Insurance income | 17,058 | 21,811 |
| Other income | 4,740 | 5,257 |
| Total fee and commission income | 105,463 | 108,921 |
| Fee and commission expense | | |
| Product acquisition and retention costs | 21,299 | 28,149 |
| Fees payable to group undertakings | 145 | 1,258 |
| Other fees paid | 14,242 | 11,434 |
| Total fee and commission expense | 35,686 | 40,841 |
| | - | - |
| Change in expected credit losses and other credit impairment charges | | |
| Net impairment charge on loans and advances | - | - |
| Change in expected credit losses and other credit impairment charges | 70,289 | 50,137 |
| Total change in expected credit losses and other credit impairment charges | 70,289 | 50,137 |
| General and administrative expenses | | |
| Remediation costs | 220,251 | 62,846 |
| Expenses payable to group undertakings | 35,526 | 37,134 |
| Other expenses | 49,905 | 56,607 |
| Total general and administrative expenses | 305,682 | 156,587 |

¹ Travel Money income has been re-classified from Fee income from group undertakings to Product Fee income in 2019

² Product acquisition costs have been re-classified from Fee and Commission Income to Interest income in 2019

3. Other operating income

| | 2019 £'000 | 2018 £'000 |
|--------------------------------------|---------------|---------------|
| Sublease rental income | 568 | 426 |
| M&S Profit Share Income ¹ | 65,697 | - |
| Total other operating income | 66,265 | 426 |
| Net other operating income | 66,265 | 426 |

¹ As disclosed in Note 11 M&S plc profit share has been re-classified from Operating Expenses (£0.9m) in 2018 to Other Operating Income in 2019 (£66m).

4. Employee compensation and benefits

Total employee compensation

| | 2019 | 2018 |
|---|---------------|---------------|
| | £'000 | £'000 |
| Wages and salaries including share-based payments | 37,147 | 37,631 |
| Social security costs | 3,272 | 2,788 |
| Post-employment benefits | 5,446 | 5,716 |
| Year ended 31 Dec | 45,865 | 46,135 |

Employee compensation is paid by HSBC and recharged to the Entity.

Average number of persons employed by the Entity during the year

| | 2019 | 2018 |
|----------------------------|--------------|--------------|
| Head Office Administration | 645 | 733 |
| Selling and Distribution | 731 | 768 |
| Year ended 31 Dec | 1,376 | 1,501 |

Post employment benefit plans

The Entity's employees are members of various schemes. Some are defined benefit plans, of which the largest is the HSBC Bank (UK) Pension Scheme ('the principal plan').

The principal plan

The principal plan has a defined benefit section and a defined contribution section. The defined benefit section was closed to future benefit accrual in 2015, with defined benefits earned by employees at that date continuing to be linked to their salary while they remain employed by HSBC UK Bank plc. The plan is overseen by an independent corporate trustee, who has a fiduciary responsibility for the operation of the plan. Its assets are held separately from the assets of the group.

To meet the requirements of the Banking Reform Act, from 1 July 2018, the main employer of the plan changed from HSBC Bank plc to HSBC UK Bank plc, with additional support from HSBC Holdings plc.

There is no contractual agreement or stated policy for charging the net defined benefit cost from HSBC UK Bank plc to the other members of the group pension plan. Instead the Entity makes a regular payment to HSBC UK Bank plc, for HSBC UK Bank plc to invest in the various schemes on behalf of the Entity's employees. The Entity would not contribute to any scheme deficit, except through amendments to its regular payments. Full disclosure of the principal actuarial financial assumptions used to calculate the defined benefit pension plans at December 31, 2019, of which employees of the Entity are members, are disclosed in the statutory accounts of HSBC UK Bank plc.

5. Share-based payments

The share-based payment income statement charge is recognised in wages and salaries as follows:

| | 2019 | 2018 |
|--|------------|------------|
| | £'000 | £'000 |
| Savings-related and other share award option plans | 399 | 340 |
| Year ended 31 Dec | 399 | 340 |

HSBC share option plans

Savings-related share option plans ('Sharesave')

- Two plans: the UK plan and the International Plan. The last grant of options under the International Plan was in 2012.
- From 2014, eligible employees can save up to £500 per month with the option to use the savings to acquire shares.
- Exercisable within six months following either the third or fifth anniversaries of the commencement of a three-year or five-year contract, respectively.
- The exercise price is set at a 20% (2018: 20%) discount to the market value immediately preceding the date of invitation.

Calculation of fair values

The fair values of share options are calculated using a Black-Scholes model. The fair value of a share award is based on the share price at the date of the grant.

Marks and Spencer Financial Services Plc

Movement on HSBC share option plans

| | Savings-related share options | |
|---|-------------------------------|------------------------|
| | Number | WAEP ¹ £ |
| Outstanding at 1 Jan 2019 | 1,303 | 5.84 |
| Granted during the year | 586 | 4.69 |
| Exercised during the year | (301) | 4.45 |
| Expired during the year | (276) | 5.41 |
| Outstanding at 31 Dec 2019 | 1,312 | 5.74 |
| Weighted average remaining contractual life (years) | | 2 |

| | Savings-related share options | |
|---|-------------------------------|------------------------|
| | Number | WAEP ¹ £ |
| Outstanding at 1 Jan 2018 | 1,325 | 5.43 |
| Granted during the year | 533 | 5.45 |
| Exercised during the year | (150) | 4.12 |
| Expired during the year | (405) | 4.62 |
| Outstanding at 31 Dec 2018 | 1,303 | 5.84 |
| Weighted average remaining contractual life (years) | | 2 |

The weighted average fair value of share options outstanding, which is calculated when transactions are contracted, was £6.22 (2018: £6.31).

6. Directors' emoluments

The aggregate emoluments of the Directors of the Entity, computed in accordance with the Companies Act 2006 as amended by statutory instrument 2008 No. 410, were:

| | 2019 £'000 | 2018 £'000 |
|--|---------------|---------------|
| Fees | 189 | 195 |
| Salaries and other emoluments ^{2,3} | 516 | 533 |
| Pension contributions | 53 | 76 |
| Annual incentives ⁴ | 163 | 223 |
| Year ended 31 Dec | 921 | 1,027 |

¹ Fees included fees paid to non-executive Directors.

² Salaries and other emoluments include fixed pay allowance

³ For 2019, no remuneration is disclosed for Directors who are employed by other companies within the HSBC Group and their services are incidental to their other responsibilities within the HSBC Group.

⁴ Awards made to executive Directors in respect of 2019 performance comprise a mixture of cash and HSBC Holdings plc ordinary shares. The amount shown comprised £98,100 in cash, £11,700 in deferred cash (vesting annually over a three year period), £35,100 in restricted shares and £18,000 in deferred restricted shares (vesting annually over a three year period) issued under the HSBC Share Plan.

Awards made to executive Directors in respect of 2018 performance comprise a mixture of cash and HSBC Holdings plc ordinary shares. The amount shown comprised £118,378 in cash, £nil in deferred cash (vesting annually over a three year period), £nil in restricted shares and £104,658 in deferred restricted shares (vesting annually over a three year period) issued under the HSBC Share Plan.

2 Directors exercised share options over HSBC Holdings plc ordinary shares during the year (2018: 2).

Awards were made to 4 Directors under long-term incentive plans in respect of qualifying services rendered in 2019 (2018: 5 Directors). During 2019, 4 Directors received shares in respect of awards under long-term incentive plans that vested during the year (2018: 5).

No retirement benefits are accruing to Directors under a defined benefit scheme and are accruing to 4 Directors under money purchase schemes in respect of Directors' qualifying service. Contributions of £53,100 (2018: £76,458) were made during the year to money purchase arrangements and £nil to defined benefit schemes in respect of Directors' qualifying service (2018: £nil).

Discretionary bonuses for Directors are based on a combination of individual and corporate performance and are determined by the Remuneration Committee of the Entity's ultimate parent company, HSBC Holdings plc. The cost of any conditional awards under the HSBC Share Plan and the HSBC Plan 2011 ('the Plans') is recognised through an annual charge based on the fair value of the awards, apportioned over the period of service to which the award relates. Details of the Plans are contained within the Directors' Remuneration Report of HSBC Holdings plc.

Of these aggregate figures, the following amounts are attributable to the highest paid Director:

| | 2019 £'000 | 2018 £'000 |
|--------------------------------|---------------|---------------|
| Salaries and other emoluments | 226 | 266 |
| Annual incentives ¹ | 95 | 99 |
| Year ended 31 Dec | 321 | 365 |

Marks and Spencer Financial Services Plc

¹ Awards made to the highest paid Director in respect of 2019 performance comprise a mixture of cash and HSBC Holdings plc ordinary shares. The amount shown comprised £35,100 in cash, £11,700 in deferred cash (vesting annually over a three year period), £35,100 in restricted shares and £12,600 in deferred restricted shares (vesting annually over a three year period) issued under the HSBC Share Plan. Awards made to the highest paid Director in respect of 2018 performance comprise a mixture of cash and HSBC Holdings plc ordinary shares. The amount shown comprised £39,600 in cash, £15,300 in deferred cash (vesting annually over a three year period), £32,400 in restricted shares and £59,400 in deferred restricted shares (vesting annually over a three year period) issued under the HSBC Share Plan.

The highest paid Director received 8,992 (2018: 9,261) shares, in respect of qualifying services, as the result of awards under long-term incentive plans that vested during the year. The highest paid Director exercised 0 (2018: 4447) share options over HSBC Holdings plc ordinary shares during the year.

Pension contributions of £9,900 (2018: £24,300) were made by the Entity in respect of services by the highest paid Director during the year.

7. Auditors' remuneration

| | 2019 £'000 | 2018 £'000 |
|---|---------------|---------------|
| Audit fees for statutory audit | | |
| - Fees relating to current year | 364 | 298 |
| Fees for other services provided to the Entity | | |
| - Other audit-related services pursuant to regulation | 40 | 34 |
| - Other services | 16 | — |
| Year ended 31 Dec | 420 | 332 |

Certain elements of audit work are performed centrally across the HSBC group. These items are not recharged to the Entity.

8. Tax

Tax expense

| | 2019 £'000 | 2018 £'000 |
|---|---------------|----------------|
| Current tax | | |
| UK corporation tax | | |
| - For this year | 31,123 | 25,332 |
| - Adjustments in respect of prior years | (495) | (1,400) |
| Total current tax | 30,628 | 23,932 |
| Deferred tax | | |
| - For this year | 1,961 | 917 |
| - Effects of changes in tax rates | (61) | 19 |
| - Adjustments in respect of prior years | 131 | 1,109 |
| Total deferred tax | 2,031 | 2,045 |
| Year ended 31 Dec | 32,659 | 25,977 |
| Equity items | | |
| - Current tax | (56) | (1,088) |
| - Current tax - prior year | — | (938) |
| - Deferred tax - current year | 75 | 302 |
| - Deferred tax - prior year | — | 24 |
| Total equity items | 19 | (1,700) |
| Other comprehensive income items | | |
| - Deferred tax - current year | — | — |
| - Deferred tax - prior year | — | — |
| Total other comprehensive income items | — | — |

The UK corporation tax rate applying to the Entity was 19% (2018: 19%).

The UK Government proposed to reduce the main rate of UK corporation tax to 19% with effect from 1 April 2017 and to 18% with effect from 1 April 2020. A further rate reduction to 17% was proposed from 1 April 2020, instead of the reduction to 18% as originally planned. These reductions in the corporation tax rate were enacted in the Finance (No 2) Act 2016.

The UK Government introduced a surcharge on banking companies in the Finance (No 2) Act 2015 to apply with effect from 1 January 2016. The Entity meets the definition of a banking company and is therefore subject to the 8% bank surcharge.

Marks and Spencer Financial Services Plc

Tax reconciliation

The tax charged to the income statement differs from the tax expense that would apply if all profits had been taxed at the UK Corporation tax rate as follows:

| | 2019 | | 2018 | |
|---------------------------------------|---------------|----------------|---------------|--------------|
| | £'000 | (%) | £'000 | (%) |
| (Loss)/Profit before tax | (85,901) | | 45,020 | |
| Tax at 19% (2018: 19%) | (16,321) | 19.00 | 8,554 | 19.00 |
| Adjustments in respect of prior years | (364) | 0.42 | (291) | (0.65) |
| Permanent disallowables | 57,508 | (66.95) | 10,308 | 22.90 |
| Impact due to changes in tax rates | (61) | 0.07 | 19 | 0.04 |
| Other | (1,231) | 1.43 | 263 | 0.58 |
| Banking surcharge | (6,872) | 8.00 | 7,052 | 15.66 |
| Share options | — | — | 72 | 0.16 |
| Year ended 31 Dec | 32,659 | (38.02) | 25,977 | 57.70 |

Permanent disallowables include PPI and other customer redress, due to the government making banks' conduct payments non-deductible for corporation tax purposes from July 2015.

9. Deferred tax assets

The following table shows the non current gross deferred tax assets and liabilities recognised in the balance sheet and the related amounts recognised in the income statement:

| | Property, plant and equipment | Share based payments | Other temporary differences | FVOCI reserves | IFRS 9 Transitional Adjustments | Total |
|--------------------------|-------------------------------|----------------------|-----------------------------|----------------|---------------------------------|---------------|
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| At 1 Jan 2019 | 5,138 | 199 | 239 | — | 9,058 | 14,634 |
| Income statement charge | (709) | (40) | (74) | — | (1,075) | (1,898) |
| Equity statement expense | — | (75) | — | — | — | (75) |
| Prior year adjustments | 32 | — | (165) | — | — | (133) |
| At 31 Dec 2019 | 4,461 | 84 | — | — | 7,983 | 12,528 |

| | Property, plant and equipment | Share based payments | Other temporary differences | FVOCI reserves | IFRS 9 Transitional Adjustments | Total |
|----------------------------------|-------------------------------|----------------------|-----------------------------|----------------|---------------------------------|---------------|
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| As at 31 Dec 2017 | 5,185 | 569 | 1,118 | (244) | — | 6,628 |
| Impact on transition to IFRS 9 | — | — | — | 244 | 10,133 | 10,377 |
| At 1 Jan 2018 | 5,185 | 569 | 1,118 | — | 10,133 | 17,005 |
| Income statement (charge)/credit | 174 | (39) | 4 | — | (1,075) | (936) |
| Equity statement expense | — | (302) | — | — | — | (302) |
| Prior year adjustments | (221) | (29) | (883) | — | — | (1,133) |
| At 31 Dec 2018 | 5,138 | 199 | 239 | — | 9,058 | 14,634 |

There are no unrecognised deferred tax liabilities arising from the Entity's investments in subsidiaries.

The deferred tax asset position will be recovered in the following years from future profits.

10. Reconciliation of (loss)/profit before tax to net cash flow from operating activities

| | 2019 | 2018 |
|---|------------------|------------------|
| | £'000 | £'000 |
| (Loss)/profit before tax | (85,901) | 45,020 |
| Non-cash items included in profit and loss | | |
| Depreciation, amortisation and impairment | 5,025 | 1,008 |
| Credit-related impairment losses | 46,747 | 58,517 |
| Increase/(decrease) in provisions | 80,707 | (98,777) |
| Impact of first time adoption of IFRS 9 | — | (39,817) |
| Profit on disposal of investments | (53) | (1,789) |
| | 132,426 | (80,858) |
| Change in operating assets | | |
| Change in prepayments and accrued income | (2,409) | 376 |
| Change in loans and advances to customers | (411,300) | (439,678) |
| Change in other assets | (91,023) | 11,523 |
| Change in balances with central banks ¹ | 4,336 | (2,316) |
| Change in Loans and advances to banks ² | 65,000 | 340,000 |
| | (435,396) | (90,095) |
| Change in operating liabilities | | |
| Change in accruals and deferred income | (248) | (4,487) |
| Change in customer accounts | (126,918) | (252,135) |
| Change in other liabilities | (24,080) | (59,651) |
| | (151,246) | (316,273) |
| Cash and cash equivalents comprise | | |
| Cash and cash equivalents ¹ | 9,361 | 5,881 |
| Items in the course of collection from other banks | 7,704 | 30,246 |
| Loans and advances to banks of one month or less ² | 1,465,247 | 1,391,726 |
| Deposit by banks of one month or less | (230,000) | (27,682) |
| Less: Items in the course of transmission to other banks | (6,589) | (2,660) |
| | 1,245,723 | 1,397,511 |

¹ At 31 December 2019 £4m, 2018 £4.3m. 2017 £2.0m was not available for use by the Entity as it relates to mandatory deposits at central banks

² In 2019 the Entity excluded loans and advances to banks of less than 3 months but greater than 1 month from cash and cash equivalents. These were previously included due to being cancellable on demand. In addition in 2019 the Entity has included its cash ratio deposit account in cash and cash equivalents in line with the parent company accounting policy. Relevant comparatives have been re-presented and also include other cash equivalents not included in 2018 cash and cash equivalents. The net effect of this change was to decrease cash and cash equivalents by £340m in 2018 and by £640m in 2017.

11. Analysis of financial assets and liabilities by measurement basis

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost.

| | Amortised cost | Total |
|--|------------------|------------------|
| | £'000 | £'000 |
| At 31 Dec 2019 | | |
| Assets | | |
| Cash and balances at central banks | 9,361 | 9,361 |
| Items in the course of collection from other banks | 7,704 | 7,704 |
| Loans and advances to banks | 1,700,247 | 1,700,247 |
| Loans and advances to customers | 4,138,465 | 4,138,465 |
| Prepayments and accrued income | 3,858 | 3,858 |
| Other assets | 135,602 | 135,602 |
| Total financial assets | 5,995,237 | 5,995,237 |
| Total non-financial assets | | 34,766 |
| Total assets | | 6,030,003 |
| Liabilities | | |
| Deposits by banks | 3,055,000 | 3,055,000 |
| Customer accounts | 2,123,314 | 2,123,314 |
| Items in the course of transmission to other banks | 6,589 | 6,589 |
| Accruals, deferred income and other liabilities | 105,617 | 105,617 |
| Provisions | 195,507 | 195,507 |
| Subordinated liabilities | 95,202 | 95,202 |
| Total financial liabilities | 5,581,229 | 5,581,229 |
| Total non-financial liabilities | | 31,066 |
| Total liabilities | | 5,612,295 |

Marks and Spencer Financial Services Plc

| | Amortised cost | Total |
|--|------------------|------------------|
| | £'000 | £'000 |
| At 31 Dec 2018 | | |
| Assets | | |
| Cash and balances at central banks | 10,211 | 10,211 |
| Items in the course of collection from other banks | 30,246 | 30,246 |
| Loans and advances to banks | 1,691,726 | 1,691,726 |
| Loans and advances to customers | 3,773,913 | 3,773,913 |
| Prepayments and accrued income | 1,449 | 1,449 |
| Other assets | 44,578 | 44,578 |
| Total financial assets | 5,552,123 | 5,552,123 |
| Total non-financial assets | | 17,779 |
| Total assets | | 5,569,902 |
| Liabilities | | |
| Deposits by banks | 2,627,092 | 2,627,092 |
| Customer accounts | 2,250,232 | 2,250,232 |
| Items in the course of transmission to other banks | 2,660 | 2,660 |
| Accruals, deferred income and other liabilities | 107,232 | 107,232 |
| Provisions | 114,800 | 114,800 |
| Subordinated liabilities | 79,196 | 79,196 |
| Total financial liabilities | 5,181,212 | 5,181,212 |
| Total non-financial liabilities | | 24,244 |
| Total liabilities | | 5,205,456 |

12. Fair value of financial instruments not carried at fair value

Where repricing is greater than six months using discounted cash flow, each loan or deposit is valued using a LIBOR-based discount curve applied to the expected cash flows.

Fair values at the balance sheet date of the assets and liabilities set out below are estimated for the purpose of disclosure as follows:

| | Carrying amount | Fair values | | | Total |
|---------------------------------|-----------------|----------------------|-------------------------|--------------------------------------|-----------|
| | | Valuation techniques | | | |
| | | Quoted price | Using observable inputs | With significant unobservable inputs | |
| | | | | | |
| | £'000 | £'000 | £'000 | £'000 | £'000 |
| At 31 Dec 2019 | | | | | |
| Assets | | | | | |
| Loans and advances to banks | 1,700,247 | — | 1,700,247 | — | 1,700,247 |
| Loans and advances to customers | 4,138,465 | — | — | 4,138,465 | 4,138,465 |
| Liabilities | | | | | |
| Deposits by banks | 3,055,000 | — | 3,055,000 | — | 3,055,000 |
| Customer accounts | 2,123,314 | — | 2,123,314 | — | 2,123,314 |
| Subordinated liabilities | 95,202 | — | 95,202 | — | 95,202 |
| At 31 Dec 2018 | | | | | |
| Assets | | | | | |
| Loans and advances to banks | 1,691,726 | — | 1,691,726 | — | 1,691,726 |
| Loans and advances to customers | 3,773,913 | — | — | 3,773,913 | 3,773,913 |
| Liabilities | | | | | |
| Deposits by banks | 2,627,092 | — | 2,627,092 | — | 2,627,092 |
| Customer accounts | 2,250,232 | — | 2,250,232 | — | 2,250,232 |
| Subordinated liabilities | 79,196 | — | 79,196 | — | 79,196 |

Other financial instruments not carried at fair value are typically short-term in nature and reprice to current market rates frequently. Accordingly, their carrying amount is a reasonable approximation of fair value. They include cash and balances at central banks and items in the course of collection from and transmission to other banks, all of which are measured at amortised cost.

Valuation

Fair value is an estimate of 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. It does not reflect the economic benefits and costs that Entity expects to flow from an instrument's cash flow over its expected future life. The Entity's valuation methodologies and assumptions in determining fair values for which no observable market process are available may differ from those of other companies.

Marks and Spencer Financial Services Plc

Loans and advances to banks and customers

The fair values of loans and advances are based on observable market transactions, when available. When they are unavailable, fair values are estimated using valuation models incorporating a range of input assumptions. These assumptions may include: value estimates from third-party brokers reflecting over-the-counter trading activity; forward-looking discounted cash flow models, using assumptions which M&S Bank believes are consistent with those that would be used by market participants in valuing such loans; and trading inputs from other market participants including observed primary and secondary trades.

The fair value of loans reflects expected credit losses at the balance sheet date and estimates of market participants' expectations of credit losses over the life of the loans, and the fair value effect of repricing between origination and the balance sheet date. For credit impaired loans, fair value is estimated by discounting future cash flows over the time period they are expected to be recovered.

Deposits by banks, customer accounts and subordinated liabilities

The fair values of on-demand deposits are approximated by their carrying value. For deposits with longer-term maturities, fair values are estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities.

For all financial instruments, the fair value is equal to the carrying value in the balance sheet.

13. Loans and advances to banks

| | 2019 | 2018 |
|---|------------------|------------------|
| | £'000 | £'000 |
| Loans and advances held with parent | 1,699,633 | 1,691,503 |
| Nostro balances with parent and fellow subsidiaries | 614 | 223 |
| At 31 Dec | 1,700,247 | 1,691,726 |

Amounts due from group undertakings are unsecured, interest bearing and have fixed dates of repayment which range from 15 January 2020 to 13 April 2022. Previously these were classified as cash and cash equivalents. In 2019 these items have been re-presented and are now excluded from cash and cash equivalents for the purposes of the cash flow statement. All loans and advances to other banks have variable interest rates and are repayable on demand.

Loans with variable rates totalled £0.6m (2018: £0.2m).

14. Loans and advances to customers

| | 2019 | 2018 |
|---------------------------------------|------------------|------------------|
| | £'000 | £'000 |
| Gross loans and advances to customers | 4,266,221 | 3,855,365 |
| Impairment allowances (Note 28) | (127,756) | (81,452) |
| At 31 Dec | 4,138,465 | 3,773,913 |

This has resulted in the recognition of £68.3m within loans and advances to customers as at 31 December 2019 (31 December 2018: £63.6m).

- The estimated life is reviewed annually and MBS Bank have assessed 7 years as continuing to be the most appropriate life (2018: 7 years).

Where these proportions differ from forecast in relation to balance and interest an adjustment to the carrying value of the asset must be recognised in the financial statements.

Management have assessed the sensitivity of balance and interest assumptions by considering the impact of changes to these on significant other plans.

decrease in the assumed interest yield would decrease the asset value by £6.1m.

conversely, increases in the above assumptions would increase asset values by similar amounts. The entity has considered the impact of persistent debt regulation and made an estimate of the impact of future EIR assets (£2.9m reduction in the asset).

Marks and Spencer Financial Services Plc

15. Investments in subsidiaries

Details of all subsidiaries, as required under section 409 of Companies Act 2006, are set out below. The principal countries of operation are the same as the countries of incorporation.

| As at 31 Dec 2019 | Country of Incorporation | Interest in Equity Capital (%) | share Class | No. of shares |
|-------------------------------|-----------------------------|-----------------------------------|-------------|---------------|
| Kings Meadow Nominees Limited | United Kingdom | — | 0 | — |

| As at 31 Dec 2018 | Country of Incorporation | Interest in Equity Capital (%) | share Class | No. of shares |
|--|-----------------------------|-----------------------------------|----------------|---------------|
| Kings Meadow Nominees Limited ¹ | United Kingdom | 100 | Ordinary £1.00 | 2 |

¹ Registered office: Kings Meadow, Chester Business Park, Chester CH99 9FB

Kings Meadow Nominees Limited was dissolved on 25th December 2019.

16. Property, plant and equipment

| | Equipment, fixtures and fittings | |
|--------------------------|----------------------------------|---------------|
| | 2019 | 2018 |
| | £'000 | £'000 |
| Cost | | |
| At 1 Jan | 50,067 | 50,264 |
| Additions | 682 | 520 |
| Disposals | — | (717) |
| As at 31 Dec | 50,749 | 50,067 |
| Accumulated depreciation | | |
| At 1 Jan | 48,466 | 48,477 |
| Charge for the year | 737 | 706 |
| Disposals | — | (717) |
| As at 31 Dec | 49,203 | 48,466 |
| Net book value | | |
| At 1 Jan | 1,601 | 1,787 |
| As at 31 Dec | 1,546 | 1,601 |

17. Intangible assets

| | Software development costs | |
|--------------------------|----------------------------|---------------|
| | 2019 | 2018 |
| | £'000 | £'000 |
| Cost | | |
| At 1 Jan | 56,329 | 55,978 |
| Additions | — | 351 |
| Adjustment | (198) | — |
| As at 31 Dec | 56,131 | 56,329 |
| Accumulated amortisation | | |
| At 1 Jan | 54,785 | 54,483 |
| Charge for the year | 330 | 302 |
| Impairment | — | — |
| Adjustment | (475) | — |
| As at 31 Dec | 54,640 | 54,785 |
| Net book value | | |
| At 1 Jan | 1,544 | 1,495 |
| As at 31 Dec | 1,491 | 1,544 |

18. Other assets

| | 2019 | 2018 |
|-------------------------------------|----------------|---------------|
| | £'000 | £'000 |
| Amounts due from group undertakings | 28,421 | 422 |
| Profit Share due from M&S plc | 88,563 | 24,866 |
| Other items due from M&S plc | 12,408 | 13,185 |
| Other assets | 6,210 | 6,105 |
| At 31 Dec | 135,602 | 44,578 |

Amounts due from group undertakings are unsecured and repayable on demand.

Profit share due from M&S plc will be recovered in line with the relationship agreement, through offsetting future profit share charges as profits are earned.

Marks and Spencer Financial Services Plc

19. Deposits by banks

| | 2019 | 2018 |
|-------------------------------------|------------------|------------------|
| | £'000 | £'000 |
| Amounts due from group undertakings | 3,055,000 | 2,622,783 |
| Deposits from other banks | — | 4,309 |
| At 31 Dec | 3,055,000 | 2,627,092 |

Amounts due from group undertakings contractual maturity is detailed in Note 24.

20. Customer accounts

| | 2019 | 2018 |
|---|------------------|------------------|
| | £'000 | £'000 |
| Retail customers | | |
| Credit balances on unsecured loans and advances | 8,946 | 8,306 |
| Customer deposits | 2,114,368 | 2,241,926 |
| At 31 Dec | 2,123,314 | 2,250,232 |

Customer savings deposits have variable interest rates and are repayable on demand. Customer deposits with variable rates totalled £1,742m (2018: £1,791m). Customer deposits with fixed rates totalled £372m (2018: £451m).

21. Accruals, deferred income and other financial liabilities

| | 2019 | 2018 |
|---|----------------|----------------|
| | £'000 | £'000 |
| Accruals and deferred income | 18,279 | 18,526 |
| Amounts owed to group undertakings | — | — |
| Amounts owed to intermediate parent undertaking | 4,854 | 8,819 |
| Amounts owed to other group companies | 20,949 | 29,357 |
| Items in the course of settlement | 35,627 | 36,644 |
| Other liabilities | 25,908 | 13,886 |
| At 31 Dec | 105,617 | 107,232 |

Amounts repayable to group undertakings are unsecured, interest free and have no fixed date of repayments.

22. Provisions

| | Restructuring provision | Skilled person review Provision | NOSIA provision | Customer redress provision | Fraud Provision | ECL on undrawn commitments | Total |
|--|-------------------------|---------------------------------|-----------------|----------------------------|-----------------|----------------------------|----------------|
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| At 1 Jan 2019 | 743 | — | — | 113,312 | — | 745 | 114,800 |
| Increase/ (Decrease) in provision ¹ | 1,797 | 15,192 | 13,323 | 212,229 | 444 | (106) | 242,879 |
| Provision utilised | (268) | — | (13,077) | (148,738) | — | — | (162,083) |
| Provision released | (89) | — | — | — | — | — | (89) |
| At 31 Dec 2019 | 2,183 | 15,192 | 246 | 176,803 | 444 | 639 | 195,507 |
| At 1 Jan 2018 | 567 | — | — | 212,558 | — | — | 213,125 |
| Increase in provision | 1,314 | — | — | 62,846 | — | 745 | 64,905 |
| Provision utilised | (1,138) | — | — | (162,092) | — | — | (163,230) |
| Provision released | — | — | — | — | — | — | — |
| At 31 Dec 2018 | 743 | — | — | 113,312 | — | 745 | 114,800 |

¹ Increases/(Decreases) in provisions are recognised within operating expenses (PPI, Skilled Person Review and NOSIA), Interest Income (Skilled Person Review and NOSIA) and Fee Income (Skilled Person Review and NOSIA)

Restructuring provision

A provision of £2.2m (2018: £0.7m) exists for redundancy payments to a number of employees where employment is to be terminated as part of a restructuring programme. The provision reflects the full amount of payments agreed with the individuals affected.

Customer redress - Collections and recoveries related matters (skilled persons review)

At 31 December 2019, a provision of £15.2m was held to the estimated liability for redress payable to customers following a review of historical collections and recoveries practices in the UK.

The provision has been estimated in respect of a number of different customer cohorts who may have been impacted. The exact redress to be paid is dependent on the extraction of significant detailed historical data. The complete data was not available as at 31 December 2019 and therefore estimates have been made in respect of the customer redress due.

As such there remains considerable uncertainty in respect of both the numbers of affected customers and the level of redress to be paid, and the provision remains subject to significant judgement. Given that the provision relates to a number of different matters, there is no single material assumption and the provision has been considered by management in respect of each individual matter and also holistically across all matters for reasonableness. Redress is expected to be completed during 2020.

The table below sets out sensitivities to the assumptions used but it is not intended to indicate a range of any final amount payable.

| Assumption | £m |
|--|-----|
| 20% increase/decrease in population of customers impacted | 2.8 |
| 20% increase/decrease in level of redress to be paid in respect of interest and fees charged | 1.5 |

Customer redress - PPI

At 31 December 2019, £154m (2018: £102m) of the customer remediation provision relates to the estimated liability for redress in respect of the possible mis-selling of payment protection insurance ('PPI') policies in previous years.

Payments totalling £128m were made during 2019. An increase in provisions of £212m was recognised during the year, primarily reflecting the deadline of 29 August 2019 for bringing complaints announced by the FCA, and leading to:

- a higher than expected increase in the number of inbound complaints received prior to 29 August 2019;
- the effect on the total number of inbound complaints as a result of treating customer information requests relating to PPI policies received between 29 June 2019 and 29 August 2019 as complaints;
- the additional operational expenses related to the increases in populations of potential claims;
- an industry wide exercise by the Official Receiver to pursue redress amounts in respect of bankrupt and insolvent customers; and
- an increased volume of actual or forecast legal claims for PPI mis-selling which is not affected by the deadline of 29 August 2019.

The estimated liability for redress is calculated on the basis on the return of the total premiums paid by the customer plus simple interest of 8% per annum (or the rate inherent in the related loan product where higher). The basis for calculating the redress liability is the same for single premium and regular premium policies. Future estimated redress levels are based on the historically observed redress paid to customers per policy. As at 31 December 2019, 291,320 complaints relating to PPI mis-selling have been recorded. The provision assumes a total of 327,784 complaints will be received, representing 61% of total policies sold. This estimate includes (i) inbound complaints, (ii) those information requests automatically converted into complaints, and (iii) the proactive contact exercise on certain policies ('outbound contact').

Although the deadline for bringing complaints has passed, customers can still commence litigation for PPI mis-selling. Provision has been made for the best estimate of any obligation to pay compensation in respect of an estimated 15,000 claims. However, given the limited period following the complaints time bar the volume and quality of future claims through legal channels, and the amount of any compensation to be paid remain uncertain.

The following table summarises the cumulative number of information requests received during the autoconversion period (29 June to 29 August 2019), and the number of claims expected to be worked in the future, excluding claims received through legal channels:

Marks and Spencer Financial Services Plc

The main assumptions in the mis-selling complaints provision are shown below:

| | Cumulative to 31 Dec 2019 |
|---|------------------------------|
| Information Requests received during autoconversion period (000's) | 383 |
| Information Requests awaiting evaluation (000's) | 17 |
| Remaining autoconverted complaints anticipated to be worked (000's) | 29 |
| Remaining inbound complaints anticipated to be worked (000's) | 9 |
| Total Remaining complaints to be worked (000's) ¹ | 38 |
| Average Uphold Rate per claim ² | 83% |
| Average Redress per customer ² | 3,223 |

¹ Excludes invalid claims for which no PPI policy exists.

² Includes inbound and autoconverted claims future expectation, excludes FOS and Official Receiver complaints.

The PPI provision is based upon assumptions and estimates. In particular, the profile of cases yet to be assessed could vary from recent experience, leading to uphold rates or average redress levels being observed which differ from those included in arriving at the provision.

We continued to monitor available information up until the date of the approval of the financial statements to ensure the provision estimate was appropriate.

Sensitivity to key assumptions

- A 10% increase/decrease in the uphold rate for inbound and autoconverted complaints yet to be worked would increase/decrease the redress provision by approximately £7m.
- A 10% increase/decrease in the average redress for inbound and autoconverted complaints yet to be worked would increase/decrease the redress provision by approximately £10m.

An increase/decrease in customer redress volumes of 3,000 received through legal channels would increase/decrease the redress provision by approximately £6m.

ECL on undrawn commitments

Further disclosure on 'ECL on undrawn commitments' can be found in the Credit Risk section of Note 28.

23. Subordinated liabilities

| | 2019 | 2018 |
|---|---------------|---------------|
| | £'000 | £'000 |
| £54m floating rate loan maturing March 2026 ¹ | 54,149 | 54,154 |
| £25m floating rate loan maturing December 2027 ² | 25,043 | 25,042 |
| £9m floating rate loan maturing June 2029 ³ | 9,004 | — |
| £7m floating rate loan maturing December 2029 ⁴ | 7,006 | — |
| At 31 Dec | 95,202 | 79,196 |

The subordinated loans above are presented on an IFRS accounting basis at amortised cost plus accrued interest. The loans rank behind senior obligations and qualify for inclusion within the Entity's tier 2 capital resources (loan value only).

During 2019, the Entity issued an aggregate £16m tier 2 subordinated loans. The Entity has not had any defaults of principal or interest or other breaches with respect to its subordinated liabilities during the years ended 31 December 2019 and 2018.

¹ Lender is HSBC UK Holdings Limited. The interest rate is three month sterling Libor plus 4.05%.

² Lender is HSBC UK Holdings Limited. The interest rate is three month sterling Libor plus 1.925%.

³ Lender is HSBC UK Bank plc. The interest rate is three month sterling Libor plus 2.12%.

⁴ Lender is HSBC UK Bank plc. The interest rate is three month sterling Libor plus 1.63%.

24. Maturity analysis of assets and liabilities

The following is an analysis of assets and liabilities by residual contractual maturities at the balance sheet date.

| | On demand £'000 | Due within 3 months £'000 | Due between 3 - 12 months £'000 | Due between 1 - 5 years £'000 | Due after 5 years £'000 | Undated £'000 | Total £'000 |
|--|--------------------|---------------------------------|---------------------------------------|-------------------------------------|-------------------------------|------------------|------------------|
| Assets | | | | | | | |
| Cash and balances with central banks | 9,361 | — | — | — | — | — | 9,361 |
| Items in the course of collection from other banks | 7,704 | — | — | — | — | — | 7,704 |
| Loans and advances to banks | 95,247 | 1,390,000 | 110,000 | 105,000 | — | — | 1,700,247 |
| Loans and advances to customers | 11,801 | 2,663,621 | 430,043 | 1,007,269 | 25,731 | — | 4,138,465 |
| Accrued income and other financial assets | — | 3,858 | — | — | — | — | 3,858 |
| Other assets | — | 54,476 | 19,908 | 61,218 | — | — | 135,602 |
| Right-of-use assets | — | — | — | — | — | 19,201 | 19,201 |
| Non-financial assets | — | — | — | — | — | 15,565 | 15,565 |
| At 31 Dec 2019 | 124,113 | 4,111,955 | 559,951 | 1,173,487 | 25,731 | 34,766 | 6,030,003 |
| Liabilities and Equity | | | | | | | |
| Deposits by banks | — | 705,000 | 1,015,000 | 1,335,000 | — | — | 3,055,000 |
| Customer accounts | 2,123,314 | — | — | — | — | — | 2,123,314 |
| Items in the course of transmission to other banks | 6,589 | — | — | — | — | — | 6,589 |
| Accruals and other financial liabilities | — | 965 | 2,922 | 15,451 | — | 86,279 | 105,617 |
| Subordinated liabilities | — | 202 | — | — | 95,000 | — | 95,202 |
| Provisions | — | 52,049 | 101,864 | 26,403 | — | 15,191 | 195,507 |
| Non-financial liabilities | — | 31,066 | — | — | — | — | 31,066 |
| Equity | — | — | — | — | — | 417,708 | 417,708 |
| At 31 Dec 2019 | 2,129,903 | 789,282 | 1,119,788 | 1,376,854 | 95,000 | 519,178 | 6,030,003 |

Where there is no contractual notice period, items are included in the Undated time bucket.

Loans and Advances to customers maturity has been updated in 2019 to reflect potential customer behaviour.

Other assets includes profit share recoverable from M&S plc, given the nature of the contract recovery will be over a period of time.

| | | | | | | | |
|--|------------------|----------------|----------------|------------------|----------------|----------------|------------------|
| Assets | | | | | | | |
| Cash and balances with central banks | 10,211 | — | — | — | — | — | 10,211 |
| Items in the course of collection from other banks | 30,246 | — | — | — | — | — | 30,246 |
| Loans and advances to banks | 1,391,726 | 30,000 | 215,000 | 55,000 | — | — | 1,691,726 |
| Loans and advances to customers | 97,794 | 185,991 | 748,372 | 2,088,055 | 653,701 | — | 3,773,913 |
| Accrued income and other financial assets | — | 1,449 | — | — | — | — | 1,449 |
| Other assets | — | 44,578 | — | — | — | — | 44,578 |
| Non-financial assets | — | — | — | — | — | 17,779 | 17,779 |
| At 31 Dec 2018 | 1,529,977 | 202,018 | 963,372 | 2,143,055 | 653,701 | 17,779 | 5,569,902 |
| Liabilities and Equity | | | | | | | |
| Deposits by banks | 27,682 | 659,410 | 885,000 | 1,055,000 | — | — | 2,627,092 |
| Customer accounts | 2,250,232 | — | — | — | — | — | 2,250,232 |
| Items in the course of transmission to other banks | 2,660 | — | — | — | — | — | 2,660 |
| Accruals and other financial liabilities | — | — | — | — | — | 107,232 | 107,232 |
| Subordinated liabilities | — | 196 | — | — | 79,000 | — | 79,196 |
| Provisions | — | 40,318 | 73,320 | 1,162 | — | — | 114,800 |
| Non-financial liabilities | — | 24,244 | — | — | — | — | 24,244 |
| Equity | — | — | — | — | — | 364,446 | 364,446 |
| At 31 Dec 2018 | 2,280,574 | 724,168 | 958,320 | 1,056,162 | 79,000 | 471,678 | 5,569,902 |

Marks and Spencer Financial Services Plc

25. Called up share capital

Called up share capital

Marks and Spencer Financial Services plc ordinary shares of £1.00 each, issued and fully paid

| | 2019 | | 2018 | |
|---|--------------------|----------------|-------------------|---------------|
| | Number | £'000 | Number | £'000 |
| Issued, allotted and fully paid up | | | | |
| Ordinary shares of £1 each | | | | |
| As at 1 Jan | 93,000,000 | 93,000 | 45,000,000 | 45,000 |
| Issued during the year | 167,000,000 | 167,000 | 48,000,000 | 48,000 |
| As at 31 Dec | 260,000,000 | 260,000 | 93,000,000 | 93,000 |
| Additional tier 1 instrument | | 69,000 | | 60,000 |

During 2019, the Entity issued an aggregate 167,000,000 fully paid ordinary shares of £1.00 each to HSBC UK Bank plc for a total consideration of £167,000,000.

Other equity instruments

Marks and Spencer Financial Services plc additional tier 1 instruments

| | 2019 | 2018 |
|--|---------------|---------------|
| | £'000 | £'000 |
| £40m Undated Subordinated Additional Tier 1 instrument issued 2016 (callable March 2021) ¹ | 40,000 | 40,000 |
| £20m Undated Subordinated Additional Tier 1 instrument issued 2017 (callable December 2022) ² | 20,000 | 20,000 |
| £9m Undated Subordinated Additional Tier 1 instrument issued 2019 (callable December 2024) ³ | 9,000 | 0 |
| At 31 Dec | 69,000 | 60,000 |

All the Entity's additional tier 1 capital instruments are perpetual in nature with a fixed rate of interest. The instruments are repayable, at the option of the Entity, in whole at the initial call date, or on any interest payment date after the initial call date. Interest is payable at the sole discretion of the Entity and are therefore accounted for as equity and included in the Entity's capital base as fully CRD IV compliant additional tier 1 capital.

During 2019, the Entity issued a £9m perpetual additional tier 1 capital instrument.

¹ Holder is HSBC UK Holdings Limited. The interest rate is fixed at 8.5625%.

² Holder is HSBC UK Holdings Limited. The interest rate is fixed at 5.25%.

³ Holder is HSBC UK Bank plc. The interest rate is fixed at 4.75%.

26. Contingent liabilities, contractual commitments and guarantees

The following table gives the nominal principal amounts of off-balance sheet transactions:

| | 2019 | 2018 |
|---|------------------------|------------------------|
| | £'000 | £'000 |
| Commitments | Contract amount | Contract amount |
| Undrawn formal standby facilities, credit lines and other commitments to lend | 11,122,169 | 11,305,448 |
| At 31 Dec | 11,122,169 | 11,305,448 |

The table above discloses the nominal principal amounts, which represent the maximum amounts at risk should the contracts be fully drawn upon and clients default. As a significant portion of commitments are expected to expire without being drawn upon, the total of the nominal principal amounts is not indicative of future liquidity requirements. The expected credit loss provision relating to commitments under IFRS 9 is disclosed in Note 28.

Various HSBC Group companies, including the Entity, are subject to an investigation by the FCA in connection with historical collections and recoveries operations in the UK. This matter is at a very early stage. Based on the facts currently known, it is not practicable at this time for the Entity to predict the resolution of this matter, including the timing or any possible impact on the Entity, which could be significant.

Contingent liabilities relate to regulatory matters arising out of M&S Banks normal business operations.

27. Right-of-use assets

Effects of reclassification on the adoption of IFRS 16

On transition to IFRS16, the entity recognised an additional £23m of right-of-use assets and £23m of lease liabilities.

When measuring lease liabilities, the entity discounted lease payments using the incremental borrowing rate at 1 January 2019.

The Weighted-average rate applied is 1.82%.

| | 2019 |
|--|---------------|
| | £'000 |
| Operating lease commitment at 31 December 2018 | 4,066 |
| Finance lease liabilities recognised as at 31 December 2018 | 4,066 |
| - Extension and termination options reasonable certain to be exercised | 19,093 |
| Lease liabilities recognised at 1 January 2019 | 23,159 |

| | Right-of-use asset | |
|---------------------------------|--------------------|-------|
| | 2019 | 2018 |
| | £'000 | £'000 |
| Cost | | |
| At 1 Jan | 23,159 | — |
| As at 31 Dec | 23,159 | — |
| Accumulated depreciation | | |
| At 1 Jan | — | — |
| Charge for the year | 3,958 | — |
| As at 31 Dec | 3,958 | — |
| Net book value | | |
| At 1 Jan | 23,159 | — |
| As at 31 Dec | 19,201 | — |

28. Management of financial risk

All of the Entity's activities involve to varying degrees, the analysis, evaluation, acceptance and management of risks or combination of risks. The most important types of risk include financial risk, which comprises credit risk, liquidity risk and market risk. The management of financial risk and consideration of profitability, cash flows and capital resources form a key element in the Directors' assessment of the Entity as a going concern.

Credit risk management

Credit risk is the risk of financial loss if a customer or counterparty of the Entity fails to meet a payment obligation under a contract. Credit risk arises principally from direct lending.

Within the overall framework of the HSBC Group policy, the Entity has an established risk management process encompassing credit approvals, the control of exposures, credit policy direction to the business, and the monitoring and reporting of exposures.

The management of the Entity is responsible for the quality of its credit portfolios and follows a credit process involving delegated approval authorities and credit procedures, the objective of which is to identify problem exposures in order to accelerate remedial action while building a portfolio of high quality risk assets. The Entity's credit risk rating systems and processes differentiate exposures in order to highlight those with greater risk factors and higher potential severity of loss. Regular reviews are undertaken to assess and evaluate levels of risk concentration.

The Entity's risk rating system facilitates the internal ratings-based ('IRB') approach under Basel II to support calculation of the minimum credit regulatory capital requirement.

Marks and Spencer Financial Services Plc

Summary of credit risk

A summary of our current policies and practices regarding credit risk is set out on pages 24-26.

There were no material changes to our policies and practices for the management of credit risk in 2019.

A temporary pause in defaulting accounts has resulted in an increase of £16.9m in Stage 3 balances which will be addressed through the re-commencement of the default process in Q1 2020.

The disclosure below presents the gross carrying/nominal amount of financial instruments to which the impairment requirements in IFRS 9 are applied and the associated allowance for ECL. Due to the forward-looking nature of IFRS 9, the scope of financial instruments on which ECL are recognised is greater than the scope of IAS 39.

The IFRS 9 allowance for ECL has increased from £82m at 1 January 2019 to £128m at 31 December 2019. The IFRS 9 allowance for expected credit losses ('ECL') at 31 December 2019 comprises £127m in respect of assets held at amortised cost and £1m in respect of loan commitments and financial guarantees.

The following tables analyse loans by industry sector and represent the concentration of exposures on which credit risk are managed.

Summary of financial instruments to which the impairment requirements of IFRS 9 are applied

| | 2019 | | 2018 | |
|---|--|--|--|---|
| | Gross carrying/ nominal amount £'000 | Allowance/ Provision for ECL ¹ £'000 | Gross carrying/ nominal amount £'000 | Allowance/ Provision for ECL ¹ £'000 |
| Loans and advances to customers at amortised cost | 4,266,221 | (127,756) | 3,855,365 | (81,452) |
| Loans and advances to banks at amortised cost | 1,700,247 | — | 1,691,728 | — |
| Other financial assets at amortised cost ² | 175,725 | — | 86,484 | — |
| Total gross carrying amount on balance sheet | 6,142,193 | (127,756) | 5,633,575 | (81,452) |
| Loans and other credit related commitments | 11,122,169 | (639) | 11,305,448 | (745) |
| Total nominal amount off-balance sheet² | 11,122,169 | (639) | 11,305,448 | (745) |
| At 31 Dec | 17,264,362 | (128,395) | 16,939,023 | (82,197) |

¹ The total ECL is recognised in the loss allowance for the financial asset unless the total ECL exceeds the gross carrying amount of the financial asset, in which case the ECL is recognised as a provision

² Represents the maximum amount at risk should the contracts be fully drawn upon and clients default

³ Other assets includes cash and balances at central banks, items in the course of collection from other banks, and prepayments and accrued income

The following table provides an overview of the Entity's credit risk by stage and industry, and the associated ECL coverage. The financial assets recorded in each stage have the following characteristics:

- Stage 1: Unimpaired and without significant increase in credit risk on which a 12-month allowance for ECL is recognised.
- Stage 2: A significant increase in credit risk has been experienced since initial recognition on which a lifetime ECL is recognised.
- Stage 3: Objective evidence of impairment, and are therefore considered to be in default or otherwise credit-impaired on which a lifetime ECL is recognised.

Summary of credit risk by stage distribution and ECL coverage by industry sector

| | Gross carrying/nominal amount | | | Allowance for ECL | | | ECL Coverage % | | |
|--|-------------------------------|----------------|---------------|-------------------|-----------------|-----------------|----------------|--------------|--------------|
| | Stage 1 | Stage 2 | Stage 3 | Stage 1 | Stage 2 | Stage 3 | Stage 1 | Stage 2 | Stage 3 |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | % | % | % |
| Loans and advances to customers at amortised cost | 3,536,903 | 659,355 | 69,963 | (12,652) | (85,366) | (29,738) | — | (0.1) | (0.4) |
| Loans and advances to banks at amortised cost | 1,700,247 | — | — | — | — | — | — | — | — |
| Other financial assets measured at amortised cost ¹ | 175,725 | — | — | — | — | — | — | — | — |
| Loan and other credit-related commitments | 11,041,637 | 52,824 | 27,708 | (639) | — | — | — | — | — |
| - personal | 11,041,637 | 52,824 | 27,708 | (639) | — | — | — | — | — |
| At 31 Dec 2019 | 16,454,512 | 712,179 | 97,671 | (13,291) | (85,366) | (29,738) | — | (0.1) | (0.3) |
| Loans and advances to customers at amortised cost | 3,319,770 | 481,526 | 54,069 | (12,077) | (58,483) | (10,892) | — | (0.1) | (0.2) |
| Loans and advances to banks at amortised cost | 1,691,726 | — | — | — | — | — | — | — | — |
| Other financial assets measured at amortised cost ¹ | 86,484 | — | — | — | — | — | — | — | — |
| Loan and other credit-related commitments | 11,276,082 | 3,014 | 26,352 | (745) | — | — | — | — | — |
| - personal | 11,276,082 | 3,014 | 26,352 | (745) | — | — | — | — | — |
| At 31 Dec 2018 | 16,374,062 | 484,540 | 80,421 | (12,822) | (58,483) | (10,892) | — | (0.1) | (0.1) |

¹ Other assets includes cash and balances at central banks, items in the course of collection from other banks, and prepayments and accrued income.

Unless identified at an earlier stage, all financial assets are deemed to have suffered a significant increase in credit risk when they are 30 days past due and are transferred from stage 1 to stage 2. The disclosure below presents the aging of stage 2 financial assets by those less than 30 days past due and therefore presents those financial assets classified as stage 2 due to aging (30 days past due) and those identified at an earlier stage (less than 30 days past due). Past due financial instruments are those loans where customers have failed to make payments in accordance with the contractual terms of their facilities.

Marks and Spencer Financial Services Plc

| | Gross carrying/nominal amount | | | Allowance for ECL | | | ECL coverage % | | |
|---|-------------------------------|-----------------------------|------------------------------|-------------------|-----------------------------|------------------------------|----------------|-----------------------------|------------------------------|
| | Of which | | | Of which | | | Of which | | |
| | Stage 2 | 1 to 29 Days past due | 30 and > Days past due | Stage 2 | 1 to 29 Days past due | 30 and > Days past due | Stage 2 | 1 to 29 Days past due | 30 and > Days past due |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | % | % | % |
| Loans and advances to customers at amortised cost | 659,355 | 21,259 | 13,869 | (85,366) | (5,491) | (6,671) | (12.9) | (25.8) | (48.1) |

| | Gross carrying/nominal amount | | | Allowance for ECL | | | ECL coverage % | | |
|---|-------------------------------|-----------------------------|------------------------------|-------------------|-----------------------------|------------------------------|----------------|-----------------------------|------------------------------|
| | Of which | | | Of which | | | Of which | | |
| | Stage 2 | 1 to 29 Days past due | 30 and > Days past due | Stage 2 | 1 to 29 Days past due | 30 and > Days past due | Stage 2 | 1 to 29 Days past due | 30 and > Days past due |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | % | % | % |
| Loans and advances to customers at amortised cost | 481,526 | 21,733 | 12,358 | (58,483) | (5,171) | (5,543) | (12.1) | (23.8) | (44.9) |

Reconciliation of allowances for loans and advances to banks and customers including loan commitments and financial guarantees

| | 2019 | 2018 |
|--|---------------|---------------|
| | ECL allowance | ECL allowance |
| | £'000 | £'000 |
| At 1 Jan | (82,197) | (62,753) |
| ECL income statement charge for the period | (85,097) | (69,232) |
| Assets written off | 38,899 | 50,025 |
| Exchange and other movements | — | (237) |
| At 31 Dec | (128,395) | (82,197) |
| ECL income statement charge for the period | 85,097 | 69,232 |
| Add: Recoveries | (14,808) | (19,095) |
| Add: Modification gains or (losses) on contractual cash flows that did not result in derecognition | — | — |
| Total ECL income charge for the period | 70,289 | 50,137 |

Credit exposure

Maximum exposure to credit risk

The following table presents our maximum exposure before taking account of any collateral held or other credit enhancements (unless such enhancements meet accounting offsetting requirements). The table excludes financial instruments whose carrying amount best represents the net exposure to credit risk and it excludes equity securities as they are not subject to credit risk. For the financial assets recognised on the balance sheet, the maximum exposure to credit risk equals their carrying amount; for financial guarantees and similar contracts granted, it is the maximum amount that we would have to pay if the guarantees were called upon. For loan commitments and other credit-related commitments, it is generally the full amount of the committed facilities.

The following table provides information on balance sheet items, offsets, and loan and other credit-related commitments.

| | 2019 | | | 2018 | | |
|---|------------------|--------|------------|------------------|--------|------------|
| | Maximum exposure | Offset | Net | Maximum exposure | Offset | Net |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Loans and advances to banks at amortised cost | 1,700,247 | — | 1,700,247 | 1,691,726 | — | 1,691,726 |
| Loans and advances to customers at amortised cost | 4,266,221 | — | 4,266,221 | 3,855,365 | — | 3,855,365 |
| Other assets ¹ | 175,725 | — | 175,725 | 86,484 | — | 86,484 |
| Total on balance sheet exposure to credit risk | 6,142,193 | — | 6,142,193 | 5,633,575 | — | 5,633,575 |
| Total off balance sheet | | | | | | |
| - Loan and other credit related commitments | 11,122,169 | — | 11,122,169 | 11,305,448 | — | 11,305,448 |
| At 31 Dec | 17,264,362 | — | 17,264,362 | 16,939,023 | — | 16,939,023 |

¹ Other assets includes cash and balances at central banks, items in the course of collection from other banks, and prepayments and accrued income.

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Concentration of credit risk exposure

Concentrations of credit risk arise when a number of counterparties or exposures have comparable economic characteristics, or such counterparties are engaged in similar activities, or operate in the same geographical areas or industry sectors, so that their collective ability to meet contractual obligations is uniformly affected by changes in economic, political or other conditions (see loans and advances to customers by industry table on Note 14).

Due to the retail-based nature of its lending activities, the Entity is not exposed to any significant concentration risk.

Credit deterioration of financial instruments

A summary of our current policies and practices regarding the identification, treatment and measurement of stage 1, stage 2 and stage 3 (credit impaired) can be found in Note 1.2 of the financial statements.

Measurement uncertainty and sensitivity analysis of ECL estimates

The recognition and measurement of expected credit loss ('ECL') involves the use of significant judgement and estimation. We form multiple economic scenarios based on economic forecasts, apply these assumptions to credit risk models to estimate future credit losses, and probability-weight the results to determine an unbiased ECL estimate.

Methodology

We use multiple economic scenarios to reflect assumptions about future economic conditions, starting with three economic scenarios based on consensus forecast distributions, supplemented by alternative or additional economic scenarios and/or management adjustments where, in management's judgement, the consensus forecast distribution does not adequately capture the relevant risks.

The three economic scenarios represent the 'most likely' outcome and two less likely outcomes referred to as the Upside and Downside scenarios. Each outer scenario is consistent with a probability of 10%, while the Central scenario is assigned the remaining 80%, according to the decision of the Group's senior management. This weighting scheme is deemed appropriate for the unbiased estimation of ECL in most circumstances.

Economic assumptions in the Central consensus economic scenario are set using consensus forecasts which represent the average of forecasts of external economists. Reliance on external forecasts helps ensure that the Central scenario is unbiased and maximises the use of independent information. The Upside and Downside scenarios are selected with reference to externally available forecast distributions and are designed to be cyclical, in that GDP growth, inflation and unemployment usually revert back to the Central scenario after the first three years. We determine the maximum divergence of GDP growth from the Central scenario using the 10th and the 90th percentile of the entire distribution of forecast outcomes. While key economic variables are set with reference to external distributional forecasts, we also align the overall narrative of the scenarios to macroeconomic risks. This ensures that scenarios remain consistent with the more qualitative assessment of these risks. We project additional variable paths using the external provider's global macro model.

The Upside and Downside scenarios are generated once a year, reviewed at each reporting date to ensure that they are an appropriate reflection of management's view and updated if economic conditions change significantly. The Central scenario is generated every quarter. For quarters without updates to outer scenarios, wholesale and retail credit risk use the updated Central scenario to approximate the impact of the most recent outer scenarios.

Additional scenarios are created as required, to address those forward-looking risks that management consider are not adequately captured by the consensus. At the reporting date, we have deployed additional scenarios to address economic uncertainty.

Description of consensus economic scenarios

The economic assumptions presented in this section have been formed internally by the HSBC Group specifically for the purpose of calculating expected credit loss.

The consensus Central scenario

Our Central scenario is one of moderate growth over the forecast period 2020-2024. Global GDP growth is expected to be 2.8% on average over the period, which is marginally lower than the average growth rate over the period 2014-2018. We note:

- Expected average rates of GDP growth over the 2020-2024 period are lower than average growth rates achieved over the 2014-2018 period. This reflects expectations that the long-term impact of current economic uncertainty will be moderately adverse.
- The unemployment rate is expected to rise over the forecast horizon.
- Inflation is expected to be stable and will remain close to central bank targets in our core markets over the forecast period.
- The Bank of England kept its main policy interest rates in 2019 and is expected to continue to maintain a low interest rate environment over the projection horizon.

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The following table describes key macroeconomic variables and the probabilities assigned in the consensus Central scenario.

| Central scenario | Average 2020-2024 | Average 2019-2023 |
|----------------------------------|----------------------|----------------------|
| | UK | UK |
| GDP growth rate (%) | 1.6 | 1.7 |
| Inflation (%) | 2.0 | 2.1 |
| Unemployment (%) | 4.4 | 4.5 |
| Short term interest rate (%) | 0.6 | 1.2 |
| 10 year treasury bond yields (%) | 1.7 | 2.6 |
| House price growth (%) | 3.0 | 2.9 |
| Equity price growth (%) | 2.8 | 3.2 |
| Probability (%) | 55 | 50 |

The consensus Upside scenario

The economic forecast distribution of risks (as captured by consensus probability distributions of GDP growth) has shown a decrease in upside risks over the course of 2019. In the first two years of the Upside scenario, global real GDP growth rises before converging to the Central scenario.

Increased confidence, de-escalation of trade tensions, removal of trade barriers, expansionary fiscal policy, positive resolution of economic uncertainty in the UK, stronger oil prices and a calming of geopolitical tensions are the risk themes that support the Upside scenario.

The following table describes key macroeconomic variables and the probabilities assigned in the consensus Upside scenario.

| Upside scenario | Average 2020-2024 | Average 2019-2023 |
|----------------------------------|----------------------|----------------------|
| | UK | UK |
| GDP growth rate (%) | 2.1 | 2.2 |
| Inflation (%) | 2.4 | 2.3 |
| Unemployment (%) | 4.0 | 4.2 |
| Short term interest rate (%) | 0.6 | 1.3 |
| 10 year treasury bond yields (%) | 1.7 | 2.7 |
| House price growth (%) | 4.4 | 4.1 |
| Equity price growth (%) | 4.4 | 6.0 |
| Probability (%) | 10 | 10 |

The consensus Downside scenario

The distribution of risks (as captured by consensus probability distributions of GDP growth) has shown a marginal increase in downside risks over the course of 2019 (see discussion on the economic uncertainty below). In the Downside scenario, global real GDP growth declines for two years before recovering towards its long-run trend. House price growth either stalls or contracts and equity markets correct abruptly in our major markets in this scenario. The potential slowdown in global demand would drive commodity prices lower and result in an accompanying fall in inflation. Central banks would be expected to enact loose monetary policy, which in some markets would result in a reduction in the key policy interest rate. The scenario is consistent with our top and emerging risks.

The following table describes key macroeconomic variables and the probabilities assigned in the Consensus Downside scenario.

| Downside scenario | Average 2020-2024 | Average 2019-2023 |
|----------------------------------|----------------------|----------------------|
| | UK | UK |
| GDP growth rate (%) | 1.4 | 1.1 |
| Inflation (%) | 1.7 | 1.7 |
| Unemployment (%) | 4.8 | 4.8 |
| Short term interest rate (%) | 0.1 | 0.3 |
| 10 year treasury bond yields (%) | 0.8 | 1.6 |
| House price growth (%) | 1.6 | 1.0 |
| Equity price growth (%) | (1.1) | (0.2) |
| Probability (%) | — | — |

Alternative Downside scenarios for the UK

Three alternative Downside scenarios were maintained in 2019 for the UK, reflecting management's view of the distribution of economic risks. These scenarios reflect management's judgement that the consensus distribution does not adequately reflect the risks that stem from the UK's departure from the EU on 31 January 2020. Management evaluated events over the course of 2019 and assigned probabilities to these scenarios that take into consideration all relevant economic and political events. The three scenarios and associated probabilities are described below.

- UK alternative Downside scenario 1: Economic uncertainty could have a large impact on the UK economy resulting in a long-lasting recession with a weak recovery. This scenario reflects the consequences of such a recession with an initial risk-premium shock and weaker long-run productivity growth. This scenario has been used with a 25% weighting.

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- UK alternative Downside scenario 2: This scenario reflects the possibility that economic uncertainty could result in a deep cyclical shock triggering a steep depreciation in sterling, a sharp increase in inflation and an associated monetary policy response. This represents a tail risk and has been assigned a 5% weighting.
- UK alternative Downside scenario 3: This scenario reflects the possibility that the adverse impact associated with economic uncertainty currently in the UK could manifest over a far longer period of time with the worst effects occurring later than in the above two scenarios. This scenario is also considered a tail risk and has been assigned a 5% weighting.

The table below describes key macro-economic variables and the probabilities for each of the Alternative Downside scenarios:

Downside scenario (average 2020 - 2024)

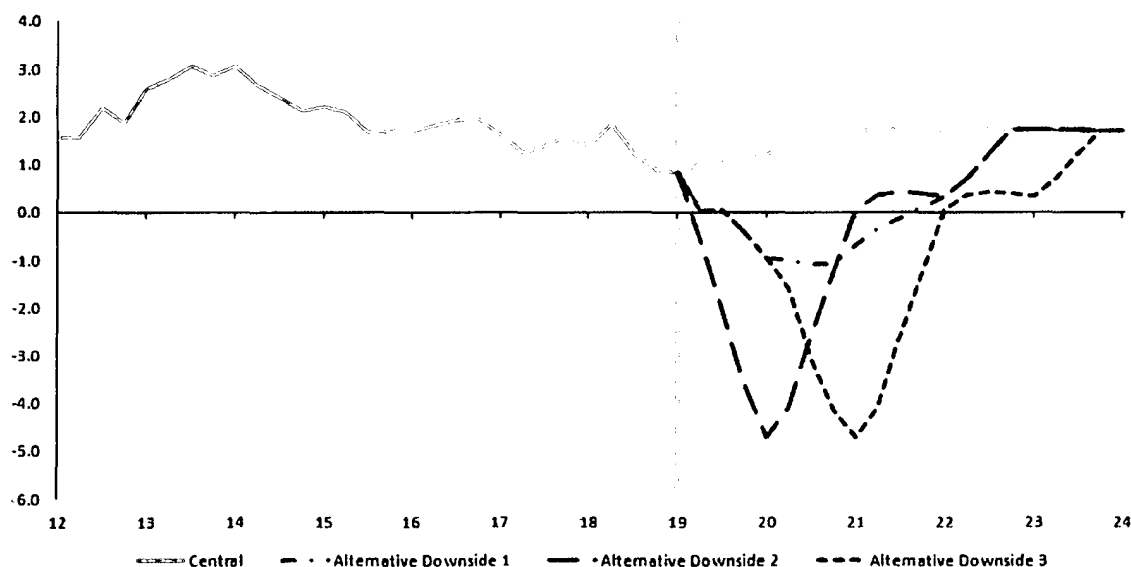
| | Alternative Downside scenario 1 | Alternative Downside scenario 2 | Alternative Downside scenario 3 |
|----------------------------------|---------------------------------|---------------------------------|---------------------------------|
| GDP growth rate (%) | 0.3 | (0.3) | (0.8) |
| Inflation (%) | 2.3 | 2.5 | 2.7 |
| Unemployment (%) | 6.5 | 8.0 | 7.7 |
| Short term interest rate (%) | 0.4 | 2.5 | 2.5 |
| 10 year treasury bond yields (%) | 1.8 | 4.0 | 4.0 |
| House price growth (%) | (1.7) | (3.7) | (4.8) |
| Equity price growth (%) | (3.3) | (4.6) | (9.6) |
| Probability (%) | 25 | 5 | 5 |

Downside scenario (average 2019 - 2023)

| | Alternative Downside scenario 1 | Alternative Downside scenario 2 | Alternative Downside scenario 3 |
|----------------------------------|---------------------------------|---------------------------------|---------------------------------|
| GDP growth rate (%) | 0.5 | (0.1) | (0.7) |
| Inflation (%) | 2.2 | 2.4 | 2.7 |
| Unemployment (%) | 6.5 | 8.0 | 7.7 |
| Short term interest rate (%) | 0.4 | 2.5 | 2.5 |
| 10 year treasury bond yields (%) | 1.8 | 4.0 | 4.0 |
| House price growth (%) | (1.5) | (3.3) | (4.8) |
| Equity price growth (%) | (0.9) | (2.3) | (7.5) |
| Probability (%) | 30 | 5 | 5 |

The conditions that resulted in departure from the consensus economic forecasts will be reviewed regularly as economic conditions change in future to determine whether these adjustments continue to be necessary.

The graph below shows the historical and forecasted GDP growth rate for five years for the various economic scenarios.



How economic scenarios are reflected in the retail calculation of ECL

We have developed and implemented a globally consistent methodology for incorporating forecasts of economic conditions into ECL estimates. The impact of economic scenarios on PD is modelled at a portfolio level. Historical relationships between observed default rates and macroeconomic variables are integrated into IFRS 9 ECL estimates by using economic response models. The impact of these scenarios on PD is modelled over a period equal to the remaining maturity of underlying asset or assets. The impact on LGD is modelled for mortgage portfolios by forecasting future loan-to-value ('LTV') profiles for the remaining maturity of the asset by using national level forecasts of the house price index and applying the corresponding LGD expectation.

Impact of UK economic scenarios on ECL

At 31 December 2019, the impact of using additional scenarios to the consensus distribution to address economic uncertainty in the UK was £28.4m (2018: £29m). We also considered developments after the balance sheet date and concluded that they did not necessitate any adjustment to the approach or judgements taken on 31 December 2019.

Economic scenarios sensitivity analysis of ECL estimates

Management considered the sensitivity of the ECL outcome against the economic forecasts as part of the ECL governance process by recalculating the ECL under each scenario described above for selected portfolios, applying a 100% weighting to each scenario in turn. The weighting is reflected in both the determination of a significant increase in credit risk and the measurement of the resulting ECL.

The ECL calculated for the Upside and Downside scenarios should not be taken to represent the upper and lower limits of possible actual ECL outcomes. The impact of defaults that might occur in future under different economic scenarios is captured by recalculating ECL for loans in stages 1 and 2 at the balance sheet date. The population of stage 3 loans (in default) at the balance sheet date is unchanged in these sensitivity calculations. Stage 3 ECL would only be sensitive to changes in forecasts of future economic conditions if the LGD of a particular portfolio was sensitive to these changes.

There is a particularly high degree of estimation uncertainty in numbers representing tail risk scenarios when assigned a 100% weighting, and an indicative range is provided for the UK tail risk sensitivity analysis.

For retail credit risk exposures, the sensitivity analysis includes ECL for loans and advances to customers related to defaulted obligors. This is because the retail ECL for secured mortgage portfolios including loans in all stages is sensitive to macroeconomic variables.

ECL under each scenario is given as a percentage of the gross carrying amount as at 31 December 2019.

| IFRS 9 ECL sensitivity to future economic conditions ¹ | | |
|--|-------------|-------------|
| | 2019 | 2018 |
| | UK | UK |
| | £m | £m |
| ECL coverage of loans and advances to customers at 31 December 2019 | | |
| Reported ECL (£m) | 128 | 82 |
| Gross carrying amount (£m) | 4,266 | 3,855 |
| Reported ECL coverage (%) | 3.01 | 2.13 |
| Coverage ratios by scenario: | | |
| Consensus Central scenario (%) | 2.27 | 1.37 |
| Consensus Upside scenario (%) | 1.94 | 1.19 |
| Consensus Downside scenario (%) | 2.89 | 1.82 |
| Coverage ratios for alternative scenarios (%): | | |
| - UK AD1 | 4.07 | 3.20 |
| - Tail risk scenarios (UK AD2-3) | 5.24 - 6.31 | 4.45 - 5.48 |
| ECL for alternative scenarios (£m) | | |
| - UK AD1 | 174 | 123 |
| - Tail risk scenarios (UK AD2-3) | 224 - 269 | 172 - 211 |

¹ ECL sensitivities exclude portfolios utilising less complex modelling approaches

² ECL sensitivity includes only On balance sheet financial instruments to which IFRS 9 impairment requirements are applied.

At 31 December 2019, the significant level of retail ECL sensitivity in the portfolio was observed due to the interaction between economic forecasts, the quantum of exposures and credit characteristics of the underlying portfolios.

The changes in sensitivity from 31 December 2018 is reflective of changes in lending volumes, credit quality and movements in foreign exchange. The increase in stage 3 ECL due to a pause in write-offs and changes in credit quality.

For all the above sensitivity analyses, as the level of uncertainty, economic forecasts, historical economic variable correlations or credit quality changes, corresponding changes in the ECL sensitivity would occur.

Marks and Spencer Financial Services Plc

Post-model adjustments

In the context of IFRS 9, post-model adjustments ('PMAs') are short-term increases or decreases to the expected credit loss at either a customer or portfolio level to account for model deficiencies, expert credit judgement applied following management review and challenge and for any late breaking events. We have internal governance in place to regularly monitor post-model adjustments and where possible to reduce the reliance on these through model recalibration or redevelopment as appropriate.

Post-model adjustments do not include the additional ECL impairment allowances made in respect to the UK economic uncertainty and global trade tensions, as these are captured within the existing governance process for multiple economic scenarios impact on ECL.

Post-model adjustments as at 31 December 2019 were £14m for the Entity's business (2018:£2.25m).

Payments related to development of the new credit card model have not yet been implemented in the live environment.

Reconciliation of changes in gross carrying/nominal amount and allowances for loans and advances to banks and customers including loan commitments and financial guarantees

The following disclosure provides a reconciliation by stage of the Entity's gross carrying/nominal amount and allowances for loans and advances to banks and customers, including loan commitments and financial guarantees.

The transfers of financial instruments represents the impact of stage transfers upon the gross carrying/nominal amount and associated allowance for ECL. The net remeasurement of ECL arising from stage transfers represents the increase or decrease in ECL due to these transfers, for example, moving from a 12-month (stage 1) to a lifetime (stage 2) ECL measurement basis. Net remeasurement excludes the underlying CRR/PD movements of the financial instruments transferring stage. This is captured, along with other credit quality movements in the 'changes in risk parameters – credit quality' line item.

The 'new financial assets originated or purchased', 'net further lending' and 'assets derecognised (including final repayments)' represent the gross carrying/nominal amount and associated allowance ECL impact from volume movements within the Entity's lending portfolio.

| | Non credit - impaired | | | | Credit impaired | | | |
|---|-------------------------------|-------------------|-------------------------------|-------------------|-------------------------------|-------------------|-------------------------------|-------------------|
| | Stage 1 | | Stage 2 | | Stage 3 | | | |
| | Gross carrying/nominal amount | Allowance for ECL | Gross carrying/nominal amount | Allowance for ECL | Gross carrying/nominal amount | Allowance for ECL | Gross carrying/nominal amount | Allowance for ECL |
| At 1 Jan 2019 | 16,287,578 | (12,822) | 484,540 | (58,483) | 80,421 | (10,892) | 16,852,539 | (82,197) |
| Transfer of financial instruments | | | | | | | | |
| - transfers from stage 1 to stage 2 | (183,957) | 1,517 | 183,957 | (1,517) | — | — | — | — |
| - transfers from stage 2 to stage 1 | 83,204 | (5,242) | (83,204) | 5,242 | — | — | — | — |
| - transfers to stage 3 | (140) | 3 | (20,288) | 4,299 | 20,428 | (4,302) | — | — |
| - transfers from stage 3 | 41 | (33) | 6,833 | (380) | (6,873) | 413 | — | — |
| Net remeasurement of ECL arising from transfer of stage | — | 3,183 | — | (4,749) | — | (1) | — | (1,567) |
| New financial assets originated or purchased | 1,012,896 | (4,348) | — | — | — | — | 1,012,896 | (4,348) |
| Changes to risk parameters- further lending/ repayments | (514,348) | 1,294 | 140,342 | (5,003) | 42,596 | (9,900) | (331,410) | (13,609) |
| Changes to risk parameters (credit quality) | — | 1,490 | — | (24,774) | — | (43,955) | — | (67,240) |
| Asset derecognised (including final repayments) | (406,488) | 1,667 | — | — | — | — | (406,488) | 1,667 |
| Assets written off | — | — | — | — | (38,899) | 38,899 | (38,899) | 38,899 |
| At 31 Dec 2019 | 16,278,785 | (13,291) | 712,180 | (85,366) | 97,672 | (29,738) | 17,088,637 | (128,395) |
| ECL release/(charge) for the period | | 3,286 | | (34,526) | | (53,856) | | (85,097) |
| Recoveries | | — | | — | | 14,808 | | 14,808 |
| Total change in ECL for the period | | 3,286 | | (34,526) | | (39,048) | | (70,289) |

Marks and Spencer Financial Services Plc

| | Non credit - impaired | | | | Credit impaired | | | |
|---|--------------------------------|-------------------|--------------------------------|-------------------|--------------------------------|-------------------|--------------------------------|-------------------|
| | Stage 1 | | Stage 2 | | Stage 3 | | | |
| | Gross carrying/ nominal amount | Allowance for ECL | Gross carrying/ nominal amount | Allowance for ECL | Gross carrying/ nominal amount | Allowance for ECL | Gross carrying/ nominal amount | Allowance for ECL |
| At 1 Jan 2018¹ | 13,609,867 | (28,305) | 153,911 | (23,150) | 93,541 | (11,298) | 13,857,319 | (62,753) |
| Transfer of financial instruments | | | | | | | | |
| - transfers from stage 1 to stage 2 | (96,403) | 876 | 96,403 | (876) | — | — | — | — |
| - transfers from stage 2 to stage 1 | 135,632 | (1,403) | (135,632) | 1,403 | — | — | — | — |
| - transfers to stage 3 | (64) | — | (6,469) | 2,546 | 6,533 | (2,546) | — | — |
| - transfers from stage 3 | 29 | (11) | 132,859 | (163) | (132,888) | 174 | — | — |
| Net remeasurement of ECL arising from transfer of stage | — | — | — | (935) | — | — | — | (935) |
| Net new and further lending/repayments | 3,702,641 | (4,246) | — | — | — | — | 3,702,641 | (4,246) |
| Changes to risk parameters - credit quality | 62,721 | 12,314 | 468,995 | (61,696) | 220,671 | (61,798) | 752,387 | (111,180) |
| Asset derecognised (including final repayments) | (1,126,845) | 8,190 | (225,527) | 24,388 | (57,412) | 14,552 | (1,409,784) | 47,130 |
| Assets written off | — | — | — | — | (50,024) | 50,024 | (50,024) | 50,024 |
| Others | — | (237) | — | — | — | — | — | (237) |
| At 31 Dec 2018¹ | 16,287,578 | (12,822) | 484,540 | (58,483) | 80,421 | (10,892) | 16,852,539 | (82,197) |
| ECL release/(charge) for the period | | 15,720 | | (35,333) | | (49,618) | | (69,232) |
| Recoveries | | — | | — | | 19,095 | | 19,095 |
| Total change in ECL for the period | | 15,720 | | (35,333) | | (30,523) | | (50,137) |

¹ 2018 brought forward and closing balances updated to include loans and advances to banks (2018: £1.7bn; 2017: £2.23bn)

| | At 31 Dec 2019 | | | Twelve months ended 31 Dec 2019 | | | At 31 Dec 2018 | | | Twelve months ended 31 Dec 2018 | | |
|--|--------------------------------|-------------------|-----------------|---------------------------------|-------------------|-----------------|--------------------------------|-------------------|-----------------|---------------------------------|-------------------|-----------------|
| | Gross carrying/ nominal amount | Allowance for ECL | ECL charge | Gross carrying/ nominal amount | Allowance for ECL | ECL charge | Gross carrying/ nominal amount | Allowance for ECL | ECL charge | Gross carrying/ nominal amount | Allowance for ECL | ECL charge |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| As above | 17,088,637 | (128,395) | (70,289) | 16,852,539 | (82,197) | (50,137) | 16,852,539 | (82,197) | (50,137) | 16,852,539 | (82,197) | (50,137) |
| Other financial assets measured at amortised cost ¹ | 175,725 | — | — | 86,484 | — | — | 86,484 | — | — | 86,484 | — | — |
| Summary of financial instruments to which the impairment requirements in IFRS 9 are applied | 17,264,362 | (128,395) | (70,289) | 16,939,023 | (82,197) | (50,137) | 16,939,023 | (82,197) | (50,137) | 16,939,023 | (82,197) | (50,137) |
| Total allowance for ECL/total income statement | N/A | (128,395) | (70,289) | N/A | (82,197) | (50,137) | N/A | (82,197) | (50,137) | N/A | (82,197) | (50,137) |
| ECL charge for the period | N/A | (128,395) | (70,289) | N/A | (82,197) | (50,137) | N/A | (82,197) | (50,137) | N/A | (82,197) | (50,137) |

¹ Other assets includes cash and balances at central banks, items in the course of collection from other banks, and prepayments and accrued income

The contractual amount outstanding of financial assets written off during the period that are still subject to enforcement activities amounted to £232k.

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Credit quality

Credit quality of financial instruments

The Entity assesses the credit quality of all financial instruments that are subject to credit risk. The credit quality of financial instruments is a point in time assessment of the probability of default of financial instruments, whereas IFRS 9 stages 1 and 2 are determined based on relative deterioration of credit quality since initial recognition. Accordingly, for non-credit impaired financial instruments there is no direct relationship between the credit quality assessment and IFRS 9 stages 1 and 2, though typically the lower credit quality bands exhibit a higher proportion in stage 2. The five credit quality classifications defined below each encompass a range of granular internal credit rating grades assigned to the retail lending business and the external ratings attributed by external agencies to debt securities, as shown in the table below. Under IAS 39 retail lending credit quality was disclosed based on expected-loss percentages. Under IFRS 9 retail lending credit quality is now disclosed based on a 12-month probability-weighted PD.

| Quality classification | Debt Securities and other bills | Retail Lending |
|------------------------|--|--|
| Strong | External credit rating A- and above | Internal credit rating Band 1 and 2 |
| Good | BBB+ to BBB- | Band 3 |
| Satisfactory | BB+ to B and unrated | Band 4 and 5 |
| Sub-standard | B- to C | Band 6 |
| Credit-impaired | Default | Band 7 |

Quality classification definitions

- 'Strong' exposures demonstrate a strong capacity to meet financial commitments, with negligible or low probability of default and/or low levels of expected loss.
- 'Good' exposures require closer monitoring and demonstrate a good capacity to meet financial commitments, with low default risk.
- 'Satisfactory' exposures require closer monitoring and demonstrate an average-to-fair capacity to meet financial commitments, with moderate default risk.
- 'Sub-standard' exposures require varying degrees of special attention and default risk is of greater concern.
- 'Credit-impaired' exposures have been assessed as impaired.

Distribution of financial instruments by credit quality

| | Gross carrying/notional amount | | | | | Allowance provision for ECL | Net |
|---|--------------------------------|------------------|----------------|---------------|-----------------|-----------------------------|---------------------------|
| | Strong | Good | Satisfactory | Substandard | Credit impaired | Total | |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Loans and advances to banks | 1,700,247 | — | — | — | — | 1,700,247 | 1,700,247 |
| Loans and advances to customers | 2,273,391 | 1,059,257 | 831,491 | 32,119 | 69,963 | 4,266,221 | 4,138,465 |
| Other financial assets held at amortised cost ¹ | 175,725 | — | — | — | — | 175,725 | 175,725 |
| At 31 Dec 2019 | 4,149,363 | 1,059,257 | 831,491 | 32,119 | 69,963 | 6,142,193 | 6,014,437 |
| Loan and other credit related commitments for loans and advances to customers | 9,980,533 | 920,333 | 186,757 | 6,838 | 27,708 | 11,122,169 | (639) 11,121,530 |
| Loans and advances to banks | 1,691,726 | — | — | — | — | 1,691,726 | 1,691,726 |
| Loans and advances to customers | 2,170,150 | 975,931 | 626,476 | 28,739 | 54,069 | 3,855,365 | 3,773,913 |
| Other financial assets held at amortised | 86,484 | — | — | — | — | 86,484 | 86,484 |
| At 31 Dec 2018 | 3,948,360 | 975,931 | 626,476 | 28,739 | 54,069 | 5,633,575 | (81,452) 5,552,123 |
| Loan and other credit related commitments for loans and advances to customers | 10,232,228 | 883,611 | 156,840 | 6,417 | 26,352 | 11,305,448 | (745) 11,275,336 |

¹ Other assets includes cash and balances at central banks, items in the course of collection from other banks, and prepayments and accrued income.

² For the purposes of this disclosure gross carrying value is defined as the amortised cost of a financial asset, before adjusting for any loss allowance.

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Distribution of financial instruments to which the impairment requirements of IFRS 9 are applied by credit quality stage allocation

| | Gross carrying/notional amount | | | | | | Allowance provision for ECL | Net |
|--|--------------------------------|------------------|------------------|---------------|-----------------|-------------------|-----------------------------|-------------------|
| | Strong | Good | Satisfactory | Substandard | Credit impaired | Total | | |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Loans and advances to banks at amortised cost | 1,700,247 | — | — | — | — | 1,700,247 | — | 1,700,247 |
| - stage 1 | 1,700,247 | — | — | — | — | 1,700,247 | — | 1,700,247 |
| Loans and advances to customers at amortised cost | 2,273,391 | 1,059,257 | 831,491 | 32,119 | 69,963 | 4,266,221 | (127,756) | 4,138,465 |
| - stage 1 | 2,273,391 | 1,059,257 | 204,255 | — | — | 3,536,902 | (12,652) | 3,524,251 |
| - stage 2 | — | — | 627,236 | 32,119 | — | 659,355 | (85,366) | 573,989 |
| - stage 3 | — | — | — | — | 69,963 | 69,963 | (29,738) | 40,225 |
| Other financial assets measured at amortised cost ¹ | 175,725 | — | — | — | — | 175,725 | — | 175,725 |
| - stage 1 | 175,725 | — | — | — | — | 175,725 | — | 175,725 |
| Loans and other credit related commitments | 9,980,533 | 920,333 | 186,757 | 6,838 | 27,708 | 11,122,169 | (639) | 11,121,530 |
| - stage 1 | 9,980,533 | 920,333 | 140,770 | — | — | 11,041,636 | (639) | 11,040,997 |
| - stage 2 | — | — | 45,987 | 6,838 | — | 52,825 | — | 52,825 |
| - stage 3 | — | — | — | — | 27,708 | 27,708 | — | 27,708 |
| At 31 Dec 2019 | 14,129,896 | 1,979,589 | 1,018,249 | 38,957 | 97,671 | 17,264,362 | (128,395) | 17,135,967 |

| | Gross carrying/notional amount | | | | | | Allowance provision for ECL | Net |
|--|--------------------------------|------------------|----------------|---------------|-----------------|-------------------|-----------------------------|-------------------|
| | Strong | Good | Satisfactory | Substandard | Credit impaired | Total | | |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Loans and advances to banks at amortised cost | 1,691,726 | — | — | — | — | 1,691,726 | — | 1,691,726 |
| - stage 1 | 1,691,726 | — | — | — | — | 1,691,726 | — | 1,691,726 |
| Loans and advances to customers at amortised cost | 2,170,150 | 975,931 | 626,476 | 28,739 | 54,069 | 3,855,365 | (81,452) | 3,773,913 |
| - stage 1 | 2,170,150 | 975,931 | 173,689 | — | — | 3,319,770 | (12,077) | 3,307,693 |
| - stage 2 | — | — | 452,787 | 28,739 | — | 481,526 | (58,483) | 423,043 |
| - stage 3 | — | — | — | — | 54,069 | 54,069 | (10,892) | 43,177 |
| Other financial assets measured at amortised cost ¹ | 86,484 | — | — | — | — | 86,484 | — | 86,484 |
| - stage 1 | 86,484 | — | — | — | — | 86,484 | — | 86,484 |
| Loans and other credit related commitments | 10,232,228 | 883,611 | 156,840 | 6,417 | 26,352 | 11,305,448 | (745) | 11,304,703 |
| - stage 1 | 10,232,228 | 883,611 | 156,840 | 3,403 | — | 11,276,082 | (745) | 11,275,337 |
| - stage 2 | — | — | — | 3,014 | — | 3,014 | — | 3,014 |
| - stage 3 | — | — | — | — | 26,352 | 26,352 | — | 26,352 |
| At 31 Dec 2018 | 14,180,588 | 1,859,542 | 783,316 | 35,156 | 80,421 | 16,939,023 | (82,197) | 16,856,826 |

¹ Other assets includes cash and balances at central banks, items in the course of collection from other banks, and prepayments and accrued income.

² For the purposes of this disclosure gross carrying value is defined as the amortised cost of a financial asset, before adjusting for any loss allowance

Credit impaired loans

The Entity determines that a financial instrument is credit-impaired and in stage 3 by considering relevant objective evidence, primarily whether:

- contractual payments of either principal or interest are past due for more than 90 days;
- there are other indications that the borrower is unlikely to pay such as that a concession has been granted to the borrower for economic or legal reasons relating to the borrower's financial condition; and
- the loan is otherwise considered to be in default. If such unlikelihood to pay is not identified at an earlier stage, it is deemed to occur when an exposure is 90 days past due, even where regulatory rules permit default to be defined based on 180 days past due. Therefore the definitions of credit-impaired and default are aligned as far as possible so that stage 3 represents all loans which are considered defaulted or otherwise credit impaired.

Marks and Spencer Financial Services Plc

Renegotiated loans and forbearance

Where customers are in (or approaching) financial difficulty, due consideration is given to provide assistance to customers (either on a temporary or permanent basis) to help them meet the contractual commitments relating to their account. The Entity policy provides guidance on when customers are considered to be in financial difficulty and the various forbearance tools that are available to assist them. It is recognised that customers find themselves in financial difficulties as a result of many different situations and Collections staff speaking with customers will often be best placed to understand the individual circumstances and needs of specific customers. Prior to agreeing a forbearance an appropriate level of assessment on a customer's affordability is completed to ensure any solution agreed with the customer is sustainable.

The following table shows the gross carrying amounts of the group's holdings of renegotiated loans and advances to customers by industry sector and by stages. Personal renegotiated loans are deemed to remain credit-impaired until repayment or derecognition.

| | At 31 Dec 2018 | | | | At 31 Dec 2017 | | | |
|---|-------------------------------|---------------------------|----------|---------|-------------------------------|---------------------------|----------|---------|
| | Neither past due not impaired | Past due but not impaired | Impaired | Total | Neither past due not impaired | Past due but not impaired | Impaired | Total |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Retail | — | — | 25,878 | 25,878 | — | — | 19,037 | 19,037 |
| Residential Mortgages | — | — | — | — | — | — | — | — |
| Other personal | — | — | 25,878 | 25,878 | — | — | 19,037 | 19,037 |
| Commercial and real estate | — | — | — | — | — | — | — | — |
| Corporate and commercial | — | — | — | — | — | — | — | — |
| Financial | — | — | — | — | — | — | — | — |
| Other | — | — | — | — | — | — | — | — |
| | — | — | 25,878 | 25,878 | — | — | 19,037 | 19,037 |
| Impairment allowance on renegotiated loans | | | | (8,367) | | | | (4,579) |
| Renegotiated loans and advances as % of total gross loans (%) | | | | 0.6 | | | | 0.5 |

Impaired loans and advances

The table below analyses the loan impairment charges for the year and the impairment allowances recognised for impaired loans and advances that are either individually assessed or collectively assessed, and collectively impairment allowances on loans and advances classified as not impaired. Mortgage LTV ranges from less than 50% to 100%, the majority (68%) of the mortgage balance is in LTV 81%-90%.

Movement in impairment allowances on loans and advances to customers

| | 2019 | | | 2018 | | |
|---|-----------------------|-----------------------|----------|-----------------------|-----------------------|----------|
| | Individually assessed | Collectively assessed | Total | Individually assessed | Collectively assessed | Total |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| At 1 Jan | — | 81,452 | 81,452 | — | 62,244 | 62,244 |
| Amounts written off | — | (38,899) | (38,899) | — | (50,024) | (50,024) |
| Recoveries of amounts written off in previous years | — | 14,808 | 14,808 | — | 19,095 | 19,095 |
| New allowances net of allowance releases | — | 70,394 | 70,394 | — | 50,137 | 50,137 |
| At 31 Dec | — | 127,755 | 127,755 | — | 81,452 | 81,452 |
| Impairment allowances % of loans and advances | — | 3.1 | 3.1 | — | 2.2 | 2.2 |

Liquidity risk management

Liquidity risk is the risk that the Entity does not have sufficient financial resources to meet obligations as they fall due or will have access to such resources only at an excessive cost. The risk arises from mismatches in the timing of cash flows.

The Entity is part of the Domestic Liquidity Sub-group ('Liquidity Group') of HSBC UK Bank plc and therefore part of the internal liquidity control and management structure of HSBC UK Bank plc. The Entity's liquidity position is managed as part of the HSBC Bank UK plc Liquidity Group, under which members agree to provide liquidity support when necessary.

The following is an analysis of undiscounted cash flows payable under various financial liabilities by remaining contractual maturities at the balance sheet date:

| | On Demand | Due within 3 months | Due between 3-12 months | Due between 1-5 years | Due after 5 years | Total |
|---|------------|---------------------|-------------------------|-----------------------|-------------------|------------|
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Deposits by banks | — | 713,248 | 1,032,564 | 1,363,272 | — | 3,109,084 |
| Customer accounts | 2,123,314 | — | — | — | — | 2,123,314 |
| Accruals, deferred income and other liabilities | — | 965 | 2,922 | 15,451 | — | 19,338 |
| Current tax liabilities | — | 31,066 | — | — | — | 31,066 |
| Subordinated liabilities | — | 202 | — | — | 95,000 | 95,202 |
| Loan commitments | 11,122,169 | — | — | — | — | 11,122,169 |
| Provisions | — | 52,049 | 101,864 | 26,403 | — | 180,316 |
| At 31 Dec 2019 | 13,245,483 | 797,530 | 1,137,350 | 1,405,126 | 95,000 | 16,680,489 |

Marks and Spencer Financial Services Plc

| | | | | | | |
|--------------------------|------------|---------|---------|-----------|--------|------------|
| Deposits by banks | 27,681 | 658,471 | 901,808 | 1,079,048 | — | 2,667,008 |
| Customer accounts | 2,250,232 | — | — | — | — | 2,250,232 |
| Current tax liabilities | — | 24,244 | — | — | — | 24,244 |
| Subordinated liabilities | — | 196 | — | — | 79,000 | 79,196 |
| Loan commitments | 11,305,448 | — | — | — | — | 11,305,448 |
| Provisions | — | 40,318 | 73,320 | 1,162 | — | 114,800 |
| At 31 Dec 2018 | 13,583,361 | 723,229 | 975,128 | 1,080,210 | 79,000 | 16,440,928 |

Market risk management

Market risk is the risk that movements in market factors including interest rates and foreign exchange rates will impact the Entity's income or the value of its portfolios.

The Entity's objective is to manage and control market rate exposures while maintaining a market profile consistent with its risk appetite.

Interest rate risk

Interest rate risk is managed internally by monitoring the sensitivity of the fair value of the Entity's assets and liabilities to a 0.01% shift in yield curves (the present value of a basis point or 'PVBp'). At 31 December 2019 the Entity's risk as measured by PVBp was £ 6,908 (2018: £9,369). PVBp is the change in the present value of future cash flows and not recognised as an immediate gain or loss in the income statement.

The table below discloses the mismatch of the dates on which interest on financial assets and financial liabilities are next reset to market rate on a contractual basis or, if earlier, the dates on which the instruments mature as at 31 December 2019. Actual reset dates may differ from contractual dates owing to prepayments and the exercise of options. In addition, contractual terms may not be representative of the behaviour of financial assets and liabilities.

| | Not more than 3 months | Between 3 and 6 months | Between 6 months and 1 year | Between 1 and 5 years | More than 5 years | Non-interest bearing | Total |
|---|------------------------|------------------------|-----------------------------|-----------------------|-------------------|----------------------|------------------|
| At 31 Dec 2019 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Assets | | | | | | | |
| Loans and advances to banks | 1,485,247 | 45,000 | 65,000 | 105,000 | — | — | 1,700,247 |
| Loans and advances to customers | 798,499 | 776,828 | 383,995 | 1,752,169 | 31,556 | 395,419 | 4,138,466 |
| Other assets | 23,911 | 455 | 821 | 3,212 | 180 | 162,711 | 191,290 |
| Total assets | 2,307,657 | 822,283 | 449,816 | 1,860,381 | 31,736 | 558,130 | 6,030,003 |
| Liabilities | | | | | | | |
| Deposits by banks | 705,000 | 705,000 | 310,000 | 1,335,000 | — | — | 3,055,000 |
| Customer accounts | 1,304,880 | 115,240 | 149,310 | 553,885 | — | — | 2,123,315 |
| Other liabilities | 144,070 | — | — | — | — | 194,708 | 338,778 |
| Subordinated liabilities | 95,202 | — | — | — | — | — | 95,202 |
| Shareholders' equity | — | — | — | — | — | 417,708 | 417,708 |
| Total equity and liabilities | 2,249,152 | 820,240 | 459,310 | 1,888,885 | — | 612,416 | 6,030,003 |
| Interest rate sensitivity gap | 58,505 | 2,043 | (9,494) | (28,504) | 31,736 | (54,286) | — |
| Cumulative interest rate sensitivity gap | 58,505 | 60,548 | 51,054 | 22,550 | 54,286 | — | — |

| | Not more than 3 months | Between 3 and 6 months | Between 6 months and 1 year | Between 1 and 5 years | More than 5 years | Non-interest bearing | Total |
|---|------------------------|------------------------|-----------------------------|-----------------------|-------------------|----------------------|------------------|
| At 31 Dec 2018 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Assets | | | | | | | |
| Loans and advances to banks | 1,421,726 | 115,000 | 100,000 | 55,000 | — | — | 1,691,726 |
| Loans and advances to customers | 790,924 | 778,090 | 315,299 | 1,464,313 | 23,500 | 401,787 | 3,773,913 |
| Other assets | 46,027 | 427 | 769 | 3,058 | 173 | 53,809 | 104,263 |
| Total assets | 2,258,677 | 893,517 | 416,068 | 1,522,371 | 23,673 | 455,596 | 5,569,902 |
| Liabilities | | | | | | | |
| Deposits by banks | 687,092 | 660,000 | 225,000 | 1,055,000 | — | — | 2,627,092 |
| Customer accounts | 1,400,468 | 186,394 | 183,620 | 479,750 | — | — | 2,250,232 |
| Other liabilities | 129,395 | — | — | — | — | 119,541 | 248,936 |
| Subordinated liabilities | 79,196 | — | — | — | — | — | 79,196 |
| Shareholders' equity | — | — | — | — | — | 364,446 | 364,446 |
| Total equity and liabilities | 2,296,151 | 846,394 | 408,620 | 1,534,750 | — | 483,987 | 5,569,902 |
| Interest rate sensitivity gap | (37,474) | 47,123 | 7,448 | (12,379) | 23,673 | (28,391) | — |
| Cumulative interest rate sensitivity gap | (37,474) | 9,649 | 17,097 | 4,718 | 28,391 | — | — |

29. Legal proceedings and other regulatory matters

The Entity is party to legal proceedings and regulatory matters arising out of its normal business operations. The Entity considers that none of these matters are material.

30. Related party transactions

(a) Transactions with Key Management Personnel

Key Management Personnel ('KMP') are defined as those persons having authority and responsibility for planning, directing and controlling the activities of the Entity directly and indirectly and include members of the Board of Directors of the Entity, and the Board of Directors of HSBC UK Bank plc.

IAS 24 'Related Party Disclosures' requires the following additional information for key management compensation.

A number of KMP are not directors of the Entity and are paid by other HSBC Group companies which make no recharge to the Entity. It is not possible to make reasonable apportionment of their emoluments in respect of the Entity. Accordingly, no emoluments in respect of these KMPs is included in the following disclosure.

Members of the Entity's Exec Co are not considered KMP as it is the body of the Exec Co, not individual members, that has the authority and responsibility for planning, directing and controlling the activities of the Entity. 2019 numbers have been prepared on this basis.

The following represents the compensation for Directors of the Entity in exchange for services rendered to the Entity for the period they served during the year.

Compensation of Key Management Personnel

| | 2019 | 2018 |
|------------------------------|-------|-------|
| | £'000 | £'000 |
| Short-term employee benefits | 921 | 1,903 |
| Post-employment benefits | 53 | 215 |

Transactions, arrangements and agreements with Key Management Personnel¹

The table below sets out transactions which fall to be disclosed under IAS 24 'Related Party Disclosures' between the Entity and its Key Management Personnel.

| | 2019 | | 2018 | |
|--------------------|---------------------------------|------------------------|---------------------------------|------------------------|
| | Highest balance during the year | Balance at 31 December | Highest balance during the year | Balance at 31 December |
| | £'000 | £'000 | £'000 | £'000 |
| Cards | 36 | 14 | 76 | 42 |
| Other ² | 100 | 51 | 270 | 158 |

¹ Includes close family members

² Other includes saving and insurance products

The above transactions were made in the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with persons of a similar standing or, where applicable, with other employees. The transactions did not involve more than the normal risk of repayment or present other unfavourable features.

(b) Transactions with other related parties

Transactions detailed below include amounts due to/from HSBC Bank plc and its subsidiaries

| | 2019 | | 2018 | |
|-----------------------------|--|------------------------|--|------------------------|
| | Highest balance during the year ¹ | Balance at 31 December | Highest balance during the year ¹ | Balance at 31 December |
| | £'000 | £'000 | £'000 | £'000 |
| Assets | | | | |
| Loans and advances to banks | — | — | 2,317,564 | — |
| Liabilities | | | | |
| Deposits by banks | — | — | 2,593,082 | — |
| Other liabilities | 32,376 | 7,342 | 38,261 | 21,056 |

¹ The disclosure of the year end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year

| | 2019 | 2018 |
|-------------------------------------|--------|--------|
| | £'000 | £'000 |
| Income statement | | |
| Interest income | — | 5,677 |
| Interest expense | 3,317 | 9,747 |
| Fee income | — | 16,299 |
| Fee expense | — | 626 |
| Other operating income | — | — |
| General and administrative expenses | 28,124 | 29,261 |

Marks and Spencer Financial Services Plc

Transactions detailed below include amounts due to/from HSBC Holdings plc

| | 2019 | | 2018 | |
|--------------------------|--|------------------------|--|------------------------|
| | Highest balance during the year ¹ | Balance at 31 December | Highest balance during the year ¹ | Balance at 31 December |
| | £'000 | £'000 | £'000 | £'000 |
| Liabilities | | | | |
| Subordinated amounts due | 79,755 | — | 79,711 | 79,196 |
| Additional tier 1 equity | 60,000 | — | 60,000 | 60,000 |

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

| | 2019 | 2018 |
|-------------------------|-------|-------|
| | £'000 | £'000 |
| Income statement | | |
| Interest expense | 1,615 | 3,190 |
| Dividend expense | 3,416 | 4,572 |

Transactions detailed below include amounts due to/from Marks and Spencer Savings and Investments Limited and/or Marks and Spencer Unit Trust Management Limited

| | 2019 | | 2018 | |
|--------------------|--|------------------------|--|------------------------|
| | Highest balance during the year ¹ | Balance at 31 December | Highest balance during the year ¹ | Balance at 31 December |
| | £'000 | £'000 | £'000 | £'000 |
| Assets | | | | |
| Other assets | 4,813 | 4,813 | 700 | 423 |
| Liabilities | | | | |
| Other liabilities | 11,844 | 11,844 | 12,577 | 8,301 |

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

| | 2019 | 2018 |
|-------------------------------------|-------|-------|
| | £'000 | £'000 |
| Income statement | | |
| Interest expense | 66 | 58 |
| General and administrative expenses | 2,995 | 3,378 |

The above transactions were made in the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with persons of a similar standing or, where applicable, with other employees. The transactions did not involve more than the normal risk of repayment or present other unfavourable features.

Transactions detailed below include amounts due to/from Marks and Spencer Retail Financial Services Holdings Limited

| | 2019 | | 2018 | |
|--------------------|--|------------------------|--|------------------------|
| | Highest balance during the year ¹ | Balance at 31 December | Highest balance during the year ¹ | Balance at 31 December |
| | £'000 | £'000 | £'000 | £'000 |
| Liabilities | | | | |
| Other liabilities | — | — | 35,364 | — |

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

Transactions detailed below include amounts due to/from HSBC UK Bank Plc

| | 2019 | | 2018 | |
|-----------------------------|--|------------------------|--|------------------------|
| | Highest balance during the year ¹ | Balance at 31 December | Highest balance during the year ¹ | Balance at 31 December |
| | £'000 | £'000 | £'000 | £'000 |
| Assets | | | | |
| Loans and advances to banks | 1,885,871 | 1,700,247 | 1,811,516 | 1,691,503 |
| Other assets | 51,759 | 30,396 | — | — |
| Liabilities | | | | |
| Deposits by banks | 3,100,000 | 3,055,000 | 2,643,984 | 2,622,782 |
| Subordinated amounts due | 16,000 | 16,000 | — | — |
| Additional tier 1 equity | 9,000 | 9,000 | — | — |
| Other liabilities | 20,779 | 11,514 | 10,906 | 8,819 |

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

Marks and Spencer Financial Services Plc

| | 2019 | 2018 |
|-------------------------------------|--------|--------|
| | £'000 | £'000 |
| Income statement | | |
| Interest income | 13,273 | 6,561 |
| Interest expense | 27,519 | 11,848 |
| Fee income | — | 17,904 |
| Fee expense | 146 | 632 |
| General and administrative expenses | 4,407 | 4,495 |

Transactions detailed below include amounts due to/from HSBC UK Holdings Limited

| | 2019 | | 2018 | |
|------------------------------------|--|------------------------|--|------------------------|
| | Highest balance during the year ¹ | Balance at 31 December | Highest balance during the year ¹ | Balance at 31 December |
| | £'000 | £'000 | £'000 | £'000 |
| Assets | | | | |
| Cash and balances at central banks | — | — | — | — |
| Liabilities | | | | |
| Subordinated amounts due | 79,789 | 79,193 | — | — |
| Additional tier 1 equity | 60,000 | 60,000 | — | — |
| Other liabilities | — | — | — | — |

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year

| | 2019 | 2018 |
|-------------------------------------|-------|-------|
| | £'000 | £'000 |
| Income statement | | |
| Interest income | — | — |
| Interest expense | 1,702 | 3,190 |
| General and administrative expenses | — | — |
| Dividend expense | 1,144 | 4,572 |

31. Parent undertakings

The ultimate parent undertaking and ultimate controlling party is HSBC Holdings plc which is the parent undertaking of the largest group to consolidate these financial statements. HSBC UK Bank plc is the parent undertaking of the smallest group to consolidate these financial statements.

All companies are registered in England and Wales.

Copies of HSBC Holdings plc's and HSBC UK Bank plc's consolidated financial statements can be obtained from:

HSBC Holdings plc
8 Canada Square
London E14 5HQ
United Kingdom
www.hsbc.com

HSBC UK Bank plc
1 Centenary Square
Birmingham B1 1HQ
United Kingdom
www.hsbc.com

32. Events after balance sheet date

No significant events affecting the Entity have occurred since the end of the financial year.