TAXATION

	2018 £m	2017 £m	2016 £m
UK corporation tax:			
Current tax on profits for the year	**(1,386)**	(1,346)	(1,010)
Adjustments in respect of prior years	**11**	126	156
	(1,375)	(1,220)	(854)
Foreign tax:			
Current tax on profits for the year	**(34)**	(40)	(20)
Adjustments in respect of prior years	**5**	10	2
	(29)	(30)	(18)
Current tax charge	**(1,404)**	(1,250)	(872)
Deferred tax	**(156)**	(478)	(852)
Tax expense	**(1,560)**	(1,728)	(1,724)

2018 COMPARED WITH 2017

In 2018, a tax expense of £1,560 million arose on the profit before tax of £5,960 million and in 2017 a tax expense of £1,728 million arose on the profit before tax of £5,625 million. The statutory corporation tax rates were 19.0 per cent for 2018 and 19.25 per cent for 2017.

The tax expense for 2018 represents an effective tax rate of 26.2 per cent compared to 30.7 per cent in 2017. The reduction in effective tax rate compared to 2017 was largely due to higher non-deductible conduct risk provisions in the prior year.

2017 COMPARED WITH 2016

In 2017, a tax expense of £1,728 million arose on the profit before tax of £5,625 million and in 2016 a tax expense of £1,724 million arose on the profit before tax of £3,888 million. The statutory corporation tax rates were 19.25 per cent for 2017 and 20 per cent for 2016.

The tax expense for 2017 represented an effective tax rate of 30.7 per cent. The high effective tax rate in 2017 was largely due to the banking surcharge, and restrictions on the deductibility of conduct provisions.

LINE OF BUSINESS INFORMATION

The requirements for IFRS segmental reporting are set out in IFRS 8, *Operating Segments* which mandates that an entity’s segmental reporting should reflect the way in which its operations are viewed and judged by its chief operating decision maker. As a consequence, the Group’s statutory segmental reporting follows the underlying basis as explained below (see also note 4 to the financial statements).

The Group Executive Committee, which is the chief operating decision maker for the Group, reviews the Group’s internal reporting based around these segments (which reflect the Group’s organisational and management structures) in order to assess performance and allocate resources. The segments are differentiated by the type of products provided and by whether the customers are individuals or corporate entities and the performance assessment includes a consideration of each segment’s net interest revenue; consequently the total interest income and expense for all reportable segments is presented on a net basis. The internal reporting is on an underlying profit before tax basis. The Group Executive Committee believes that this basis better represents the underlying performance of the Group. IFRS 8 requires that the Group presents its segmental profit before tax on the basis reviewed by the chief operating decision maker that is most consistent with the measurement principles used in measuring the Group’s statutory profit before tax. Accordingly, the Group presents its segmental underlying basis profit before tax in note 4 to the financial statements.

The aggregate total of the underlying basis segmental results constitutes a non-GAAP measure as defined in the United States Securities and Exchange Commission’s Regulation G. Management uses aggregate underlying profit before tax, a non-GAAP measure, as a measure of performance and believes that it provides important information for investors because it is a comparable representation of the Group’s performance. Profit before tax is the comparable GAAP measure to aggregate underlying profit before tax. The table below sets out the reconciliation of this non-GAAP measure to its comparable GAAP measure.

The Group’s activities are organised into three financial reporting segments: Retail; Commercial Banking; and Insurance and Wealth.

With the exception of PPI, charges in relation to conduct provisions (referred to as remediation) are included in underlying profit. In addition, results in relation to certain assets which are outside the Group’s risk appetite, previously reported as part of run-off within Other, have been transferred into Retail and into Commercial. Comparatives have been restated accordingly.

Comparisons of results on a historical consolidated statutory basis are impacted by a number of items. In order to provide more meaningful and relevant comparatives, the results of the Group and divisions are presented on an ‘underlying’ basis. The following items are excluded in arriving at underlying profit:

- losses on redemption of the Enhanced Capital Notes in 2016 and the volatility in the value of the embedded equity conversion feature;
- restructuring, including severance-related costs, the costs of implementing regulatory reform including ring-fencing, the rationalisation of the non-branch property portfolio, the integration of MBNA and Zurich’s UK workplace pensions and savings business;
- market volatility and other items, which includes the effects of certain asset sales, the volatility relating to the Group’s own debt and hedging arrangements and that arising in the insurance businesses and insurance gross up, the unwind of acquisition-related fair value adjustments and the amortisation of purchased intangible assets; and
- payment protection insurance provisions.

The results of the businesses are set out below on the underlying basis:

	2018 £m	2017[1] £m	2016[1] £m
Retail	**4,272**	3,770	3,303
Commercial Banking	**2,160**	2,231	2,246
Insurance and Wealth	**927**	899	809
Other	**707**	728	424
Underlying profit before tax	**8,066**	7,628	6,782

1 Segmental analysis restated, as explained above.

Reconciliation of underlying profit to statutory profit before tax for the year

	Note	2018 £m	2017 £m	2016 £m
Underlying profit before tax		**8,066**	7,628	6,782
Enhanced Capital Notes	1	**–**	–	(790)
Market volatility and asset sales	2	**(50)**	279	439
Amortisation of purchased intangibles	3	**(108)**	(91)	(340)
Restructuring costs	4	**(879)**	(621)	(622)
Fair value unwind and other items	5	**(319)**	(270)	(231)
Payment protection insurance provision	6	**(750)**	(1,300)	(1,350)
Statutory profit before tax		**5,960**	5,625	3,888

1. Enhanced Capital Notes

The Group completed tender offers and redemptions in respect of its Enhanced Capital Notes (ECNs) in March 2016, resulting in a net loss to the Group of £721 million in the year ended 31 December 2016, principally comprising the write-off of the embedded equity conversion feature and premiums paid under the terms of the transaction. In addition there was a charge of £69 million reflecting the change in fair value of the embedded equity conversion feature in the period prior to the transaction.

2. Market volatility and asset sales

Market volatility and asset sales of £50 million included the loss on sale of the Irish mortgage portfolio of £105 million and an adjustment to the past service pension liability. Also included was negative insurance and policyholder interests volatility totalling £103 million compared to positive volatility of £286 million in 2017 and negative volatility of £91 million in 2016.

Volatility comprises the following:

	2018 £m	2017 £m	2016 £m
Insurance volatility	**(506)**	196	(152)
Policyholder interests volatility	**46**	190	241
Insurance hedging arrangements	**357**	(100)	(180)
Total	**(103)**	286	(91)

Management believes that excluding volatility from underlying profit before tax provides useful information for investors on the performance of the business as it excludes amounts included within profit before tax which do not accrue to the Group's equity holders and excludes the impact of changes in market variables which are beyond the control of management.

The most significant limitations associated with excluding volatility from the underlying basis results are:

(i) Insurance volatility requires an assumption to be made for the normalised return on equities and other investments; and

(ii) Insurance volatility impacts on the Group's regulatory capital position, even though it is not included within underlying profit before tax.

Management compensates for the limitations above by:

(i) Monitoring closely the assumptions used to calculate the normalised return used within the calculation of insurance volatility; these assumptions are disclosed below; and

(ii) Producing separate reports on the Group's current and forecast capital ratios.

Insurance volatility

The Group's insurance business has policyholder liabilities that are supported by substantial holdings of investments. IFRS requires that the changes in both the value of the liabilities and investments are reflected within the income statement. The value of the liabilities does not move exactly in line with changes in the value of the investments. As the investments are substantial, movements in their value can have a significant impact on the profitability of the Group. Management believes that it is appropriate to disclose the division's results on the basis of an expected return in addition to results based on the actual return. The impact of the actual return on these investments differing from the expected return is included within insurance volatility.

The expected gross investment returns used to determine the underlying profit of the business are based on prevailing market rates and published research into historical investment return differentials for the range of assets held. The basis for calculating these expected returns reflects an average of the 15 year swap rate over the preceding 12 months updated throughout the year to reflect changing market conditions. The volatility movements in the period were largely driven by insurance volatility arising from equity market movements and credit spreads. The capital impact of equity market movements is hedged within Insurance and this also reduces the IFRS earnings exposure.

Policyholder interests volatility

The application of accounting standards results in the introduction of other sources of significant volatility into the pre-tax profits of the life, pensions and investments business. In order to provide a clearer representation of the performance of the business, and consistent with the way in which it is managed, adjustments are made to remove this volatility from underlying profits. The effect of these adjustments is separately disclosed as policyholder interests volatility.

Accounting standards require that tax on policyholder investment returns relating to life products should be included in the Group's tax charge rather than being offset against the related income. The result is, therefore, to either increase or decrease profit before tax with a related change in the tax charge. Timing and measurement differences exist between provisions for tax and charges made to policyholders. Consistent with the expected approach taken in respect of insurance volatility, differences in the expected levels of the policyholder tax provision and policyholder charges are