The Co-operative Bank plc
Annual report and accounts
2013

Contents

Page

Key Performance Indicators
3 Bank performance

Strategic report
7 Chairman's statement
8 Our two business areas: Core and Non-core
9 Our strategy
10 Business model
11 Chief Executive's review
13 Summary financial review
15 Detailed financial review
21 Detailed financial review – Outlook
22 Detailed financial review – An update on capital raising
23 Detailed financial review – Key Performance Indicators
25 Detailed Key Performance Indicators
26 Principal risks and uncertainties
29 Social, community and human rights
30 Group structure

Corporate governance
32 Biographies of the Board
34 Directors' report
36 Corporate Governance report
44 Audit Committee report
51 Risk Committee report
54 Nomination Committee report
55 Values and Ethics Committee report
57 Board effectiveness
58 Statutory disclosures information
59 Statement of Directors' responsibilities
60 Directors' Remuneration report

Page

Risk management
70 Risk Governance structure
71 Board and sub-committees
72 Executive and Management Committees
75 Risk management
117 Capital management

Financial statements
124 Independent auditor's report to the members of The Co-operative Bank plc only
127 The Bank financial statements
134 Notes to the Bank financial statements
220 The Company financial statements
226 Notes to the Company financial statements

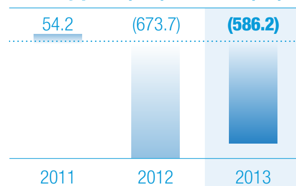
Other information
265 Shareholder information
266 Glossary
274 Forward looking statements
275 Appendix 1 – EDTF recommendations

Key Performance Indicators

The Key Performance Indicators presented below[4] reflect the way in which the performance of the Bank was measured in 2013. As it implements the Turnaround Plan, management intends to review these measures.

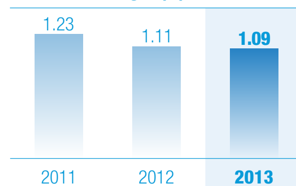
Total Bank

Statutory profit (loss) before tax (£m)



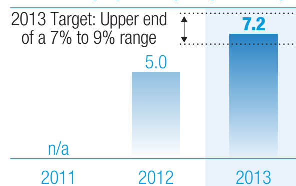
The continued statutory loss before tax reflects principally the high level of credit impairments and charges for conduct risk offset by profit from the LME in 2013

Net Interest Margin[5] (%)



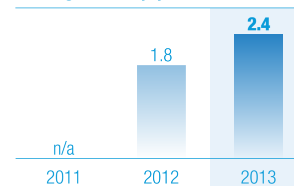
The broadly stable Net Interest Margin reflects a strengthening retail performance offset by lower Treasury returns

Common Equity Tier 1 (CET1) Ratio[1, 2] (%)



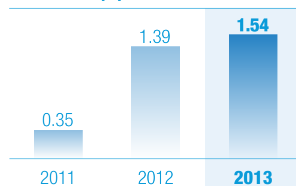
The improvement in the CET1 ratio despite continuing losses reflects the successful completion of the LME in December 2013

Leverage ratio[1, 2] (%)



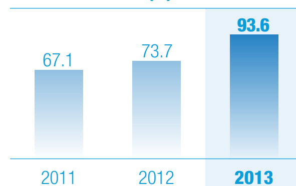
Following the LME we have increased our ratio by 0.6%

Cost of Risk (%)



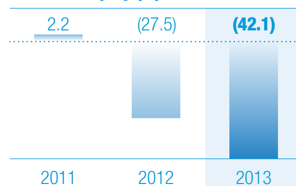
The increase in cost of risk reflects predominantly the improved impairment strategies implemented in the first half of the year

Cost Income Ratio (%)



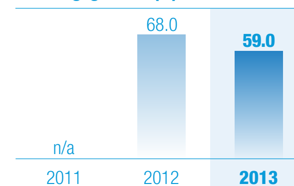
Driven by lower net interest income from balance sheet contraction and significant one-off costs

Return on Equity (%)



The increased negative return on equity in 2013 reflects a reduced loss being more than offset by the reduction in equity

Staff Engagement[3] (%)

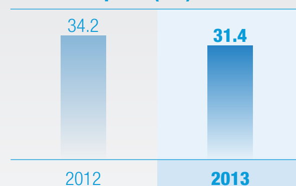


Our staff engagement scores reflect a very difficult year in 2013 and we are committed to improving staff engagement during 2014

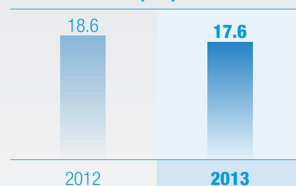
Core Bank[4,6]

Net Interest Margin (%)[5]

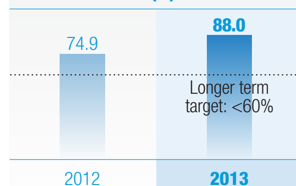
Customer Deposits (£bn)[7]



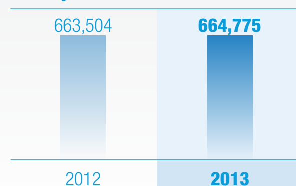
Customer Assets (£bn)



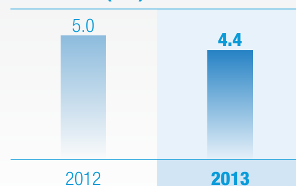
Cost Income Ratio[5] (%)



Primary Current Account Holders

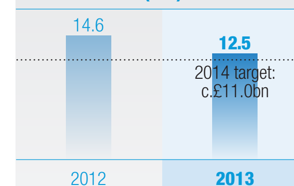


Credit RWAs (£bn)

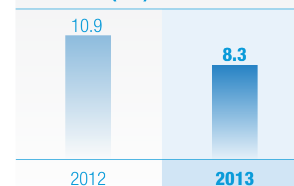


Non-core Bank[4,6]

Customer Assets (£bn)



Credit RWAs (£bn)



Please see 'Key Performance Indicators' on page 25 for explanations of why these metrics are important and how they are calculated.

1. Capital ratios not reported in respect of 2011 as calculation methodology for CRD IV was still in development.
2. Restated for CFSMS (see note 3 to the accounts) and on a CRD IV fully loaded basis.
3. As part of The Co-operative Group in 2012 and for the majority of 2013, staff engagement scores were measured in respect of The Co-operative Banking Group (rather than the Bank).
4. KPIs are calculated on a management accounts basis as this is how we manage our business.
5. Excludes provision for customer redress.
6. 2012 figures have been restated, please see note 5 of the accounts for details.
7. Includes BaCB deposits which have reduced by £2.6bn in 2013. Retail deposits have reduced by £0.2bn (see page 19).

Bank performance

The results today reflect the magnitude of the issues that have come to light since I joined The Co-operative Bank ten months ago. In addition, as we outlined on the 24 March 2014, further costs have materialised since the completion of the Liability Management Exercise (LME) in December 2013 as a result of a continuing review of The Co-operative Bank's legacy operations, assets and liabilities by the new Executive Team.

During 2013 the task for the new management was to keep the Bank alive. The successful completion of the LME prevented the Bank from going into resolution, preserving the Bank for our customers and protecting jobs without cost to the taxpayer. However, there continue to be significant issues which need to be resolved. As already announced on 24 March 2014, the management team's continuing review has unearthed a range of conduct and legal issues since December 2013 which has contributed to the need to further strengthen the Bank's capital position over and above The Co-operative Group's 2014 contribution.

Whilst these risks were identified in the LME prospectus, the financial impact of these additional items, together with the higher than expected cost of separation from The Co-operative Group, means that the starting capital position of the Bank for the 4-5 year recovery period is weaker than in the plan announced last year. The proposed capital raising will enable us to reset this starting point and continue with the execution of our original business plan which remains unchanged.

It is early days but initial progress on our business plan is encouraging and we remain enthusiastic about the long term potential for the Bank. We have started to simplify the business; we are reducing costs and are currently ahead of schedule in de-risking our assets. We are also beginning to fix the fundamentals of the Bank as we drive the change needed to return to our roots as a bank focused on our retail and SME customers.

Community banking is the heart of our business and despite our recent troubles the Core Business has seen significant stability. Year on year, our Core Retail deposit balances are broadly unchanged. In the future, we will be investing in IT to both deliver digital banking in a way that meets our customers' expectations and also improve the systems that lie behind our products. We will also be asking our customers' opinions as we renew the values and ethical principles that remain at the centre of why they choose to bank with us. There are still major hurdles ahead to overcome. The level of change required in improvement in processes, systems and culture is significant. We are determined to rebuild trust in the Bank after the events of last year and reward the loyalty our customers and shareholders have shown us.

We appreciate that customers and other stakeholders continue to feel angry about how past failings placed the future of the business so seriously at risk. I would like to apologise to them, to thank them for their continued loyalty and to thank colleagues for their commitment during such difficult times.

Niall Booker
Chief Executive

Key highlights and outlook

The Bank ended a very difficult year with stable liquidity and an improved capital position; further capital is required:

- Liquidity built mid-year successfully saw the Bank through the volatility of the second half of 2013
- The Liability Management Exercise (LME) generated £1.2bn of Common Equity Tier 1 (CET1) before costs
- Further provisions and charges for customer redress and legal issues of £412m, the write down of the deferred tax assets of £158m and higher than expected costs of separation from The Co-operative Group of £39m have adversely impacted CET1
- As a result, the year end CET1 ratio of 7.2% is below prior guidance
- As announced on 24 March 2014, additional CET1 is required in addition to the 2014 contribution from The Co-operative Group

Pre LME statutory losses of £1.3bn reduced to £586m after LME profit of £688m

- Loss before tax includes operating costs of £686m, credit impairments, predominantly in Non-core of £516m, full year provisions for conduct and legal risk of £412m, IT write down of £148m, write down of deferred tax assets of £158m
- In addition, costs of separation are significant, including operational costs of £39m and tax costs of degrouping of £56.9m
- Provisions for conduct and legal risks include potential customer redress related to mortgage products of £114m, breaches of the Consumer Credit Act of £110m, PPI of £103m, interest rate swap mis-selling of £33m and others of £52m
- Net interest margin remained broadly stable at 1.09% (2012: 1.11%) as Retail performance improved
- Cost income ratio rose from 73.7% in 2012 to 93.6% in 2013 reflecting lower income from balance sheet contraction and significant one-off costs

Core Business franchise has seen significant stability but financial difficulties in the past year have impacted short term performance

- Core Retail net interest income up 7% to £428.1m; Core Retail deposit balances broadly unchanged at £27.9bn from £28.1bn in 2012 (a decline of less than 1%). Core Business net interest margin was stable at 1.7% (2012: 1.7%), reflecting improvements in Core Retail interest income offset by lower Treasury yields
- The number of primary current accounts rose slightly from 663,504 in 2012 to 664,775 at year end 2013 (+0.2%)

Run down and exit of Non-core underway with disposals programme ahead of schedule

- Reduction in Non-core customer assets from £14.6bn to £12.5bn; with £1.5bn reduction in second half of 2013
- Corresponding reduction in Non-core credit risk weighted assets from £10.9bn to £8.3bn
- Non-core firmly on track to meet previously stated target of £11.5bn of Non-core loans at the end of 2014; target now re-set to c.£11.0bn at the end of 2014

Simplification of the business underway as we reshape

- Exit from international operations underway with the previously announced closure of operations in Guernsey and the Isle of Man
- Bank in early discussions to potentially sell its stake in Unity Trust Bank; any sale subject to regulatory approval
- Size of branch network reduced by 15% in 2013 (51 branches) and on track to achieve a further 15% reduction in 2014
- Year end FTE numbers reduced from 7,780 in 2012 to 6,704 in 2013

Focus for 2014 on implementation of our plan to reshape the Bank around our Retail and SME customers

- New current account switching offer launched in February 2014; initial response encouraging
- Introduced new mortgage offers and market leading savings rates
- Cost reduction programme and necessary investments have begun across the business
- Work to develop our SME proposition has begun
- We will be asking for our customers' opinions on our Ethical Policy in the Spring as we look to rebuild trust in the Bank
- Legacy issues will continue to have a negative impact and constrain our financial performance for some time
- Known conduct issues will continue to have some impact on 2014 income due to foregone income on products where income cannot be charged until operational remediation completed
- The Bank remains subject to multiple external inquiries which are likely to lead to continued scrutiny

Strategic report

7	Chairman's statement
8	Our two business areas: Core and Non-core
9	Our strategy
10	Business model
11	Chief Executive's review
13	Summary financial review
15	Detailed financial review
21	Detailed financial review – Outlook
22	Detailed financial review – An update on capital raising
23	Detailed financial review – KPIs
25	Detailed Key Performance Indicators
26	Principal risks and uncertainties
29	Social, community and human rights
30	Group structure

Strategic report

The Directors present their Strategic report for the Bank for the year ended 31 December 2013 as required by the Companies Act 2006. During 2013 the UK Government issued a new requirement for all companies to produce a Strategic report, with specific requirements for quoted companies with listed ordinary shares. Although the Bank's ordinary shares are not listed, the Bank has adopted these requirements which include a review of strategy and business model and the principal risks and uncertainties of the Bank. The Strategic report includes the following:

	Pages
Chairman's statement	**7**
Our two business areas: Core and Non-core	**8**
Our strategy	**9**
Business model	**10**
Chief Executive's review	**11**
Summary financial review	**13**
Detailed financial review	**15**
Detailed financial review – Outlook	**21**
Detailed financial review – An update on capital raising	**22**
Detailed financial review – Key Performance Indicators	**23**
Detailed Key Performance Indicators	**25**
Principal risks and uncertainties	**26**
Social, community and human rights	**29**
Group structure	**30**

This Strategic report for the Bank has been drawn up and presented in accordance with, and in reliance upon, the Companies Act 2006. The liabilities of Directors in connection with this report shall be subject to the limitations and restrictions provided by such law.

Approved by the Board of Directors and signed on behalf of the Board.

Richard Pym
Chairman
10 April 2014

Chairman's statement

This is my first annual report since I was appointed as Chairman of The Co-operative Bank plc in June 2013 and it is fair to say it has been an extraordinarily difficult year.

I joined the Bank at very short notice, and the scale of our poor financial situation has since been exposed. We are subject to multiple external reviews and investigations, an entirely necessary response to the events over recent years. This must not be brushed away and it is important we understand fully how standards fell so short. On behalf of the Board I apologise that customers, investors and colleagues were let down so severely.

Rebuilding the Bank is a significant challenge but I believe we now have the tools to begin turning the business around. Niall Booker, a veteran of the banking world, joined the Bank at the same time as me, and he and his new Executive Team have worked closely with the Board over the second half of last year to understand the true state of the Bank. Devising a Recapitalisation Plan acceptable to all stakeholders in very difficult circumstances, we were able to complete the Liability Management Exercise (LME) in December without which we wouldn't be here today. This was certainly a key achievement and could not have been accomplished without the support of the vast majority of our subordinated bondholders, customers and colleagues for which we are extremely grateful.

The implications of separating the Bank from The Co-operative Group were not fully known at the time of the LME. We now estimate that the complexities involved, and the consequent cost and tax implications, are very significant. Together with providing for the costs of further customer redress, these items have adversely impacted our capital base. As a consequence we announced on 24 March 2014, that we have started the process of raising additional capital. This will strengthen our Common Equity Tier 1 (CET1) position as we embark on our Turnaround Plan. This is over and above the already planned contribution from The Co-operative Group in 2014 upon which we are still dependent.

The loyalty of our customers during this difficult time has been considerable. We have also been reminded that what the business is supposed to stand for is important for society as a whole. That is why the task of rebuilding the Bank counts so much. As such, for the first time we have embedded in the legal constitution of the Bank a pledge that requires us to act in line with the principles and values associated with The Co-operative Movement and we have established a Board Committee to ensure our adherence to those standards. Further details are outlined in the Values and Ethics section of this report. It is also important to acknowledge the commitment of colleagues who have gone about their work with huge professionalism during this period of corporate turmoil. I would like to say a heartfelt thank you to all of them.

Whilst The Co-operative Group remains our single largest shareholder, it must also be stressed that the Bank is now run and governed quite separately and The Co-operative Group has a right to nominate only two Directors to the Bank's Board although following the announcement of the need to raise additional capital, their nominated Board member has stepped down. We do, of course, remain united by our values and ethics and the many customers that we also share.

We are in the process of reshaping the Board to improve the governance in the Bank and have appointed new Non-Executive Directors who bring significant experience. Most recently, we welcomed Dennis Holt as our Senior Independent Director on 3 February 2014. Dennis has 36 years of executive experience at major financial services firms including as UK Chief Executive of AXA and as a main Board Executive Director at Lloyds TSB in charge of the Retail bank. Bill Thomas joined us on 28 October 2013 after holding very senior roles in information technology firms and will help to improve Board supervision of our IT activities. These add to the appointments made over the course of the first half of the year. We are currently recruiting for a number of other Board roles including an Independent Chair of our Values and Ethics Committee. Full details of the appointments made to date and the steps we are taking are outlined in the Governance section.

Turning this Bank around will be neither a simple task nor a short journey and the most significant risks and challenges the Bank faces are outlined on pages 26 to 28 of this report. There is also no doubt that rebuilding confidence and trust is a major challenge. We have a focused team, a clear strategy and a distinct brand and are now progressing our plan to return the Bank to its roots as a simpler and efficient bank serving retail and SME customers. I said at the time of our interim results that the UK retail banking market continues to suffer from a lack of choice and The Co-operative Bank has an important role in providing a viable alternative to the traditional banks. The support we have received from customers and colleagues is hugely appreciated and continues to demonstrate why rebuilding The Co-operative Bank is so worthwhile.

Richard Pym
Chairman
10 April 2014

Our two business areas:
Core and Non-core

As part of the Bank's plan to simplify, de-risk and reshape its business and to address the underlying issues which it faces, the Core and Non-core business areas are now managed as set out below:

During the year we continued to refine the allocation of our customers between Core and Non-core business areas. This revised allocation resulted in a transfer of additional corporate assets and liabilities into Non-core totalling £4.4bn. 2012 comparatives have therefore been restated to reflect this re-allocation.

	Core Business	Non-core Business (Co-operative Asset Management)
Definition	• Consistent with the Bank's strategy and risk appetite	• Inconsistent with the Core Business strategy and risk appetite • Cannot be supported by Core Business' Retail platform • Non-performing, defaulted, unprofitable and/or capital intensive products
	Includes: • Retail banking (Retail) – which trades as The Co-operative Bank, Britannia and **smile**, together with the Bank's intermediary mortgage brand, Platform, and includes Retail secured and unsecured lending • Business and Commercial Banking (BaCB) – which services small and medium sized businesses (SMEs) which will typically (i) have a turnover of less than £25m; (ii) have borrowing requirements of less than £5m; and (iii) otherwise meet the Bank's risk appetite (including charities, social businesses and co-operatives) • Treasury • Unity Trust Bank[1]	**Includes:** • Corporates – which typically have a turnover of over £25m or otherwise do not meet the Bank's risk appetite • Commercial Real Estate • Project Finance • Housing Associations • Local Authorities • Renewable Energy and Asset Finance • Optimum (a closed book of predominantly interest-only, intermediary and acquired mortgage book assets) • Illius (a closed portfolio of repossessed residential properties)
Focus	• Retail and SME customers • Relationship-based banking • Where we have strong market credentials, relationships and expertise • Easy-to-understand products	• Managing these businesses to achieve the most appropriate asset value on an individual portfolio basis; or • Targeting run down or exit
Customer Assets/Credit RWAs	**£17.6bn / £4.4bn**	**£12.5bn / £8.3bn**

1. Unity Trust Bank operates in the corporate banking and social economy sectors and is consolidated into the Bank's results on the basis of control. On 14 January 2014, it was announced that we are in discussions with the Board of Unity Trust Bank about a potential sale of our 26.7% shareholding. Discussions are at an early stage and any decision on a changed ownership structure would be subject to regulatory approval.

Our strategy

As part of the overall Recapitalisation Plan announced last year (see page 13 for a fuller description of the plan), the Bank has taken a number of actions to address the challenges it faces starting with the LME which was completed in December 2013. In parallel with the raising of additional capital announced on 24 March 2014, the focus now turns to implementing the Bank's strategy of becoming, over the next four to five years, a smaller and efficient bank retaining Co-operative values and focused on Retail and SME customers.

Business model

Core

As at 31 December 2013, the Core Bank had 4.7m customers, of which 4.6m were Retail and 0.1m were SME customers, and operated through a network of 294 branches, 22 business banking centres and 3 primary call centres, over 2,500 ATMs, the internet and digital channels.

Non-core

Managing these businesses to achieve the most appropriate asset value or targeting run down or exit.

How we make money

Business activity	Balance sheet impact	Income statement impact	Principal Risks
We lend money to customers	Loans create assets in our balance sheet that will generate future income	We earn interest income and may incur credit impairment charges	• Credit risk • Market risk • Operational risk • Liquidity and funding risk • Conduct risk
We collect deposits from customers	Deposits are a source of funding for the Bank (liabilities) which often incur interest expense	We may pay interest on deposits	• Liquidity and funding risk • Market risk • Operational risk • Conduct risk
We source funding from other banks and the capital markets	Wholesale funding is a liability for the Bank on which we incur interest expense	We pay interest on wholesale funding	• Liquidity and funding risk • Market risk • Operational risk
We provide transactional banking facilities	Minimal	We earn net fee and commission revenue	• Operational risk • Conduct risk
We invest in people in order to execute our strategy and deliver service to our customers	Minimal	Staff costs	• Operational risk • Conduct risk • People risk • Pension risk
We invest in our operations (IT and infrastructure) to deliver service to our customers while managing costs	Property, plant and equipment	Other operating costs	• Operational risk • Strategic and business risk

Chief Executive's review

Overarching strategy

The Bank's overarching strategy, which involves a Turnaround Plan of approximately four to five years, is to leverage our historic brand strength and high levels of customer service satisfaction to create, over time, an efficient and profitable bank with a reduced overall risk profile and to reduce our risk weighted assets.

This will require us to simplify and focus the Core business on Retail banking and small and medium sized business customers where we feel we have strong existing market credentials, customer relationships and expertise, whilst achieving significant operational efficiencies.

Those assets which are not consistent with our strategy and classified as part of the Non-core business will be actively managed to achieve the most appropriate asset value on an individual portfolio basis or targeted for run down or exit.

Since joining the Bank ten months ago, the challenges we face to turn the business around have been the subject of extensive comment. The results we are announcing today reflect the magnitude of these issues as well as further costs which have materialised since the completion of the Liability Management Exercise (LME).

We appreciate that our customers and stakeholders rightly continue to feel angry about how the Bank found itself in a financial situation which placed the future of the business so seriously at risk. I would like to apologise to them and thank our customers for the loyalty they have shown us over the last year and our colleagues for their commitment and professionalism during such difficult times.

Performance review

The legacy issues the new management team and I have inherited will continue to impact the performance of the business for some time. The full year results for 2013 reflect the further impacts of previously reported issues of impairment charges, predominantly in the Non-core business, the write down on our IT assets as outlined at our interims, increased conduct risk provisions (including PPI) and elevated operating costs. Additionally, the complexity and cost of separating the Bank from The Co-operative Group is proving greater than originally expected and further conduct risk and legal issues have emerged. Whilst the Core Bank remains profitable at an operating level, there is no doubt that our financial difficulties and other issues have impacted the 2013 performance of the Core franchise.

Stable liquidity and improved capital position

Against this financial picture, we have overcome some significant obstacles. Our focus on building liquidity enabled us to successfully navigate the turbulence of the second half of the year and also take the steps required to improve our capital position. The completion of the Liability Management Exercise (LME) in December was a key achievement and added over £1.2bn of CET1 before costs. The scale of this achievement is not to be underestimated and we are immensely grateful for the support of our subordinated bondholders.

As announced on 24 March 2014 and detailed on page 22, we are in the process of raising additional CET1 over and above the 2014 contribution from The Co-operative Group upon which we remain dependent. The complexity of the Bank's separation from The Co-operative Group was outlined in the LME prospectus and the higher than anticipated costs and tax implications associated with it together with the additional conduct and legal risks have impacted on the Bank's capital position. This additional capital will give us further room to begin to implement our Turnaround Plan to reshape the Bank around our Retail and SME customers.

Simplifying the business

Creating a viable business that is sustainable in the long term means that we must simplify our business and significantly reduce our costs. We have already taken a number of actions, announcing the closure of operations in Guernsey and the Isle of Man and are in the early stages of discussions to sell our stake in Unity Trust Bank. Alongside this, the cost reduction programme has begun across the business and as part of this we have previously announced a reduction in the branch network. These decisions are, of course, difficult but are driven by the reality of the situation the Bank is in.

Chief Executive's review continued

Focus on the Core Bank

Despite the unprecedented circumstances the Bank has faced, we believe there are some real positives to build on as we focus our attention on implementing that plan and increasing returns in the Core Bank. Customer satisfaction has been historically strong, and Core Retail deposits have been broadly stable reducing by less than one per cent in 2013. Our objective is to build on our strength in the Retail business by deepening those relationships whilst for our SME customers our plan is to deliver a straightforward banking proposition focused on the communities in which the branches sit. Work is underway to develop this.

Run down and exit in Non-core

A priority for the Bank is to reduce the level of Non-core assets, which are inconsistent with the Bank's strategy and risk appetite, as we streamline the business and focus our efforts on supporting Retail and SME customers. These assets now sit in the Non-core division called Co-operative Asset Management (CoAM) and developing exit plans for these portfolios, which balance maximum value, capital preservation, liquidity and the need to strengthen our balance sheet, are well underway. Our target is to reduce Non-core customer assets to c.£11.0bn by the end of 2014 and Non-core customer assets have already been reduced by a total of £2.1bn in 2013 through a combination of formal trade sales, proactive rebanking of our Corporate clients and the natural run off of the Corporate book. We have also successfully restructured a number of existing relationships.

Preserving our Values and Ethics

Balancing the requirement to make these difficult changes to the business with the need to preserve what makes us distinct is no easy task. It is critical to maintain our commitment to customer service and the Co-operative values that have set us apart for the last 140 years. We recognise the importance of ethics and values for all of our customers and remain committed to upholding them. This is why, for the first time, the Bank's constitution in the form of its Articles of Association includes a commitment to act in line with the principles and values associated with the Co-operative Movement and we have established a Values and Ethics Committee to ensure that we adhere to them.

We are seeking customers' views as we review and renew our commitment to values and ethics and will be engaging customers in this process and seeking their input to our Ethical Policy later in the Spring. The Bank's Ethical Policy has been renewed and expanded in line with customers' views on four separate occasions since its launch in 1992 and it is only right that at this point in our history we engage with customers again. The work to make this happen has now begun and we will let customers know more in the coming months. Further details are found in the Values and Ethics Committee Report.

Separation and transformation

From December last year the Bank's ownership structure changed and it is no longer a wholly owned subsidiary of The Co-operative Group as 70% of the Bank's shares are now owned by other shareholders. The Bank is therefore run and governed separately from The Co-operative Group with an independent Board with its own Chairman, Chief Executive and a new management team. We are continuing to progress operational and logistical separation of the Bank from the Group. This task is both extremely time consuming and complex and we have taken additional provisions of £39m to cover the work required to complete it.

Looking forward, we aim to put customers at the centre of what we do and will strive to make things simpler, removing unnecessary processes and ensuring our pricing is transparent. We intend to simplify our product range for both Retail and SME customers and we need to invest in our digital capabilities to make it easier for our customers to do business with us in the manner and at the time that suits them best.

However, to achieve this there are major issues to address in all areas of the Bank, not least in IT. There are also significant execution risks around the scale of the transformation required. This will involve making substantial investments and we have already planned in the region of £500m over the next three years to achieve the changes necessary. At the same time we have initiated an overhaul of our internal risk controls and conduct risk procedures.

Outlook

We have completed the LME, the cornerstone of our Recapitalisation Plan, however it is clear there is still a significant task ahead to return the Bank to financial health and additional capital will be required to do so. The plan is challenging, the legacy issues will continue to impact the profitability of the Bank for some time and we know we have a lot to do to rebuild trust in the Bank after the events of last year. It is critical that we can attract and retain the right quality of people to drive forward the change required. We know that the Bank is likely to continue to come under increased scrutiny, in the short to medium term at least, as a result of the regulatory and other investigations announced in 2013 and 2014. These inquiries are entirely understandable but they will of course create specific challenges for the Bank and demand considerable attention from the Board. The most significant risks and uncertainties the Bank faces to implement our plan are outlined in the Principal Risks and Uncertainties section of this Report and Accounts.

In the last few months, we have begun to introduce additional customer focused initiatives for both existing and new customers including a distinct current account switching offer and competitive mortgage rates. The response to date has been encouraging and these are small positive steps forward in re-engaging with customers. We continue to be mindful of the adverse impact of ongoing media coverage on these initiatives.

There are without doubt major hurdles still to overcome but the initial progress we are beginning to make on implementing our plan is encouraging. We have started to simplify the business, reduce costs and de-risk the Non-core assets and we are advancing plans to re-engage with customers on the values and ethics that remain at the heart of The Co-operative Bank. Of course, there is a considerable journey ahead of us which we do not underestimate. Our aim is to create a smaller, efficient bank focused on serving individuals and small and medium sized businesses set apart by its values and ethics, its quality of service and its determination to do the right things by its customers. Despite the troubles we have faced this remains at the heart of why customers choose to bank with us and, we believe, will continue to differentiate us in the future.

I'd like to take the opportunity here to thank colleagues for their hard work and fortitude, their commitment to our customers undoubtedly contributed to the stability of our Core franchise during these difficult times and will continue to be vital to the renewal of the Bank moving forward.

Niall Booker
Chief Executive

Summary financial review

Capital

- LME generated over £1.2bn CET1 before costs, with a further commitment of £0.3bn by end 2014
- CET1 ratio at the end of the year is 7.2% (2012 restated 5.0%)
- Bank remains below ICG and will remain so for most of the plan period
- Additional CET1 is in the process of being raised. See page 22 for additional information

Liquidity

- Downgrades of the Bank and its listed debt by rating agencies, primarily in Q2 2013, and negative publicity surrounding the Bank, caused significant wholesale corporate and business banking outflows. Year on year current account balances were broadly flat
- Throughout 2013 the Bank has remained above regulatory minima

Profitability

- The LME generated a profit of £688m bringing the overall loss before tax to £586m. Loss before LME of £1,275m (£674m loss 2012), including an Operating result of £507m
- Conduct risk and legal provisions in the year of £412m affected statutory loss, however, Core business remained profitable at an operating level
- Credit impairment provisions in the year total £516m (2012: £469m) primarily in the Non-core book
- IT write downs of £148m (2012: £150m)

Recapitalisation and the Liability Management Exercise

During the year the Bank carried out a refinancing exercise with the aim of increasing the level of capital held. This exercise involved issuing new shares and new debt in exchange for cash and existing debt and preference shares.

Background

The Bank received a letter from the Financial Services Authority (FSA), in January 2013, addressed to the Board, notifying it of a revised Individual Capital Guidance (ICG) and greatly increased Capital Planning Buffer (CPB) to be held exclusively in Core Tier 1 capital. Whilst the Bank had capital sufficient to meet the revised ICG[1], the letter acknowledged that the size of the CPB meant that the Bank would be in breach of this from the outset. The letter requested that the Board prepare, and present to the Prudential Regulation Authority (PRA), as the successor to the FSA by the end of April 2013, a credible plan that would restore the Bank's capital strength to an appropriate level and a timeline for delivery.

Accordingly, the Bank initiated a capital planning process (the Pennine Plan) to consider the shortfall and actions to address it, and the plan was discussed with the PRA during its evolution.

In March 2013, the Interim Financial Policy Committee (FPC) of the Bank of England recommended that the PRA should take steps to ensure that all major UK banks and building societies, including the Bank, held capital resources equivalent to at least 7% of their risk-weighted assets (assessed using the Basel III definition of equity capital) by December 2013.

This requirement, together with the Basel III requirement for CET1 to remain above 4.5% at all times and a Leverage Ratio of 3%, were fed into an enhanced version of the Pennine Plan in May (an initial plan having been submitted to the PRA as requested). The levels of expected loss in the corporate lending portfolio and other risks were also reassessed, which indicated that the Bank was likely to breach its ICG later in 2013.

After discussion with the PRA, this work culminated in the Bank and The Co-operative Group announcing on 17 June 2013 that the Bank required additional aggregate CET1 of no less than £1.5bn, (of which at least £1bn should be raised in 2013) and the Recapitalisation Plan was launched.

The enhanced Pennine Plan was updated to include the CET1 and the non-CET1 capital to be raised as part of the Recapitalisation Plan. The resultant plan did not expect to restore the CPB at any time in the five year planning period, but did expect to achieve ICG compliance by the end of the planning period. The required minimum CET1 ratios of 7% in normal conditions and 4.5% under stress were expected to be met in 2013. The completion of the LME raised £1.2bn before costs and the 2013 year end CET1 ratio stood at 7.2%.

The Recapitalisation Plan

The £1.5bn Recapitalisation Plan consisted of three elements:

a) The Liability Management Exercise (LME) to generate c.£1.2bn of new CET1;

b) The commitment of The Co-operative Banking Group to contribute £333m of CET1 by the end of 2014; and

c) £40m of CET1 generated in 2014 from interest savings on the securities surrendered in the LME.

a) The LME

A core part of the Recapitalisation Plan was achieved through completion of the LME on 20 December 2013. This involved the following elements:

i. The issuance of £0.2bn of new subordinated debt and £0.6bn of new ordinary shares in exchange for £1.3bn of existing debt and preference shares and additional contributions from bondholders of £0.1bn;

ii. The cancellation of £0.4bn of existing ordinary share capital which resulted in the creation of a capital redemption reserve of the same value; and

iii. The sale of investment assets that were used as economic hedges for the existing debt, generating a profit of £11m. These assets had been accounted for as available for sale and therefore there was an equivalent reduction in the available for sale reserve.

b) The contribution of £333m by The Co-operative Banking Group. This is due or paid up as follows:

i. £20m paid in December 2013;

ii. £50m paid in January 2014;

iii. £100m due by 30 June 2014; and

iv. £163m due by 31 December 2014.

1. Capital resources would still have been in surplus to ICG had the restatement detailed in note 3 to the financial statements been made at the time.

Summary financial review continued

c) The balance of the £1.5bn is interest saved in 2014 on securities surrendered as part of the LME

Elements (a) and (b) together created additional CET1 in the following ways:

i. New ordinary shares – a total of £0.8bn of new ordinary shares were issued to both existing bondholders and The Co-operative Banking Group. This was recorded as share capital and share premium as shown in the table below;

ii. Income – £0.7bn was recognised in the income statement. This arose because the amount of existing debt and preference shares and contributions received (£1.3bn and £0.4bn) was greater than the amount of the new debt and shares issued (£0.2bn and £0.8bn). In accordance with company law, which requires that share premium is determined by reference to the amount of debt extinguished, £0.6bn was transferred from retained earnings to share premium; and

iii. These increases in CET1 were offset by associated costs of £52m of the LME.

The effects of these transactions are shown in the table below and can be seen in the statement of changes in equity on page 133, along with the other borrowed funds and share capital notes on pages 182 and 205.

Overall impact of the recapitalisation transactions

The table below shows the effect of the recapitalisation transactions on profit and reserves.

		Effect on reserves					
Effect of the Recapitalisation Plan on profit and reserves (£m)	Profit	Retained earnings	Share capital	Share premium	Available for sale reserve	Capital redemption reserve	Net effect on reserves
Issuance of new debt and ordinary shares in exchange for existing debt and contributions	707.7	707.7	12.5	777.5	–	–	1,497.7
Sale of assets hedging pre-LME debt positions	11.1	11.1	–	–	(11.1)	–	–
Effect of transactions with a profit impact (before costs)	**718.8**	**718.8**	**12.5**	**777.5**	**(11.1)**	**–**	**1,497.7**
Costs associated with LME transaction	(30.5)	(30.5)	–	(21.3)	–	–	(51.8)
Effect of transactions with a profit impact (after costs)	**688.3**	**688.3**	**12.5**	**756.2**	**(11.1)**	**–**	**1,445.9**
Other LME transactions (with no profit impact):							
Cancellation of share capital (capital redemption reserve created)	–	–	(410.0)	–	–	410.0	–
Transfer of retained earnings to share premium account	–	(594.8)	–	594.8	–	–	–
Total effect of Recapitalisation transactions on profit and reserves	**688.3**	**93.5**	**(397.5)**	**1,351.0**	**(11.1)**	**410.0**	**1,445.9**

Impact on Regulatory Capital

As at 31 December 2013, the Recapitalisation Plan generated an additional £1.2bn of CET1 on a regulatory basis pre costs, as calculated below. Further CET1 will be generated during 2014 as a result of interest savings and receipt of the contribution due from The Co-operative Banking Group (which cannot be counted for Regulatory purposes until received). The table includes a reconciliation to the effect on statutory reserves as at 31 December 2013.

Effect of Recapitalisation Plan on CET1 (£m)	Retained earnings	Share capital/ redemption reserve	Share Premium	Effect on capital and reserves
Effect as at 31 December 2013 before costs	133.8	9.8	1,062.0	1,205.6
Costs associated with LME transaction	(30.5)	–	(21.3)	(51.8)
CET1 Capital raised as at 31 December 2013	**103.3**	**9.8**	**1,040.7**	**1,153.8**
Contribution due from The Co-operative Group during 2014	–	2.7	310.3	313.0
Effect of interest savings during 2014	40.0	–	–	40.0
CET1 Capital raised as at 31 December 2014	**143.3**	**12.5**	**1,351.0**	**1,506.8**
Reconciliation to statutory reserves as at 31 December 2013:				
Remove effect of interest savings (2014 impact)	(40.0)	–	–	(40.0)
Include effect of discounting (statutory impact for 2013)	(9.8)	–	–	(9.8)
Effect on statutory reserves as at 31 December 2013	**93.5**	**12.5**	**1,351.0**	**1,457.0**
Available for sale reserve impact (not CET1 Capital)				(11.1)
Total effect on statutory reserves as at 31 December 2013				**1,445.9**

Detailed financial review

Capital

In plain english:

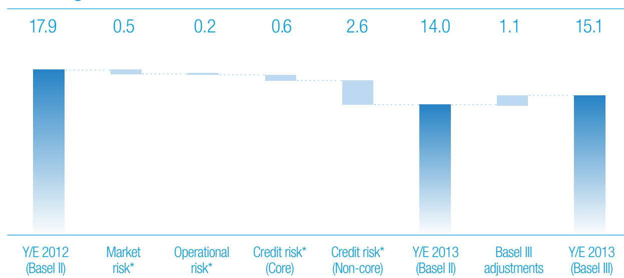
Capital is held by the Bank to protect its depositors and to cover the different risks faced by the Bank. The minimum amount of capital the Bank is required to hold is set by European and national regulators. The capital requirement is set with reference to the amount of risk the Bank takes, defined by the amount of risk weighted assets the Bank holds for credit risk, market risk and operational risk. Credit risk represents 91% of risk weighted assets which are calculated by weighting different types of loan according to the potential loss that might be incurred.

The amount of capital the Bank holds to meet requirements is specified in terms of the type of capital with specific requirements for Common Equity Tier 1, the highest quality of capital, as well as total Tier 1 and total capital.

As at 31 December 2013 the Basel II capital framework applied to the Bank. The Basel III capital framework came into effect from 1 January 2014 and within the European Union this has been implemented by a new Capital Requirements Directive (CRD IV). Under Basel III a Leverage Ratio has been introduced which is a simpler measure of Bank capital levels and is based on the amount of good quality capital (Tier 1) compared to the overall balance sheet of the Bank.

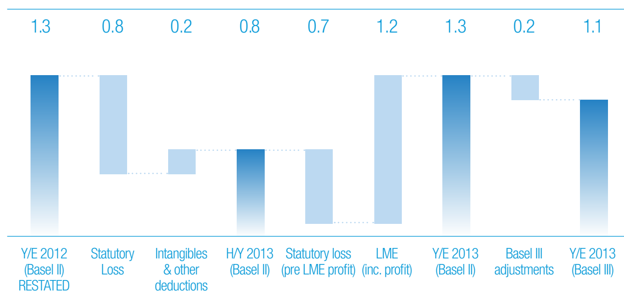
During 2013, the Bank has made progress toward improving the capital position and reducing the overall risk profile of the Bank. Completion of the LME, together with reduction in the balance sheet and risk weighted assets, has resulted in an improvement in the capital position, however due to the materialisation of additional conduct risks and the costs of separation, the Directors now consider that additional capital will be required.

Risk Weighted Assets £bn

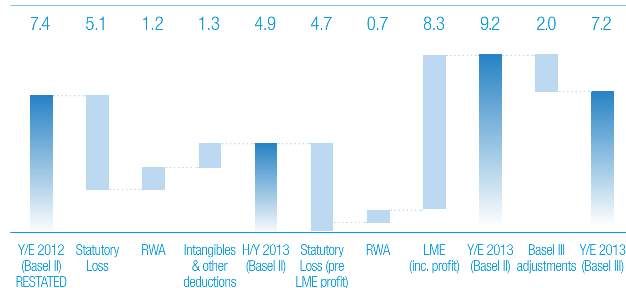


* Credit risk, market risk, operational risk are defined in the glossary.

Core Tier 1 £bn



Core Tier 1%



Basel II/CRD III capital position

	2013	Restated 2012	Change
Capital ratios			
Core Tier 1 ratio	**9.2%**	7.4%	1.8%
Total capital ratio	**10.1%**	12.8%	(2.7%)
Risk weighted assets (£bn)	**14.0**	17.9	(3.9)

CRD IV fully-loaded capital position

	2013	Restated 2012	Change
Capital ratios			
Common Equity Tier 1 ratio	**7.2%**	5.0%	2.2%
Total capital ratio	**8.6%**	9.0%	(0.4%)
Risk weighted assets (£bn)	**15.1**	18.8	(3.7)
Leverage ratio	**2.4%**	1.8%	0.6%

The LME improved Core Tier 1 by £1.2bn before costs in 2013 with a further injection of £313m due to be provided by The Co-operative Banking Group by the end of 2014. Fully-loaded CRD IV CET1 ratio has increased from 5.0% to 7.2%.

Risk weighted assets have decreased by £3.9bn over the year. Non-core assets have been actively managed down and this is reflected in the £2.6bn reduction in Non-core risk weighted assets. Risk weighted assets for market risk have decreased by £0.5bn due to the sale of the Bank's trading assets.

Leverage ratio is 2.4% as at 31 December 2013, below the proposed 3.0% regulatory minimum due to be implemented in 2018.

The Bank is not currently compliant with its Individual Capital Guidance, being the PRA's statement as to the regulatory capital it expects the Bank to hold, although the Bank does meet its Pillar 1 capital requirements.

The higher than anticipated losses reported in these accounts have been factored into the Bank's latest capital plans, and the Board announced on 24 March 2014 that additional CET1 is now required to remain adequately capitalised, and to provide the previously envisaged start position from which to proceed with the Turnaround Plan. The new capital plan, which has been shared with the PRA, forecasts that the Bank will meet the 7% CET1 ratio throughout the planning period. The new capital plan anticipates meeting ICG by the latter part of the planning period, however full compliance with its current CPB is not anticipated during the planning period. The PRA understands the Bank's plan and is exercising forbearance in this regard. Leverage ratio of 3% is expected to be achieved before the 2018 requirement.

Detailed financial review continued

Liquidity

Overview

The Bank raises the majority of its funding through accepting retail and corporate deposits. The Bank also maintains a range of funding programmes targeting wholesale investors.

During the first half of the year, there were corporate deposit outflows due to credit rating downgrades of approximately £1.5bn.

During the second half of the year, the announcement of the LME and other publicity led to an increased risk of significant outflows, however the Bank maintained its regulatory liquidity buffer to ensure its financial obligations were met as and when they fell due.

The focus of the funding and liquidity strategy of the Bank has been to:

- Reduce the holding of investment grade bonds that were not eligible to be included in the liquid asset buffer (LAB). This maintained cash held at central banks. It also reduced reliance on short dated secured financing to fund such assets and in turn reduced the amount of Treasury assets encumbered by the Bank;
- Substantially increase secondary liquidity by increasing the availability of mortgage collateral for funding;
- Enter into secured private bilateral facilities to mitigate the loss of credit rating sensitive corporate deposits; and
- Maintain ratings of secured funding programmes, by the implementation of rating agency compliant back-up servicing arrangements to ensure market access.

The Bank's deleveraging strategy will continue to reduce funding and liquidity pressure.

Credit rating

In May 2013, Moody's downgraded the Bank's long term credit rating by six notches from A3 to Ba3. In June, Moody's further downgraded the Bank's long term credit rating by four notches from Ba3 to Caa1. In addition, in June 2013, Fitch downgraded the Bank's long term credit rating by three notches from BBB- to BB-.

The credit rating downgrades have:

i. led to sub-investment grade ratings on the Bank's senior debt in turn leading to a significant reduction in the demand for these types of instrument;

ii. negatively impacted the Bank's ability to access short term unsecured wholesale funding; and

iii. increased the Bank's collateral requirements within some clearing systems.

On 14 November 2013, Fitch further downgraded the Bank from BB- to B. This did not have a material impact on the Bank as the current low credit rating has reduced the deposit base's sensitivity to rating changes.

	Long term	Short term
Moody's	Caa1	NP
Fitch	B	B

In plain english:

A company's credit rating is an indication of a company's creditworthiness. The evaluation is made by a credit ratings agency. Some companies have internal rules which mean that they can only place money with a bank of a certain credit rating. When the Bank was downgraded therefore, some businesses were forced to move their money, others perceived increased risk (including individuals) and reduced their deposits with the Bank.

Liquidity portfolio

The Bank's liquidity resources as at 31 December 2013 were £11.2bn compared to £8.7bn as at 31 December 2012. The table below analyses the Bank's liquidity portfolio by product and by liquidity value. Primary liquidity consists of liquid assets that are eligible under BIPRU 12.7(LAB) and secondary liquidity consists of all other liquid assets (including self-issued retained securitisations).

Primary liquidity has remained broadly constant over the year. The sale of investment securities has increased the quality of primary liquidity. The increase in availability of mortgage collateral has improved the quantity of secondary liquidity.

	2013 £m	2012 £m	Change £m
Operational balances with Central Banks	**5,076.3**	5,121.0	(44.7)
Gilts	**789.5**	664.8	124.7
Central government and multilateral development bank bonds	**1,112.2**	1,455.1	(342.9)
Total primary liquidity	**6,978.0**	7,240.9	(262.9)
Total secondary liquidity	**4,215.4**	1,416.8	2,798.6
Total liquidity	**11,193.4**	8,657.7	2,535.7

Retail and commercial funding

The majority of the Bank's funding comes from retail and commercial accounts. As at 31 December 2013, customers deposits were £33.0bn compared to £36.8bn as 31 December 2012.

Retail deposits remained broadly stable only declining by approximately £0.2bn.

The total amount of the Bank's corporate deposits fell by approximately £3.3bn in 2013, which the Bank believes was probably caused by the credit rating downgrade. Due to the Bank's current low rating, the corporate deposit base is now less sensitive to rating downgrades.

Detailed financial review continued

	2013 £m	2012 £m	Change £m
Current accounts:			
Retail	**3,378.1**	3,276.5	101.6
Corporate	**2,298.9**	3,066.7	(767.8)
Total current accounts	**5,677.0**	6,343.2	(666.2)
Instant access savings accounts			
Retail	**8,097.2**	8,875.3	(778.1)
Corporate	**666.2**	877.0	(210.8)
Total instant access saving accounts	**8,763.4**	9,752.3	(988.9)
Term deposits and bonds			
Retail	**9,879.5**	9,900.1	(20.6)
Corporate	**1,344.9**	3,615.5	(2,270.6)
Total term deposits and bonds	**11,224.4**	13,515.6	(2,291.2)
Individual savings accounts (ISA):			
Retail – ISA Fixed	**3,853.1**	3,415.3	437.8
Retail – ISA Demand	**2,455.2**	2,406.2	49.0
Total ISA accounts	**6,308.3**	5,821.5	486.8
Other deposits	**1,028.3**	1,339.9	(311.6)
Total customer deposits	**33,001.4**	36,772.5	(3,771.1)

Wholesale funding

The Bank uses wholesale funding to supplement retail and commercial deposits by raising longer term funds (over one year in duration) and to diversify the source of funds to support the plan of the Bank. The Bank has a variety of long term wholesale funding sources outstanding, including securitisations, covered bonds and euro medium term notes.

The LME reduced subordinated debt funding by c.£1bn. Following the ratings downgrade of the Bank, the Bank has put in place back-up servicing arrangements for its secured funding programmes. This has maintained the programmes' ratings helping to ensure market access if required.

The Bank also entered into secured private bilateral facilities to mitigate the loss of credit rating sensitive corporate deposits.

	2013 £m	2012 £m	Change £m
Preference shares, PSBs and subordinated debt	**196.3**	1,335.3	(1,139.0)
Secured funding	**4,339.5**	4,262.0	77.5
Repos	**2,119.3**	2,483.3	(364.0)
Market borrowing	**56.6**	703.7	(647.1)
MTNs	**884.0**	961.6	(77.6)
Total wholesale funding	**7,595.7**	9,745.9	(2,150.2)

For 2014, capital market maturities are limited to €25m MTN in February and £0.4bn optional call of Silk Road Finance Number Two securitisation in September.

	2013 £m	2012 £m	Change £m
Repayable in less than 1 month	**2,010.3**	1,815.0	195.3
Repayable between 1 and 3 months	**67.8**	365.6	(297.8)
Repayable between 3 and 12 months	**157.2**	613.6	(456.4)
Repayable between 1 and 5 years	**1,800.8**	5,093.3	(3,292.5)
Repayable in more than 5 years	**3,559.6**	1,858.4	1,701.2
Total	**7,595.7**	9,745.9	(2,150.2)

Total Bank income statement

2013 resulted in a statutory loss before taxation of £586m (2012: £674m loss). This loss included a profit on the LME of £688m.

The main factors impacting on financial performance are:

- Credit impairment £516m (2012: £469m)
- Intangible asset impairment of the Core banking platform replacement £148m (2012: £150m)
- Conduct and legal risk provisions, including PPI, £412m (2012: £150m)
- Increased operating costs £686m (2012: £583m)
- LME £688m profit post costs and fair value adjustments (2012: nil)
- Reduction in the size of the balance sheet year on year by £6.4bn

The Core business remained profitable from an operating perspective, generating an operating result of £10m (2012: £118m). The Non-core business, not managed for profit but targeted for rundown and exit, incurred a loss of £517m (2012: £399m loss), mainly due to impairment charges.

The Bank's Net Interest Margin remained broadly stable at 1.09% (2012: 1.11%), of this, core NIM at 1.7% has remained flat.

This was offset by lower Treasury yields as the Bank sold part of its portfolio to strengthen liquidity.

Balance Sheet contraction and lower non-interest income has led to income falling by £76m to £695m. Coupled with increased operating costs, predominantly one-off costs, as set out below, this has led to a rise in the Cost Income ratio to 93.6% (2012: 73.7%).

	2013 £m	2012 £m	Change £m
Retail	**14.2**	50.1	(35.9)
BaCB	**13.7**	25.0	(11.3)
Treasury/other	**(17.8)**	43.0	(60.8)
Core operating result	**10.1**	118.1	(108.0)
Non-core	**(516.7)**	(398.6)	(118.1)
Operating result	**(506.6)**	(280.5)	(226.1)

Overall, the balance sheet reduced by £6.4bn over the year, £3bn of which related to customer assets. This was driven by a combination of strategic run down of Non-core assets and a reduction in new mortgage lending. Whilst Retail deposits remained broadly stable, liabilities in BaCB and Corporate Non-core fell as a result of rating agency downgrades. This also contributed to a fall in operating income for the Bank.

Detailed financial review continued

	2013 £m	2012 £m	Change £m
Operating income	**695.1**	771.2	(76.1)
Operating costs – steady state	**(650.7)**	(568.2)	(82.5)
Operating costs – strategic initiatives	**(34.8)**	(14.8)	(20.0)
	(685.5)	(583.0)	(102.5)
Impairment losses	**(516.2)**	(468.7)	(47.5)
Operating result	**(506.6)**	(280.5)	(226.1)
Non Operating Costs	**(155.9)**	(108.7)	(47.2)
Intangible asset impairment	**(148.4)**	(150.0)	1.6
Conduct/legal risk	**(411.5)**	(149.7)	(261.8)
LME	**688.3**	–	688.3
Fair value amortisation	**(52.1)**	15.2	(67.3)
(Loss)/profit before taxation	**(586.2)**	(673.7)	87.5

The numbers referenced and presented on these pages are on a management accounts basis. A reconciliation of these numbers to the statutory accounts basis is provided in the Segmental Reconciliation in note 5.

Credit impairment losses

In line with expectations, 2013 has seen substantial impairment charges totalling £516m (2012: £469m). Of the total charge, 92% (£476m) is in the Non-core business.

The Non-core corporate loan book continues to be reviewed on a case-by-case basis to assess credit risk impairment requirements and reflect changes in the work out approach on a significant number of assets. This accounts for approximately half of the overall Non-core charge. Additionally, there have been continued improvements in credit risk management, improving the data on which impairment assessments are made, resulting in increased impairments in the Non-core book. Those credit impairments which occur in the ordinary course of business, due to changes in customer circumstances, have also been incurred in both the Core and Non-core businesses.

Intangible asset impairment and IT strategy

In the second quarter of 2013, the Directors concluded that the IT platform previously under development would no longer be implemented, as it was inconsistent with the Bank's simplified strategy going forward, resulting in a write down of £148m (2012: £150m).

The revised IT strategy is focused on incremental improvements in the existing platform rather than wholesale replacement.

Conduct risk and legal provisions

The total conduct and legal risk charge for the year of £412m (2012: £150m) included costs to settle claims relating both to PPI (£103m) and other potential conduct issues spanning mortgage products (£114m), failings relating to sales of third party insurance products (£26m) and interest rate swaps (£33m).

Interest refunds relating to technical compliance with the Consumer Credit Act have also been provided for (£110m).

The increase in PPI costs primarily reflected a change in estimations regarding PPI redress, ie more money expected to be paid to more customers.

Conduct issues provided for relate to mortgage products including potential issues surrounding early repayment charges and forbearance practices in the Optimum book.

Operating costs

Operating costs (excluding fair value amortisation and strategic investment costs) for the year are £651m (2012: £568m). These increases arise from predominantly one-off costs including a data quality provision relating to legacy issues of £20m, dilapidations provision of £12m, higher consultancy fees of £15m and rates costs on ATMs outside of Co-operative stores (£16m) as well as increased costs of temporary staff.

Despite the headline numbers, cost saving initiatives were implemented in 2013 and resulted in underlying headcount reductions during the second half of 2013.

A significant driver of the increased operating costs for strategic initiatives is the IT and business resiliency programme instigated in 2013 to work towards a more robust and stable IT platform.

Non-operating costs also increased, reflecting the continuing transformation costs required to restructure the business. These costs include the one-off costs to execute the LME of approximately £31m. Costs to implement the branch rationalisation programme of approximately £12m (closure of 43 branches) and severance costs of approximately £13m will deliver savings against operating costs in future years.

There is a clear management focus on driving cost savings as a fundamental part of the Bank's strategy. Plans are in place to reduce operating costs through the delivery of a number of initiatives targeting further reductions in staff numbers and reduced third party spend.

Total Bank balance sheet

Total assets

	2013 £m	Restated 2012 £m	Change £m
Cash and balances at central banks	**5,418.8**	5,433.0	(14.2)
Loans and advances to banks	**1,594.4**	1,904.1	(309.7)
Loans and advances to customers	**30,322.2**	33,339.5	(3,017.3)
Investment securities	**4,499.4**	6,889.8	(2,390.4)
Other assets	**1,561.3**	2,206.4	(645.1)
Total assets	**43,396.1**	49,772.8	(6,376.7)

The balance sheet of 2012 has been restated to account for tangible and intangible assets (£278m) which were held on the balance sheet of CFSMS Limited (formerly a fellow subsidiary of The Co-operative Banking Group). See note 3 to the accounts for full disclosure of this restatement.

In line with our strategy, 2013 has seen a planned reduction in assets, mainly in the Non-core division. Core assets have also reduced in line with the Bank's pricing strategy and liquidity requirements.

Detailed financial review continued

Total liabilities

	2013 £m	Restated 2012 £m	Change £m
Deposits by banks	**2,757.5**	3,612.0	(854.5)
Customer accounts	**33,001.4**	36,772.5	(3,771.1)
Debt securities and derivatives	**4,733.9**	5,681.3	(947.4)
Other borrowed funds	**196.3**	1,258.6	(1,062.3)
Other liabilities	**929.7**	598.2	331.5
Total Liabilities	**41,618.8**	47,922.6	(6,303.8)

Customer deposits have reduced, primarily in the Core business banking (BaCB) and Non-core businesses, over the year due to the Bank having been downgraded by the ratings agencies and other negative publicity surrounding the Bank.

Core

As described on page 8, the Bank is managed in two divisions: Core (comprising the Retail, Business and Commercial Banking (BaCB) and Treasury/other areas) and Non-core. The following section covers performance in more detail for each of these areas.

Retail

	2013 £m	2012 £m	Change £m
Net interest income	**428.1**	399.9	28.2
Non-interest income	**123.7**	135.8	(12.1)
Net income	**551.8**	535.7	16.1
Operating costs – steady state	**(486.1)**	(434.6)	(51.5)
Operating costs – strategic initiatives	**(18.5)**	(9.6)	(8.9)
Impairment losses	**(33.0)**	(41.4)	8.4
Operating result	**14.2**	50.1	(35.9)
Customer assets	**16,790.9**	17,662.7	(871.8)
Customer liabilities	**27,899.3**	28,141.5	(242.2)

The Retail operating result for 2013 is a profit of £14m (2012: £50m). This performance and balance sheet reflects both the changing shape of the UK retail market, as well as the Bank's key priority of maintaining liquidity.

The Retail Bank has generated additional net interest income from increased pricing over back book and new business lending, consistent with pricing trends of the Bank's competitors. Additionally, the retail market has seen a softening in pricing for deposits on the back of initiatives such as Funding for Lending. The Retail Bank has benefitted from this trend, although the Bank remained towards the upper end of the market for customer deposit rates.

The Retail Bank has also strategically reduced its balances with non-relationship unsecured lending customers, as well as making tactical mortgage pricing decisions, remaining competitive whilst supporting liquidity objectives.

The Retail customer deposit base has decreased by £0.2bn year on year, reflecting some outflows as a consequence of the combination of rating agency downgrades, negative publicity for the Bank and current account switching competition. The previous outflows have now stabilised and the Bank's 2014 current account switching offer has seen encouraging take-up.

The combined impact of these factors is to increase overall income, including a particularly strengthened net interest income performance.

The Retail operating cost base has been affected by a number of large specific impacts as previously discussed.

Additionally, project expenditure has been incurred, primarily on increasing the resilience of the IT estate and delivering regulatory initiatives such as 7 day account switching.

Business and Commercial Banking (BaCB)

	2013 £m	2012 £m	Change £m
Net interest income	**69.5**	63.1	6.4
Non-interest income	**14.9**	15.3	(0.4)
Net income	**84.4**	78.4	6.0
Operating costs – steady state	**(59.2)**	(49.7)	(9.5)
Operating costs – strategic initiatives	**(5.6)**	(1.7)	(3.9)
Impairment losses	**(5.9)**	(2.0)	(3.9)
Operating result	**13.7**	25.0	(11.3)
Customer assets	**844.9**	936.3	(91.4)
Customer liabilities	**3,479.0**	6,041.4	(2,562.4)

Business and Commercial Banking (BaCB) delivered an operating profit of £14m in 2013 (2012: £25m).

As expected, the rating agency downgrades referred to earlier led to significant outflows of more rating sensitive corporate and commercial customers. BaCB was not immune from this impact. BaCB anticipated these withdrawals and therefore tactically set new lending and refinancing pricing to bring it in line with the market as well as conserve liquidity and capital. Hence, as existing borrowers continued to repay facilities, the lending portfolio shrank by £0.1bn. These factors combined to generate higher net interest income.

The increase in BaCB's cost base reflects similar issues to the Bank as a whole as well as third party advisor costs and additional costs of temporary staff. In line with the Retail division, BaCB saw increased costs on strategic and regulatory initiatives such as IT resiliency and 7 day current account switching.

Detailed financial review continued

Core

Treasury/other businesses

	2013 £m	2012 £m	Change £m
Net interest income	**9.6**	50.5	(40.9)
Non-interest income	**17.4**	16.3	1.1
Net income	**27.0**	66.8	(39.8)
Operating costs – steady state	**(38.2)**	(25.8)	(12.4)
Operating costs – strategic initiatives	**(5.6)**	(1.7)	(3.9)
Impairment losses	**(1.0)**	3.7	(4.7)
Operating result	**(17.8)**	43.0	(60.8)
Assets	**10,933.7**	13,580.3	(2,646.6)
Liabilities	**8,028.1**	10,248.6	(2,220.5)

The Treasury operation is the principal source of Net Income in this business. Unity Trust Bank is included in this sector, and contributed a £1.6m operating profit in the year.

In response to the events at the Bank, and the rating agency actions, the shape of the Treasury balance sheet changed over the period. In order to maintain the strength of the liquidity position, the Bank sold the majority of its higher yielding assets that did not contribute to the liquidity buffer. This reduced the yield of the overall portfolio, reducing interest income. The sale of the assets generated a profit of £53.3m net of any related derivatives (2012: £33.5m).

The cut in the Bank's rating to below Investment Grade led to a reduction in the Bank's rating sensitive deposits. These deposits had a lower cost of funding and this action coupled with the issuance of higher cost term funding increased the average cost of funding of the Bank's liquidity portfolio. This also led to a decrease in the net income of the Treasury balance sheet.

In response to the lower credit rating, the Bank was required to increase collateral used within central payment systems. The assets required for collateral typically consist of lower yielding government bonds and Treasury bills thereby further impacting net interest income.

The Bank accessed the Bank of England's 'Funding for Lending' scheme in the first half of the year, drawing £900m of Treasury Bills. The Treasury Bills remain available to the Bank until March 2017. The fee payable under the scheme is linked to net lending growth.

Increases in operating costs were a result of higher staffing costs, as well as the Bank-wide issues mentioned earlier.

Strategic investments included developing the Core interest rate risk management system, as well as progressing the enhancement of the Treasury transaction management and settlement systems.

Non-core

Non-core balance sheet

	2013 £m	2012 £m	Change £m
Corporate CoAM	**5,646.1**	7,313.7	(1,667.6)
Optimum	**7,326.1**	7,645.2	(319.1)
Illius	**162.2**	171.2	(9.0)
Assets	**13,134.4**	15,130.1	(1,995.7)
Corporate CoAM	**831.0**	1,541.4	(710.4)
Optimum	**–**	–	–
Illius	**–**	–	–
Liabilities	**831.0**	1,541.4	(710.4)
Customer Assets	**12,473.4**	14,579.8	(2,106.4)
Customer Liabilities	**831.0**	1,541.4	(710.4)

Non-core income statement

	2013 £m	2012 £m	Change £m
Net interest income	**(3.8)**	32.3	(36.1)
Non-interest income	**35.7**	58.0	(22.3)
Net income	**31.9**	90.3	(58.4)
Operating costs – steady state	**(67.3)**	(58.0)	(9.3)
Operating costs – strategic initiatives	**(5.0)**	(1.9)	(3.1)
Impairment losses	**(476.3)**	(429.0)	(47.3)
Operating result	**(516.7)**	(398.6)	(118.1)

In line with the Bank's strategy, the Bank is actively reducing the level of Non-core assets. This is reflected in the Bank's income statement as lower income and higher impairments. Consequently, the Non-core operating result shows continued and increased losses in 2013 of £517m (2012: £399m).

The Corporate portfolio represented £447m of the loss (2012: £394m) driven by the impairment charge, whilst the Optimum portfolio, a closed book of intermediary and acquired mortgage book assets, recorded a loss of £60m (2012: £3m). The Illius business, a closed residential property portfolio, incurred a loss of £10m (2012 loss: £2m). This loss reflects the decision to designate the portfolio as Non-core and a consequential change in strategy, from hold for yield and value, to disposal.

Balance sheet assets – Non-core

The Corporate CoAM assets, net of provisions, have decreased from £7.3bn at the end of 2012 to £5.6bn through controlled asset sales and re-banking activity. The closed Optimum portfolio has also reduced as customers continue to pay down their mortgages.

A strategic priority of the Bank is to reduce the level of Non-core assets, to streamline the business and focus on Retail and SME customers. To support this priority, a programme of debt reduction is underway comprising formal trade sales and a pro-active re-banking of Corporate clients. In 2013, a total of £1bn was removed from the Non-core balance sheet through these actions contributing to a £2bn reduction in Non-core assets.

Balance sheet liabilities – Non-core

Corporate liabilities have fallen as customers moved their money out of the Bank following the downgrades by the ratings agencies.

Outlook

Non-adjusting post balance sheet events occurred between 31 December 2013 and the date of approval of these Financial Statements. These are discussed in detail in note 42 on page 219.

There is a significant task ahead to turn the Bank around, however, the management team believes the plan will deliver a sustainable improvement in performance over time. Although the completion of the LME improved our capital position, as announced on 24 March 2014 additional capital is required and the raising of this CET1 is in progress. The Board is still considering listing the Bank on the London Stock Exchange but the timing of such a listing remains uncertain as a result of a number of factors including the conclusions of the ongoing regulatory reviews.

Our plan is to serve the needs of individuals and SMEs where we have heritage and strong customer relationships. We are focused on delivering the strategy to be a smaller, efficient bank distinguished by our values and ethics.

Looking forward, the short to medium term outlook for the Bank remains challenging. The Bank is dependent on the macroeconomic environment and competitive landscape in which it operates, as well as the effective execution of the objectives that underpin the strategy such as continued deleveraging of Non-core assets, re-pricing, investment in IT and strong cost management. The Bank also needs to attract and retain appropriately skilled people. In parallel, the regulatory and other investigations announced in 2013 and 2014 are likely to subject the Bank to greater scrutiny from regulators and the media, which could cause reputational damage and potentially distract management and take resources away from the implementation of the strategy. The most significant of the risks and challenges the Bank faces are summarised in the Principal Risks and Uncertainties section of this Annual Report and Accounts.

An update on capital raising

As announced on 24 March 2014, the Bank is in the process of raising £400m additional Common Equity Tier 1 (CET1). Having appointed advisors to assist in the proposed CET1 raising, the Bank is now engaged in constructive discussions with holders of a majority of the Bank's share capital (including The Co-operative Group). These shareholders are supportive of the planned £400m capital raise, subject to the final structure and timing of the capital raising being agreed.

In December 2013, the Liability Management Exercise was completed, without which the Bank would not be here. 2013 results show a loss before tax of £1.3bn before the profit of £688m arising from the LME. While the Bank's underlying performance in the second half of 2013 was in line with management's expectations, the Bank has incurred significant charges through the year and greater than expected in H2 2013, related to, inter alia, provisions for potential additional costs of customer redress, costs relating to breaches of the Consumer Credit Act (CCA) and additional losses relating to the write-off of deferred tax assets.

Absent additional CET1, the Bank may fall below the current regulatory expectation of 7% CET1 ratio in the near term. Accordingly, the Board is proposing to raise additional CET1 in the coming months. This is in addition to the remaining £263m[1] of the £333m 2014 contribution due from The Co-operative Group on which we remain dependent.

Successful completion of the proposed capital raising remains subject to a number of uncertainties. These include finalisation of transaction structure, obtaining necessary Board, regulatory and shareholder approvals, the finalisation and execution of definitive documentation and prevailing market conditions. Accordingly, there cannot be certainty that the proposed CET1 raising will be completed when planned or needed, on favourable terms, or at all. The completion of this transaction is a material uncertainty as to the going concern status of the Bank.

1. £20m paid in December 2013 and taken into account in the calculation of December 2013 CET1. £50m paid in January 2014 but not taken into account in the calculation of December 2013 CET1.

Key Performance Indicators[1]

The key performance indicators presented below reflect the way in which the performance of the Bank has been measured during the latter half of 2013. As it implements the Turnaround Plan, management intends to review these measures.

Capital KPIs

	Definition	Why it is important to the business and management	
Common Equity Tier 1 ratio	Capital requirements are part of the regulatory framework governing how banks and depository institutions are measured. Capital ratios express the Bank's capital as a percentage of its risk weighted assets as defined by the Regulatory authorities. CET1 is broadly equivalent to tangible shareholders' funds less certain capital deductions	The Bank is required to maintain minimum regulatory capital and capital ratios at all times. The CET1 ratio is important for the Bank's ability to withstand any future market wide or individual stresses.	**2013: 7.2%** 2012: 5.0% 2013 target: towards the upper end of the range of 7% to 9% (communicated on 29 August 2013)
Leverage ratio	A ratio calculated by reference to CRD IV fully-loaded Tier 1 capital (after deductions) divided by adjusted balance sheet exposure	UK banks have been encouraged to disclose this ratio since 2013 (in respect of 2012), and are required to disclose this ratio from 2015. This ratio must be maintained at 3% or above from 1 January 2018.	**2013: 2.4%** 2012: 1.8%

Returns KPIs

	Definition	Why it is important to the business and management	
Statutory profit/loss before tax	This represents operating profit/(loss) less intangible asset impairment, the cost of customer redress, levies, taxes and various non-recurring items.	This is a primary profitability measure used by management to assess performance.	**2013: (£586.2m)** 2012: (£673.7m)
Net interest margin[2]	Net interest income (the difference between interest received from loans and other assets and interest paid out on deposits and other liabilities) divided by average total assets.	The net interest margin is the key measure of the Bank's ability to generate revenue.	**2013: 1.09%** 2012: 1.11%
Cost of risk	Impairment charges (amounts provided for non-performing loans) expressed as a percentage of average loans during the year.	A principal measure of the quality of loans which the Bank has extended.	**2013: 1.54%** 2012: 1.39%
Cost Income ratio	The proportion of the Bank's revenue which is used to fund its operating costs, calculated by dividing steady state costs by total income.	A principal measure of the efficiency of the Bank's overall operations.	**2013: 93.6%** 2012: 73.7%
Return on Equity	The ratio of profit/(loss) for the year (after tax) to equity, expressed as a percentage.	A measure of how well a company uses shareholders' funds to generate a profit.	**2013: (42.1)%** 2012: (27.5)%

By its nature, achieving a target involves risks and uncertainties because it is a forward looking statement that relates to, and depends on, circumstances, that may or may not occur, in the future. A target is not a guarantee of future performance. The Bank's actual results may differ significantly from those suggested by a target. Please see Going Concern, Principal Risks and Uncertainties and Risk Management for information on factors that may mean any targets may not be achieved when planned for, or at all.

1. KPIs are calculated on a management accounts basis as this is how we manage our business. Therefore these measures do not include several items which are reported in the statutory loss. This may render these metrics difficult to reconcile on a statutory basis.
2. Net interest margin is calculated on a management accounts basis and excludes a number of items which are reported in the statutory loss for the year. These include relevant legal and conduct provisions and fair value unwinds. This may render these metrics difficult to reconcile on a statutory basis.

Detailed financial review continued

HR KPIs

	Definition	Why it is important to the business and management	
Staff engagement	When considering our people, the key performance indicator is employee engagement. Changes were made to how the engagement score was compiled and measured in 2013. Engagement scores have been taken comparing 2013 with 2012 using the previous methodology. Under the new methodology, the score was 62% for The Co-operative Banking Group. A direct comparison to previous years cannot be made using the new methodology. Bank only measures are not available in this and previous years, therefore The Co-operative Banking Group scores are reported here.	Our people are vital to our success. Given the challenges the Bank has faced, it is essential that colleagues continue to feel engaged and committed to the business.	Old measure **2013: 59%** 2012: 68% New measure **2013: 62%**

Gender diversity

The Bank is required to publish data on gender diversity among its Directors, Executive and senior managers. The data as at 31 December 2013 is set out in the table below:

	Male		Female	
	Number	%	Number	%
Directors	7	78%	2	22%
Executive and senior managers	11	73%	4	27%

Due to the structure at the end of the year of most employees being employed by a former fellow subsidiary, CFSMS, the Bank has considered these people, who, since separation, work for the Bank, as Bank employees. The above numbers only include permanent employees.

Detailed Key Performance Indicators

Core Bank Key Performance Indicators

The Core business represents lines of activity that are consistent with the Bank's strategy and risk appetite and includes Retail, BaCB and Treasury.

Core Bank

	Definition	Why it is important to the business and management	
Net interest margin	Net interest income (the difference between interest received from loans and other assets and interest paid out on deposits and other liabilities) divided by average total assets.	The net interest margin is the key measure of the Core Bank's ability to generate revenue.	**2013: 1.7%** 2012: 1.7%
Customer Deposits[1]	The amount of money customers hold in their accounts with the Bank, also known as liabilities.	The Core Bank needs customers to deposit money with the Bank so that it is able to fund loans to other customers.	**2013: £31.4bn** 2012: £34.2bn Target: controlled customer lending and deposit growth from 2015
Customer Assets	The amount of money the Bank has lent to customers as loans.	The interest received on loans is the Core Bank's primary source of revenue.	**2013: £17.6bn** 2012: £18.6bn Target: controlled customer lending and deposit growth from 2015
Cost income ratio	The proportion of the Bank's revenue which is used to fund its operating costs, calculated by dividing steady state costs by total income.	A principal measure of the efficiency of the Core Bank's overall operations.	**2013: 88.0%** 2012: 74.9% 2018 target: <60%
Primary current account holders	Customers holding an account with the Bank who on average turn over £800 or more per month.	A measure of the size of the Core Bank's active customer base.	**2013: 664,775** 2012: 663,504
Credit RWAs	Total assets adjusted by different risk weightings for different types of assets (to reflect their inherent potential for default) with the aim of more accurately reflecting the Bank's exposure to potential losses.	Asset types which attract high risk weightings require the Core Bank to hold more equity capital to absorb potential losses.	**2013: £4.4bn** 2012: £5.0bn

1. Includes BaCB deposits which have reduced by £2.6bn in 2013 (see page 19).

Non-core Bank Key Performance Indicators

The Non-core business consists of those asset classes which are not consistent with the Bank's Core strategy and are managed to achieve the most appropriate asset value on an individual portfolio basis or are targeted for run down or exit.

Non-core Bank

	Definition	Why it is important to the business and management	
Customer Assets	The amount of money the Bank has lent to customers as loans.	The interest received on loans is the Bank's primary source of revenue; conversely, impairments on those loans create losses which reduce capital.	**2013: £12.5bn** 2012: £14.6bn 2014 target: £11.0bn; continue deleveraging thereafter at a slower pace.
Credit RWAs	Total assets adjusted by different risk weightings for different types of assets (to reflect their inherent potential for default) with the aim of more accurately reflecting the Bank's exposure to potential losses.	Asset types which attract high risk weightings require the Bank to hold more equity capital to absorb potential losses. Reducing RWAs in Non-core will, all other things being equal, increase the Bank's CET1 ratio.	**2013: £8.3bn** 2012: £10.9bn

Principal risks and uncertainties

The Bank's Principal Risks and Risk Management Framework

The table below outlines how the Bank's Risk Management Framework categorises the key financial and non-financial risks to which the Bank is exposed. This is the Board approved segmentation of the risks that we face into ten Principal Risks to allow us to identify, assess, manage, monitor and report on our risks in a uniformed fashion across the business.

Risk type	Definition	Page
Credit risk	The current or prospective risk to earnings and/or capital arising from a borrower's failure to meet the terms of any contract with the Bank or the various subsidiaries of the Bank or such borrower's failure to perform as agreed.	79
Liquidity and funding risk	The risk that the Bank's resources will prove inadequate to meet its liabilities as they contractually fall due or as a result of any contingent or discretionary cash outflows that may occur in a stress. It arises from the mismatch of timings of cash flows generated from the Bank's assets and liabilities (including derivatives).	102
Market risk	The risk that the value of assets and liabilities, earnings and/or capital may change as a result of changes in market prices of financial instruments. The majority of the Bank's market risk arises from changes in interest rates.	107
Operational risk	The risk of loss resulting from inadequate or failed internal processes, people and systems or external events. This encompasses the effectiveness of risk management techniques and controls to minimise these losses. Legal risk including litigation is also managed within this risk type.	110
Reputational risk	The risk associated with an issue which could in some way be damaging to the brand of the Bank, including issues arising as a result of the Bank's strategic decisions or business performance, operational failure or external perception.	112
Strategic and business risk	The risk arising from changes to the Bank's businesses and the environment in which it operates, specifically the risk of not being able to carry out the Bank's business plan and desired strategy.	113
People risk	The risk characterised by individuals being engaged by other members of The Co-operative Group, senior management being on contracts for services with other members of The Co-operative Group, an inability to attract and retain sufficiently qualified employees, unduly high employee turnover, loss of key staff, lack of succession planning and staff development, and indicators of behaviours which are not compliant with the Bank's values.	114
Regulatory risk	The risk of fines, public censure, limitation on business, requirements for legal or operational restructuring, or restitution costs arising from the failure to understand, interpret, implement and comply with UK and EU regulatory requirements.	114
Conduct risk	The risk that the Bank's behaviour, offerings or interactions will result in unfair outcomes for customers.	115
Pension risk	The risk to the Bank's capital and company funds from the Bank's exposure to scheme liabilities (to the extent liabilities are not met by scheme assets) and risks inherent in the valuation of scheme liabilities and assets.	116

The Risk Management Framework helps the Bank to mitigate and manage most risks which could cause the Bank's future results, financial condition and prospects to differ materially. The Bank uses its Risk Management Framework to capture, model and articulate a risk appetite that generates an internal view of both capital and liquidity requirements for the Bank.

For more information about how we do that, see the Risk Management section.

We outline below:

- The background to the significant risks and uncertainties faced by the Bank; and
- The most significant risks and uncertainties faced by the Bank.

Although these risks and uncertainties are managed within the Bank's Risk Management Framework, there remains a risk that these risks and uncertainties could negatively impact the Bank's results, operations and financial condition, including requiring greater capital and liquidity than currently held.

Background to the significant risks and uncertainties faced by the Bank

The Bank faces an extremely difficult and unprecedented situation following its June 2013 announcement of a significant shortfall in CET1 of £1.5bn.

The cornerstone of the Recapitalisation Plan was the LME. The Bank believes that the failure of the LME would have resulted in the Bank becoming subject to a resolution procedure under the Banking Act of 2009.

To complete the Recapitalisation Plan, The Co-operative Banking Group must contribute the remaining £263m of £333m CET1 it committed to contribute by the end of 2014 (of which it has already paid £70m). If The Banking Group is unable to meet its commitment to contribute £263m and is unable to draw on its support from The Co-operative Group, the Bank may have insufficient CET1 to meet the PRA's requirements.

On 24 March 2014, the Bank announced a requirement to raise additional CET1 in addition to the above. Without this additional capital the Bank may have insufficient CET1 to meet the PRA's requirements.

Principal risks and uncertainties continued

Having removed an element of the uncertainty around the going concern status of the Bank with the successful completion of the LME in December 2013, the Bank now faces significant challenges in executing its Turnaround Plan not least the requirement for additional CET1 as discussed on page 22. In addition, the Bank will need to simultaneously execute a number of complex and concurrent changes in an environment where adverse publicity regarding events and the Bank's difficulties (and the circumstances that led to those difficulties) may have damaged the Bank's brand and reputation.

These significant challenges arise from:

External factors

Many of these are similar to those other financial institutions may face, for example, deterioration in general economic conditions, instability of global financial markets and the management of credit risk, interest rate risk, currency risk and market risk and risks from regulatory change and an increasing regulatory enforcement and litigious environment.

Internal factors

Risks and uncertainties that are specific to the Bank, some of which create doubt around the Bank's ability to continue as a going concern. A summary of these risks and uncertainties are discussed in note 1 to the Bank's financial statements.

We outline below the most significant of those risks and uncertainties specific to the Bank that could have a significant impact on the Bank's results of operations, financial conditions and prospects.

Key strategic risks and uncertainties

The most significant risks and uncertainties facing the execution of the Bank's strategy and Turnaround Plan include:

- the Bank's Turnaround Plan is in the early stages of implementation and has yet to be proven;
- the Bank does not have a track record in successfully executing large scale changes like those contemplated by its plan;
- the required improvement and re-engineering of the Bank's IT platform and operational process is significant in scale, complexity and cost. Any delays in, or failure by, the Bank to deliver the re-engineering of the Bank's IT platform may result in significant additional investment costs, subject the Bank to further regulatory scrutiny and impact the Bank's ability to deliver its turnaround strategy;
- a number of senior appointments are needed to strengthen the Board and senior management team and need to be embedded;
- implementation of significant cost reductions, branch closures, redundancies and reorientation of the Bank's distribution channels may not achieve the targeted cost savings. These cost savings may have a negative impact on the Bank's brand, customer service and levels of customer satisfaction and therefore income;
- a failure by the Bank to reduce and deleverage the Non-core Business in a controlled manner may negatively impact the Bank's operating results and financial position (in particular, its net interest margin) and may result in greater than expected losses;
- the Non-core Business has significant impairment risk, especially given the concentration of the Non-core corporate asset book;
- given the relative size of the Bank's Retail deposit base as compared with other sources of funding, the Bank is particularly exposed to liquidity risks caused by any serious loss of confidence by its depositors resulting in unusually high levels of withdrawals;
- the Bank may be required to hold more regulatory capital, or to take other steps to mitigate the risks identified, as part of the stress tests of capital adequacy, profitability and capital ratios that the Bank and seven other UK banks will submit by June 2014 to the FCA and PRA for consideration by the fourth quarter of 2014;
- the Bank's non compliance with its ICG relies on the PRA exercising forbearance in this regard. The PRA has the discretion to revisit, change or withdraw that forbearance. If the Bank fails to meet its ICG, there is a risk that the PRA may exercise any of its wide-ranging powers over the Bank including imposing a resolution procedure on the Bank at any time;
- the Bank needs to raise additional CET1. This is additional to the non-CET1 capital already contemplated by the Bank's four to five year Turnaround Plan. Further additional equity and/or debt capital may be required, beyond that contemplated currently, because of increased capital requirements (applicable to the Bank or banks generally), actual costs and losses exceeding those estimated in the Bank's plan or if the Bank does not deliver on its plan as anticipated; and
- the Bank may be unable to raise any additional CET1 or other capital it may need on favourable terms, when needed, or at all.

Key operational risks and uncertainties

In this section, by operational risks and uncertainties, we mean risks and uncertainties relating to the Bank's internal activities, systems and controls. The most significant operational risks and uncertainties faced by the Bank include:

- the Bank's underlying business and financial systems are dated and suffer from a lack of integration and investment since the Britannia merger; consequently many processes rely on significant manual intervention to cope with a poor systems infrastructure;
- the Bank's systems of control have been weak and there have been failings by the Bank's business units in a number of areas in the past as discussed in the Corporate Governance Report;
- although the foundation of the Bank's more robust controls including the Bank's revised and updated Risk Management Framework (adopted in September 2013) have been laid, it will take time and significant work to embed across the Bank;
- the Bank currently depends on The Co-operative Group to provide a number of services including certain critical functions: IT, personnel, assets and to on-supply certain services, data and assets by third party suppliers; and
- a complex project to separate the Bank from The Co-operative Group is underway. While a large proportion of the Bank's staff have now been transferred from CFSMS to the Bank, negotiations continue with The Co-operative Group in relation to the transfer of key assets used by the Bank, and arrangements for the provision of key functions and services to the Bank, including IT. Discussions are focusing on the contractual basis on which those assets, functions and services will be provided, because it is anticipated that the Bank's dependency on such assets, functions and services will continue in the short to medium term. The separation project is much more complex and costly than initially contemplated.
- In the event that the current process of consultation on changes to governance arrangements at the Co-operative Group or any adverse findings of any of the various enquiries and investigations underway which impact on the Co-operative Group, result in organisational disruption in operations or decision making at the Co-operative Group, the execution risks to the process of logistical separation could increase with an associated risk of increased costs and disruption for the Bank.

Principal risks and uncertainties continued

Key regulatory and conduct risks and uncertainties

The Bank is under intense regulatory scrutiny and expects that environment to continue. The Bank is also the subject of multiple regulatory and other investigations and enquiries into events at the Bank and circumstances surrounding them. These include:

- the Treasury Select Committee has been conducting an ongoing review which began in the second quarter of 2013 and has focused on numerous concerns surrounding the Bank. The Committee will publish a report of its findings, the timing of which is not known;
- the Kelly review was announced on 12 July 2013. Sir Christopher Kelly was jointly appointed by The Co-operative Group and the Bank to review the events that led to the requirement for the Bank's plan to address its £1.5bn capital shortfall. It is looking at the decision to merge the Bank with the Britannia Building Society in 2009 and the proposed acquisition of the Verde assets of Lloyds Banking Group. It will include an analysis of strategic decision-making, management structures, culture, governance and accounting practices and aspects of the role of the Bank's auditors. The intention is for the findings to be reported at The Co-operative Group's Annual General Meeting in May 2014;
- the Treasury announced on 22 November 2013 that it would conduct an independent investigation into events at the Bank and the circumstances surrounding them from 2008 including the Verde transaction and Britannia acquisition. The investigation will include a review of the conduct of regulators and Government but is not anticipated to commence until it is clear that it will not prejudice the outcome of the Financial Conduct Authority and Prudential Regulation Authority enforcement investigations;
- the Financial Conduct Authority announced on 6 January 2014 that it will be undertaking enforcement investigations into events at the Bank. The investigation will look at the decisions and events up to June 2013; and
- the Prudential Regulation Authority announced on 6 January 2014 that it is undertaking an enforcement investigation in relation to the Bank and as part of that investigation will consider the role of former senior managers.

The outcome of each of these investigations is difficult to predict. These investigations and inquiries are likely to result in:

- significant expense which may include damages, fines and other penalties;
- greater scrutiny and/or intervention from regulators, further regulatory action and/or litigation;
- taking a significant amount of management time and resources away from management of the Bank's business including execution of the Bank's plan; and
- further adverse publicity and reputational damage to the Bank, its brand and its ability to recruit and retain personnel and customers.

In addition, the Bank is exposed to the inherent risks relating to the mis-selling of financial products, interest rate hedging products, acting in breach of regulatory principles or requirements and giving negligent advice or other conduct determined by the Bank or the regulators to be inappropriate, unfair or non-compliant with applicable law or regulations. Any failure to manage these risks adequately could lead to further significant provisions, costs and liabilities and/or reputational damage.

The Bank also faces both financial and reputational risk where legal or regulatory proceedings are brought against it or other financial institutions. Liability for damages may be incurred by third parties harmed by the conduct of the Bank's business.

The Bank continues to be exposed to the risks of non-compliance with the Consumer Credit Act which has highly technical requirements impacting on customer facing documentation, operational implementation and systems design. While the Bank has identified certain instances where its documentation or processes have not been fully compliant with the technical requirements, there may be other instances of non-compliance which have not yet been identified. The consequences of non-compliance with the Consumer Credit Act can include interest and default charges paid by a customer in prior periods being required to be refunded and the customer agreement not being enforceable by the Bank without a court order until the breach is remedied.

Regulatory responsibility for the Consumer Credit Act passed to the FCA on 1 April 2014 and may lead to additional sanctions on banks in the event they are not fully compliant, or a requirement to pay additional redress to customers.

Pensions risks and uncertainties

The Bank participates in the following pensions schemes:

- the Pace Scheme, whose sponsoring employer is The Co-operative Group. The Bank is a participating employer in this scheme;
- the Britannia Scheme, whose sponsoring employer is CFSMS; and
- three of the Bank subsidiaries are participating employers in this scheme.

The Bank is a guarantor in respect of this scheme. Currently, the Pace scheme is accounted for as a defined contribution plan. In the future, the Bank may be required to account for the Pace scheme as a defined benefit scheme. This is referred to in more detail in note 36 in the Bank financial statements.

To the best of the Directors' knowledge and belief, having made reasonable enquiries, there is no contractual agreement determining how the deficit recovery contributions are funded by the participants. The Bank therefore has not recognised a liability in respect of any part of the existing deficit funding. Whilst the Bank continues to define contribution account for the Pace scheme, an obligation would be required, if the Bank enters into an agreement with regards to funding any deficit obligation. A formal triennial valuation of Pace as at 5 April 2013 is underway but has not yet been completed. When completed it may reveal a significant funding deficit and there is therefore a risk that in future periods the Bank will recognise significant liabilities in respect of the scheme in its accounts.

There is uncertainty over the amount that the Bank will have to pay while it continues to participate in Pace. The Bank's obligations to contribute to Pace would increase significantly if another large employer in Pace becomes insolvent while the Bank continues to participate. If the Bank seeks to address these risks by terminating its participation, the default position is that material liabilities in respect of the deficit in Pace will arise. The Co-operative Group and the Bank have agreed that at either parties request it may enter into good faith discussions to manage this by reaching agreement so that the liabilities properly attributable to the Bank (and an equivalent proportion of assets) would be transferred to a separate scheme, or a segregated section of Pace, on the Bank's exit but, as no arrangements have yet been agreed (and there is a risk that none can be agreed), there is uncertainty over the amount that the Bank will have to pay in the event that it exits Pace. The Pace scheme is not sectionalised and operates on a 'last man standing' basis. In the event that other participating employers become insolvent and the full statutory debt is not recovered on insolvency, the Bank would become liable for the remaining liabilities.

In respect of the Britannia Scheme, the Bank will need to manage the liabilities that could arise on separation from The Co-operative Group; this will require the co-operation of the trustees of the Britannia Scheme, which may not be forthcoming.

Other pensions risks and uncertainties include the risk to the Bank's capital and funds from the Bank's exposure to scheme liabilities (to the extent liabilities are not met by scheme assets), risks inherent in the valuation of scheme liabilities and assets, risks regarding the split of liabilities between the Bank and other participating employers while the Bank continues to participate in Pace and on exit from Pace and, in respect of the Britannia Scheme, risks on separation from The Co-operative Group.

Social, community and human rights

As part of The Co-operative Group for the greater part of the year, we continued to implement our commitments to social responsibility and sustainability, such as protecting the environment, supporting local communities and tackling social justice through Group initiatives and activities.

In the future, values and ethics will continue to be firmly embedded in our approach as they have been since the Bank's inception over 140 years ago.

We believe that it is important that we maintain our differentiated characteristics and ethos, continuing to adhere to the values of the wider Co-operative Movement under our new ownership structure.

Values and ethics are therefore central to the success of the Bank in the future and remain at the heart of our business. Therefore for the first time we have embedded in the Articles of Association of the Bank a pledge that requires us to act in line with the principles and values associated with The Co-operative Movement.

In addition, we have begun work to review and renew our Ethical Policy and will be re-engaging with customers in Spring 2014 to listen to their views. Our Ethical Policy has been renewed and expanded on four separate occasions since its launch in 1992. We believe that it is only right that at this point in our history we listen to customers again.

Review of the year

Our commitment to social inclusion extends through our range of products and services, for example, the Bank in conjunction with ABCUL provides current account operating services for Credit Unions.

Our community investment programme champions employee volunteering, with our staff volunteers supporting a range of initiatives including Number Partners, Reading Partners, e-mentoring or acting as school governors. Teams from the Bank are actively involved in the local community on a range of challenges.

This year we were also actively involved in The Co-operative Group Charity of the Year partnership with the Carers Trust. We engaged with thousands of colleagues, members and customers and together we raised more than £5m to support 20,000 young carers across the UK, transforming their lives through opportunities, support and advice.

Protecting the environment

In line with our Ethical Policy, we do not lend to businesses or projects that conflict with our statements on environmental sustainability. We also seek to minimise our own environmental impacts and in 2013 The Co-operative Bank maintained its certification to the ISO 14001 standard. To our knowledge we are still the only financial services organisation in the world to achieve this leading standard across all business activities and products.

The Co-operative Bank sourced 98.8% of its electricity from renewables in 2013, and maintained its 'beyond carbon neutral' policy for the seventh consecutive year, by offsetting its operational greenhouse gas emissions[1] plus an extra 10% to address legacy issues.

Since October 2013, new Government regulations[2] require all UK quoted companies to report on their greenhouse gas (GHG) emissions as part of their Annual Report and Accounts. The Bank measures its direct GHG emissions in carbon dioxide equivalent (tCO_2e) using the latest UK Government guidance[3]. The direct GHG footprint encompasses energy consumption, refrigerant leakages from major occupancies and all business travel (air, rail and road). All greenhouse gas data and related commentary is externally assured[4].

Total greenhouse gas emissions by source, 2013

Source of emissions	Total emissions (tCO_2e)
Fuel combustion	3,796
Electricity consumption*	25,790
Refrigerant leakages	504
Business travel	1,753
Total	**31,843**
Carbon intensity (tCO_2e/£m turnover)	**19.8**

* If electricity from renewable sources is accounted as zero carbon then emissions from electricity would be 320 tCO_2e.

1. Remaining emissions from gas, brown electricity, business travel, and major occupancy refrigerants once green electricity supply is discounted.
2. The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013.
3. Department for Environment, Food and Rural Affairs, Environmental Reporting Guidelines: Including Mandatory greenhouse gas emissions reporting guidance, June 2013 (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/206392/pb13944-env-reporting-guidance.pdf).
4. Assurance is provided by DNV GL in accordance with the AA1000 Assurance Standard (2008).

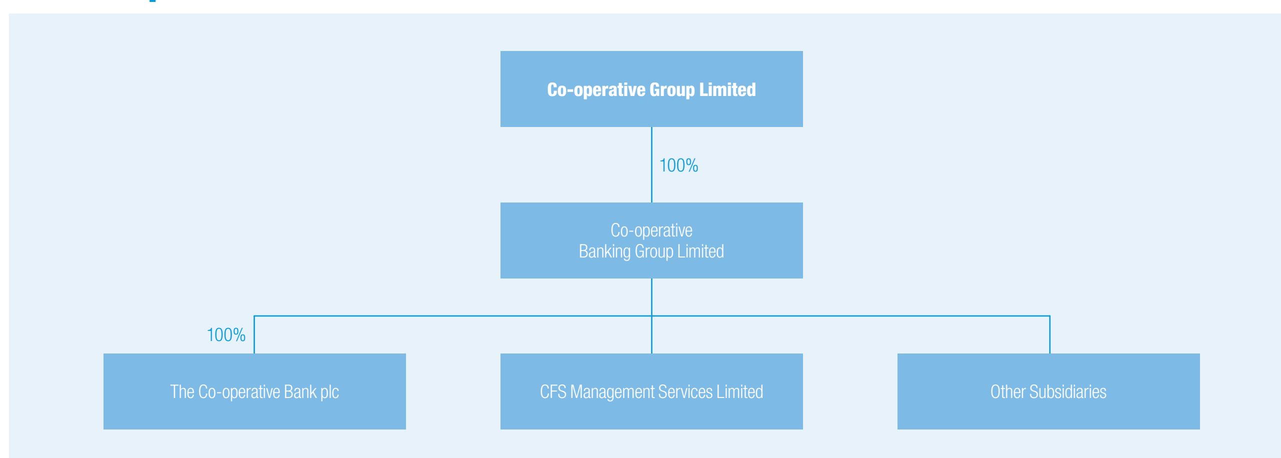
Group structure

The Bank's ownership structure changed in December 2013 as a result of the LME. The charts below set out the structure as it was at 31 December in each of 2012 and 2013.

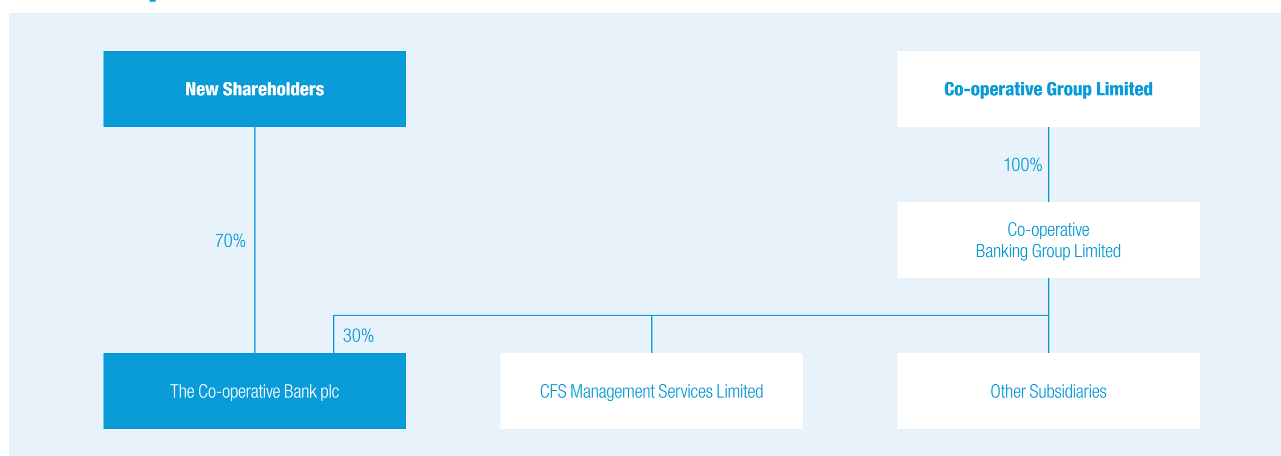
The Bank has adopted governance and other internal structures so that its businesses are run and governed separately and the Bank has its own Board and management team. Following the changes illustrated below, The Co-operative Group remains the single largest shareholder of the Bank and no other shareholder owns more than 9.9% of the Bank's shares. New shareholders are former owners of the Bank's subordinated bonds who received or subscribed for shares as part of the LME.

The Co-operative Group and The Co-operative Banking Group are described as being the parent of the Bank interchangeably in this report and accounts.

Ownership of the Bank as at 31 December 2012[1]



Ownership of the Bank as at 31 December 2013



1. At 31 December 2012, of the 8.2 billion ordinary shares then issued in the Bank, 8,199,999,960 were held by The Co-operative Banking Group and 40 were held directly by Group.

Corporate governance

32	Biographies of the Board
34	Directors' report
36	Corporate Governance report
44	Audit Committee report
51	Risk Committee report
54	Nomination Committee report
55	Values and Ethics Committee report
57	Board effectiveness
58	Statutory disclosures information
59	Statement of Directors' responsibilities
60	Directors Remuneration report

Biographies of the Board[1]

Richard Pym
Chairman

Richard joined the Board as Chairman in June 2013. He is a Chartered Accountant, has over 21 years' experience in financial services and has held a series of senior roles, including Group Chief Executive of Alliance & Leicester plc. He is currently Chairman of UK Asset Resolution Limited, Bradford & Bingley plc, Northern Rock (Asset Management) plc, BrightHouse Group plc, Caversham Finance Limited and Nordax Finans AB (publ).

Committee membership: Nomination (Chairman), V & E (Chairman).

John Richard Coates
Non-Executive Director

Richard joined the Board in January 2013. He has over 25 years' experience in the retail financial services sector. Richard was a senior partner at KPMG from 1985 to 2003 in its retail financial services practice. He joined Northern Rock plc as a Non-Executive Director in August 2008 and chaired its Audit Committee from January 2010 until its acquisition by Virgin Money in January 2012. He is currently a Non-Executive Director of the Police Mutual Assurance Society.

Committee membership: Audit (Chairman), Risk, Remuneration, Nomination, V & E.

Niall Booker
Chief Executive Officer

Niall joined the Board in June 2013. He has held a variety of senior roles at HSBC in a career of more than 30 years spanning retail and corporate banking. Most recently, he was Group Managing Director and Chief Executive Officer of HSBC North America Holdings Inc. In this role he had responsibility for working through the issues in HSBC Finance Corporation, where he was Chief Executive Officer, including working closely with the regulators of HSBC North America Holdings. Niall has been a member of the Committee of Council of Glenalmond College since 2012 and its Chairman since 2013.

Anne Margaret Gunther
Non-Executive Director

Anne joined the Board in September 2011. She has 35 years' experience in a range of financial services environments. She was Chief Executive of Standard Life Bank and then Chief Executive of Norwich and Peterborough Building Society, securing its merger with the Yorkshire Building Society. Anne is an Advisory Board member and past Chair of the Warwick Business School and is a Non-Executive Director of MBNA Limited and of the North, East and West Devon NHS Clinical Commissioning Group.

Committee membership: Remuneration (Chairman), Risk, V & E.

Dennis Holt
Senior Independent Director

Dennis joined the Board in February 2014. Dennis's experience in banking and insurance spans 36 years as an Executive and a further seven as a Non-Executive Director, involving a wide range of economic and competitive environments. He spent 31 years at Lloyds TSB, latterly as Main Board Executive Director in charge of the retail bank. This was followed by five years at AXA as UK Chief Executive and a member of the Global Executive Committee. As a Non-Executive he has served amongst others as Chair of LV and of Bank of Ireland UK, as well as deputy Chair of Bank of Ireland plc. He is currently Chairman of Beazley plc and its subsidiary Beazley Furlonge Limited.

Committee membership: Remuneration, Nomination.

1. As at 1 April 2014

Biographies of the Board continued

Richard Graeme Barclay Hardie
Non-Executive Director

Graeme joined the Board in May 2013. He was previously Managing Director of NatWest retail bank and Executive Director of retail banking at Abbey National Bank plc. He was a senior adviser of retail markets at the Financial Services Authority (as it was known) and Non-Executive Director at Metro Bank (UK) Limited. He is currently a Non-Executive Director of FNZ (UK) Ltd and is a Director of Northpoint Consultancy Services Limited.

Committee membership: Risk (Chairman), Audit, Remuneration, Nomination, V & E.

William Gennydd Thomas
Non-Executive Director

Bill joined the Board in October 2013. He is a former Senior Vice President of HP Enterprise Services and was on the Executive Committee of EDS plc as Executive-Vice President. He has IT expertise and is an experienced leader and general manager with a track record in leading major change in large organisations. He has extensive commercial and operational experience, working domestically and internationally with both public and private sector organisations. Bill is Chair of the Advisory Board at Cranfield University School of Management and is on the management and Board of Leeds University Business School. He is currently a Non-Executive Director of XChanging plc, GFI SA and Balfour Beatty plc and a partner in Hopton Estates.

Committee membership: Risk, V & E.

Merlyn Vivienne Lowther
Non-Executive Director

Merlyn joined the Board in September 2011. She was Chief Cashier of the Bank of England from 1999 to 2004 and a Non-Executive Director of Schroders plc from 2004 until 2013 where she chaired its audit and risk committee from 2010 until 2013. She is currently a trustee of the Winston Churchill Memorial Trust and The Henry Smith Charity.

Committee membership: Audit, Risk, V & E.

Directors' report

The Directors present their report and audited accounts for the year ended 31 December 2013.

General information

The Bank provides a range of banking and financial services in the United Kingdom. See page 10 for a full description of our business model and focus.

Dividends

The Directors are focused on returning the Bank to financial health in the future. The Bank is in the early stages of being turned around and will continue to be impacted by legacy issues for some time, and as such, the Directors do not expect the Bank to pay dividends in the near future. In any event, the Bank has agreed with the PRA not to make any dividend payments until further notice without the prior consent of the PRA. Therefore the Bank is not able to recommend payment of a dividend given the continuing losses (2012: £nil).

Business review, future developments, post balance sheet events and financial risk management objectives and policies

The business review and future developments, key performance indicators, principal risks and uncertainties and post balance sheet events are referred to in the Strategic report starting on page 5. Financial risk management objectives and policies can be found as detailed below:

	Pages
Business review and future developments	11
Key performance indicators	23
Principal risks and uncertainties	26
Financial risk management objectives and policies	75
Post balance sheet events	219

Going concern

There continues to be material uncertainty around the implementation of the remaining component of both the Recapitalisation Plan and the Turnaround Plan. The Directors' judgement that it is appropriate to use the Going Concern basis in preparing the Bank and Company's accounts is set out in detail in the Basis of Preparation section of the Annual Report and Accounts.

The Bank and Company's business activities, together with its financial position, and the factors likely to affect its future development and performance, are set out in the Strategic report on pages 7 to 30. In addition, the risk management section includes the Bank's objectives, policies and processes for managing its risk and details of its exposure to risk. The Capital Management section provides information on the Bank's Capital policies and Capital resources.

Consequently, after making enquiries, the Directors are satisfied that the Bank and Company have sufficient resources to continue in business for the foreseeable future and have therefore continued to adopt the Going Concern basis in preparing the financial statements. When making this assessment, the Directors act within the principles of the Financial Reporting Council's 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009' report.

Political donations

It is the Bank's policy that no donations are made for political purposes.

Directors details

Details of Directors, including appointments and resignations during the financial year, and changes since the end of the financial year are provided on page 38 of the Governance section of the report.

Details of the Directors offering themselves for election and re-election at the next Annual General Meeting are provided on page 39.

Directors third party and pension scheme indemnity provisions

Details of insurance and indemnities in place for the benefit of the Directors are provided within the Corporate Governance Report on page 57.

Significant contracts

Details of related party transactions are set out in note 39 on pages 199 to 204.

Corporate responsibility

The Bank's corporate responsibility activities are outlined on page 29.

CO_2 emissions

The Bank's greenhouse gas emissions report is detailed on page 29 of the Annual Report and Accounts

Employees

During the year, the majority of The Co-operative Bank's employees had contracts with CFSMS Limited and the cost of their services was recharged to subsidiaries, including the Bank. Following the legal separation of the Bank and it ceasing to be a wholly-owned subsidiary of The Co-operative Group, employment contracts for the majority of those employees who spend the majority of their working time on activities related to the Bank were transferred from CFSMS Limited to the Bank on 23 January 2014 by Transfer of Undertakings. This is further explained in the post balance sheet event note.

The Bank operates learning and development initiatives across the organisation as part of a continuous improvement programme, supporting its approach to performance management, personal development, talent and succession planning.

The Bank continues to consult and communicate with colleagues on customer, organisation and business performance issues, using colleague publications, surveys, conferences, videos and both informal and formal consultations with Unite, the Britannia Staff Union, and other trades unions. The Unions continue to be fully involved where organisational change and other issues affect colleagues.

Directors' report continued

During 2013, The Co-operative Group membership of a number of diversity advisory bodies including Employers Disability Forum, Race for Opportunity, Opportunity Now and Stonewall and Inclusive Employers, provided the Bank, through the common organisational structures of the Banking Group, with information on diversity.

Employees with disabilities

The Bank is a holder of the 'Positive about Disabled People' symbol, a recognition given by Jobcentre Plus to employers who have agreed to meet five commitments regarding the recruitment, employment, retention and career development of disabled people. The Bank has policies and processes in place to support disabled colleagues in the workplace. Further guidance, and information for colleagues, on disability issues is available through human resources and on the colleagues' intranet. The Bank recognises its responsibility for making reasonable adjustments for new colleagues with disabilities and for those individuals who develop disabilities whilst in employment.

Employees' wellbeing

The Bank recognises that health and wellbeing at work are vital. Wellbeing services include an occupational health scheme, physiotherapy services and seasonal wellbeing initiatives such as discounted allergy testing and flu jabs. In addition to this, colleagues and their immediate families have access to an external employee assistance programme, providing free expert advice on a wide range of medical, legal and family issues.

Corporate Governance report

The Corporate Governance report can be found on pages 36 to 68 and, together with this Directors report of which it forms part, fulfils the requirements of the Corporate Governance Statement for the purpose of the Financial Conduct Authority's Disclosure and Transparency Rules (DTR).

By order of the Board

Richard Pym
Chairman
10 April 2014

Corporate Governance report

Chairman's introduction

My starting point for introducing the Corporate Governance Report for the Bank is to acknowledge that the previous standards of governance plainly fell seriously short of what was required. The scale of the issues facing the Bank, with the discovery of a significant capital shortfall so late in the economic cycle, have been extensively commented on and have naturally dominated the Board agenda over the last 12 months. It is also clear that their after effects will command our attention for some time.

As the Chairman appointed in June 2013, it is my responsibility to ensure that we have a strong and well-functioning Board comprising individuals with both the right experience and personal qualities to be stewards of the business. I have therefore been leading a Board renewal to ensure we can more effectively supervise the governance regime moving forward.

As a result, there have been significant changes to the composition of the Board over the last 12 months which reflect, in part, the legal separation of the Bank from The Co-operative Banking Group. Many of the Directors who have stood down have served the Bank with dedication over a number of years. Merlyn Lowther and Anne Gunther will be standing down from the Board at the AGM, having seen the Bank through the successful completion of the Liability Management Exercise in December. I appreciate their efforts over recent months.

It is also vital to strengthen the Board at a number of levels and we have already appointed new Non-Executive Directors to do so. We welcomed Dennis Holt as our Senior Independent Director in February 2014 whose executive experience spans 36 years at major financial services firms. This includes as UK Chief Executive of AXA and as a main Board Director at Lloyds TSB in charge of the Retail bank. William Thomas joined in October 2013 after holding very senior roles in information technology firms and will help improve Board supervision of our IT activities. These add to the appointments made over the course of the first half of the year with Graeme Hardie, who chairs the Bank's Risk Committee, joining the Board in May 2013 and Richard Coates, who chairs the Audit Committee of the Bank, joining the Board in January 2013.

There are a number of further appointments in progress which, subject to regulatory approval, will continue to strengthen the Board. In 2014 we begin our journey to create a viable business that is sustainable in the long term and adheres to the Co-operative values and ethics on which the Bank is founded. Our current search for an independent Director to chair the new Values and Ethics Board Committee, established in November 2013, reflects that. For the first time, the values and ethics of The Co-operative Movement are now embedded in the legal constitution of the Bank and this Committee will ensure we adhere to the standards expected of a co-operative business.

The last 12 months have brought significant change for the business and, as outlined above, the Board has now started the process of rebuilding the governance structures of the Bank to remedy the issues of recent years. This is a challenging task, but ensuring there is a strong framework by which risk can be assessed and managed is critical to the long term success of an institution which serves over 4.7m customers.

Richard Pym
Chairman

Compliance with the UK Corporate Governance Code

The UK Corporate Governance Code, published by the Financial Reporting Council in September 2012 (the Code), sets out standards of good practice in relation to Board leadership and effectiveness, remuneration, accountability and relations with shareholders.

Until 20 December 2013, the Bank was a wholly owned subsidiary of The Co-operative Banking Group, which in turn was a wholly owned subsidiary of the Co-operative Group Limited. The Co-operative Group Limited was the ultimate holding entity of The Co-operative Banking Group (CBG) and its subsidiaries. CBG maintained a common governance, organisational and risk management structure for its subsidiaries, including the Bank. In particular, CBG operated a common Board and set of Board Committees to oversee the business of its subsidiaries, including the Bank. During the second half of 2013, the Bank began putting in place its own Board and Board Committees and its own revised, updated and independent governance structures.

As the Bank adjusts to its changed ownership structure and independent governance structures, the Directors will continue to support high standards of Corporate Governance. The Bank complied with the principles of the 2010 and 2012 Code during the year with the exception of: independence of the Board (B 1.2); a separate Nomination Committee (B 2.1); adoption of a diversity policy by the Bank (B 2.4); and an external evaluation of the Board (B 6) as discussed in the relevant section.

Role and responsibilities of the Board

The Board has collective responsibility for the long term success of the Bank. Its role is to provide leadership of the Bank within a framework of prudent and effective controls which enables risk to be assessed and managed. It sets the Bank's values and standards and ensures that its obligations to its shareholders, customers and other stakeholders are understood and met.

The Board sets the Bank's strategy and approves plans presented by management for the achievement of the strategic objectives it has set. It determines the nature and extent of the significant risks it is willing to take in achieving its strategic objectives and is responsible for ensuring maintenance of sound risk management and internal control systems.

In October 2013, the Board approved a schedule of Matters Reserved for the Board and authorities delegated to the Chief Executive Officer (CEO). The full schedule of Matters Reserved for the Board is available on the Bank's website. Such reserved matters include decisions on strategic and long term objectives, the approval of published financial statements, major acquisitions and disposals, significant investments and other capital expenditure, and approval of the Bank's risk appetite and its Risk Management Framework.

Implementation of the strategy set by the Board and the management and day-to-day running of the Bank is delegated to the CEO with the exception of the Matters Reserved for the Board.

The Board

As reported in the Chairman's introduction to this report, there have been significant changes to the composition of the Board during 2013 and there will be further appointments during 2014.

Composition

Details of the members of the Board, their biographies and details of length of service are set out on pages 32 to 33.

At the end of 2013, the Bank's Board of Directors comprised two Executive Directors (Niall Booker and Rodney Bulmer) and seven Non-Executive Directors (including the Chairman). Dennis Holt was appointed as the Senior Independent Non-Executive Director on 3 February 2014, and Rodney Bulmer resigned on 28 February 2014 and Alastair Asher resigned on 24 March 2014 making the total number of Directors at the end of March 2014 eight (seven Non-Executive Directors and one Executive Director).

The Bank regards Richard Coates, Anne Gunther, Graeme Hardie, Merlyn Lowther, Bill Thomas and Dennis Holt as Independent Non-Executive Directors, within the meaning of 'independent' as defined in the Code. Richard Pym was independent on appointment as Chairman. Alistair Asher was appointed on 31 December 2013 as The Co-operative Group's nominated Non-Executive Director and as such is not regarded as independent for the purposes of the Code. He resigned on 24 March 2014.

The Code recommends that at least half the Board of Directors (excluding the Chairman) should comprise Independent Non-Executive Directors. The Code states that the Board should determine whether a Director is independent in character and judgement and whether there are any relationships or circumstances which are likely to affect, or could appear to affect, the Director's judgement. The Directors consider at least half the Board to be independent. The composition of the Board did not meet this requirement of the Code for a period of 15 days between 1 January 2013 and 16 January 2013.

All the Independent Non-Executive Directors have considerable experience and make valuable contributions to the Bank. The Independent Non-Executive Directors constructively challenge and help develop proposals on strategy and bring strong, independent judgement, knowledge and experience to the Board's deliberations.

The Independent Non-Executive Directors are of sufficient calibre and number that their views carry significant weight in the Board's decision making and this will continue as new members are added to the Board during 2014.

Board changes

During 2013 there were a significant number of changes to the Board of the Bank. Eleven Directors resigned from the Board of the Bank and seven Directors were appointed.

Current members of the Board		Independent	Appointed
Richard Pym	Chair	On appointment	11 June 2013
Niall Booker	Executive Director		11 June 2013
Richard Coates	Non-Executive Director	Independent	16 January 2013
Anne Gunther	Non-Executive Director	Independent	6 September 2011
Graeme Hardie	Non-Executive Director	Independent	1 May 2013
Merlyn Lowther	Non-Executive Director	Independent	7 September 2011
William Thomas	Non-Executive Director	Independent	28 October 2013
Dennis Holt	Senior Independent Director	Independent	3 February 2014

Members of the Board resigning since 1 January 2013		Independent	Appointed	Resigned
Paul Flowers	Chair		8 June 2009	5 June 2013
Rodney Bulmer	Executive Director		18 May 2013	28 February 2014
Barry Tootell	Executive Director		4 April 2008	10 May 2013
Alistair Asher	Non-Executive Director		31 December 2013	24 March 2014
Duncan Bowdler	Non-Executive Director		8 July 2009	9 October 2013
David Davies	Non-Executive Director	Independent	3 June 2003	12 June 2013
Peter Harvey	Non-Executive Director	Independent	1 August 2009	9 October 2013
Peter Marks	Non-Executive Director		9 June 2009	16 May 2013
Robert Newton	Non-Executive Director	Independent	1 August 2007	9 October 2013
Bennett Reid	Non-Executive Director		8 June 2009	31 December 2013
Euan Sutherland	Non-Executive Director		9 August 2013	31 December 2013
Leonard Wardle	Non-Executive Director		2 February 2006	9 October 2013
Martyn Wates	Non-Executive Director		13 November 2007	5 June 2013

Richard Pym was appointed Chairman on 11 June 2013. Niall Booker was appointed Chief Executive Officer of the Bank on 10 June 2013 and appointed to the Board on 11 June 2013.

Prior to October 2013, CBG operated a common Board and set of Board Committees to oversee the business of its subsidiaries, including the Bank. The composition of the Board of the Bank had therefore been identical to that of its then immediate parent company, CBG. As part of the process of recapitalisation of the Bank, it was considered necessary to change the composition of the Boards of the Bank and The Co-operative Banking Group prior to the recapitalisation.

On 9 October 2013 Duncan Bowdler, Peter Harvey, Robert Newton and Leonard Wardle stepped down from the Bank's Board. At the same time, certain Bank Directors who also sat on the Board of The Co-operative Banking Group (Richard Pym, Niall Booker, Rodney Bulmer, Richard Coates, Anne Gunther, Graeme Hardie, Merlyn Lowther and Bennett Reid) stepped down from the Board of CBG. The Bank considers the Independent Non-Executive Directors who are members of the Bank Board and who previously sat on the common Boards of both the Bank and The Co-operative Banking Group to continue, as regards the Bank, to be 'independent' for the purposes of the Code.

Rodney Bulmer resigned from the Board on 28 February 2014. Additional Executive representation on the Board is being considered in view of Rodney's departure.

Alistair Asher resigned from the Board on 24 March 2014. Alistair will not currently be replaced by The Co-operative Group.

In order to further strengthen the Bank's Board, Dennis Holt was appointed on 3 February 2014 as Senior Independent Director. Recruitment is underway to appoint a further Independent Non-Executive Director from a human resources background to chair the Remuneration Committee and for an Independent Non-Executive Director to Chair the Values and Ethics Committee.

Nominee Directors

For so long as the Co-operative Group Limited remains a bona fide co-operative society, the Articles of Association of the Bank provide the Co-operative Group Limited with the right, in certain prescribed circumstances, to appoint up to two representatives to the Board of the Bank. The Bank's Articles of Association can be found on the Bank's website.

Euan Sutherland (the former Chief Executive Officer of the Co-operative Group Limited) was appointed to the Board on 9 August 2013 and, together with Bennett Reid, represented the Co-operative Group Limited. Bennett and Euan stepped down from the Board on 31 December 2013. Alistair Asher was the nominee of the Co-operative Group Limited for the purposes of the Articles of Association between his appointment to the Board of the Bank on 31 December 2013 and his resignation on 24 March 2014.

The Co-operative Group does not currently intend to appoint a replacement.

In connection with the recapitalisation, certain other shareholders may nominate up to two persons to be appointed to the Board. More details are set out in the Shareholder relations section on page 41.

The role of the Chairman

Richard Pym, the current Chairman of the Bank, was appointed on 11 June 2013 and for the purposes of the Code was considered independent on appointment. Details of Richard's professional commitments are included in his biography. The Board is satisfied that these commitments do not interfere with the performance of Richard's duties for the Bank.

The Bank's Chairman is a Non-Executive Director who leads the Board in the determination of its strategy and in the achievement of its objectives. The Chairman takes personal responsibility for organising the business of the Board, ensuring its effectiveness and setting its agenda. The Chairman has no involvement in the running of the day to day business of the Bank. His role is to facilitate the effective contribution of Directors, constructive relations between the Executive and Non-Executive Directors, ensure Directors receive accurate, timely and clear information and that there is effective communication with shareholders. The division of responsibilities between the Chairman and the Chief Executive is clearly defined and was last approved by the Board on 8 October 2013.

The role of the Senior Independent Director

Dennis Holt was appointed as the Senior Independent Director on 3 February 2014. Details of Dennis' professional commitments are included in the biographies. The Board is satisfied that these commitments do not interfere with the performance of the Senior Independent Director's duties for the Bank.

The Senior Independent Director is available to shareholders if they have concerns that the normal channels of the Chairman, Chief Executive Officer or other Executive Directors have failed to resolve, or for which such channels of communication are inappropriate.

During 2013, the Bank did not designate a member of the Board as the Senior Independent Director as the role was filled jointly by the then Deputy Chairs, Peter Harvey and David Davies.

The Senior Independent Director will meet with the other Non-Executive Directors without the Chairman present once a year and on other occasions as appropriate to appraise the Chairman's performance.

The role of the Chief Executive Officer (CEO) and the Executive team

The CEO has direct charge of the Bank on a day to day basis and is accountable to the Board for the financial and operational performance of the Bank. The current CEO is Niall Booker, who was appointed onto the Board on 11 June 2013.

It is the responsibility of the Executive team to implement the strategic objectives as agreed by the Board. The Executive team, under the leadership of the CEO, is responsible for the management of the Bank.

The Secretary to the Board

The Secretary is responsible for advising the Board through the Chairman on all governance matters. All Directors have access to the advice and services of the Secretary. The Articles of Association provide that the appointment and removal of the Secretary is a matter for the Board, as do the Matters Reserved to the Board.

The current Secretary is Brona McKeown, who was appointed on 2 December 2013 and is also General Counsel of the Bank. Moira Lees was Secretary of the Bank until 9 October 2013 and Kathrine Bancroft held office from 9 October 2013 until 2 December 2013.

Appointment and reappointment of Directors

All Non-Executive Directors are appointed to the Board for an initial term of three years but, under the terms of their appointment, are required to submit themselves for annual re-election at the Bank's Annual General Meeting (AGM). All current Directors will offer themselves for election or re-election at the AGM in 2014, with the exception of Anne Gunther and Merlyn Lowther who intend to retire from the Board with effect from the AGM and therefore will not offer themselves for re-election. The terms of appointment of the Non-Executive Directors are available for inspection on request to the Secretary.

The biographical details of all Directors are discussed on page 32 to 33 and can also be found here on our website at:

http://www.co-operativebank.co.uk/aboutus/governance/Directors

How the Board operates

Meetings and attendance

The Board usually meets on a monthly basis and there were 12 scheduled meetings in 2013. However, due to the exceptional circumstances of the Bank there were a significant number of extra Board meetings during 2013, the majority of which took place in the latter half of the year in order to consider events leading up to the recapitalisation. Consequently there were 45 meetings of the Board or special purpose Committees of the Board in 2013. In addition to the formal Board meetings which took place there were a significant number of Board update calls where the Executive team updated the Board on the progress towards recapitalisation of the Bank.

The Board is scheduled to hold 12 Board meetings and two strategy meetings in 2014. The strategy meetings will be attended by senior Executives and will consider performance and longer term planning. If necessary, the Chairman and Non-Executive Directors meet in the absence of Executive Directors. Members of the wider Executive and senior management team are invited to Board meetings for specific items. This assists key messages from the boardroom to be articulated to the business and vice versa. In addition members of the Executive seek advice from Non-Executive Directors on a one to one basis.

Corporate Governance report continued

Information to Directors

Directors and usual attendees of Board and Committee meetings use a Board portal and an electronic tablet as their primary method of receipt of papers. The electronic tablet is also used to store supporting material including constitutional documents and the minutes of previous meetings.

During the planning for the recapitalisation, the Board was frequently required to consider papers on an urgent basis which was made possible via the electronic tablet. In ordinary circumstances, Board and Committee papers are aimed to be made available for Directors to access five days before a meeting, which provides the opportunity for Directors to prepare for meetings.

Attendance

The following table sets out the frequency of, and attendance at, the Board and Board Committee meetings for 2013 by Directors:

Name	Appointed date	Resigned date	Board meetings[1] attended (entitled to attend)	Audit Committee[2] attended (entitled to attend)	Risk Committee[2] attended (entitled to attend)	Remuneration Committee[2] attended (entitled to attend)	Nomination Committee attended (entitled to attend)
Richard Pym	11 June 2013		32 (33)				2 (2)
Richard Coates	16 January 2013		35 (39)	13 (13)	2 (4)	2 (2)	2 (2)
Anne Gunther[3]			36 (38)	2 (3)	12 (12)	9 (9)	
Graeme Hardie	1 May 2013		31 (35)	6 (6)	4 (4)	2 (2)	2 (2)
Merlyn Lowther			35 (37)	2 (4)	12 (12)		
William Thomas	28 October 2013		9 (9)				
Niall Booker	11 June 2013		27 (32)				
Alistair Asher[4]	31 December 2013	24 March 2014					
Rodney Bulmer	18 May 2013	28 February 2014	26 (30)				
Paul Flowers		5 June 2013	8 (11)			3 (3)	
Duncan Bowdler		9 October 2013	23 (26)	6 (6)		3 (4)	
David Davies		12 June 2013	8 (11)		3 (6)	1 (3)	
Peter Harvey		9 October 2013	25 (27)	7 (9)			
Peter Marks		16 May 2013	4 (6)			2 (2)	
Robert Newton		9 October 2013	22 (25)	5 (6)	10 (11)		
Bennett Reid		31 December 2013	29 (37)	4 (8)			1 (1)
Euan Sutherland	9 August 2013	31 December 2013	15 (23)				
Leonard Wardle		9 October 2013	25 (28)			2 (2)	
Martyn Wates		5 June 2013	6 (9)				
Barry Tootell		10 May 2013	7 (7)				

Number of meetings in 2013

Board meetings	45[1]
Audit Committee meetings	13
Risk Committee meetings	12
Nomination Committee	2
Remuneration Committee	9

1. Board meetings include Special Purpose Committees of the Board. 45 Board meetings or Special Purpose Committee meetings of the Board were held in 2013 and no one single Director was called to attend all 45 meetings.
2. Includes meetings of CBG Committees considering Bank matters.
3. Anne Gunther was appointed to the Audit Committee on 17 October 2013 as an interim measure to ensure a quorum and stepped down from the Committee on 30 January 2014.
4. Alistair Asher was appointed to the Board on 31 December 2013 and so did not attend any Board or Committee meetings in 2013 as none were held on 31 December 2013.

Corporate Governance report continued

The number in brackets indicates the total number of meetings the Director was eligible to attend during the year. A significant number of the additional Board meetings were held on short notice which had an impact on attendance. Where Directors are unable to attend Board meetings, usually for reasons of illness or a requirement to hold at shorter notice than is usual, the Chairman encourages Directors to provide their views, questions and comments directly to him.

During 2013, all Directors met, and in most cases exceeded, the time commitment set out in their letter of appointment.

Relations with Shareholders

At the start of 2013 the Bank had two ordinary shareholders. The majority of ordinary shares were held by The Co-operative Banking Group, a wholly owned subsidiary of the Co-operative Group Limited. The remainder of the shares were held directly by the Co-operative Group Limited.

As part of the recapitalisation of the Bank, on 20 December 2013 all of the Bank's ordinary shares were re-designated as deferred shares, cancelled and new ordinary shares of 5 pence each were issued. The Co-operative Group Limited now holds, including through The Co-operative Banking Group, approximately 30% of the new ordinary shares of the Bank. As at 1 March 2014, no other single shareholder holds more than 9.9% of the new ordinary shares. In addition, on 20 December 2013, all the issued preference shares were transferred to the Co-operative Group Limited, which waived all rights to income and capital in respect of the preference shares.

During 2013, the Board had significant dialogue with the Co-operative Group Limited and the Bank's prospective shareholders which helped to develop the shape of the Recapitalisation Plan. Post LME the Bank has an increased number of shareholders. The Chairman, the Senior Independent Director and the Executive team (including operating through its Investor Relations team), led by the Chief Executive continue this dialogue which is reported back to the Board. All Directors will be encouraged to attend the Bank's AGM.

Co-existence Principles and the use of The 'Co-op' brand

The Bank owns the trademark rights to the Co-operative Bank brand.

The Co-existence Principles govern the use of trademarks containing 'Co-operative' or 'Co-op' and other associated trademarks owned by both parties. These principles are as follows:

Until a Trigger Event (namely the removal of the Values and Ethics provisions entrenched in the Bank's Articles of Association) The Co-operative Group cannot conduct any business under a brand that combines the words 'Co-operative' or 'Co-op' and 'Bank'. After the Relationship Agreement (see below) ends and until a Trigger Event, the Bank can continue to use the terms 'Co-operative' and 'Co-op' provided it does not confuse the public into believing that the Bank is still a part of The Co-operative Group. After the expiry of the non-compete period of three years after the Relationship Agreement ends, The Co-operative Group is free to conduct any financial services business under any of its brands, subject to the restriction placed on its use of 'Co-operative' or 'Co-op' with 'Bank'. Until five years after the end of the non-compete period, The Co-operative Group cannot conduct any business which competes with the Bank under a main business brand including the words 'Co-operative' or 'Co-op'.

Furthermore, the Secretary of State for Business, Innovation and Skills may direct the Bank to change its registered name if, in his opinion, it gives so misleading an indication of the nature of its activities as to be likely to cause harm to the public. The FCA has the power to prevent the use of the 'Co-operative' name, or to take other action regarding the Bank's branding, if the FCA considers this desirable to protect consumers, to promote competition in the interests of consumers or to protect the integrity of the UK financial system.

Relationship Agreement

In anticipation of the completion of the LME and the Bank ceasing to be a wholly-owned subsidiary of The Co-operative Group, the Bank entered into a relationship agreement with The Co-operative Group and Banking Group on 4 November 2013 (Relationship Agreement) to regulate the basis of their on-going relationship. The Relationship Agreement will continue for so long as The Co-operative Group remains a significant shareholder of the Bank (ie the right to exercise, or control the exercise of, 20% of the voting rights at a general meeting). It includes appropriate measures regarding the degree of control that The Co-operative Group and its associates may exercise over management of the Bank.

Under the Relationship Agreement, The Co-operative Group undertakes that it will conduct transactions with the Bank on arm's length terms and not seek to influence the day-to-day running of the Bank. Amendments to existing contracts and arrangements in place between The Co-operative Group and the Bank will require the approval of a majority of Independent Directors. The Relationship Agreement contains provisions on conflicts and related party transactions.

The Relationship Agreement requires the Bank to have a Values and Ethics Committee which is required to:

- recommend to the Board for approval and adoption the Co-operative and ethical policies of the Bank; and
- represent, monitor and advise the Board on matters concerning the interests of customers, suppliers, employees and other stakeholders in their dealings with the Bank.

Under the Bank's Articles of Association, there is a requirement to promote and conduct its business to the extent practicable in a manner informed by the established values of The Co-operative Movement having regard to:

- how it relates to, communicates with, balances the interests of, and otherwise deals with its stakeholders; and
- how it applies the profits of the Bank, in accordance with the dividend policy set out in its Articles of Association.

The Co-operative Group has the right to appoint and remove:

- up to two persons to the Board provided that The Co-operative Group controls directly or indirectly 25% or more of the voting rights exercisable at a general meeting of the Bank; or
- one person to the Board provided that The Co-operative Group controls directly or indirectly 20% or more, but less than 25% of the voting rights exercisable at a general meeting of the Bank. The Co-operative Group Limited has the ability to appoint one of these Directors to the Values and Ethics Committee.

Corporate Governance report continued

Subject to certain conditions, the Relationship Agreement also provides a mechanism for the appointment of up to two approved persons as Non-Executive Directors (after having been nominated for such purpose by the subscribers of ordinary shares under the purchase agreement with the Bank dated 4 November 2013). A person so nominated can be appointed if less than 25% of relevant votes object to the appointment of such persons within a specified timeframe.

The Co-operative Group Limited has agreed not to transfer the shares held directly or indirectly by the Co-operative Group Limited outside its group before 20 December 2018.

Provisions are included in the Relationship Agreement concerning the fact that The Co-operative Group and Bank share many of the same customers and it is therefore necessary to mitigate risks and deal with practical issues concerning the processing of data.

The Relationship Agreement contains provisions that restrict or limit the Bank's ability to issue any shares, or other equity securities or any securities convertible into, or exchangeable for, or grant any right to subscribe for, shares or other equity securities (subject to specified exceptions) without the consent of the Co-operative Group Limited for up to a maximum period of three years after 20 December 2013. No such consent is required for certain limited issues of Relevant Securities including:

i. issues comprising an equity capital raising required or taken by the Bank in anticipation (acting reasonably) of any such requirement, by a government authority or regulator; and

ii. until 20 December 2014 (or admission to listing if earlier), any allotment of equity securities in connection with any rights issue or pre-emptive offer to an aggregate of £200m, and in such instances The Co-operative Group must either vote in favour or abstain on shareholder resolutions granting authority to allot and disapply pre-emption rights.

The Co-operative Group Limited has agreed in the Relationship Agreement that for the duration of the period ending on the later to occur of (1) two years after the termination of the Relationship Agreement and (2) 20 December 2020, the Co-operative Group Limited will, subject to certain exceptions:

- continue to use the Bank as its exclusive provider of financial services (excluding lending) in respect of financial services that are being provided by the Bank to The Co-operative Group on an exclusive basis as at the date of the Relationship Agreement (Exclusive Financial Services) and principal provider of financial services in respect of financial services that are not Exclusive Financial Services;
- continue to use the Bank as its principal provider of financial services in respect of financial services that are not Exclusive Financial Services that have been provided by the Bank to The Co-operative Group in the 12 month period prior to 4 November 2013;
- promote the Bank's banking business and facilitate and encourage its customers and members to hold bank accounts with, and otherwise use the services of, the Bank; and
- support the enhancement and rejuvenation of The Co-operative brand and franchise.

The Relationship Agreement will terminate immediately (but without prejudice to accrued rights and obligations) if The Co-operative Group ceases to be a Significant Shareholder in the Bank (ie hold more than 20% of the voting rights exercisable at a general meeting of Bank). Certain key obligations of The Co-operative Group under the Relationship Agreement will survive such termination. These include The Co-operative Group's commitments (a) to use Bank as an exclusive or principal provider of financial services as outlined above, and (b) not to operate a business which principally involves the provision of banking and other services in the UK that were provided by the Bank at the date of the Relationship Agreement or in the 12 months prior to it (excluding any business activities carried on by The Co-operative Group at the date of the LME). Further, termination of the Relationship Agreement will not affect the continued inclusion in the Bank's Articles of Association of the provisions requiring the Bank to operate in accordance with co-operative principles, and those describing the purpose and authority of the Values and Ethics Committee, and how it should be constituted, although the right of The Co-operative Group to appoint a director to the Bank's Values and Ethics Committee falls away when The Co-operative Group is no longer a Significant Shareholder in the Bank.

Separation

Prior to the LME, certain functions of the Bank were centralised and carried out by The Co-operative Group. Project Unity and CFSMS Arrangements are the two key arrangements in place under which the Bank receives the supply of services, assets and/or personnel. Two key agreements in connection with Project Unity are the existing IT Services Agreement and a Professional Master Services Agreement in relation to the provision of other services. CFSMS was established as a direct subsidiary of The Co-operative Banking Group in 2005 to enable economies of scale through the sharing of employees and sourcing of third party services across The Co-operative Banking Group, including the Bank.

Following the announcement of the Bank's Recapitalisation Plan in June 2013, the Bank and The Co-operative Group worked to amend certain provisions of Project Unity and CFSMS Arrangements. Those amendments were close to finalisation when The Co-operative Group announced on 21 October 2013 that it was in discussion with bondholders, and that many elements of the Plan would need to change in material respects to reflect the fact that the Bank would no longer be a subsidiary of The Co-operative Group. Accordingly the Bank and The Co-operative Group have been working towards renegotiation of the arrangements under which the Bank receives staff and services from The Co-operative Group. Pending finalisation of the revised arrangements, the Bank and The Co-operative Group agreed high level principles (the Separation Principles) to govern their separation discussions.

The Separation Principles include an overarching agreement to act in good faith and, amongst other things:

- until alternative arrangements for Project Unity and the CFSMS Arrangements are agreed, The Co-operative Group will continue to provide services to the Bank under the same terms that such services are currently provided;
- for those costs allocated by The Co-operative Group in its sole discretion, the Bank and The Co-operative Group will take reasonable steps to avoid the Bank incurring costs incremental to those it currently incurs;
- The Co-operative Group and the Bank will mitigate costs arising for The Co-operative Group or the Bank from (i) The Co-operative Group being a less than 50% shareholder of the Bank or (ii) agreed steps taken in connection with the separation process;
- an additional mark up (of no more than 20%) may be charged by The Co-operative Group for services provided under Project Unity after the LME but not in respect of the first 12 months in respect of all services;
- costs will be allocated between the Bank and The Co-operative Group on an equitable basis; and
- a working group consisting of representatives from the Bank and The Co-operative Group will be established to address and oversee the separation work-stream.

For further information on the separation of the Bank and The Co-operative Group, refer to note 39.

Appointment and replacement of Directors

The Directors retire from office at each Annual General Meeting. A retiring Director is eligible for re-election. The Nomination Committee is responsible for considering and making recommendations to the Board in respect of appointments to the Board.

Powers of the Directors

The powers of the Directors are determined by the Companies Act 2006 and the Bank's Articles of Association.

Powers of the Board

The Board may exercise all the powers of the Bank to:

- pay pensions or other benefits to any Director or employee;
- establish participation in any profit-sharing or incentive scheme; and
- support and subscribe to any institution or association which may be for the benefit of the Bank, its Directors or employees, and subscribe to any charitable or public object.

Subject to the provisions of the Bank's Articles of Association and the Relationship Agreement, the Bank may exercise the powers conferred by the applicable statutory provisions to:

- increase its share capital by allotting new shares;
- reduce its share capital, any capital redemption reserve and any share premium account;
- subdivide or consolidate and divide all or any of its share capital;
- redenominate all or any of its shares and reduce its share capital in connection with such redenomination;
- issue redeemable shares; and
- purchase all or any of its own shares including any redeemable shares.

The Bank may pass an ordinary resolution authorising the Board to allot shares in the Bank or to grant rights to subscribe for or to convert any security into shares.

The Relationship Agreement and the rights of the preference shares owned by the Co-operative Group Limited contain various provisions that may limit the Bank's ability to issue or allot shares, other equity securities or any securities convertible into, or exchangeable for, or grant any right to subscribe for, shares or other equity securities, without the consent of the Co-operative Group Limited.

Further details on voting rights can be found on page 58 – Statutory Disclosures Information

Board Committees

During the first half of 2013 CBG and its subsidiaries maintained a common governance, organisational and risk management structure for its subsidiaries, including the Bank. In particular, CBG operated a common Board and set of Board Committees to oversee the business of the subsidiaries of the Banking Group, including the Bank. The Banking Group Committees considered matters for the entire Co-operative Banking Group of companies, including the Bank.

From July 2013, the Board began to establish its own separate Bank Board Committees. The Nomination Committee and a separate Remuneration Committee were established in July 2013. Separate Bank Board Risk and Audit Committees were established in August 2013 and the Values and Ethics Committee (a new Committee) was constituted on 1 November 2013.

All Board Committees have terms of reference describing the authority delegated to it by the Board. Each of these Committees has a role in ensuring the effective oversight by the Board of the Bank and its subsidiaries. The terms of reference for all the Committees can be found at:

http://www.co-operativebank.co.uk/aboutus/governance/terms-of-reference-for-board-committees

The Board receives the minutes of all Committee meetings.

Information on the Committees can be found on the following pages:

	Page
Audit Committee	44
Risk Committee	51
Nomination Committee	54
Values and Ethics Committee	55
Remuneration Committee	60

Audit Committee report

Introduction by Audit Committee Chairman

"2013 was a very challenging year for the Bank and the Audit Committee played its part in ensuring the right discussions and debates were had around those topics of internal control and financial reporting, so central to a business in our position. This is reflected in the number of times the Committee met during the year – 13. The Committee, throughout all its changes in composition, challenged the judgements of management and reviewed the work of the internal and external audit teams. I'd like to thank my colleagues, past and present, for their commitment to the Committee over the year."

Richard Coates
Audit Committee Chairman

Purpose of the Audit Committee

To monitor, review and report to the Board on the formal arrangements established by the Board in respect of the financial and narrative reporting of the Bank, the internal controls and the Risk Management Framework, the internal audit and the external audit process.

Current Audit Committee			Previous members		
Richard Coates	Appointed 16 January 2013	Chairman since 9 April 2013	Peter Harvey	Resigned 8 October 2013	Resigned as Chairman on 9 April 2013
Graeme Hardie	Appointed 30 August 2013		Bob Newton	Resigned 30 August 2013	
Merlyn Lowther	Appointed 9 October 2013		Bennett Reid	Resigned 9 October 2013	
Anne Gunther	Appointed 17 October 2013	Resigned 30 January 2014	Duncan Bowdler	Resigned 30 October 2013	

Until August 2013, the Committee was a joint Committee for all The Co-operative Banking Group companies including the Bank. It was then reconstituted, in line with improvements to the Bank's governance, as a separate Committee of the Bank's Board.

During the year there have been a number of changes to the composition of the Audit Committee. Bennett Reid and Richard Coates brought recent and relevant financial experience, Bennett Reid and Duncan Bowdler were also members of The Co-operative Group's Audit and Risk Committee. The number of common members on the Board Risk Committee also increased from one to four during the year. Bennett Reid and Duncan Bowdler were the only members of the Committee not considered to be independent during the year. The composition of the Committee will be reviewed again following the appointment of additional independent Non-Executive Directors to the Board in 2014.

Meetings of the Committee are generally attended by the CEO, CFO, invited members of the finance and risk teams and the Director of Internal Audit, none of whom do so as of right. The external auditors attend Committee meetings and private meetings are held with internal and external auditors as necessary to afford them the opportunity of discussions without the presence of management. The Committee met 13 times during the financial year. The Chairman of the Committee reports back to the Board on the outcomes of meetings and the Board receives the minutes of all Committee meetings.

Audit Committee report continued

Principal responsibilities of the Audit Committee	Key areas discussed and reviewed by the Committee in 2013 include
Financial and Narrative reporting	
• Review the content of the Annual Report and Accounts and advise the Board on whether, taken as a whole, it is fair, balanced and understandable and provides the information necessary for shareholders to assess the Bank's performance, business model and strategy	• Advised the Board that the Annual Report and Accounts, taken as a whole, are fair, balanced, and understandable
• Monitor the integrity of the financial statements of the Bank	• Going Concern basis of preparation of the accounts
• Review and challenge where necessary:	
– the consistency of, and any changes to, significant accounting policies both on a year on year basis and across the Bank;	• Discussed all financial results in 2013
– the methods used to account for significant or unusual transactions where different approaches are possible;	
– whether the Bank has followed appropriate accounting standards and made appropriate estimates and judgements, taking into account the views of the external auditor; and	• Revisions to presentation of Annual Report and Accounts and Compliance with the UK Corporate Code • Impact of future financial reporting standards
– the clarity and completeness of disclosure in the Bank's financial reports and the context in which statements are made.	• The Committee considered work on Financial Policies and procedures in 2013 as part of the LME Prospectus
• Reviewing and reporting to the Board on significant financial reporting issues and judgements, including matters communicated to it by the auditor	• Annual Report sections on Corporate Governance • Key judgements in finalising the financial statements for the half year, audited accounts for the LME Prospectus and Annual Report and Accounts for the year to December 2013 • Key judgements discussed as part of the 2013 accounts process are detailed on pages 147 to 153
Internal controls and risk management systems	
• Review the adequacy and effectiveness of the Bank's internal financial controls and internal control and risk management systems and statements in the Annual Report concerning internal controls and risk management	• Changes to Audit Committee's Terms of Reference • The Committee considered a report on the effectiveness of the Bank's system of internal control. The review covered all material controls, including financial, operational and compliance controls and risk management systems • The Committee considered reports of fraudulent activity and other major breakdowns in controls

Audit Committee report continued

Principal responsibilities of the Audit Committee	Key areas discussed and reviewed by the Committee in 2013 include
Internal Audit	
• Approve the appointment or termination of appointment of the Director of Internal Audit	• External Quality Assessment (EQA) completed
• Review and approve the charter of the internal audit function and ensure the function has the necessary resources and access to information to enable it to fulfil its mandate, and is equipped to perform in accordance with appropriate professional standards for internal auditors	• Internal Audit transition to a new Target Operating Model based on the Chartered Institute of Internal Auditors (CIIA) guidance on Effective Internal Audit in Financial Services • Gap analysis against newly issued guidance from the CIIA
• Ensure the Director of Internal Audit has direct access to the Board Chairman and to the Committee Chair, and is accountable to the Committee	
• Review and assess the annual internal audit work plan and the reasons for any significant change or delay to this plan	• Quarterly review and challenge of the IA plan
• Receive reports on the results of the internal auditor's work	• Review of quarterly audit activity reports covering key thematic risks and high risk audits
• Review and monitor management's responsiveness to the internal auditor's findings and recommendations	• The Committee receives all red rated internal audit reports and invites management to present findings and remedial action • Implementation status reports on audit recommendations
• Meet with the Director of Internal Audit at least once a year without the presence of management	
• Monitor and review the effectiveness of the Bank's internal audit function, in the context of the Bank's overall risk management system	
External Audit	
• Consider and make recommendations to the Board, to be put to shareholders for approval at the AGM, in relation to the appointment, re-appointment and removal of the external auditor	• External auditor effectiveness and independence • In line with good Corporate Governance considered the appointment of external auditors to the Bank with a view to putting the audit out to tender in 2014
• Ensure that at least once every ten years the audit services contract is put out to tender and oversee the selection process	
• If an auditor resigns, investigate the issues leading to this and decide whether any action is required	
• Oversee the relationship with the external auditors and review the findings of the audit with the external auditor	• The Committee engages fully with the external auditors on all of the key judgements
• Review any representation letter(s) requested by the external auditor before they are signed by management	• Review of management representation letters to the external auditors
• Review the management letter and management's response to the auditor's major findings and recommendations	• External auditor management letter containing observations arising from the annual and interim audits leading to recommendations for control or financial reporting improvement
• Develop and implement policy on the supply of non-audit services by the external auditor	• Reviewed the external audit strategy including policy on non audit fees

Principal responsibilities of the Audit Committee	Key areas discussed and reviewed by the Committee in 2013 include
Whistleblowing, Bribery prevention and Anti-money laundering/Terrorist financing	
• Review the adequacy and security of the Bank's arrangements for its employees and contractors to raise concerns, in confidence, about possible wrongdoing in financial reporting or other matters and recommend the Bank's Whistleblowing policy to the Board	• Reviewed whistleblowing arrangements
• Review the adequacy and effectiveness of the Bank's systems and procedures for the prevention of bribery and recommend the Bribery Prevention policy to the Board	• The Risk Committee considered reporting on the anti-bribery and corruption framework
• Review regular reports from the Money Laundering Reporting Officer and the adequacy and effectiveness of the Bank's anti-money laundering and counter terrorist financing systems and controls	• Reviewed reporting from the Money Laundering Reporting Officer
• Reviews the Committees Terms of Reference and monitoring its execution	

The work of the Audit Committee in 2013 is considered in more detail below.

Significant accounting matters

During the year the Committee considered the following significant accounting issues, matters and judgements in relation to the Bank's half year and full year 2013 financial statements as well as the disclosure and presentation of those areas in the Annual Report and Accounts. These were discussed and debated with both the external auditors (KPMG Audit Plc) and management.

Going concern

The continuing operation of the Bank and the Company is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Bank and the Company have adequate resources to continue to operate for the foreseeable future, the Directors have considered a number of factors. The assessment of the going concern basis of preparation has been subject to a thorough process involving analysis and discussion by management, Executive and Board Committees and the Board, in line with our governance processes and discussion with the PRA. This analysis covered forecast information for the Bank's planning period, 2014-2018, with a particular focus on the period up to and including 2015, as well as the management actions agreed as part of the Recapitalisation Plan (as defined and detailed in the Strategic report.

The forecasts covering the planning period included stressed scenarios, which the Board considered to be reasonable and appropriate.

The Bank has reaffirmed and updated its Plan and has continued its engagement with the PRA in relation to this Plan. There continues to be a material uncertainty around the Going Concern situation of the Bank. Further information can be found in note 1 of the Bank financial statements.

Deferred tax assets

Aligned with the above going concern consideration, the Committee deliberated and challenged the recognition of a deferred tax asset (DTA), the key judgement being the Bank's ability to recover the deferred tax assets based on forecasts of future taxable profits. The Committee debated how many years could be reasonably projected and agreed that the length of the Board approved plan was the longest period that should be considered. The Committee challenged the Plan and sensitivities to the Plan including credit impairment levels and economic drivers. This was a key area of discussion for the Committee during 2013. The DTA was not recognised in the unaudited interim results as the Plan was not considered sufficiently robust at that point. In the audited interim accounts included as part of the Prospectus, the Plans were considered robust enough to recognise a DTA. Following additional losses included in the 2013 accounts and the requirement for additional capital to be raised, the Committee concluded that a DTA could not be recognised at the 2013 year end. Following a successful capital raise, this judgement will continue to be reviewed.

Impairment of intangible assets

The Audit Committee discussed with management and the external auditor the valuation of intangible assets. The write-off of the Core banking replacement asset was a direct consequence of a change in IT strategy agreed by the Board in Q2 2013. Intangible assets on the 2013 balance sheet include the FD online system and seven day account switching. The factors supporting these valuations and levels of impairment, including customer numbers and switching rates, were debated by the Audit Committee.

Liability Management Exercise (LME) accounting

The accounting for the LME was complex and the valuation of the Bank highly judgemental. The Committee reviewed alternate valuation methodologies including internal calculations, based on the Bank's financial plan, and external market valuations. The Committee considered the external valuation, appropriately discounted for the relatively thin volume of transactions to be the most robust and in line with accounting standards. The valuation used sat within a range of possible valuations.

Conduct risk and legal provisioning

The Audit Committee discussed each conduct risk provision including recognition, level of provision and associated disclosures. Detailed papers were presented setting out the underlying assumptions in each provision, and these were debated and challenged by the Audit Committee.
As part of reviewing the results for 2013, the Audit Committee reviewed recommendations from management that further provisions should be taken in respect of a number of risks including PPI and Interest Rate Swap Mis-selling. Key assumptions included population affected, size of redress, customer response rate and interest rates. The Committee also considered completeness of these provisions. The Committee took legal as well as management advice in considering the Bank's breaches of the Consumer Credit Act and reviewed the quantum of the related provisions.

Impairment of loans and advances to customers

The Audit Committee reviewed detailed papers presented by management covering the drivers of the Non-core division impairment provision, including inter-alia the emergence period and probability of default, the impairment of governance and controls and methodologies and the substantive evidence supporting model parameters.

In terms of the corporate collective provision, the Committee reviewed and challenged changes to the methodology and supporting data analysis, particularly in respect of probabilities of default, loss emergence periods and management overlays to model outputs. The outcome was benchmarked against the treatment adopted by the Bank's peer group.

The Committee carefully considered evidence in the post balance sheet period as to whether additional provisions were required relating to the conditions existing at the balance sheet date.

CFSMS assets

The Committee considered whether the intangible and tangible assets solely used by the Bank but held on the balance sheet of CFSMS (previously a fellow subsidiary of The Banking Group) should, under accounting standards 'risk and rewards' test, in fact be held on the balance sheet of the Bank. Following debate and challenge covering legal ownership, the historical position and other factors, the Directors concluded that the preferable accounting treatment would be to include these assets in the Bank's 2013 balance sheet and restate prior years.

Pensions

There were two major judgements concerning pensions which the Audit Committee considered in the year. Firstly whether the accounting of the Bank's participation in the Pace defined benefit scheme post separation from The Co-operative Group should be on a defined contribution defined benefit basis. After debate, the Committee concurred with management that the information is not currently available to account on a DB basis.

The second judgement concerned the Britannia pension scheme, held on the balance sheet of CFSMS. The Committee discussed and agreed with management that the pension scheme was correctly accounted for in the books of CFSMS.

Unadjusted errors

The auditors reported to the Committee the mis-statements that they had found in the course of their work and no material amounts remain unadjusted.

Internal controls

Where material risks have been identified, the Bank has instigated action to strengthen its systems of internal control to mitigate these risks. The Board is ultimately responsible for the Bank's system of internal controls and it discharges its duties in this area by ensuring management implements effective systems of risk identification, assessment and mitigation. These risk management systems are designed to manage, rather than eliminate, the risk of failure to achieve business objectives and cannot provide absolute assurance against material misstatement or loss.

Management is responsible for establishing and maintaining adequate internal controls over financial reporting, including the consolidation process. Internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes. A strategic planning, budgeting and forecasting process is in place. Monthly financial information is reported to the Board and management. ExCo reviews performance against budget and forecast on a monthly basis and senior financial managers regularly carry out an analysis of material variances.

Responsibility for reviewing the effectiveness of the internal controls has been delegated to the Audit Committee by the Board.

The Committee uses information drawn from a number of different sources to carry out this review:

- Internal Audit provides objective assurance – their annual work plan is developed in conjunction with management and approved by the Audit Committee focusing on key risks and key internal controls. In the light of Internal Audit's recommendations, management develops and implements corrective action plans, which are tracked to completion by Internal Audit, with the results reported to executive management and to the Committee;
- An annual review of the Bank's systems of internal control was undertaken by the Committee and facilitated by the Risk Function;
- Further objective assurance is provided by the external auditors and other external specialists.

Turnbull review of effectiveness of internal control

In the course of 2013 certain control failings became evident which prompted further investigation and in line with the Code and the supporting Turnbull guidance, the Directors have undertaken a more systematic review of the effectiveness of the Bank's system of internal control. This review covered all material controls, including financial, operational and compliance controls and risk management systems. The assessment approach was aligned to the Bank's overarching Risk Management Framework (RMF) and the effectiveness of the constituent control frameworks designed to manage the Bank's Principal Risks. The key conclusions of this review were as follows:

- As described on pages 51 to 53, the Bank has a well-defined RMF that sets out a hierarchy of strategies, policies and standards to support risk based decision making and operational control. The RMF was revised and updated at the time of separation of the Bank from The Co-operative Group, and is considered to be in line with peer institutions
- There were changes in senior leadership during 2013 and the strategic imperative was to recapitalise the Bank and restructure it into Core and Non-core components. A more in depth analysis of the control frameworks, conducted by new senior management, has identified a number of control failings. The leadership team is focused upon ensuring there are robust controls in place to underpin the business strategy
- A stronger Risk Function was established in the period of late 2012 to early 2013. There have been a number of control improvements across multiple risk disciplines during 2013. The challenge going forward will be to attract new, and retain existing key staff to maintain and support transformation of the Bank in a controlled way
- Historically, the Internal Audit function did not meet the standards recently set out by the Chartered Institute of Internal Auditors in relation to financial services. In addition, internal audit action points were not addressed by line management in line with agreed timescales. In 2013, a new Target Operating Model (TOM) was implemented which significantly improved the capability of the function. Where progress is not being made on audit issues, these are now routinely escalated to the Executive and Board Audit Committees. This is part of the wider cultural changes being introduced across the Bank
- Various elements of Operational Risk management were concluded to be ineffective in 2013. Some examples of weaknesses include an over-reliance on manual intervention in processes, inadequate business continuity and disaster recovery arrangements, poor logical access management and ineffective outsourcing. Progress has been achieved in a number of areas but significant work is still required from a people, process and systems perspective to embed an effective and sustainable operational risk framework, and to enhance the control culture
- Significant control failures have been identified in relation to Regulatory and Conduct matters and, similar to other organisations, material provisions have been required in 2013. Major efforts are being made to rectify these failings and prevent their recurrence
- The Bank's underlying business and financial systems are dated and have suffered from a lack of integration and investment since the Britannia merger. Whilst the Bank does not believe this will result in inaccuracies or delays in the financial or other information which it is required to publish, the significant, costly manual intervention does nevertheless lead to an increased level of financial reporting risk. A number of control enhancements were made in 2013. Further investment and automation is required to maintain compliance with emerging regulatory and statutory reporting requirements
- Internal audit findings and risk events reported in 2013 support the above assessment of the Bank's system of internal control

After reviewing the presentations and reports from management and consulting, where necessary, with the external auditors, the Committee was satisfied that the financial statements appropriately addressed the critical judgements and key estimates (both in respect of the amounts reported and the disclosures). The Committee was also satisfied that the significant assumptions used for determining the value of assets and liabilities had been appropriately scrutinised, challenged and were sufficiently robust.

In summary, the Bank's systems of control were weak and had failings in a number of areas in the past. The foundations of a more robust RMF were defined in late 2012 to early 2013, some improvements in controls were made in 2013 but further work is required to implement and embed all elements of the control framework across the Bank. This will need to be supported by improved capability across the three lines of defence as well as a cultural shift in driving accountability for actions. This is a corporate priority for 2014.

Alignment with Risk Committee

The Committee held a joint meeting with the Risk Committee to discuss issues relevant to both Committees including the new Risk Management Framework, change capability, internal controls delivery and management information.

Internal Audit

The Bank has an Internal Audit department comprising 20 in-house auditors supported by an Internal Audit co-source arrangement with Deloitte LLP and Grant Thornton UK LLP. This provides specialist skills where it would be inefficient to resource internally. The Internal Audit Director reports jointly to the Chairman of the Audit Committee and to the CEO.

A total of 45 Internal Audit reports were delivered during the year across a cross-section of activities identified and prioritised by Internal Audit with input from management and the Committee. The Internal Audit plan is based upon a quarterly planning cycle which gives flexibility on the type of assurance provided, aligned to the changing risk profile of the Bank. All audit plans are shared and agreed directly with individual stakeholders and ExCo for feedback. The audit plan is approved by the Audit Committee, and shared with the regulator, quarterly.

To provide robust coverage of risks, Internal Audit has an audit universe which provides a holistic view of audit coverage at a business entity level. In addition, a top down risk assessment is performed of the key thematic risks faced by the Bank which could frustrate business plan delivery. Areas covered include business plan execution, conduct and IT strategy as well as the major prudential risks including capital planning and liquidity forecasting.

Internal audit reports are reviewed in conjunction with operational and line management and then by ExCo and other Board Committees as appropriate. Audit findings and the related management actions are tracked to completion by Internal Audit. Where audit issues are overdue these were reported to ExCo and the Audit Committee and escalated as appropriate. The Committee is provided with reports on material findings and recommendations and regular updates on the progress made by management in addressing the findings. All action points are recorded on a bank-wide database to facilitate tracking and reporting.

An External Quality Assessment (EQA) was completed on Internal Audit during 2013 and a report issued, which was presented to the Audit Committee during the year. As a result of the EQA, the Internal Audit function implemented a new Target Operating Model (TOM) which was primarily aimed at improving the capability of the team and quality of assurance provided. In addition, as part of the new TOM, a gap analysis was completed against the new Chartered Institute of Internal Auditors (CIIA) standards for Financial Services which reaffirmed that the design met the upgraded guidance.

The Internal Audit annual self-assessment was approved by the Audit Committee, gaps and improvement actions were noted, including stretching performance targets for 2014 as part of the Internal Audit scorecard.

Other matters discussed during the year

External audit

The external auditors are appointed by shareholders to provide an opinion on the financial statements and certain other disclosures prepared by the Directors. Following their reappointment at the 2013 AGM, KPMG Audit Plc acted as the external auditors to The Co-operative Bank plc throughout the year. The Committee is responsible for oversight of the external auditors, including reviewing the audit strategy and, on behalf of the Board, approving the audit fee. The Audit Committee has developed and implemented policy on the supply of non-audit services by the external auditors to avoid any threat to auditor objectivity and independence, taking into consideration any relevant guidance on the matter.

Non-audit services are normally limited to assignments that are closely related to the annual audit or where the work is of such a nature that a detailed understanding of the Bank is necessary. Management regularly provides the Committee with reports on audit, audit-related and non-audit expenditure, together with proposals of any significant non-audit related assignments.

The Committee reviews and, where necessary, challenges management to ensure auditor objectivity and independence is not impaired. Fees for audit related and non-audit services incurred during the year amounted to £4.5m (2012: £3.1m). Details of the fees paid for audit services, audit related services and non-audit services can be found in note 6 to the financial statements. The Committee is satisfied that the overall levels of audit-related and non-audit fees are not material relative to the income of the external audit offices and firm as a whole and did not impair the objectivity and independence of the external auditors.

The Committee has evaluated the performance, independence and objectivity of KPMG Audit Plc and also reviewed their effectiveness as external auditors and taken into account the following factors:

- the external auditors' progress achieved against the agreed audit plan and communication of any changes to the plan, including changes in perceived audit risks;
- the competence with which the external auditors handled the key accounting and audit judgements and communication of the same with management and the Committee;
- the external auditors' compliance with relevant regulatory, ethical and professional guidance on the rotation of partners;
- the external auditors' qualifications, expertise and resources and their own assessment of their internal quality procedures; and
- the stability that would be provided by continuing to use KPMG Audit Plc.

The Audit Committee is also responsible for ensuring that, at least every ten years, the audit services contract is put out to tender (the last tender being in 2011). KPMG Audit Plc (or its predecessor firm) has audited the Bank for over 40 years. The lead audit partner at the Bank level has changed regularly and in recent years every five years in accordance with professional and regulatory standards designed to safeguard independence and objectivity. The most recent lead audit partner rotation was in 2013 when John Ellacott was appointed Senior Statutory Auditor. In addition, senior audit staff rotate periodically in accordance with KPMG's internal policies on independence. The next formal tender of the external audit contract will take place in 2014.

Risk Committee report

Introduction by Risk Committee Chairman

"The scale of the risks identified in the second half of 2013 were such that they required full Board consideration. Consequently, the focus has been on overhauling our internal risk controls and conduct risk procedures. The management of the Bank's risks are now distinct from The Co-operative Banking Group's and a separate Risk Management Framework has been established. There is much change required and there is no doubt that embedding the Risk Management Framework will be challenging. In addition, there are still significant risks facing the business which could impact its ability to implement its Plan. Our role is to ensure rigorous challenge and debate of the Bank's key risks, challenging management on strategic decisions and the Plan and driving accountability amongst the senior management team."

Graeme Hardie
Risk Committee Chairman

Purpose of the Risk Committee

To review and report its conclusions to the Board on the Bank's risk appetite and Risk Management Framework, taking a forward looking perspective and anticipating changes in business conditions.

Current Risk Committee			Previous members	
Graeme Hardie	Appointed 21 August 2013	Chairman since 21 August 2013	David Davies	Resigned 12 June 2013
Merlyn Lowther		Resigned as Chairman on 21 August 2013	Robert Newton	Resigned 9 October 2013
Richard Coates	Appointed 21 August 2013			
Anne Gunther				
William Thomas	Appointed 1 January 2014			

Prior to 21 August 2013, The Co-operative Banking Group (CBG) Risk Committee considered risk for the whole of CBG. On 21 August, a new Bank Risk Committee was set up to oversee the risk of the Bank. The CBG Risk Committee and the Bank Risk Committee met in total 12 times during the financial year.

In performing its duties, the Committee has access to the services of the Chief Risk Officer, the Chief Executive Officer, the Chief Financial Officer, the Director of Internal Audit as well as external professional advisers.

Risk Committee report continued

Principal responsibilities of the Board Risk Committee	Key areas discussed and reviewed by the Committee in 2013 include
Risk Management Framework • Review and challenge the design and implementation of the Risk Management Framework and recommend to the Board for approval • At least annually, review the quality and effectiveness of the Risk Management Framework and the Risk Management Framework Policy • Ensure the remit of the risk management function has: – adequate resources and appropriate access to information to enable it to perform its function effectively and in accordance with the relevant professional standards, and – adequate independence, being free from management or other restrictions. • Review the capability of the Bank to identify, assess, and manage new risk types	• The main focus of the Committee's work throughout the year has been overseeing the implementation of the new Risk Management Framework developed in 2012 and amended and updated in 2013 • The Committee reviewed the development and embedding of the Risk Management Framework • During the year the Committee has reviewed its own effectiveness. The results of the review are being used to assist in the development of the effectiveness of the Committee under its revised terms of reference • Key positions in operational risk and compliance were filled at the start of 2013; these completed the new senior management risk team and enabled significant improvements to be made in the understanding of the risks being run in these areas
Risk culture • Review, promote and challenge the Bank's risk culture, and seek assurance to satisfy itself that an appropriate risk culture prevails in the organisation • Provide qualitative and quantitative advice to the Remuneration Committee on risk weightings to be applied to performance objectives incorporated in executive remuneration	• The core risk culture was developed, with a re-launch of the Risk control self assessment methodology
Risk appetite, limits and tolerances • Review, challenge and recommend to the Board for approval risk appetite, risk measures, risk tolerance and risk limits • Review, challenge and exercise oversight of capital and liquidity management and advise the Board on strategy for capital and liquidity management • Annually review, challenge and recommend to the Board for approval the ICAAP • Annually review, challenge and recommend to the Board for approval the ILAA	• The Committee reviewed and challenged risk appetite, limits and tolerances providing recommendations to the Board • Liquidity was a concern at times throughout the year. In the first half of the year announcements, including the 2012 results in March, the withdrawal from the Verde transaction in April, the Moody's downgrade in May and the Recapitalisation Plan in June all had the capacity to damage confidence in the Bank and create potential knock on effects on liquidity. Thus, the Committee members discussed and challenged the extent and strength of our liquidity risk management planning. As the year progressed, and the Bank remained in the media spotlight, the frequency of reporting was increased
Business strategy • Provide detailed review and challenge of proposed business strategy giving consideration to the impact on the Bank's risk profile and make recommendations to the Board • Ensure an appropriate due diligence is carried out focusing on risk aspects and implications for risk profile and appetite when advising the Board on strategic acquisitions or disposals	• Plans to strengthen the Bank's capital base started to be developed in early 2013 and continued for much of the year. While progress on these was reported to the Committee, the subject was of such significance to the future of the Bank that the full Board were engaged in their consideration with Committee members providing appropriate oversight and challenge • The Committee met regularly to review and assess the risks associated with the proposed acquisition of the Verde business from Lloyds Banking Group, providing oversight and challenge

Risk Committee report continued

Principal responsibilities of the Board Risk Committee	Key areas discussed and reviewed by the Committee in 2013 include
Risk monitoring	
• Consider, oversee and advise the Board on, and provide challenge on the Bank's exposure to, all significant risks to the business, and dedicate clear and explicit focus to current and forward-looking aspects of risk exposure, especially where those risks could undermine strategy reputation or long term viability	• Board Risk Committee receives monthly KPIs
• Review and challenge management's risk mitigation and control remediation actions	
• In cooperation with the Audit Committee, monitor identified control failings and weaknesses that raise systemic risk issues and management actions taken to resolve them	
• Review reports on any material breaches of risk limits and the adequacy of proposed action	
• Consider risks posed to the Bank by the current and prospective macroeconomic and financial environment, drawing on financial stability assessments such as those published by the Bank of England, the Prudential Regulation Authority, the Financial Conduct Authority and other authoritative sources that may be relevant for the Bank's risk policies when preparing advice for the Board	• In light of the significant additional impairment recognised in the 2012 accounts, the Committee received regular reports on the largest corporate exposures where management considered there was a risk of losses
Regulatory risks and Compliance	• The Committee approved the 2013 annual compliance monitoring plan and received information in regards to material escalated Conduct Risk issues identified during 2013
• Review and approve the annual regulatory monitoring plan and the	• The Committee also received updates from the CRO in relation to ongoing appropriateness of the compliance function
• reasons for any significant changes to the plan, taking into account the regulatory risks identified from time to time	
• Review, consider and challenge regular reports from the Compliance Officer and keep under review the adequacy and effectiveness of the Bank's compliance function	
Risk Reporting	
• Receive reports, findings and recommendations from the Executive Risk Committee noting significant issues	• The Risk Committee considered reporting on the anti-bribery and corruption framework
• In co-operation with the Audit Committee, review and approve the statements to be included in the annual report concerning internal controls and risk management	
Chief Risk Officer	
• Recommend to the Board the appointment and/or removal of the Chief Risk Officer	
• Review the resignation of the Chief Risk Officer and make a recommendation to the Board about its acceptance	
• Meet at least once a year with the Chief Risk Officer without the presence of management	

Nomination Committee report

Introduction by Nomination Committee Chairman

"The main focus of the Nomination Committee since its inception has been the reorganisation and strengthening of the Board but due to the importance of this issue a lot of the discussions on this have been conducted in main Board meetings."

Richard Pym
Nomination Committee Chairman

Purpose of the Nomination Committee

To review and make recommendations on the Board composition, succession planning for Executive Directors, Non-Executive Directors and certain Senior Executives, identifying and nominating candidates for Board vacancies and evaluation of candidates for the Board.

Current Nomination Committee	Appointed
Richard Pym (Chair)	17 July 2013
Richard Coates	17 July 2013
Graeme Hardie	17 July 2013
Dennis Holt	25 February 2014

Previous members	Appointed	Resigned
Bennett Reid	17 July 2013	09 October 2013

During 2013 the Nomination Committee considered appointments of Non-Executive Directors to the Board and key Executive appointments. The Bank has engaged external search consultancy JCA Group to assist in the search for Non-Executive Directors. Spencer Stuart have been retained by those shareholders (other than the Co-operative Group Limited) which may nominate two Non-Executive Directors under the Relationship Agreement (details of which can be found within this report). Neither JCA Group nor Spencer Stuart have any connection with the Bank.

During 2014 the Nomination Committee intends to develop a policy to promote diversity on the Board in recognition that a diverse Board represents the views of society, brings a wide range of skills and knowledge to the Board and enhances challenge and discussion from a diverse range of viewpoints. Such policy will include a target for the representation of the underrepresented gender on the Board (currently women). At the end of 2013, of the nine Directors on the Bank's Board two were women.

Values and Ethics Committee report

Introduction by Values and Ethics Committee Chairman

"I am pleased to present the first report of the Bank's newly-created Values and Ethics Committee (V&E Committee). The V&E Committee's Terms of Reference were approved on 1 November 2013 and can be found on the Bank's website. The Committee met for the first time on 29 January 2014."

Richard Pym
Values and Ethics Committee Chairman

Purpose of the Value and Ethics Committee

To recommend to the Board for its approval and adoption the Co-operative Values and Ethical Policies of the Bank.

The members of the V&E Committee are as follows:

Current members	Appointed	Resigned
Richard Pym (Chair since 13 December 2013)	13 December 2013	
Richard Coates	13 December 2013	
Anne Gunther	13 December 2013	
Graeme Hardie	13 December 2013	
Merlyn Lowther	13 December 2013	
Bill Thomas	13 December 2013	
Alistair Asher	29 January 2014	24 March 2014

The V&E Committee was constituted on 1 November 2013 demonstrating the Bank's commitment to promoting and conducting its business in accordance with the established values of The Co-operative Movement. The Board has commenced its search for an Independent Director to chair the V&E Committee. The Co-operative Group has the right to appoint and remove one of its appointees to the Committee whilst it indirectly or directly holds 20% or more of the ordinary shares of the Bank. Alistair Asher was the Group's nominee until his resignation on 24 March 2014. The Group has currently chosen not to appoint a member of the Board.

The Committee will meet at least twice a year and will prepare an annual report for approval by the Board.

The V&E Committee Chairman, together with other members of the Committee will attend the Bank Annual General Meeting to answer any shareholder questions on the Committee's activities.

Values and Ethics Committee report continued

Principal responsibilities of the Value and Ethics Committee	Key areas discussed and reviewed by the Committee in 2013 include
• Recommends to the Board for approval and adoption the Co-operative Values and Ethical Policies of the Bank • Advise the Board on matters concerning the interests of customers, suppliers, employees and other stakeholders in their dealings with the Bank in line with the objectives of the Bank as described in the Articles of Association for: i. legal and regulatory requirements applicable to the Bank and its Directors; ii. the need for the Bank's operations to be commercially sustainable and profitable; and iii. the desirability of maintaining and enhancing the public reputation and image of the Bank. • Monitor and report to the Board on: i. customer satisfaction levels (with a focus on service levels and on products in the light of the Bank's Ethical Policies, in each case assessed by reference to relevant customer metrics); ii. alignment of treatment of the Bank's customers with its Values and Ethical Policies; iii. alignment of employee training and culture with its Values and Ethical Policies; iv. corporate social responsibility, community investment, environmental and other projects and activities of the Bank; v. the establishment of a clear ethical policy and ethical strategy informed by customer consultation that aligns with the commercial strategy and is reviewed annually; vi. the extent to which executive remuneration policies are consistent with the Bank's Values and Ethical Policies; vii. provision of products and services to sectors/organisations with clear social justice or community benefit purpose; viii. the development of products and services with 'ethical' features; ix. the Company's approach to improving the social and environmental impacts of the Bank's own operations; and x. the choice of suppliers, partners and third party relationships which should be informed by the Bank's 'ethical' policy.	• Committee discussed and approved the adoption of six interim ethical principles to drive the direction of change until a new set of principles could be developed • Approval of the ethical consultation timetable and questionnaire • Approval of the decision making framework whereby Executive Committee (ExCo) makes recommendations to the Committee for its approval. The establishment of a working group of Bank colleagues was also approved • Metrics for the Committee to be determined and established during 2014

Board effectiveness

Performance evaluation

During the 2013 financial year, the Bank did not satisfy the Code provision regarding external evaluation of the Board. The Board last underwent an external evaluation exercise of its effectiveness at the end of 2010, and an external review had been planned for 2013. In view of the significant change in the composition of the Board, and the focus on the Recapitalisation, an external evaluation has been postponed until late 2014.

An internal self-assessment of Board effectiveness took place at the end of 2013. The Directors were asked for their individual views on the composition and membership of the Board, the way the Board works, the role of Committees and learning and development opportunities. The outcome of the self assessment noted that the new Board composition, and the focus of the Board on the Recapitalisation Plan meant that assessing performance was difficult. The Board recognised that the steps which had been taken to change the composition of the Board during 2013, together with a continuing focus on strengthening specific areas of expertise on the Board, would assist the Board in becoming more effective.

The Board recognises the requirement to undertake a formal and rigorous annual evaluation of its own performance and that of its Committees and individual Directors.

As the majority of the Directors have been appointed during 2013, the Chairman intends to evaluate the contribution and commitment to the role of each Director during 2014 and to carry out individual assessments with each of the Directors during 2014 and early 2015 when they have served at least 12 months in office.

During 2014, the Non-Executive Directors, led by Dennis Holt as the Senior Independent Director, will be responsible for the performance evaluation of the Chairman, taking into account the views of Executive Directors.

Induction and continuing professional development

All newly appointed Directors undertake a structured induction programme which is designed to provide them with key business information about the Bank, and includes briefing sessions with members of the Executive team and a branch visit.

As part of the approved persons process, an individual training plan is designed for each Director which is reviewed periodically. Collective training sessions are scheduled to take place on a regular basis the evening before Board meetings but due to the exceptional events of 2013 much of the scheduled training did not take place and the allocated training sessions were used to consider urgent business issues. In the last quarter of 2013, the Board undertook training on Basel III and sessions to assist their understanding of the new Bank strategy and Recapitalisation Plan.

In addition to formal training sessions, the Directors, where appropriate, have one-to-one sessions with members of the Executive.

An electronic ‘Reading Room’ is available as a resource to enable the Directors to access, revisit and review copies of presentations and materials from formal development sessions.

The Chairman addresses the development needs of the Board as a whole, with a view to developing its effectiveness. He ensures that the Directors’ professional development needs are identified and that they are adequately informed about the Bank and their responsibilities as Directors.

Conflicts of interest

Pursuant to the Companies Act 2006, the Directors have a duty to avoid situations in which they have or may have interests that conflict with those of the Bank unless that interest is first authorised by the other Directors. The Bank’s Articles of Association allow the Board to authorise such potential conflicts and there is a procedure to deal with actual or potential conflicts. Directors are reminded, at each Board meeting, of their duty to report actual or potential conflict as soon as they become aware of any such events. All potential conflicts approved by the Board are recorded in the Conflicts of Interest Register which is reviewed by the Board annually. The Board considered the Conflicts of Interest Register at the beginning of 2014 and was satisfied that all potential conflicts had been appropriately considered and approved. The Board has determined that a Director with a potential or actual conflict will not be permitted to form part of the quorum or vote upon the matter giving rise to the conflict.

Prior to taking up any external appointment or responsibilities, Directors are asked to consult with the Company Secretary and the Chairman.

Directors and their interests

No Director had a material interest at any time during the year in any contract of significance, other than a service contract, with the Bank or any of its subsidiary undertakings.

No Director had a beneficial interest in any shares in the Bank.

Insurance and indemnities

During 2013 the Bank, through its then parent company the Co-operative Group Limited, maintained appropriate Directors’ and Officers’ liability insurance. The Bank itself now holds appropriate Directors’ and Officers’ liability insurance in respect of legal action against its Directors and Officers. In addition, qualifying third party indemnity provisions (as defined by section 234 of the Companies Act 2006) were put in place during the 2013 financial year for the benefit of the then Directors and, at the date of this report, are in force for the benefit of the Directors and Officers in relation to certain losses and liabilities which they may incur in connection with their appointment.

Professional advice and Board support

A number of external consultants provide from time to time professional advice to the Board. There is an agreed procedure by which the Directors may take independent professional advice at the Bank’s expense in furtherance of their duties.

Statutory disclosures information

Share capital structure, transfer restrictions and takeover bid related disclosures

As provided in the Bank's Articles of Association, the Bank has two classes of share capital; ordinary shares, representing 80% of the total share capital, and preference shares representing 20% of the total share capital. For information about the ownership of each class of shares, please see the Corporate Governance Report – Relations with Shareholders on page 41.

Transfer of shares

Shareholders may transfer any shares in any manner which is permitted by law and is from time to time approved by the Board. PRA approval is required if a person intends to acquire or increase its 'control' of a UK authorised person (which includes the Bank). Acquiring 'control' includes where a person first holds 10% or more of the shares or voting power in the Bank. Increasing control means when an existing shareholder increases their shareholding or entitlement to voting power from a holding below certain thresholds to a holding above them. The thresholds are 10%, 20%, 30% or 50% of shares or voting power.

Voting rights

Subject to the Bank's Articles of Association and to any special rights or restrictions as to voting for the time being attached to any shares, the provisions of the Companies Act 2006 shall apply in relation to voting rights of the Bank's shares.

Ordinary shareholders are entitled to vote at general meetings and appoint proxies. On a show of hands, every member or proxy has one vote. On a poll, every member present in person or by proxy has one vote for every share held. Ordinary shareholders may receive (1) dividends, (2) assets upon the liquidation of the Bank and (3) capital payments through the capitalisation of reserves as provided in the Bank's Articles of Association.

In connection with the LME, the Co-operative Group Limited acquired the entire issued amount of the Bank's preference shares, and signed a deed of waiver waiving any rights to income and capital in respect of the preference shares. As holder of the preference shares, the Co-operative Group Limited has the right to speak and vote at a general meeting of the Bank if (1) its rights are being varied or (2) the Bank is being wound up or there is other return of capital.

Rights attaching to the preference shares can only be varied by consent of the holder of the preference shares. The Bank's Articles of Association require this consent to be obtained for certain:

- issuances of shares or grants of any rights to subscribe for or to convert shares or other securities into share capital ranking in priority to or pari passu with the preference shares or being capable of being redeemed whilst any of the preference shares are in issue, or the variation of the rights of any class of shares so as to fall within the foregoing; and
- repayments or reductions in the Bank's share capital.

Statement of Directors' responsibilities in respect of the Annual Report and Accounts and the financial statements

The Directors are responsible for preparing the Annual Report and Accounts and the consolidated financial statements of The Co-operative Bank plc and its subsidiaries (the Bank) and parent company financial statements for The Co-operative Bank (the parent company) in accordance with applicable law and regulations.

Company law requires the Directors to prepare Bank and parent company financial statements for each financial year. Under that law they have elected to prepare the Bank and the parent company financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and applicable law.

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 Bank and parent company and of their income statement for that year. In preparing each of the Bank and parent company financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with IFRSs as adopted by the EU; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Bank and the parent company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the parent company's transactions and disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Bank and to prevent and detect fraud and other irregularities.

The Directors are also responsible for preparing, in accordance with applicable laws and regulations, a Strategic Report, Directors' report and Corporate Governance Statement that complies with that law and those regulations. The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

The Directors consider the Annual Report and Accounts and financial statements, taken as a whole, to be fair, balanced and understandable and provide the information necessary for shareholders to assess the Company's performance, business model and strategy.

Disclosure of information to the Auditor

So far as the Directors are aware, there is no relevant Audit information of which the Bank's Auditors are unaware, and the Directors have taken all steps that they ought to have taken as Directors in order to make themselves aware of any relevant Audit information and to establish that the Bank's Auditors are aware of that information.

We confirm that to the best of our knowledge:

- the financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and income statement of the Company and the undertakings included in the consolidation taken as a whole; and
- the Directors' report includes a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

By Order of the Board

Richard Pym
Chairman
10 April 2014

Directors' Remuneration report

Introduction by Remuneration Committee Chairman

"The main focus of the Remuneration Committee has been to ensure remuneration attracts and retains the talent required to lead the Bank going forward. It also ensures that an overall view of remuneration is taken throughout the Bank by recommending the overarching principles and parameters for the remuneration policy across the Bank."

Anne Gunther
Remuneration Committee Chairman

Purpose of the Remuneration Committee

To determine remuneration for the Executive Directors and the Executive Committee of the Bank and to set and recommend to the Board for approval, the overarching principles and parameters of the remuneration policy across the Bank to ensure an overall coherent approach to remuneration for all employees. In addition, the Remuneration Committee ensures remuneration is compliant with the Prudential Regulation Authority's Remuneration Code for the relevant individuals.

Until October 2013, there was a Remuneration and Appointments Committee for all Co-operative Banking Group companies. On 17 July 2013 the Bank established a Remuneration Committee and responsibility for the remuneration of Bank Executive Directors transferred to this committee.

For the role of Chief Executive of the Bank, prior to 17 July 2013 the remuneration for this role was governed by The Co-operative Group Remuneration and Appointments Committee and from this date is governed by the Bank Remuneration Committee.

Prior to 17 July 2013: the Co-operative Banking Group Limited Remuneration and Appointments Committee		From 17 July 2013: the Bank Remuneration Committee		
	Resigned		Appointed	Resigned
Paul Flowers	5 June 2013	Anne Gunther (chairman)	17 July 2013	
David Davies	12 June 2013	Richard Coates	9 October 2013	
Anne Gunther	9 October 2013	Graeme Hardie	9 October 2013	
Duncan Bowdler	9 October 2013	Dennis Holt	25 February 2014	
Peter Marks	16 May 2013	Leonard Wardle		9 October 2013
Leonard Wardle	19 November 2013	Duncan Bowdler		9 October 2013

A Remuneration Committee met a total of 9 times during 2013 to discuss Bank remuneration matters.

The Bank Chief Executive, the General Counsel and the HR Director are invited to attend the meetings of the Committee, but are not present when their own remuneration or terms and conditions are being considered. Other individuals are invited to attend for specific agenda items when necessary.

Further detail on the Bank Remuneration Committee, the members, advisers and the Terms of Reference are included in this report.

Further detail on the Bank Remuneration Committee (the Committee)

The Committee members are all Non-Executive. They have no personal financial interests in the Committee's decisions and they have no involvement in the day-to-day management of the Bank. The Bank's Board believes that all members of the Committee are independent for the purpose of reviewing remuneration matters.

Adviser

To ensure that it received independent advice on remuneration matters, throughout the 2013 year, the Committee used New Bridge Street (an Aon Hewitt company) as its independent adviser. New Bridge Street supplied survey data and advised on market trends and other general remuneration issues. Other than specialist advice in relation to the Bank's remuneration issues, New Bridge Street did not provide other services to the Bank and on that basis, the Committee considered New Bridge Street to be operating in an independent manner.

New Bridge Street is a signatory of the Remuneration Consultants Code of Conduct which requires its advice to be objective and impartial. In addition, Mischon de Reya has provided legal advice on matters pertaining to remuneration.

Directors' Remuneration report continued

Principal responsibilities of the Remuneration Committee	Major events relating to remuneration during the year
The Committee's Terms of Reference were approved by the Board on 1 November 2013. The principal responsibilities of the Committee are:	
• Set and recommend to the Board for approval the overarching principles and parameters of the remuneration policy across the Bank to ensure a coherent approach to remuneration, having regard to the risk appetite of the Bank; • Determine policy on remuneration and other main terms and conditions of employment in respect of all Bank employees who are members of the Bank Executive, being Executive Directors and members of the Executive Committee (Executives); • Receive, review and decide on issues raised in relation to retirement benefit schemes across the Bank and advise the Board on these Issues as appropriate;	• As an unquoted company, there is no requirement for the Bank to prepare a remuneration report. In the interests of good practice, the Bank has applied, where possible and appropriate, the new quoted company disclosure requirements applicable as a guideline for disclosing the remuneration of its Executive Directors. As in previous years, this report will be put forward for an advisory vote at the 2014 Annual General Meeting (AGM). • Following the Bank ceasing to be a wholly owned subsidiary of The Co-operative Group in December 2013, the Bank is developing a new director remuneration policy that will be appropriate going forward as an independent business, with the intention of aligning the interests of Directors with the Interests of shareholders in a manner consistent with the Bank's risk appetite. • Whilst the new remuneration policy is being developed, the Committee does not consider it appropriate to put it forward for a vote at the 2014 AGM. It is the current intention to put this new remuneration policy forward for a shareholder vote at the earliest appropriate stage in the future.
• Oversee contractual arrangements for Executives and approve the principal terms and conditions of their employment; • Review remuneration using comparisons against market benchmarks for the Executive roles; • Determine remuneration packages for Executive appointments; • Determine and review the policy for all incentive plans in accordance with the agreed remuneration policy and approve any amendments to all incentive plans, prior to obtaining any necessary Board and shareholder approval. Determine awards and authorise payments under incentive plans, subject to the achievement of performance and balanced scorecard metrics, and relevant underpin as applicable, and in accordance with rules of the plan.	• The business challenges articulated in the Chairman's and CEO's messages are reflected in the impacts on remuneration schemes, including those of Executive Directors, as detailed in the following report. Since the year end, the Committee has given due consideration to the impact of certain actions on business performance and has agreed the application of malus, under which payments due or potentially due to vest in the 2014 financial year under variable remuneration schemes are reduced to zero. The Committee is liaising with the Prudential Regulation Authority (PRA) to ensure this process is carried out in a satisfactory manner. As a result of the application of malus, performance hurdles not being met, and/or individuals leaving the Bank, a total of £4.97m will not be payable under variable remuneration schemes, including amounts which would have been payable in 2014 and amounts potentially due in the future. It also includes potential payments due to former Executive Directors which are now no longer payable.
• Review and agree the remuneration policy and decisions relating to remuneration including variable pay for individuals who are included on the Bank's register of 'Code Staff' for the purposes of the PRA Remuneration Code.	• As a level 1 Firm under the PRA Remuneration Code, for performance periods commencing on or after 1 January 2014, the Bank will be required to implement a ratio limiting the amount of variable pay when compared to fixed pay that it may award to Code Staff (that is, its senior managers, control functions and risk takers, together with those individuals who fall into the same remuneration bracket as the aforementioned and who could have a material impact on the firms risk profile). Whilst it is not the Committee's immediate intention to use an increased ratio, it does intend to ask shareholders at the AGM to approve an increase in the ratio from 1:1 to 1:2, to allow the Committee flexibility to use the increased limit where needed.

The Terms of Reference of the Committee are available on the Bank's website.

Annual Report on Remuneration

Single figure of remuneration

The table below shows the earnings of those appointed as or who served as an Executive Director during 2013. Where an individual served as an Executive Director for part of the year, the figures shown represent earnings for the period that they were appointed or served as an Executive Director.

Table 1 – Executive Directors

	Date of appointment	Date of resignation	**Basic salary 2013 £'000**	**Taxable benefits[3] 2013 £'000**	**Annual performance related bonus[4] 2013 £'000**	**Long term performance related bonus[5] 2013 £'000**	**Pension[6] 2013 £'000**	**Other[7] 2013 £'000**	**Total 2013 £'000**	Basic salary 2012 £'000	Taxable benefits[3] 2012 £'000	Annual performance related bonus[4] 2012 £'000	Long term performance related bonus[5] 2012 £'000	Pension[6] 2012 £'000	Total[8] 2012 £'000
Niall Booker[1]	11 June 2013	–	**669**	**10**	**–**	**–**	**111**	**943**	**1,733**	–	–	–	–	–	–
Rod Bulmer	18 May 2013	28 February 2014	**272**	**11**	**–**	**–**	**43**	**–**	**326**	–	–	–	–	–	–
Barry Tootell[2]	4 April 2008	10 May 2013	**191**	**7**	**–**	**–**	**41**	**–**	**239**	513	17	–	–	101	631
Total			**1,132**	**28**	**–**	**–**	**195**	**943**	**2,298**	513	17	–	–	101	631

1. Niall Booker was appointed as CEO on 10 June 2013.
2. Barry Tootell was placed on garden leave and stepped down as an Executive Director on 10 May 2013 and resigned on 13 December 2013. The figures in the table above are for the period 1 January 2013 to 10 May 2013. His earnings for the period whilst he was on garden leave (11 May 2013 to 13 December 2013) were: base salary £312,000; benefits in kind £16,000; and pension benefits £61,000. Barry Tootell maintained his car and healthcare benefits until 27 December 2013 (equivalent value is less than £1,000).
3. Taxable benefits include company car, car allowance, employee member dividend, and healthcare benefit and the figures represent the period of time the individual served as an Executive Director.
4. Annual performance related bonus refers to the bonus in respect of the 2013 financial year. No annual bonus payments were made to Executive Directors.
5. Long term performance related bonus (ie performance period of more than one year and ending in the 2013 financial year), refers to the 2011–2013 LTIP plan. No payment was made under the 2011–2013 LTIP as the performance measures were not met.
6. Pension includes benefits accrued in the year from participation in pension schemes (using new calculation rules and factor of 20) and cash allowances in lieu of retirement benefits.
7. The package for Niall Booker includes a fixed role based allowance that takes account of the broad range of specialist skills required of the role. The allowance is an amount of £140,000 per month and is payable quarterly in arrears for the period 10 June 2013 to 10 June 2015 at which point it will be reviewed in the context of the overall package structure. Payment of the allowance is subject to meeting minimum Pillar 1 capital requirements.
8. Figures for the 2012 year have been restated and recalculated in accordance with the new rules.

Total pension entitlements

Table 2 – Executive Directors

The table below shows the pension entitlements for the Executive Directors. Comparative figures for the prior year are shown in brackets.

The table includes those individuals who were appointed or who served as Executive Directors during the year ended 31 December 2013 and shows their pension benefits that relate to the period they were appointed as Executive Directors.

Total defined pension benefit is that which would be paid annually on retirement at normal retirement age based on service to 31 December 2013 (or the date of ceasing to be an Executive Director). There is no additional pension benefit payable in the event of an Executive Director's early retirement.

Pension scheme members have the option of paying additional voluntary contributions. Neither any contributions paid nor any benefits arising from them are shown in the above table.

	Years of service	Total defined benefit pension accrued at 31 December 2013 £'000	Increase in defined benefit pension during year (gross of inflation) £	Increase in defined benefit pension during year (net of inflation) £	Value of previous column x 20 (net of members contributions) £'000	Employer contributions to defined contribution pension £'000	Payment in lieu of pension benefit £'000	Total pension benefits £'000	Defined benefit pension normal retirement date (Age)
Niall Booker[1]	0	–	–	–	–	–	111	111	–
Rod Bulmer[2]	6	29	1,923	1,327	18	–	25	43	65
Barry Tootell[3]	5	29	1,918	1,358	22 (47)	–	19 (54)	41 (101)	65

1. Niall Booker was paid a pension allowance in lieu of pension provision.
2. Rod Bulmer was appointed as an Executive Director on 18 May 2013 and resigned on 28 February 2014. He had a restricted pension accrual based on a capped salary and was paid a restricted pension allowance.
3. Barry Tootell was placed on garden leave and stepped down as an Executive Director on 10 May 2013 and resigned on 13 December 2013. He had a restricted pension accrual based on a capped salary and was paid a restricted pension allowance.

Directors' Remuneration report continued

Long Term Incentive Plan (LTIP) scheme interests

The table below shows the LTIP interests for Executive Directors, including awards made and lapsed in the year. LTIP awards made in 2011, 2012 and 2013 were under The Co-operative Group LTIP scheme and are to be satisfied in cash (not shares).

Table 3 – LTIP scheme interests

Name of Executive	Award	Notes	Maximum award opportunity at start of the year £	Maximum 2013-2015 award opportunity granted £	Awards vested in the year £	Awards lapsed in the year £	Maximum award opportunity at end of the year £
Executive Directors as at 31 December 2013							
Niall Booker	2013–2015	1	–	1,200,000	–	–	1,200,000
Rod Bulmer	2012–2014	2	307,500	–	–	131,024	176,476
	2011–2013	3	300,000	–	–	300,000	–
Former Executive Directors							
Barry Tootell	2012–2014	4	512,500	–	–	512,500	–
	2011–2013	3	407,500	–	–	407,500	–
Tim Franklin	2011–2013	3	101,750	–	–	101,750	–
Phillip Lee	2011–2013	3	118,708	–	–	118,708	–
Neville Richardson	2011–2013	3	238,000	–	–	238,000	–

1. Niall Booker was granted a 2013-2015 LTIP award under The Co-operative Group LTIP plan. Following the Bank's separation from The Co-operative Group, it was agreed that 2/3rds of the award would be transferred to a new Bank LTIP plan when this is implemented, and the remaining 1/3rd will remain subject to the original performance measures and performance period, and any payments relating to this 1/3rd will be settled by The Co-operative Group. The original performance measures are based on specific turnaround objectives including recapitalisation of the Bank, cost savings and other business critical issues.
2. Rod Bulmer announced his intention to resign on 20 September 2013 and was deemed by the Bank Remuneration Committee as a good leaver. As a result he was entitled to retain a pro-rated part of his 2012-2014 LTIP award. Since the year end, the Committee has decided to operate a malus adjustment to all outstanding awards under the 2012-2014 LTIP including the portion retained by Rod Bulmer (maximum of £176,476 in the table above), and consequently all opportunities were reduced to zero.
3. The performance measures and underpins for the 2011-2013 LTIP awards were not met and therefore no payments were due and the awards lapsed.
4. Barry Tootell resigned on 13 December 2013 and forfeited his LTIP awards on this date.

Executive Director remuneration policy

Future policy

As discussed above, the Bank is developing a new Director remuneration policy that will be appropriate going forward as an independent business, with the intention of aligning the interests of Directors with the interests of shareholders in a manner consistent with the Bank's risk appetite.

As referred to above, whilst the new remuneration policy is being developed, the Committee does not consider it appropriate to put a future remuneration policy forward for a vote at the 2014 AGM.

Executive Director remuneration policy operated for 2013

The remainder of this section describes the remuneration components and policy that applied to the Executive Directors for 2013.

Table 4 – Remuneration components and policy for 2013 for Executive Directors

Element	Link to strategy	High level details and operation	Opportunity	Change from 2012?
Base salary	To provide a competitive base salary to attract and retain talented leaders needed to guide and lead the Bank.	Base salaries are usually reviewed annually having regard to competitive market practice. Experience and performance levels taken into account when considering increases.	For the year 2013, there were no annual salary increases for Executive Directors.	No
Role based allowance	To achieve a competitive total remuneration package in order to attract and retain the key talent needed to reflect the role, skills and experience of the individual.	The allowance can be in place for a limited period of time (for example 24 months) and will be paid in cash. Payment of the allowance is not subject to personal performance conditions. The allowance is non-pensionable. The role based allowance is subject to fixed period and is subject to review once this has expired.	To be determined based on the breadth and depth of the role and the individual.	Yes
Benefits	Competitive benefits proposition ensures talent is attracted/retained and able to undertake duties.	Benefits are provided in line with normal market practice, including car or car allowance, healthcare cover and life cover.	Car allowance £16,000. Healthcare cover at family level.	No
Pension[1]	To provide competitive pension and protection benefits to attract and retain talented leaders.	The Co-operative Group provides either a defined benefit or a defined contribution pension plan (on the same basis as applies to all other employees in The Co-operative Group/Bank) and/or an allowance so that the total value of the pension element is broadly the same as the employer contributions to the defined benefit pension plan.	Defined benefit pension plan accrual (when eligible) and/or cash alternative of up to 16% of salary or employer pension contributions of up to 16% of salary.	No
Annual Incentive Plan (AIP)	To incentivise and motivate colleagues towards achieving specified performance targets.	For 2013, no AIP was operated and the Executive Directors were not eligible for a discretionary bonus.		No
Long Term Incentive Plan (LTIP)	To incentivise senior management towards the achievement of specified long term business related performance targets, and promote the behaviours considered by the Committee to be key to the success of the Bank.	An award was made to Niall Booker under The Co-operative Group '2013–2015 Turnaround LTIP' which is intended to address specific business issues and focus senior management on performance aspects deemed critical to the future success of The Co-operative Group and Bank. Any payments due under the 2013–2015 LTIP will be satisfied in cash. Part of any cash payments under the LTIP made to Executive Directors is deferred for an additional six months and payment of the deferred element is subject to performance conditions.	For awards made in relation to 2013 (the 2013–2015 LTIP awards), the maximum opportunity was 100% of salary.	Yes

1. The Bank participates in the Co-operative Pension Scheme (Pace) which is a registered occupational pension scheme.

Directors' Remuneration report continued

Pension – Pace

Pace includes the defined benefit section (Pace Complete) and the defined contribution sections (Pace Essential and Pace Extra). All employees can choose to join Pace Complete once they have completed two or more consecutive years' service.

- Pace Complete provides defined benefit pensions based on 1/60th of average pensionable earnings, revalued by inflation for each year of pensionable service. Benefits accrued as at 5 April 2006, in respect of membership of the scheme preceding Pace, continue to be linked to final pensionable salary at a member's date of leaving or retirement, whichever is earlier. The scheme also provides pensions to dependants on death.
- Members of Pace Essential, into which all eligible employees will be automatically enrolled, currently pay 1% of pay and the Group pays 2%. Members of Pace Extra, which is available to all employees, currently pay 4% of pay and the Group pays 8%.
- Under all sections a lump sum is payable if death occurs in service.
- All members of Pace have the choice of making pension contributions by salary sacrifice.

Executive Directors who are members of Pace Complete currently contribute 8% of their pensionable salary or 7% of pensionable salary (until October 2013) if they were a contributing member of Pace at 31 December 2011. The Group pays the balance of the cost of providing defined benefits.

Where an Executive Director may be impacted by the Annual Allowance or the Lifetime Allowance, they have the facility of opting out of future pension accrual in favour of a pension allowance or opting for restricted pension accrual based on a capped pensionable salary of £187,500 and receiving a restricted pension allowance in lieu of pension provision based on salary above £187,500. Where paid, the rate of pension allowance is based on the employer contribution rate to Pace Complete. This is currently 16% of pensionable salary.

Executive Directors who join Pace Extra are provided with an additional 8% of pay as a pension contribution or pension allowance for the period they are ineligible to join Pace Complete.

Supplementary life cover is provided to Executive Directors in order to provide total life cover of 4 x salary when aggregated with benefits from Pace, as appropriate.

Additional information

During the year, long term incentives were awarded on the basis that clawback provisions would apply to any payments, under which the Committee could seek to recoup part or all of a payment by reference to subsequent business performance.

Any variable payments made to the Executive Directors are subject to deferral in accordance with the Remuneration Code. Deferred payments are subject to a malus adjustment where the value can be adjusted downwards to take account of specified conditions for example, in an instance of an executive action which leads to customer detriment or if there is a material breach of risk management.

Service contracts and policy on payment for loss of office

It is the Bank's current policy that the notice period in Executive Directors service contracts should not exceed one year, save in the case of Niall Booker, whose contract can be terminated by the Company on not less than 12 months' notice, such notice not to expire prior to 10 June 2015. Niall Booker may terminate his employment by the giving of 6 months' notice to the Bank. All the other Executive Directors have contracts which can be terminated by one year's notice by either party. In the event of termination, the standard payment due to an Executive Director would be based on the value of base salary and other contractual benefits (in the case of Niall Booker, to include any role based allowance which may be due under the terms of his contract). Where it is deemed commercially beneficial for an individual to remain under a contract of employment with the Bank, they are placed on garden leave and only contractual payments are made.

The Committee could exercise its discretion relating to any deferred payments due from previous variable pay awards and could reduce such deferred payments to zero in light of subsequent events.

Non-Executive Directors

Future fee policy

The Bank is developing a new Non-Executive Director fee policy that will be appropriate going forward as an independent business. Whilst the new policy is being developed, the Committee does not consider it appropriate to put a policy forward for a vote at the 2014 AGM.

Fee policy operated for 2013

This section describes the fee policy that applied to the Non-Executive Directors for 2013.

Table 5 – Non-Executive Directors fee policy for 2013

Role	Link to strategy	High level details and operation	Opportunity
Chairman	To pay a fee covering the duties as Chairman of the Bank.	The level of fee is periodically reviewed with reference to comparable market data.	To reflect the skills and experience required for this role.
Independent Non-Executive Director (INED) and Non-Executive Directors	To pay a fee covering the duties as a Director of the Bank.	The level of fee is periodically reviewed with reference to comparable market data. Additional fees for chairing sub-committees of the Board are agreed from time to time	The additional fees vary depending on the duties/committee. The remuneration for a Bank Director is £60,000 per annum. An additional fee of £20,000 per annum is paid for performing the role of Senior Independent Director or Chairman of a Board sub-committee. No further additional fees are payable to the Chairman of the Board or the Senior Independent Director for chairing a Board sub-committee. Certain Non-Executive Directors, who served within Co-operative Banking Group including the Bank, received an aggregate basic fee of £17,361 per annum and additional fees of £2,315 and £3,472 per annum for sitting on The Co-operative Banking Group Remuneration and Appointments Committee and Co-operative Banking Group Audit Committee respectively.

None of the Non-Executive Directors, by virtue of their Board position, participate in any of the incentive plans or pension schemes, nor do they have any performance related elements of remuneration (with the exception of Alistair Asher who during his time as Non-Executive Director of the Bank participated in Group arrangements by virtue of his Group role).

The Non-Executive Directors do not have service contracts, and instead have letters of appointment. The years of their first election are shown in the tables below. All Non-Executive Directors are appointed for a three year term of office subject to satisfactory performance (unless they are filling a casual vacancy), and are subject to annual re-election at the Bank's AGM.

Single figure – Non-Executive Director's fees

During the year 2013, Paul Flowers left the Board and other associated roles under the terms of a compromise agreement. Under the agreement, a total of £95,000 was agreed to be paid by the Co-operative Group Limited, in three instalments. After payment of the first instalment, he was found to be in material breach of the terms of his compromise agreement and as a result, The Co-operative Group considers that the remaining payments under the agreement are not due and repayment of the one payment made is being pursued by The Co-operative Group.

Table 6 – Independent Non-Executive Directors

	Date first appointed	Benefits £'000	2013 fees £'000	2013 Total £'000	2012 Total £'000
Richard Pym (Chairman)[1]	11 June 2013	–	100	100	–
Richard Coates[2]	16 January 2013	–	67	67	–
Anne Gunther[3]	6 September 2011	–	71	71	60
Graeme Hardie[4]	1 May 2013	–	46	46	–
Merlyn Lowther[5]	7 September 2011	–	67	67	71
William Thomas	28 October 2013	–	10	10	–

1. Richard Pym receives a basic annual fee of £180,000 per annum. In addition to which the Bank agrees to pay an annual corporate donation of £20,000 per annum to University of Warwick undergraduate scholarship fund and £100,000 per annum to High Barnet Baptist Church (registered charity number 208653). Both donations paid quarterly in arrears. The total of the donations paid to the charities in 2013 was £67,000.
2. Richard Coates was appointed the Chair of the Co-operative Banking Group Audit Committee from 9 April 2013 until 9 October 2013 and the Chair of the Bank Audit Committee on 30 August 2013. Richard Coates received an additional fee of £11,004 per annum until 1 November 2013 when the fee was increased to £20,000 per annum.
3. Anne Gunther was Chair of the Co-operative Banking Group Remuneration and Appointments Committee from the start of the year until 9 October 2013 and appointed Chair of the Bank Remuneration Committee on 17 July 2013 which ran concurrently with The Co-operative Banking Group Remuneration and Appointments Committee until 9 October 2013. Anne Gunther received an additional fee of £9,000 per annum (covering both committees) to 1 November 2013 when the fee was increased to £20,000 per annum.
4. Graeme Hardie was appointed Chair of the Risk Committee on 21 August 2013 receiving an additional fee of £11,004 per annum until 1 November 2013 when the fee was increased to £20,000 per annum.
5. Merlyn Lowther received a fee of £11,004 per annum for chairing The Co-operative Banking Group Risk Committee from the start of the year until she stepped down on 21 August 2013.

Directors' Remuneration report continued

Table 7 – Non-Executive Directors

	Date first appointed	Benefits £'000	2013 fees £'000	2013 Total £'000	2012 Total £'000
Alistair Asher[1]	31 December 2013	–	–	–	–

1. Alistair Asher is an employee of the Co-operative Group Limited and his fees of £60,000 per annum are payable to The Co-operative Group. Alistair Asher resigned from the Board on 24 March 2014.

Dennis Holt was appointed on 3 February 2014 and did not receive any fees during the year 2013.

Table 8 – Former Non-Executive Directors

	Date of resignation	Benefits £'000	2013 fees £'000	2013 Total £'000	2012 Total £'000
Duncan Bowdler[1]	9 October 2013	–	16	16	22
Paul Flowers[2,3]	5 June 2013	–	53	53	125
Bennett Reid[4]	31 December 2013	–	27	27	20
Euan Sutherland	31 December 2013	–	–	–	–
Leonard Wardle[5]	9 October 2013	–	13	13	20
Peter Marks[6]	16 May 2013	–	–	–	–
Martyn Wates[6]	5 June 2013	–	–	–	–

1. Duncan Bowdler received a fee of £17,361 per annum for his role on the Co-operative Banking Group Board and additional fees of £2,315 per annum for sitting on the Co-operative Banking Group Remuneration and Appointments Committee until 9 October 2013 and the Bank Remuneration Committee from 17 July 2013 to 9 October 2013, and £3,472 per annum for his appointment to The Co-operative Banking Group Audit Committee until 30 August 2013.
2. The fee paid to Paul Flowers was in respect of his role as Chair of the Co-operative Banking Group and the Co-operative Bank Boards until he stepped down from the Board and Co-operative Group Deputy Chair on 5 June 2013.
3. Subject to the terms and conditions of a compromise agreement dated 14 June 2013, The Co-operative Group agreed to pay Paul Flowers compensation for the termination of appointments in the sum of £95,000 to be paid in three instalments. The first instalment of £31,000 gross was paid on 28 July 2013. Paul Flowers has since been found to be in breach of the material provisions of the compromise agreement and, under the terms of this agreement, the instalment paid is recoverable as a debt, together with all costs. The return of this instalment is being pursued. The Co-operative Group, accordingly, considers it has no obligation to pay the second and the third instalments of £32,000 each which were due to be paid 12 months and 24 months after the first instalment respectively.
4. Bennett Reid received a fee of £17,361 per annum for his role on the Co-operative Banking Group Board and an additional fee of £3,472 per annum for his appointment to the Co-operative Banking Group Audit Committee until 9 October 2013 and the Bank Audit Committee from 30 August 2013 to 9 October 2013. With effect from 1 November 2013, Bennett Reid received a fee of £60,000 per annum for sitting on the Bank's Board until he stood down on 31 December 2013.
5. Leonard Wardle received a fee of £17,361 per annum for his role as a Director on the Boards of the Co-operative Banking Group including the Co-operative Bank. Leonard Wardle stepped down from the Co-operative Bank Board with effect from 9 October 2013.
6. Peter Marks and Martyn Wates, who were employees of the Co-operative Group Limited and were entitled to fees of £17,361 per annum for sitting on the Boards of the Co-operative Banking Group including The Co-operative Bank, both agreed to waive their fees.

Table 9 – Former Independent Non-Executive Directors

	Date of resignation	Benefits £'000	2013 fees £'000	2013 Total £'000	2012 Total £'000
David Davies[1]	12 June 2013	–	35	35	90
Peter Harvey[1]	9 October 2013	–	50	50	69
Robert Newton	9 October 2013	–	46	46	97

1. David Davies and Peter Harvey were appointed as the Deputy Chairs of The Co-operative Banking Group including The Co-operative Bank received an additional fee of £15,720 per annum until they stepped down on 12 June 2013 and 9 April 2013 respectively.

Directors' Remuneration report continued

Pillar 3 disclosures

As part of its responsibilities, the Bank Remuneration Committee also oversees remuneration for individuals who are included on the Bank's register of 'Code Staff'. As noted within this Directors' Remuneration Report, a new remuneration policy is being developed for Directors. In addition and as part of the same exercise, a new remuneration policy will be developed and adopted for Code Staff.

It is intended that the new remuneration policy will be based on linking pay to performance and ensuring that any remuneration arrangements are consistent with the Bank's risk appetite. Any variable remuneration arrangements in place will incorporate performance conditions that support the Bank's strategy and also comply with the provisions of the PRA Remuneration Code.

The current policy operated for Code Staff is based on the following:

- Code Staff are defined as those staff having a material impact on the Bank's risk profile, including a person who performs a significant influence function for the Bank, a senior manager and a risk taker.
- Decisions on remuneration for Code Staff are made by the Committee. Advice is taken from the Risk function in making remuneration decisions. The design of the component parts of remuneration is as set out for the Executive Directors above.
- For Code Staff, performance related pay is risk adjusted through the use of underpins to the incentive arrangements, together with the use of deferrals, clawback and malus adjustments in accordance with the PRA Remuneration Code, as set out for the Executive Directors above.

Table 10 – Total remuneration in respect of Code Staff (Pillar 3 requirement)

	Total remuneration[1] £'000	Total fixed remuneration[2] £'000	Total variable remuneration[3] £'000	Annual incentive plan/ discretionary bonus[4] £'000	Long term incentive plan[5] £'000	Sign on payments £'000	Severance payments made in year[6] £'000
Senior Management 25	4,462	4,462	–	–	–	–	469
Other Code Staff 18	2,608	2,566	41	41	–	–	887

The table above represents the emoluments of Code Staff in relation to their services for The Co-operative Bank Plc for the year 2013, and includes any Executive Directors already disclosed in Table 1.

1. Total remuneration consists of base salary, allowances, employer pension contributions and any amounts earned under incentive schemes.
2. Total fixed remuneration consists of base salary, allowances and employer pension contributions.
3. Total variable remuneration includes amounts earned in the year under incentive schemes, including discretionary bonuses.
4. No bonus is payable under the 2013 Annual Incentive Plan. A discretionary bonus was paid to certain individuals, and the amount in the table above represents the amounts paid to Code Staff.
5. The incentive arrangements for 2014 are being reviewed and therefore there are no potential awards for 2014 to include in this column.
6. Severance payments are in respect of redundancy for both Senior Management and other Code Staff. Severance terms include both redundancy payments and the buyout of notice. Severance payments were made to four individuals and the highest total payments to a single person was £373,500.

Senior Management consists of Executive Directors, members of the Executive Committee and Non-Executive Directors.

Table 11 – Deferred remuneration in respect of Code Staff (Pillar 3 requirement)

	£'000
Deferred unvested remuneration outstanding at 1 January 2013	4,970
Deferred remuneration awarded in 2013	–
Deferred remuneration reduced in 2013 through performance adjustments	–
Deferred remuneration vested in 2013	–
Deferred unvested remuneration outstanding at 31 December 2013	4,970
Post year end adjustments:	
Deferred remuneration reduced since the year end through performance adjustments	(4,970)
Deferred unvested remuneration outstanding at 31 March 2014	–

Deferred remuneration includes awards for the performance years 2010, 2011 and 2012. As above, since the year end, the Committee has decided to apply malus to all deferred remuneration in light of recent events, and following this decision, the £4.97m is no longer due.

Number of high earners earning €1m or more

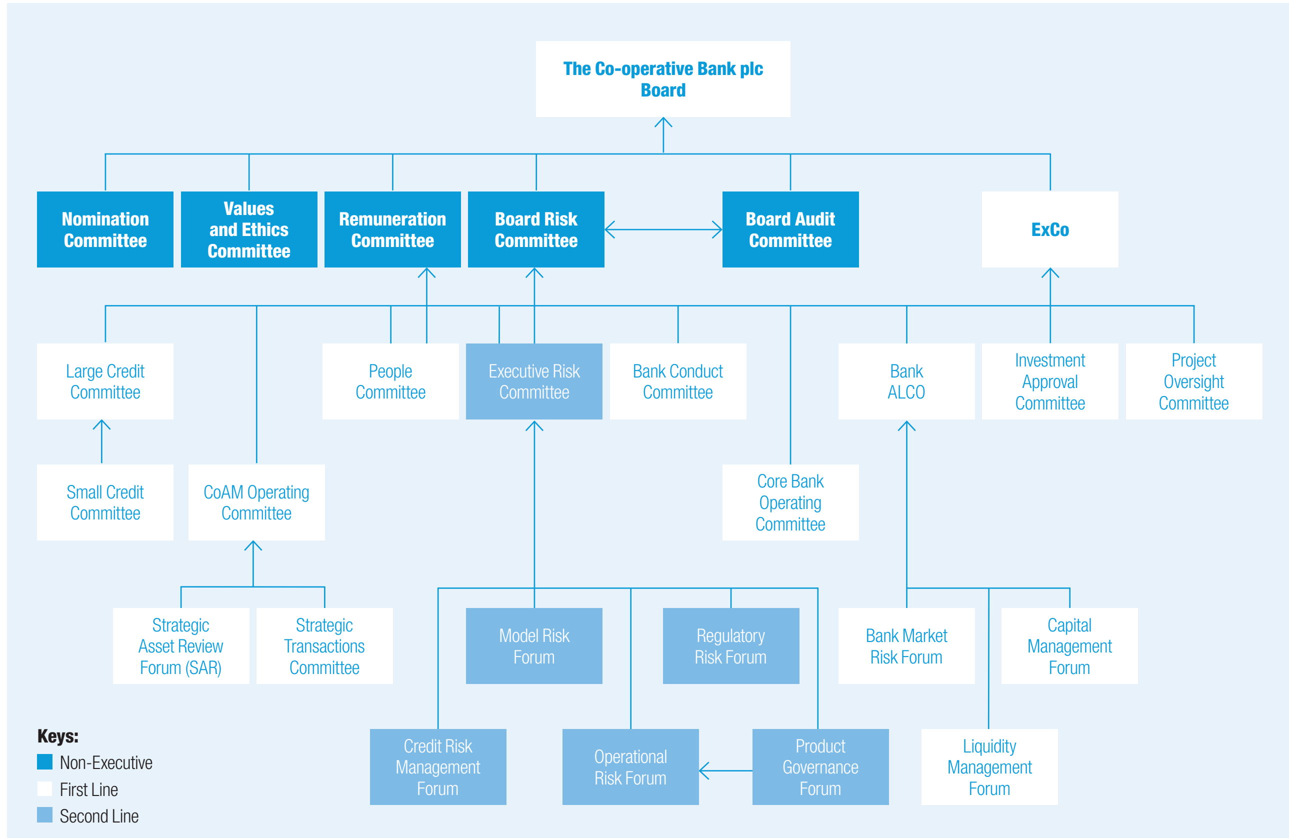
In accordance with Article 450 of the Regulation under CRD IV, the number of Code Staff who earned more than €1m in 2013 was 1 and their total remuneration falls in the band €2–2.5m. For the avoidance of doubt, this individual is included in the disclosures in Table 1 and Table 10.

Risk management

70	Risk Governance structure
71	Board and sub-committees
72	Executive and Management Committees
75	Risk management
117	Capital management

Risk Governance structure

The diagram below illustrates the Bank's Risk Management Committee structure:



First line Committees are responsible for ensuring that the risk and control environment is established and maintained in day-to-day decision making. The second line Committees give oversight and challenge to the first line and review and approve the component parts of the Risk Management Framework that are designed in the first line.

Board and sub-committees

The Bank's risk governance structure is intended to strengthen risk evaluation and management whilst ensuring the Bank manages the regulatory environment as efficiently as possible. The risk focus of these Committees is described below:

Committee	Risk focus
The Board	The responsibilities of the Board include: • setting the overall Bank risk strategy; • approving the design and implementation of risk management approaches, including the Risk Management Framework and the risk appetite statement and metrics that underpin them; • delegating authority for oversight of the Risk Management Framework, systems and high-level limits to the Board Risk Committee (BRC); • delegating authority for cascading the setting and approval of the more granular risk limits and tolerances to the CEO; • using the output of the semi-annual certification process, to approve the effectiveness of the Risk Management Framework with support from the Bank's internal audit function through their risk-based review programme; and • reviewing and challenging BRC reports on the effectiveness of the Risk Management Framework and systems. Further discussed on page 57.
Remuneration Committee	The Remuneration Committee establishes, implements and maintains remuneration policies, procedures and practices for the Executive Directors and members of the senior executive management team that are appropriate in the context of the Bank's long term business performance and are consistent with effective risk management principles. Further responsibilities are discussed on pages 60 to 61.
Board Risk Committee (BRC)	The BRC's responsibilities include oversight and advice to the Board on current and potential risks and the overall Risk Management Framework, reviewing and challenging the design, implementation and effectiveness of the Framework, internal controls and process of risk management, monitoring the Bank's performance and compliance and reporting on this to the Board. Further details of their responsibilities are discussed on pages 51 to 53.
Board Audit Committee (BAC)	BAC's responsibilities include: • assisting the Board in carrying out its responsibilities relating to internal control, including control breaches and remediation; • exercising oversight of identified Risk Management Framework failings and weaknesses as well as management actions taken to resolve them; and • its main risk management responsibilities include reviewing the Annual Report and Accounts, Pillar 3 disclosures and accounting judgements and recommending to Board for approval.
Nomination Committee	Duties include review and recommendations on the Board composition. Further details of their responsibilities are given on page 54.
Value and Ethics Committee	The V&E Committee was constituted on 1 November 2013 demonstrating the Bank's commitment to promoting and conducting its business in accordance with the established values of the Co-operative Movement. This committee is responsible for recommending to the Board for its approval and adoption, the Co-operative values and ethical policies of the Bank.

Executive and Management Committees

The Executive has established sub-committees and senior management committees whose responsibilities include implementing the Risk Management Framework, identifying the key risks facing the business and assessing the effectiveness of planned management actions. These are detailed below:

Committee	Risk focus
Executive Committee (ExCo)	ExCo manages the business in line with the risk appetite statement. It also maintains oversight of risk management processes and management information. Its responsibilities include: • overseeing the establishment and maintenance of appropriate risk management systems and controls in line with the agreed Risk Management Framework; • supporting the CEO in developing, reviewing and approving detailed risk appetite limits and tolerances as delegated by the Bank; and • ensuring the implementation of the risk strategy set by the Bank's Board so as to deliver an effective risk management environment.
Large Credit Committee (LCC)	The LCC supports the CEO and has the following main responsibilities: • sanctioning large counterparty transactions; and • managing large exposure positions.
Small Credit Committee (SCC)	The SCC is a sub-committee of the LCC and its core purpose is to independently sanction new and increased lending over set limits of authority.
Strategic Transactions Committee (STC)	Chaired by the CEO, the STC reviews, challenges and approves (where permitted within the authority delegated by the Board) strategic transactions designed to achieve the deleveraging of the balance sheet in line with the strategy outlined by the Board for the Non-core assets within the Co-operative Asset Management (CoAM) business. Any deal sanctioned by the STC must be approved by the CEO and Chief Financial Officer (CFO) of the Bank or the Treasurer of the Bank (up to the limit of their delegated authority) and a risk assessment must be carried out by the CRO or Enterprise Risk Director.
Executive Risk Committee (ERC)	The ERC is chaired by the CRO. Its purpose is to provide a mechanism to ensure all the Bank's risks are reviewed, challenged and approved (with escalation to the BRC where required).
Bank Asset and Liability Committee (ALCO)	ALCO is chaired by the CFO. It is primarily responsible for overseeing the management of capital, market, liquidity and funding risks. Its responsibilities include: • identifying, managing and controlling the Bank balance sheet risks in executing its chosen business strategy; • ensuring that the capital and liquidity position of the Bank is managed in line with policy and that adequate capital is maintained at all times; • overseeing and monitoring relevant risk control frameworks; • recommending relevant principal risk policies and detailed risk appetite limits to the CEO and the ERC for approval; and • approval of all product pricing proposals. To assist in carrying out these responsibilities, ALCO is supported by a Bank Market Risk Forum (BMRF), Liquidity Management Forum (LMF) and Capital Management Forum (CMF).
People Committee	The People Committee is chaired by the Human Resources Director. Its purpose is to: • review all people data within the Bank including headcount, contractors, absence, retention; • review the hiring of senior and critical roles; • review on at least a quarterly basis all talent data; • review all performance data on at least a half year basis; • understand the employee relations engagement plan; • ensure the colleague engagement approach is aligned to the strategic direction of the Bank; • oversee reward strategy, principles and oversight of all remuneration policies and decisions below the Executive level; • review and amend redundancy terms; • review absenteeism and monitor disciplinary proceedings; • monitor compliance with diversity and anti-discrimination legislation; and • monitor, review and implement appropriate succession plans in respect of senior members of the Bank's management teams.

Executive and Management Committees continued

Committee	Risk focus
Core Bank Operating Committee	Chaired by the Executive Director of the Core Bank, the Core Bank Operating Committee is responsible for the delivery of the business plan covering all areas of the Core Bank scorecard and provides oversight of performance. The Core Bank Operating Committee drives first line management of risk across the Core Bank and ensures that a robust and effective control environment exists.
CoAM Operating Committee	Chaired by the Executive Director CoAM, the CoAM Operating Committee is responsible for the delivery of the business plan and provides effective oversight of performance. The CoAM Operating Committee drives first line management of risk across CoAM, ensures that the correct governance processes are followed and that a robust and effective control environment exists.
Strategic Asset Review Forum (SAR)	A forum established at the discretion of the LLC and SCC for CoAM and non performing facilities. Its function is to set strategies on a case by case basis and sanction within its authority.
Product Governance Forum	The Product Governance Forum provides independent review and challenge of product proposals, to ensure effective identification, assessment and mitigation of risks prior to launch.
Operational Risk Forum (ORF)	The purpose of the ORF is to support the Operational Risk Director in the execution of his/her responsibilities including: • overseeing the design and maintenance of the Bank's operational risk framework; • overseeing the management of operational risk, providing review and challenge; • overseeing and monitoring the relevant risk control frameworks; • recommending to the CEO, CRO and ERC relevant underlying policies and detailed risk appetite limits for approval; and • ownership and oversight of the anti-money laundering regime.
Regulatory Risk Forum (RRF)	The core purpose of the RRF is to support the Regulatory Risk Director in carrying out his/her responsibilities, includes oversight of: • maintenance of the appropriate authorisations for the regulated entities within the Bank, including oversight of any variation to permission; • review and recommend to the ERC for approval of the Regulatory Risk Policy and Conduct Risk Policy; • review and approval of the Bank's Regulatory Risk Control Standard; • review and approval of the Conduct Risk Control Standard; • assessing and monitoring new products against the Product Approval Risk Policy and control standard and the Conduct Risk Policy and Conduct Risk Control Standard, as appropriate; • the Approved Persons regime; • regulatory reporting requirements; • conduct of business issues including fair treatment of customers; • financial promotions; • the training and competence regime; and • any on-going regulatory engagement.
Credit Risk Management Forum (CRMF)	The CRMF advises and supports the Credit Risk Director. Its responsibilities include: • designing the Credit Risk control implementation approach and Credit Control Framework and recommending them to the ERC; • reviewing and recommending to the ERC the Bank's Credit Risk Policy and credit measurement methodologies; • review and approve the Credit Risk Control Standard; • defining and recommending the Credit Risk Appetite and limits to the ERC; and • reviewing and challenging the credit risk processes and procedures including the credit risk rating systems.
Model Risk Forum (MRF)	The Model Risk Forum responsibilities include: • setting and approving the model review process and standards; • reviewing and recommending to the CEO and ERC the Bank's model risk policy for approval; • review and approval of the Model Risk Control Standard; and • defining the review schedule for existing models and other tasks as identified in the model risk policy.
Bank Market Risk Forum (BMRF)	The role of the BMRF is to review, challenge and monitor the market risk profile for the Bank, in line with applicable policies and within risk appetite.

Executive and Management Committees continued

<table>
<tr><th>Committee</th><th>Risk focus</th></tr>
<tr><td>Liquidity Management Forum (LMF)</td><td>The role of the LMF is to enable detailed discussion on all aspects of Bank liquidity risk management, monitoring and control including operational issues in respect of covered bond and residential mortgage backed security funding activities. It also recommends actions to be taken in order to ensure that the Bank's liquidity position remains within the agreed levels.</td></tr>
<tr><td>Capital Management Forum (CMF)</td><td>The role of the CMF is to review, challenge and monitor the Bank's capital adequacy, in line with capital policy and within risk appetite. The CMF is responsible for making recommendations to ALCO as appropriate.</td></tr>
<tr><td>Investment Approval Committee</td><td>The purpose of the Investment Approval Committee is to oversee and challenge the execution of all significant investments, divestments and major capital expenditure proposals as contained within the Bank's Five Year Turnaround Plan, in accordance with the authorities delegated to it by Bank ExCo, ensuring:
• that all investments are being made in accordance with the Bank's Five Year Business Plan;
• the strategic investment portfolio remains balanced when considering investment demands against scarce resources;
• Executive sponsors are empowered to deliver within defined constraints; and
• decisions taken are done so in accordance with the requirements of The Co-operative Bank plc Risk Management Framework and all applicable Bank PDC Risk Policies and Control Standards.</td></tr>
<tr><td>Project Oversight Committee</td><td>The purpose of the Project Oversight Committee is to oversee and challenge the delivery of the Change Portfolio for the Bank, in accordance with the authorities delegated to it by Bank ExCo, ensuring:
• there is clarity of delivery outcomes;
• that benefits are delivered within agreed time, cost and quality thresholds;
• sponsors have the necessary executive support to deliver successfully; and
• key risks and issues threatening delivery are receiving the appropriate levels of intervention.</td></tr>
<tr><td>Bank Conduct Committee</td><td>The purpose of the Bank Conduct Committee is to provide end to end oversight of business conduct and the customer experience, ensuring:
• there is a business model, strategy and culture that places the fair treatment of the customer at the heart of all business activities;
• full support of the Values and Ethics Committee;
• the Bank meets all regulatory requirements in respect of conduct risk matters;
• the Bank has an adequate, implemented and embedded Risk Management Framework in respect of conduct risk;
• design and marketing of products to meet the customer needs in the simplest and most cost effective way;
• advertising of products and services that is fair and clear;
• the right product solution is matched to the customer need and that the customer understands what they have bought;
• the account servicing meets customer needs and the standards set by the Bank (and that those standards are set at the right level);
• treatment of customers who are in financial difficulty, or vulnerable situations, with fairness and forbearance offering appropriate solutions;
• handling of complaints is fair with full investigations making clear and fair responses;
• customer facing colleagues have the training and supervision they need to achieve all conduct responsibilities;
• management information is adequate to measure and manage Conduct Risk and is fed to the appropriate individuals to support appropriate decision making;
• reward and recognition schemes encourage and support objectives; and
• quick and fair resolution of any past weaknesses in the treatment of customers.</td></tr>
</table>

Risk management

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

Introduction

This section of the Annual Report explains the management of risks faced by the Bank.

The risk management notes provide disclosures enabling the evaluation of:

- the significance of financial instruments for the Bank's financial position and performance;
- the nature and extent of risks arising from financial instruments to which the Bank has been exposed during the year and at 31 December 2013; and
- how the Bank manages those risks.

Disclosures provided are based on the information used by management in managing the Bank.

The principal risks are summarised on pages 26 to 28 of the Strategic review.

Disclosures under IFRS 7 'Financial Instruments: Disclosures' (IFRS 7) concerning the nature and extent of risks relating to financial instruments have been included in the audited sections of 'Risk Management' on pages 79 to 116.

Changes to disclosures

The Financial Stability Board, which coordinates at international level the work of national financial authorities and international standard setting bodies, established the Enhanced Disclosures Task Force (EDTF) to make recommendations for enhancing banks' risk disclosures to better meet users' needs. The Bank implemented many of the recommendations of the EDTF within its 2012 year end disclosures and has, to the fullest extent possible, implemented these recommendations for 2013 either within its financial statements or Pillar 3 disclosures.

Details of the Bank's compliance with the EDTF recommendations are shown in Appendix 1 on page 275. Further information regarding the EDTF recommendations can be found at: http://www.financialstabilityboard.org/publications/r_121029.pdf.

Contents

The following sections address the Bank's approach to risk management:

	Page
Risk management – 2013 overview	76
Risk Management Framework	76
Credit risk	79
Liquidity risk	102
Market risk	107
Operational risk	110
Reputational risk	112
Strategic and business risk	113
People risk	114
Regulatory risk	114
Conduct risk	115
Pension risk	116

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

Risk management – 2013 overview

2013 was a year of substantive change in the Risk function. In conjunction with redefining the Risk Management Framework (RMF) and constructing an effective three lines of defence model in the second half of 2012, the previous and present Chief Risk Officers (CROs) began a process of significantly strengthening the capability of the Risk Leadership team and the second line function. This enhanced Risk function, which has been in place since first quarter 2013, has been responsible for the identification of previously un-remediated policy, process and control failings. The identification of these issues led to improvements across multiple risk disciplines, most particularly in the areas of Operational, Conduct, Liquidity and Credit Risk. The further identification of risks and the subsequent improvements in policy, process and control are still ongoing.

A key element in the redefined Risk Management Framework is the reiteration that risk is not the responsibility of any one part of the institution or group of employees but rather the responsibility of all. This requirement, for a core risk culture driving our business, is one of the key improvements being embedded across the Bank.

The challenge for 2014 and beyond will be the retention of key staff to maintain and build the capability of the function to support the simplification and transformation of the Bank in a controlled manner, as well as a continuing focus on embedding a stronger Risk culture across the institution.

Risk Management Framework

Until the second half of 2013, The Co-operative Banking Group maintained common governance, organisational and risk management structures, which had been developed and implemented across its subsidiaries including the Bank.

In 2013, the Bank put in place its own revised, updated and independent Risk Management Framework and policies, which have been adopted by the Bank Executive and the Board. The Bank's new Risk Management Framework reflects the previous system in many respects, and continues to be refined to meet the Bank's specific requirements.

As a result of the new Risk Management Framework, the Bank has determined its principal risks, and the level of acceptable risks, as stipulated in the Bank's risk appetite statement, thus ensuring that there is an adequate system of risk management so that the levels of capital and liquidity held are consistent with the risk profile of the business.

The Bank has also replicated the 'three lines of defence' governance model, previously adopted by the Board of Directors of The Co-operative Banking Group. This is to ensure appropriate responsibility and accountability is allocated to the management, whilst recognising that the system is designed to manage rather than eliminate risk of failure to achieve business objectives. The three lines of defence are:

- the Bank's business teams and first line management act as the first line of defence and are responsible for identifying where a business unit is exposed to risks, including from the development of new products, processes or other business change. They also manage the risks that reside within their business units on a day-to-day basis, implementing effective monitoring and control processes to ensure that the Bank's business' risk profile is understood and maintained within the Board-defined risk appetite;
- the Bank's compliance and risk functions act as the second line of defence. They oversee and challenge the implementation and monitoring of the Risk Management Framework and consider current and emerging risks across the Bank. They also review and challenge the delegated authority framework and oversee appropriate escalation of breaches, mitigating actions and reporting to the Executive Risk Committee (ERC); and
- the Bank's internal audit function acts as the third line of defence. They are responsible for independently verifying that the principal Risk Control Framework has been implemented as intended across the business, and independently challenge the overall management of the framework to provide assurance to the Board Audit Committee (BAC) and senior management on the adequacy of both the first and second lines.

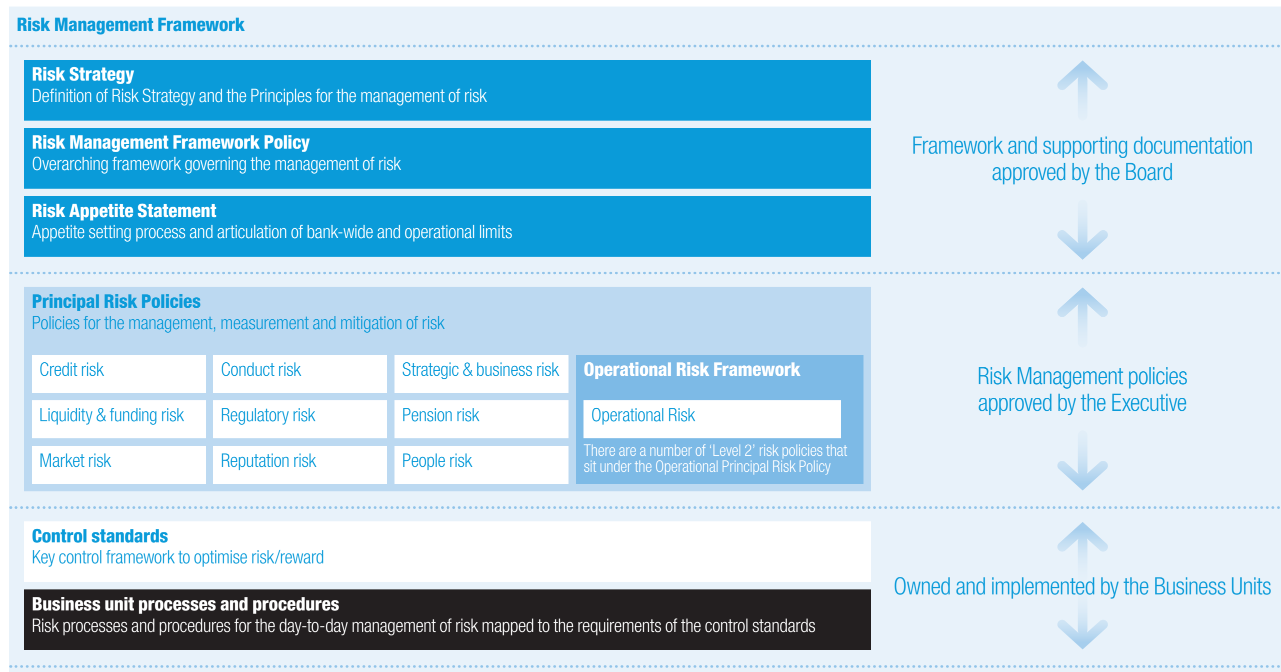
Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

The Risk Management Framework consists of a hierarchy of strategies, policies and standards which are designed to support the Bank's risk based decision making and comprises six components:

- risk strategy;
- risk management framework policy (the Risk Management Framework Policy);
- risk appetite statement;
- risk policies in respect of the Bank's Principal Risks, as defined below;
- control standards; and
- business unit operating procedures.



Strategy

The Bank's overall risk strategy is maintained by the Chief Risk Officer (CRO) and approved by the Board. The risk strategy sets out the:

- way in which risk management supports the Bank through bringing transparency, clarity and insight;
- strategic goals for risk management across the Bank; and
- risk management principles that must be followed across the Bank in order to achieve those strategic goals.

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

Principles

To achieve the strategic goals, the following principles are mandated across the organisation:

- the Board requires the business to be managed in line with the risk strategy which sets out the agreed vision within the agreed risk appetite. Risk, as well as reward, should be taken into account in a consistent way across the business when pursuing all strategic objectives to maintain the desired risk profile;
- the Board is ultimately responsible for all the Bank's risks and approves limits for the business so it may operate within the agreed risk appetite. The Board expects management to realise strategic objectives whilst operating within these limits and an effective risk culture must be in place so these limits are adhered to;
- an independent review and challenge is provided by the CRO who is supported by an appropriate governance structure to ensure effective implementation of the agreed Risk Management Framework;
- recognised, emerging or current risks are actively managed in line with the Bank's approach for identification, measurement, management, monitoring and reporting. Identification must be forward-looking to allow management to take a pro-active approach to risk;
- rigorous stress testing exercises are carried out to assess the impact of a range of adverse scenarios with different probabilities and severities to inform the Bank's strategic planning processes;
- management monitors the aggregated risk profile of the Bank and its regulated entities, and reviews trends which are reported to the Board and externally to regulators to meet external obligations; and
- high quality risk management techniques are adopted across the business with the use of these evidenced through documentation and self-certification.

Risk appetite

The Board has primary responsibility for identifying the key business risks facing the Bank, approving the Bank's risk strategy and the acceptable level of risk appetite and associated tolerances, and delegates the setting of the detailed risk limits and tolerances to the Chief Executive Officer (CEO). The CEO uses the Executive Committee (ExCo) governance structure to assist in consideration, review and setting of these more detailed risk appetite limits and tolerances.

The Bank's risk appetite framework encompasses seven key principles which are earnings volatility, capital buffer, regulatory capital adequacy, liquidity and funding, reputation and conduct, regulatory compliance and operational effectiveness.

Each of the seven risk appetite principles is supported by quantitative measures to ensure that the Bank operates within the expectations of key stakeholders, including its customers, rating agencies and regulators.

The risk appetite review process is aligned to the annual planning cycle, and accordingly the tolerances for each of the risk appetite measures have been recalibrated based on the plan for Board approval, including a refresh of some measures. The framework is being developed to incorporate the plans for each of the Core and Non-core Businesses.

Risk management committee structure

The key Executive and Non-Executive risk management committees are set out and discussed on pages 71 to 74 of the Risk management section.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk

In plain english:

Credit risk is the risk that borrowers will fail to repay what they have borrowed. The risk to the Bank includes the amounts lent not being repaid, loan interest not being received, cash flows being received later than expected, and increased collection costs. This results in the need to set aside provisions and capital to provide for future losses

1.1 Overview

Credit risk is one of the principal risks set out in the Risk Management Framework and is an integral part of the business activities of this and all other banks. It is inherent in both traditional banking products (loans, commitments to lend and contingent liabilities such as letters of credit) and in 'traded products' (derivative contracts such as forwards, swaps and options, repurchase agreements, securities borrowing and lending transactions).

The inherent risks arising from general economic conditions have been increased by the period of significant turbulence and uncertainty affecting the global economy and the global financial system, and the Eurozone in particular. The Bank continues to be exposed to these risks and their consequences, including lower consumer confidence, high levels of unemployment, interest rate volatility and increased cost of credit, which may result in increased credit risk which could have a material adverse effect on the Bank's business.

All authority to take credit risk derives from the Board. This authority is delegated to the CEO who then sub-delegates to appropriate committees and individuals. The level of credit risk authority delegated depends on seniority and experience, and varies according to the quality of the counterparty, associated security or collateral held.

The Bank's policy for credit risk is required to be approved annually by the ERC and defines appropriate standards and principles for the effective management of credit risk throughout the Bank's divisions.

Credit risk management is an essential element of the Bank's operations. As with all principal risks, the Board requires that the credit business is managed in line with the risk strategy and risk appetite set by the Board. Risk measurement is based on a set of metrics, which are aligned with the Board agreed risk appetite and support the limits framework. These metrics undergo periodic review to assure that they are fit for purpose, ie, are able to recognise both emerging and current risks. Credit risk models are subject to biennial review by the Model Risk Forum.

In May 2013, in order to strengthen internal risk controls, the Bank Executive, with the approval of the Board Risk Committee and the Board, moved all corporate lending authority to the three principle Executive Lending Committees, the LCC, SCC and STC (see Executive and Management committees section). This has proven especially beneficial during the restructuring of this portfolio into that of CoAM and BaCB as new underwriting procedure for these businesses are being formulated.

The Credit Risk Management Forum (CRMF) considers key management information to support the oversight and challenge of the credit risk embedded in each division and across the credit risk life cycle. This includes appropriate benchmarking information from similar portfolios in the market and is key to calibrating risk appetite.

The CRMF is supported by an additional three forums that exist to support the Credit Risk Director in discharging the second line mandate. These include an Impairment Charge Forum, implemented in June 2013, which was designed to ensure that the credit risk impairment and loss recognition policy standard is being implemented effectively and that there is sufficient evidence to support the credit risk impairment stock. In addition, an Impairment Adequacy Forum was implemented in the second half of 2013 as a mechanism for approving and reviewing the refresh of impairment parameters and post model adjustments. The third forum is the Treasury Credit Risk Management Forum which provides day-to-day oversight of the credit risk exposure in the Treasury division.

The retail division of the Core Bank uses both application and behavioural scoring techniques to rank a customer's risk of default with this, in common with other retail banks, being embedded in the business. The Non-core division, which includes corporate lending, includes a number of specialist models to reflect the embedded credit risk of sectors such as private finance initiatives (PFIs) and commercial property. The performance of all rating systems is governed by the IRB Model Working Group with oversight from a new Model Risk Forum that met for the first time during the third quarter of 2013.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

1.2 Credit exposure

The following analysis of credit exposure shows:

- carrying amounts by class of asset in the balance sheet;
- the gross credit exposure by class of asset (excluding allowance for losses but including credit commitments); and
- the net credit exposure by class of asset (including allowance for losses and credit commitments).

Cash and balances at central banks are credit exposures with the Bank of England and have been excluded from the analysis.

Audited

31 December 2013	Loans and advances to banks	Loans and advances to customers	Investment securities	Derivative financial instruments	Total
Analysis of balance in note 41	**17**	**18**	**19**	**20**	
Gross balance	**1,594.4**	**31,274.6**	**4,519.4**	**555.8**	**37,944.2**
Less: allowance for losses	**–**	**(952.4)**	**(20.0)**	**–**	**(972.4)**
	1,594.4	**30,322.2**	**4,499.4**	**555.8**	**36,971.8**
Analysis of credit risk exposure					
Not impaired	**1,594.4**	**27,894.9**	**4,499.4**	**548.8**	**34,537.5**
Impaired	**–**	**3,379.7**	**20.0**	**7.0**	**3,406.7**
	1,594.4	**31,274.6**	**4,519.4**	**555.8**	**37,944.2**
Credit commitments	**570.1**	**3,519.9**	**–**	**–**	**4,090.0**
Gross credit risk exposure	**2,164.5**	**34,794.5**	**4,519.4**	**555.8**	**42,034.2**
Less:					
Allowance for losses	**–**	**(952.4)**	**(20.0)**	**–**	**(972.4)**
Net credit risk exposure	**2,164.5**	**33,842.1**	**4,499.4**	**555.8**	**41,061.8**

31 December 2012	Loans and advances to banks	Loans and advances to customers	Investment securities	Derivative financial instruments	Total
Analysis of balance in note 41	17	18	19	20	
Gross balance	1,904.1	33,982.5	6,928.8	818.8	43,634.2
Less: allowance for losses	–	(643.0)	(39.0)	–	(682.0)
	1,904.1	33,339.5	6,889.8	818.8	42,952.2
Analysis of credit risk exposure					
Not impaired	1,904.1	30,251.9	6,889.8	818.8	39,864.6
Impaired	–	3,730.6	39.0	–	3,769.6
	1,904.1	33,982.5	6,928.8	818.8	43,634.2
Credit commitments	54.1	4,885.0	–	–	4,939.1
Gross credit risk exposure	1,958.2	38,867.5	6,928.8	818.8	48,573.3
Less:					
Allowance for losses	–	(643.0)	(39.0)	–	(682.0)
Net credit risk exposure	1,958.2	38,224.5	6,889.8	818.8	47,891.3

Impaired and not impaired balances in the tables above are defined in the following sections on retail credit risk, corporate credit risk and investment securities credit risk.

During the year ended 31 December 2013, there has been one change to the definition of impaired loans. BaCB and Corporate CoAM watchlist cases are now included within impaired balances and the comparative table has been updated to reflect this.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

Fair value adjustments

At the time of the merger of Britannia Building Society with the Bank, all of the assets and liabilities of Britannia were acquired at their then estimated fair values. Valuations of Britannia's assets included adjustments made for their lifetime future expected losses at that date, referred to as the credit fair value adjustments. Previously, the credit fair value adjustments have been disclosed separately in the above table; the table has now been revised to set off the credit fair value adjustments within the not impaired and impaired gross balances, to better show their gross carrying values in the Bank.

For the purposes of internal management reporting of coverage ratios, loss provisions are grossed up by the amount of remaining credit fair value adjustments and compared to the gross amounts owed by customers, as shown in section 1.3 Credit risk management.

1.3 Credit risk management

The following sections provide further analysis and disclosure of the Bank's credit risk associated with:

- 1.3.1 Loans and advances to customers;
- 1.3.2 Investment securities;
- 1.3.3 Loans and advances to banks; and
- 1.3.4 Derivative financial instruments.

1.3.1 Loans and advances to customers

The credit risk team is part of the Risk Directorate, with an independent reporting line from business management, and provides second line risk oversight. Accountability for the origination of credit risk sits with business management subject to compliance with key credit criteria, policy and risk appetite. Where business management recommends the sanction of a facility that is outside of its discretion then recommendation is made to the Large and Small Credit Committees.

On pages 83 to 99 the management of credit risk by portfolio is described covering:

- acquisition and account management;
- collateral;
- impairment assessment; and
- forbearance.

The loan portfolios are periodically reviewed to assess impairment. A loan is deemed to be impaired when there is objective evidence that a loss event has occurred on or before 31 December 2013.

Once a loan is defined as impaired, the impairment provision is calculated as the difference between the current carrying value of the asset and the expected future recovery, discounted at the loan's effective interest rate, taking into account the expected charge off rate and any supporting collateral.

Full details are contained in the significant accounting policies pages 86 to 88 in the following credit risk sections.

The tables below analyse the gross balance by impairment classification for the Core (Retail and BaCB) and Non-core (Corporate CoAM and Optimum) divisions. They include credit commitments, impairment provisions, fair value adjustments and a reconciliation to gross customer balances as this is the basis on which the business manages risk.

The increase in impairment provisions in the year to 31 December 2013 was driven primarily by revised collateral values for the corporate business and updated experience in support of our credit risk impairment policy, as well as the extended period of economic downturn which has impacted the values we have been able to realise from collateral placed against impaired loans.

The Non-core business continues to have additional impairment risk given the underlying assets, which includes Optimum, a closed book of predominantly interest-only intermediary and acquired mortgage book assets. Worsening economic and market conditions and/or increasing interest rates and/or a fall in house prices could result in the Non-core assets suffering from more than expected impairments which would adversely impact on the Bank's operating results and financial position (in particular, its net interest margin) and, in the longer term, its ability to comply with its regulatory capital requirements. The Non-core business' corporate asset book is also relatively concentrated, with the result that a small number of borrowers account for a large proportion of the total loans outstanding. Any significant future impairment of these borrowers would result in a disproportionate impact on the Bank's operating results and financial position.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

Audited

	Core			Non-core			
	Retail banking						
31 December 2013	**Secured**	**Unsecured**	**BaCB**	**Corporate**	**Optimum**	**Unity Trust Bank**	**Total**
Analysis of balance in note 18							
Gross loans and advances	**15,524.6**	**1,294.6**	**840.8**	**6,504.3**	**6,922.1**	**188.2**	**31,274.6**
Less: allowance for losses	**(4.5)**	**(160.2)**	**(5.8)**	**(738.4)**	**(35.5)**	**(8.0)**	**(952.4)**
	15,520.1	**1,134.4**	**835.0**	**5,765.9**	**6,886.6**	**180.2**	**30,322.2**
Analysis of credit risk exposure							
Not impaired	**15,379.6**	**1,077.7**	**825.2**	**4,526.5**	**5,918.8**	**167.1**	**27,894.9**
Impaired	**145.0**	**216.9**	**15.6**	**1,977.8**	**1,003.3**	**21.1**	**3,379.7**
	15,524.6	**1,294.6**	**840.8**	**6,504.3**	**6,922.1**	**188.2**	**31,274.6**
Credit commitments	**41.1**	**2,222.5**	**399.1**	**815.5**	**0.1**	**41.6**	**3,519.9**
Gross credit risk exposure	**15,565.7**	**3,517.1**	**1,239.9**	**7,319.8**	**6,922.2**	**229.8**	**34,794.5**
Less:							
Allowance for losses	**(4.5)**	**(160.2)**	**(5.8)**	**(738.4)**	**(35.5)**	**(8.0)**	**(952.4)**
Net credit risk exposure	**15,561.2**	**3,356.9**	**1,234.1**	**6,581.4**	**6,886.7**	**221.8**	**33,842.1**
Reconciliation of accounting to customer balances							
Gross loans and advances	**15,524.6**	**1,294.6**	**840.8**	**6,504.3**	**6,922.1**	**188.2**	**31,274.6**
Fair value adjustments	**4.2**	**–**	**–**	**97.7**	**92.3**	**–**	**194.2**
Other accounting adjustments	**(7.8)**	**23.6**	**29.7**	**(76.1)**	**1.8**	**(0.3)**	**(29.1)**
Gross customer balances	**15,521.0**	**1,318.2**	**870.5**	**6,525.9**	**7,016.2**	**187.9**	**31,439.7**

	Core			Non-core			
	Retail banking						
31 December 2012	Secured	Unsecured	BaCB	Corporate	Optimum	Unity Trust Bank	Total
Analysis of balance in note 18							
Gross loans and advances	15,987.2	1,393.1	815.8	8,206.7	7,338.7	241.0	33,982.5
Less: allowance for losses	(3.2)	(172.8)	(1.4)	(447.4)	(11.0)	(7.2)	(643.0)
	15,984.0	1,220.3	814.4	7,759.3	7,327.7	233.8	33,339.5
Analysis of credit risk exposure							
Not impaired	15,836.3	1,179.4	807.0	6,041.5	6,171.8	215.9	30,251.9
Impaired	150.9	213.7	8.8	2,165.2	1,166.9	25.1	3,730.6
	15,987.2	1,393.1	815.8	8,206.7	7,338.7	241.0	33,982.5
Credit commitments	389.8	2,332.2	695.0	1,467.7	0.3	–	4,885.0
Gross credit risk exposure	16,377.0	3,725.3	1,510.8	9,674.4	7,339.0	241.0	38,867.5
Less:							
Allowance for losses	(3.2)	(172.8)	(1.4)	(447.4)	(11.0)	(7.2)	(643.0)
Net credit risk exposure	16,373.8	3,552.5	1,509.4	9,227.0	7,328.0	233.8	38,224.5
Reconciliation of accounting to customer balances							
Gross loans and advances	15,987.2	1,393.1	815.8	8,206.7	7,338.7	241.0	33,982.5
Fair value adjustments	5.2	–	–	215.9	115.9	–	337.0
Other accounting adjustments	(61.4)	95.4	120.1	(151.1)	37.6	(0.6)	40.0
Gross customer balances	15,931.0	1,488.5	935.9	8,271.5	7,492.2	240.4	34,359.5

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

The comparative table has been updated to reflect the changes to Core and Non-core divisions, and in order to show BaCB and Corporate CoAM watchlist accounts being included within impaired balances.

Unity Trust Bank is accounted for as a subsidiary of the Bank. It operates its own credit processes as a separate bank, and is not included in the subsequent analysis of credit risk.

Within the analysis of credit risk exposure in the tables above, fair value adjustments relating to expected credit losses on assets obtained on the merger with Britannia Building Society in 2009 are no longer shown separately, instead they have been allocated against impaired assets.

Other accounting adjustments include accrued interest, interest fair value adjustments and effective interest rate adjustments.

The disclosures in sections 1.3.1.1 Secured residential credit risk, 1.3.1.2 Unsecured retail credit risk and 1.3.1.3 Corporate credit risk are all based on the gross customer balances in the above tables.

1.3.1.1 Secured residential credit risk

Acquisition and account management

Mortgages are loans to customers secured by a first charge over a residential property. Mortgages are originated directly to customers via branches, telephone and the internet under the Britannia and Co-operative Bank brands, and via intermediaries under the Platform brand. In the year to 31 December 2013, 66% (2012: 70%) of mortgages were originated directly and 34% (2012: 30%) through intermediaries.

The Britannia and Co-operative Bank brands only originate prime residential mortgages, while Platform primarily originates a combination of prime residential, almost prime residential and buy-to-let loans.

Historically, these loans have been advanced on a capital and interest payment basis, where the loan is repaid over the term of the loan, or interest only, where the capital element of the loan is repayable at the end of the term. All new advances are on a capital repayment basis, with the exception of buy-to-let lending and existing interest only customers moving home.

During the term of the mortgage, interest only mortgages are managed consistently with capital and repayment mortgages, except for our customer contact strategy. For interest only mortgages this aims to determine if the customer has a satisfactory repayment strategy in place upon loan maturity.

The table below shows residential mortgage completions in the year, analysed by loan-to-value (LTV) and repayment method:

Audited

	2013			2012		
	Amount advanced	**Average LTV %**	**Interest only %**	Amount advanced	Average LTV %	Interest only %
Retail prime	**1,416.1**	**62.6**	**1.8**	1,854.7	60.3	7.8
Platform prime	**607.2**	**68.7**	**–**	248.1	62.0	17.5
Total prime	**2,023.3**	**64.6**	**1.3**	2,102.8	60.5	8.9
Buy-to-let	**128.1**	**64.7**	**86.1**	538.7	63.1	84.3
Almost prime	**2.4**	**52.7**	**–**	7.6	57.0	1.2
Total completions	**2,153.8**	**64.5**	**6.2**	2,649.1	61.0	24.6

The default risk in the portfolio is recalculated monthly, using internally developed behavioural models. A regional house price index is used to reflect any changes in the value of collateral (see below). This process is also used to determine the amount of capital which is required to be held for individual loans.

Mortgages originated prior to 2009, by Platform or acquired by Britannia, are managed as part of a closed portfolio, Optimum. These loans include a range of asset types, including prime residential (both income verified and self-certified), buy-to-let, and non-conforming mortgages.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

The table below shows gross customer balances for residential mortgages analysed by current LTV banding and repayment method:

Audited

	31 December 2013				
	Retail secured		**Optimum**		
	Interest only	**Other**	**Interest only**	**Other**	**Total**
Less than 50%	**1,211.0**	**4,656.3**	**241.3**	**291.8**	**6,400.4**
50% to 60%	**559.1**	**1,841.4**	**268.1**	**194.9**	**2,863.5**
60% to 70%	**855.5**	**2,151.9**	**584.7**	**248.8**	**3,840.9**
70% to 80%	**426.9**	**2,096.8**	**1,019.4**	**278.9**	**3,822.0**
80% to 90%	**173.7**	**1,104.2**	**1,199.1**	**263.2**	**2,740.2**
90% to 100%	**115.1**	**160.6**	**1,222.7**	**149.8**	**1,648.2**
Greater than 100%	**95.7**	**72.8**	**993.3**	**60.2**	**1,222.0**
	3,437.0	**12,084.0**	**5,528.6**	**1,487.6**	**22,537.2**

	31 December 2012				
	Retail secured		Optimum		
	Interest only	Other	Interest only	Other	Total
Less than 50%	1,270.1	4,189.8	214.5	245.8	5,920.2
50% to 60%	529.4	1,703.7	199.7	158.9	2,591.7
60% to 70%	785.1	1,836.5	429.1	228.0	3,278.7
70% to 80%	773.7	1,924.3	742.9	270.9	3,711.8
80% to 90%	267.3	1,647.3	1,176.2	294.0	3,384.8
90% to 100%	162.9	458.1	1,281.9	256.0	2,158.9
Greater than 100%	177.1	205.7	1,793.9	200.4	2,377.1
	3,965.6	11,965.4	5,838.2	1,654.0	23,423.2

Interest only balances are contractually due to mature as shown below:

Audited

	31 December 2013					
	< 1 year	**1 – 5 years**	**5 – 10 years**	**10 – 20 years**	**20+ years**	**Total**
Retail Secured	**97.0**	**391.0**	**608.5**	**1,717.5**	**623.0**	**3,437.0**
Optimum	**17.9**	**346.4**	**616.8**	**4,260.6**	**286.9**	**5,528.6**
	114.9	**737.4**	**1,225.3**	**5,978.1**	**909.9**	**8,965.6**

	31 December 2012					
	< 1 year	1 – 5 years	5 – 10 years	10 – 20 years	20+ years	Total
Retail Secured	96.7	418.2	673.7	1,877.8	899.2	3,965.6
Optimum	10.5	263.1	611.1	3,890.1	1,063.4	5,838.2
	107.2	681.3	1,284.8	5,767.9	1,962.6	9,803.8

Risk management continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

The table below shows gross customer balances for residential mortgages analysed by asset class, the LTV shown is the current average percentage:

Audited

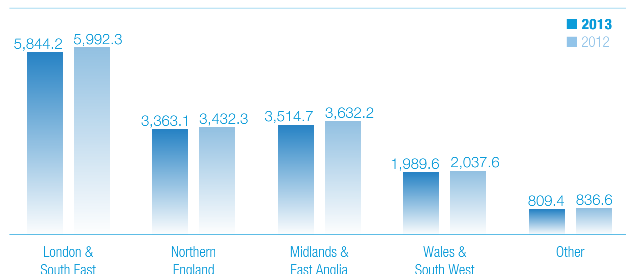
	31 December 2013					
	Retail secured			Optimum		
	Gross customer balance	Average LTV %	Interest only %	Gross customer balance	Average LTV %	Interest only %
Prime residential	**14,349.9**	**41.4**	**17.1**	**640.5**	**74.5**	**74.1**
Buy-to-let	**1,032.2**	**59.0**	**87.9**	**2,041.6**	**75.1**	**92.2**
Self-certified	**82.4**	**41.3**	**77.0**	**1,867.1**	**73.2**	**78.6**
Almost prime	**54.3**	**51.0**	**30.1**	**824.6**	**88.1**	**71.2**
Non-conforming	**2.2**	**63.2**	**60.5**	**1,642.4**	**72.5**	**68.0**
	15,521.0	**42.3**	**22.1**	**7,016.2**	**75.3**	**78.8**

	31 December 2012					
	Retail secured			Optimum		
	Gross customer balance	Average LTV %	Interest only %	Gross customer balance	Average LTV %	Interest only %
Prime residential	14,673.9	43.3	19.8	703.3	78.5	73.4
Buy-to-let	1,096.9	62.8	88.0	2,159.1	80.5	91.8
Self-certified	90.6	43.8	77.2	2,000.9	77.9	77.7
Almost prime	66.6	55.2	28.4	874.3	94.0	70.4
Non-conforming	3.0	66.2	57.2	1,754.6	77.6	66.7
	15,931.0	44.3	24.9	7,492.2	80.4	77.9

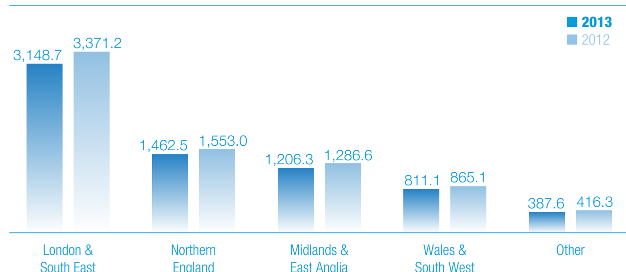
The charts below show gross customer balances analysed by geographical location:

Audited

Retail secured



Optimum



Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

Collateral

Mortgages are secured by a first charge over the property being purchased or remortgaged. Valuation of the property is normally assessed by a Royal Institution of Chartered Surveyors (RICS) certified surveyor from the Bank's approved panel. Valuations may also be assessed through the use of an automated valuation model (AVM).

It is normal practice for the Bank to reassess the valuation of collateral for the non-default book on a quarterly basis using a regional property price index.

The table below analyses the indexed value of property collateral held against mortgage portfolios:

Audited

	31 December 2013					
	Retail Secured			Optimum		
	Gross customer balance	Collateral	Cover %	Gross customer balance	Collateral	Cover %
Impaired	**149.0**	**148.3**	**99.5**	**1,095.9**	**1,062.5**	**97.0**
Not impaired	**15,372.0**	**15,356.1**	**99.9**	**5,920.3**	**5,866.2**	**99.1**
	15,521.0	**15,504.4**	**99.9**	**7,016.2**	**6,928.7**	**98.8**

	31 December 2012					
	Retail Secured			Optimum		
	Gross customer balance	Collateral	Cover %	Gross customer balance	Collateral	Cover %
Impaired	156.0	154.4	99.0	1,289.3	1,231.9	95.5
Not impaired	15,775.0	15,746.4	99.8	6,202.9	6,085.3	98.1
	15,931.0	15,900.8	99.8	7,492.2	7,317.2	97.7

In the table, collateral is constrained to a maximum of 100% of the exposure to each customer to correctly reflect the maximum protection available to the Bank.

Impairment

Where objective evidence of impairment has been observed as a result of one or more loss events, impairment held at the balance sheet date is defined as identified impairment.

Loans under Forbearance are subject to a specific identified impairment assessment.

Loans where no objective evidence has been observed are collectively assessed for unidentified impairment (ie where a loss event has occurred, but objective evidence of impairment has not yet manifested).

Loans meeting the Individually Significant asset definition (large value loans which exceed a balance threshold established by the Bank) are individually assessed for impairment.

We separate certain loans into discrete pools for the assessment of potential impairment, which has not been specifically identified but which we know has occurred due to specific conditions which we have observed. These are:

- those loans which are in arrears by less than one monthly instalment; and
- those loans where there has been a material deterioration in the borrower's external credit score in the last 12 months.

For each loan assessed for impairment, whether identified or unidentified, a shortfall is calculated based on the difference between the current loan balance and the expected 'forced sale' price of the collateral, discounted at the effective interest rate of the loan to reflect the anticipated time to sale, and taking into account anticipated fees and costs prior to sale.

The shortfall is multiplied by the probability the loan will default and further multiplied by the probability that the loan will be taken into possession to determine the impairment required.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

The table shown below reports coverage ratios calculated using:

- carrying values in the accounts; and
- impaired balances defined as one payment past due or in default (6+ months past due, possession, litigation, bankruptcy or Law of Property Act (LPA) receiver appointed).

Audited

	31 December 2013		31 December 2012	
	Retail secured	**Optimum**	Retail secured	Optimum
Gross loans and advances	**15,524.6**	**6,922.1**	15,987.2	7,338.7
of which impaired	**145.0**	**1,003.3**	150.9	1,166.9
Impaired as a % of gross loans and advances	**0.9%**	**14.5%**	0.9%	15.9%
Allowance for losses	**4.5**	**35.5**	3.2	11.0
Coverage	**3.1%**	**3.5%**	2.1%	0.9%

The increase in impairment provisions in the year to 31 December 2013 was driven by updated experience of the credit risk impairment policy. Primarily this reflects revision to the methodology to determine the probability of possession given default; an additional allowance for maturity risk on interest only mortgages; and review of emergence periods. In addition, for the Optimum portfolio specifically, an additional allowance has been raised for concentration risk.

The Bank manages recovery of customer arrears on a gross customer balance basis (excluding credit fair value adjustments and other accounting entries, as shown in the table on page 90). Gross loans and advances to customers comprises mortgages that were acquired by the Bank at discounts to the amounts that were advanced to the mortgagors (including the whole of the Optimum portfolio), and mortgages that were originated by the Bank.

In order to aid comparability with its peers, for internal management reporting purposes the Bank also calculates allowance for losses on the basis of amounts originally advanced to mortgagors, regardless of whether the Bank acquired or originated these mortgages. On this basis the retail secured allowance for losses is £8.7m (2012: £8.4m) and the coverage ratio is 5.8% (2012: 5.4%) and the Optimum allowance for losses is £127.8m (2012: £126.9m) and the coverage ratio is 11.7% (2012: 9.8%).

The Bank has refined its approach to include a calculation of coverage ratios by reference to 90+ days past due and default balances. On this new basis:

- the retail 90+ days past due and default balance is £53.1m (2012: £52.9m), 0.3% of total customer balances (2012: 0.3%) and the coverage ratio is 16.4% (2012: 15.9%); and
- the Optimum 90+ days past due and default balance is £579.9m (2012: £741.5m), 8.3% of total customer balances (2012: 9.9%) and the coverage ratio is 22.0% (2012: 17.1%).

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

The movements in impaired customer balances during the year are shown below:

Audited

	31 December 2013	
	Retail secured	**Optimum**
Balance at start of year	**156.0**	**1,289.3**
Classified as impaired during the year	**68.4**	**303.9**
Transferred to unimpaired during year	**(49.6)**	**(350.9)**
Net repayments and other	**(25.8)**	**(146.4)**
Balance at the end of year	**149.0**	**1,095.9**

The table below shows the credit quality of customer balances that are not impaired:

Audited

	31 December 2013			31 December 2012		
	Retail secured	**Optimum**	**Total**	Retail secured	Optimum	Total
Low to medium risk	**15,084.5**	**4,438.2**	**19,522.7**	15,433.3	4,546.7	19,980.0
Medium to high risk	**287.5**	**1,482.1**	**1,769.6**	341.7	1,656.2	1,997.9
	15,372.0	**5,920.3**	**21,292.3**	15,775.0	6,202.9	21,977.9

Low to medium risk is defined as exposures with a probability of default (PD) in the next year of 1% or below. Medium to high risk is defined as exposures with a PD in the next year of greater than 1%. All PDs are calculated using the internal ratings based (IRB) approach under Basel II. 2012 balances have been restated based on the same risk classification used during 2013.

Forbearance

Forbearance occurs when, for reasons relating to actual or apparent financial difficulty of the borrower, a temporary or permanent concession is granted. A concession may involve short term restructuring of the payment terms of the loan or an extension of the maturity date.

The primary aim of forbearance is to help the borrower through a temporary period of financial difficulty and return the account into a sustainable position where the facility can be serviced through to full repayment. Where the primary aim cannot be achieved, the secondary aim is to maximise recovery of debt in a manner which is affordable to the borrower.

A number of options are available to borrowers in financial difficulty. Repossession of the property will only be considered when all other avenues have been explored. The precise treatment selected depends on the borrower's individual circumstances, but may include:

- arrangements to repay outstanding arrears over a period of time, by making payments above the contractual amount. The loan is deemed to be impaired until the arrears have been cleared in full;
- short term concessions, where the borrower is allowed to make reduced repayments (or, in exceptional circumstances, no repayments) on a temporary basis to assist with a short term financial hardship. In these cases the shortfall on the repayments will accrue as arrears and the loan is deemed to be impaired;
- whilst permanent or temporary conversion to interest only repayments is no longer allowed, where this has been agreed in the past two years, a loan is considered to have been subject to forbearance;
- an extension to the mortgage term to reduce the borrower's repayments. All loans that have had a term extension in the last two years are considered to be subject to forbearance, even where these were not agreed as a forbearance treatment;
- capitalisation, where outstanding arrears are added to the capital value of the loan to be repaid over the remaining term. This is only considered by exception, with nine cases capitalised during the year to 31 December 2013 (2012: 20); and
- where applicable we will work with the customer as part of a government support scheme. In this case, unmet loan payments will continue to accrue as arrears until such time as the loan is cleared, or the outstanding payments are brought up to date.

Payment holidays are allowed as part of a customer's flexible mortgage contract. Payment holidays are not knowingly allowed for customers experiencing financial difficulty.

Mortgages subject to forbearance are assessed to determine which is the appropriate impairment treatment to apply.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

The table below analyses secured residential mortgage balances by type of forbearance and the associated gross impairment coverage (including credit fair value adjustments).

Audited

	31 December 2013				31 December 2012			
Retail secured	**Neither past due nor impaired**	**Impaired**	**Loans subject to forbearance**	**Impairment coverage**	Neither past due nor impaired	Impaired	Loans subject to forbearance	Impairment coverage
Concessions	**0.7**	**0.5**	**1.2**	**–**	0.1	0.5	0.6	–
Arrangements	**16.5**	**27.0**	**43.5**	**(0.6)**	20.5	25.5	46.0	(0.3)
Term extensions	**441.9**	**3.6**	**445.5**	**(1.3)**	462.7	4.8	467.5	(0.1)
Interest only switches	**33.6**	**2.9**	**36.5**	**(0.6)**	80.4	3.6	84.0	(0.1)
Capitalisations	**0.1**	**–**	**0.1**	**–**	1.3	0.3	1.6	–
	492.8	**34.0**	**526.8**	**(2.5)**	565.0	34.7	599.7	(0.5)

	31 December 2013				31 December 2012			
Optimum	**Neither past due nor impaired**	**Impaired**	**Loans subject to forbearance**	**Impairment coverage**	Neither past due nor impaired	Impaired	Loans subject to forbearance	Impairment coverage
Concessions	**1.1**	**3.9**	**5.0**	**(0.2)**	0.9	3.9	4.8	(0.1)
Arrangements	**28.5**	**345.8**	**374.3**	**(36.4)**	31.8	423.6	455.4	(21.9)
Term extensions	**21.1**	**1.3**	**22.4**	**(0.3)**	26.3	1.1	27.4	–
Interest only switches	**13.1**	**6.8**	**19.9**	**(0.7)**	25.9	12.1	38.0	(0.5)
Capitalisations	**–**	**–**	**–**	**–**	–	–	–	–
	63.8	**357.8**	**421.6**	**(37.6)**	84.9	440.7	525.6	(22.5)

1.3.1.2 Unsecured retail credit risk

Acquisition and account management

The Bank offers unsecured lending through loans, credit cards and overdrafts. Customers applications for credit are assessed using a combination of credit scoring and policy rules. Credit cards and overdrafts are subject to ongoing account management to determine increases or decreases in credit limits should apply as well as to manage over limit authorisations.

The portfolio risk is reassessed monthly using behavioural scorecards to determine the amount of capital required to be held for individual exposures.

The following table shows unsecured lending gross customer balances (including undrawn commitments) by product type:

Audited

	31 December 2013	31 December 2012
Loans	**570.8**	660.9
Professional and career development loans	**82.5**	73.4
Credit cards	**2,532.4**	2,703.6
Overdrafts	**355.0**	382.8
	3,540.7	3,820.7

Impairment

Impairment provision is raised for:

- identified impairment – at one penny, one day past due or in excess, based on the probability of default and the discounted cash flow of recoveries from default;
- unidentified impairment – on the performing book, based on the probability of emerging as delinquencies, the probability of default and the discounted cash flow of recoveries from default; and
- loans meeting the individually significant asset definition are individually assessed for impairment.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

Coverage ratios calculated using carrying values in the accounts are shown in the table below.

Audited

	31 December 2013	31 December 2012
Gross loans and advances	**1,294.6**	1,393.1
of which impaired	**216.9**	213.7
Impaired as a % of gross loans and advances	**16.8%**	15.3%
Allowance for losses	**160.2**	172.8
Coverage	**73.9%**	80.9%

For internal management reporting purposes the Bank includes balances sent to debt collection agencies in gross loans and advances, impaired balances and allowance for losses. This results in a coverage ratio of 82.1% (2012: 86.2%).

Forbearance

A number of forbearance options, including concessionary arrangements, are available to borrowers in financial difficulty. These are handled either with customers directly or through a third party whom they have chosen to represent them. Accounts classified as forborne remain so until the period of financial difficulty has passed and the account has demonstrated it can operate under sustainable terms.

1.3.1.3 Corporate credit risk

Acquisition and account management

The Bank operates to a lending policy which is subject to meeting criteria as laid down in the corresponding sector strategy guidelines and strict policy with regards to single name and sector concentrations. First line relationship managers submit recommendations for any new money, renewal of facilities or amendments to existing lending to the appropriate sanctioning authority. The supporting credit underwriting team, who are independent from income generation, will review and risk assess the proposal before submitting their recommendation to the sanctioning authority for approval. The credit underwriting team uses rating systems and other tools to analyse the underlying business and the counterparty's management to assess the risk of each lending proposition and its ability to repay the borrowing. Other factors considered include the potential impact of economic changes, availability of supporting collateral, the financial stability of the counterparty and its ability to withstand such change.

The lending discretions for new money are made by the LCC (mainly Non-core customers due to their size), the Strategic Asset Review (SAR) groups (Non-core only) or the SCC (Core business). The CRO, the CFO and the CEO are members of the LCC. The CoAM strategy is executed through higher risk (default and watchlist) and performing SAR groups comprising of first and second line business and credit risk representatives where the majority of decisions are taken to set run-off or exit strategies, (on occasion these strategies do require additional lending to protect value in the work out of a customer asset). Beyond certain levels of exposure and/or new money, the SAR groups make recommendations to the LCC for the fund decision.

Monitoring of portfolios and impairment provisioning governance is in place across the portfolios. Individual cases which show signs of unsatisfactory performance are managed through a specialist Corporate Business Support team who are engaged with the customers to restore them to good health or, wherever this is not possible, take actions to effect recovery.

In addition to the first line Operating Committees for BaCB and CoAM, the CRMF and ERC (and by exception the BRC) receive regular reports on the performance of the portfolio.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

The tables below show the distribution of the BaCB and CoAM gross customer balances (including commitments) by sector and risk grade, where PD grades have been mapped to regulatory slotting categories for ease of interpretation in this report.

Audited

31 December 2013	Standardised	Strong	Good	Satisfactory	Weak	Default	Total
BaCB							
Accommodation, food and licensed services	14.8	11.1	18.2	4.9	–	–	49.0
Care	20.3	12.4	26.5	0.5	–	–	59.7
Education	45.9	15.0	5.0	–	–	–	65.9
Financial services	11.5	25.6	20.0	0.8	–	0.2	58.1
Football clubs	–	–	–	–	–	–	–
Housing associations	2.2	33.6	0.8	–	–	–	36.6
Manufacturing	4.3	8.0	13.7	1.8	–	0.4	28.2
Motor trade and garages	1.5	3.8	5.2	–	–	–	10.5
PFI	–	–	–	–	–	–	–
Professional services	21.1	9.9	5.0	0.1	–	0.3	36.4
Property and construction:							
Commercial investment	6.0	9.8	226.6	0.3	–	0.1	242.8
Residential investment	2.9	0.6	55.9	–	–	–	59.4
Commercial development	0.3	0.5	14.3	–	–	–	15.1
Residential development	0.7	1.2	11.3	–	–	–	13.2
Public sector entities	3.6	–	–	–	–	–	3.6
Renewable energy	–	–	–	–	–	–	–
Retail and wholesale trade	2.3	307.8	9.3	0.2	–	–	319.6
Services	98.6	18.3	23.4	1.8	–	0.3	142.4
Transport, storage and communication	1.9	6.6	3.1	0.2	–	–	11.8
Utilities	0.1	1.5	0.3	–	–	–	1.9
Business banking	0.9	40.1	7.4	3.0	0.6	0.1	52.1
Other	5.0	1.9	0.7	–	–	–	7.6
	243.9	507.7	446.7	13.6	0.6	1.4	1,213.9

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

31 December 2013	Standardised	Strong	Good	Satisfactory	Weak	Default	Total
Corporate CoAM							
Accommodation, food and licensed services	113.7	82.4	107.7	26.1	16.2	221.8	567.9
Care	112.8	1.1	16.8	31.7	2.4	31.6	196.4
Education	29.1	17.9	–	0.6	–	0.1	47.7
Financial services	52.6	33.0	6.2	3.8	–	4.4	100.0
Football clubs	–	32.2	–	0.4	0.1	15.9	48.6
Housing associations	5.3	1,063.0	0.9	–	–	–	1,069.2
Manufacturing	17.9	9.8	6.5	16.0	0.1	6.6	56.9
Motor trade and garages	–	53.7	16.4	1.7	0.7	7.2	79.7
PFI	–	32.4	1,122.3	–	33.4	–	1,188.1
Professional services	35.6	5.5	11.5	10.0	0.2	2.0	64.8
Property and construction:							
Commercial investment	31.1	75.5	722.6	141.8	27.7	1,190.3	2,189.0
Residential investment	3.3	0.1	83.1	54.6	25.6	127.4	294.1
Commercial development	44.0	4.1	107.0	44.9	1.1	79.7	280.8
Residential development	4.9	–	42.3	11.3	2.2	9.0	69.7
Public sector entities	174.2	0.3	–	–	–	–	174.5
Renewable energy	566.9	–	–	–	–	11.2	578.1
Retail and wholesale trade	38.5	7.4	7.2	7.1	1.1	15.1	76.4
Services	109.1	74.0	18.8	21.2	0.5	29.6	253.2
Transport, storage and communication	15.3	3.4	0.6	6.7	–	6.3	32.3
Utilities	17.9	–	0.7	0.1	–	1.5	20.2
Business banking	–	–	–	–	–	0.4	0.4
Other	0.5	0.7	0.2	1.6	–	2.1	5.1
	1,372.7	1,496.5	2,270.8	379.6	111.3	1,762.2	7,393.1
Total exposure	1,616.6	2,004.2	2,717.5	393.2	111.9	1,763.6	8,607.0

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

31 December 2012	Standardised	Strong	Good	Satisfactory	Weak	Default	Total
BaCB							
Accommodation, food and licensed services	18.0	12.1	25.7	1.4	–	–	57.2
Care	43.6	17.4	29.6	5.4	0.5	–	96.5
Education	49.4	40.0	3.4	1.0	–	–	93.8
Financial services	14.9	26.8	22.4	0.1	–	–	64.2
Football clubs	–	–	–	–	–	–	–
Housing associations	7.7	44.6	0.9	–	–	–	53.2
Manufacturing	7.0	15.7	25.6	5.4	0.1	–	53.8
Motor trade and garages	2.0	2.7	6.1	0.5	–	–	11.3
PFI	–	–	–	–	–	–	–
Professional services	23.7	63.3	5.4	1.7	–	–	94.1
Property and construction:							
Commercial investment	9.7	19.3	262.8	3.0	0.1	3.3	298.2
Residential investment	9.3	5.7	54.2	1.9	–	–	71.1
Commercial development	1.5	0.7	15.4	2.1	–	1.8	21.5
Residential development	0.3	4.8	11.3	1.0	0.8	–	18.2
Public sector entities	9.2	–	–	–	–	–	9.2
Renewable energy	–	–	–	–	–	–	–
Retail and wholesale trade	7.8	308.8	11.9	0.5	–	–	329.0
Services	139.1	22.0	17.5	2.3	0.2	–	181.1
Transport, storage and communication	2.3	6.8	2.5	0.3	–	0.2	12.1
Utilities	1.8	1.5	0.5	0.4	–	–	4.2
Business banking	0.8	35.1	6.7	2.9	0.4	0.5	46.4
Other	6.8	1.5	1.1	1.0	–	–	10.4
	354.9	628.8	503.0	30.9	2.1	5.8	1,525.5

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

31 December 2012	Standardised	Strong	Good	Satisfactory	Weak	Default	Total
Corporate CoAM							
Accommodation, food and licensed services	298.6	107.1	126.5	20.3	18.1	278.1	848.7
Care	205.7	18.4	43.5	26.1	–	2.1	295.8
Education	17.7	20.5	–	0.2	–	–	38.4
Financial services	68.7	52.5	8.2	3.6	–	4.8	137.8
Football clubs	–	33.2	–	0.4	0.1	19.2	52.9
Housing associations	0.6	1,046.0	45.0	–	–	–	1,091.6
Manufacturing	80.5	4.1	18.9	7.5	15.1	9.5	135.6
Motor trade and garages	22.9	54.6	20.1	9.9	0.8	3.7	112.0
PFI	–	4.0	1,247.4	34.7	–	10.7	1,296.8
Professional services	47.0	8.2	15.9	11.4	0.8	3.8	87.1
Property and construction:							
Commercial investment	56.4	73.5	1,166.5	272.4	126.0	1,420.8	3,115.6
Residential investment	4.2	0.1	161.5	60.6	50.2	120.4	397.0
Commercial development	1.2	9.3	139.5	73.3	15.2	40.2	278.7
Residential development	1.1	0.6	49.5	13.1	7.4	5.8	77.5
Public sector entities	170.8	1.3	–	–	–	–	172.1
Renewable energy	633.7	–	–	–	–	9.2	642.9
Retail and wholesale trade	100.5	87.9	43.7	11.9	5.4	19.3	268.7
Services	326.6	98.4	41.7	28.1	17.8	23.9	536.5
Transport, storage and communication	103.0	51.3	2.8	15.8	0.4	14.9	188.2
Utilities	92.6	–	1.5	0.1	–	0.6	94.8
Business banking	–	–	–	–	–	–	–
Other	0.5	0.5	0.4	4.3	–	2.1	7.8
	2,232.3	1,671.5	3,132.6	593.7	257.3	1,989.1	9,876.5
Total exposure	2,587.2	2,300.3	3,635.6	624.6	259.4	1,994.9	11,402.0

The comparative table has been updated to reflect the changes to Core (BaCB) and Non-core (CoAM) divisions.

The Standardised category relates to sectors which for purposes of capital calculations, are not rated with a regulatory approved rating model due to the sector having insufficient numbers of customers and/or low defaults. These typically belong to the public sector entities and renewable energy sectors, and to the following customer types within other sectors: other energy efficiency schemes, leveraged (more highly geared businesses, for example, comprising of Management Buy-Outs or firms that have made business acquisitions to expand their operation) of which we have a relatively small portfolio, newly established companies with an insufficient number of published financial accounts, project finance and charities.

The criteria for the BaCB portfolio is a combination of a maximum turnover of £25m (for a single legal entity (SLE)), maximum exposure of £5m (at connection level which might comprise of several SLEs that are directly connected or share common directors/collateral) and risk rating being good, strong or standardised. BaCB also handles charities and co-operatives (irrespective of size). BaCB seeks further opportunities to lend using these criteria.

The movement of balances into the Default category in the period remains reflective of the continued challenging commercial property environment and the Bank's focus on the expected outlook for this sector, consequential forbearance strategies and the completion of the Bank's review of its default and credit risk impairment strategy.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

Collateral

The Bank uses various forms of collateral including guarantees to mitigate credit risk. Collateral is regularly reviewed to ensure continued effectiveness as part of the credit review process. Property collateral for corporate lending is categorised as security for property development or investment customers (ie 'property' lending) or owner occupied premises to secure mainstream loan and overdraft facilities. For general lending, in addition to taking charges over property assets owned by the customer, other security is taken in modest proportion to the total portfolio. This includes debentures or floating charges and guarantees (often supported by tangible security, where appropriate, including property, life policies and stocks & shares) and cash cover.

Where exposures are agreed on a secured basis, security cover is recognised only where:

- the security is legally enforceable and is of a tangible nature and type;
- an appropriate, recent and reliable valuation is held; and
- a prudent margin is applied to the valuation, for the type of security involved.

Property valuations are obtained when the facility is first approved and our lending procedures require collateral to be revalued every two years or more frequently in higher risk situations (typically annually or when a material change has occurred that is likely to affect the value and/or recoverability of the debt). In certain circumstances, such as syndicates, the multi bank facility letter may preclude revaluations at the customer's expense of all the assets as frequently as this and a decision is required by all banks involved to decide if they require the updates more frequently.

In addition, the values held in the Bank's systems are indexed for risk assessment and capital calculation using appropriate regional and asset type indexes where available, otherwise the national average index is applied.

The table below analyses the market value of the property collateral held against assets in the property and construction sectors:

Audited

	31 December 2013			31 December 2012		
	Exposure	**Collateral**	**Impairment provision**	Exposure	Collateral	Impairment provision
BaCB						
Non-default loans with ≤1 year until refinancing and all defaulted exposures regardless of term						
Less than 50%	**25.4**	**25.4**	**–**	23.4	23.4	–
50% to 60%	**13.9**	**13.9**	**–**	12.3	12.3	–
60% to 70%	**5.4**	**5.4**	**–**	7.0	7.0	–
70% to 80%	**–**	**–**	**–**	3.5	3.5	–
80% to 90%	**0.1**	**0.1**	**–**	2.7	2.7	–
90% to 100%	**0.2**	**0.2**	**–**	0.5	0.5	–
Greater than 100%	**–**	**–**	**–**	5.1	3.2	1.8
Unsecured	**2.7**	**–**	**–**	1.2	–	–
	47.7	**45.0**	**–**	55.7	52.6	1.8
Non-default loans with > 1 year until refinancing and all non-loan non-defaulted exposures regardless of term						
Less than 50%	**139.3**	**139.3**	**–**	132.7	132.7	–
50% to 60%	**84.8**	**84.8**	**–**	103.1	103.1	–
60% to 70%	**48.4**	**48.4**	**–**	85.6	85.6	–
70% to 80%	**2.8**	**2.8**	**–**	15.2	15.2	–
80% to 90%	**1.2**	**1.2**	**–**	3.8	3.8	–
90% to 100%	**1.0**	**1.0**	**–**	5.0	5.0	–
Greater than 100%	**3.4**	**3.0**	**–**	1.8	1.5	–
Unsecured	**1.8**	**–**	**–**	6.3	–	–
	282.7	**280.5**	**–**	353.5	346.9	–
	330.4	**325.5**	**–**	409.2	399.5	1.8

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

Audited

	31 December 2013			31 December 2012		
	Exposure	**Collateral**	**Impairment provision**	Exposure	Collateral	Impairment provision
Corporate CoAM						
Non-default loans with ≤1 year until refinancing and all defaulted exposures regardless of term						
Less than 50%	**53.9**	**51.7**	**2.2**	46.5	46.3	0.1
50% to 60%	**90.9**	**69.1**	**21.7**	74.9	74.5	0.4
60% to 70%	**107.8**	**107.0**	**0.8**	136.4	133.8	2.6
70% to 80%	**135.0**	**130.6**	**4.5**	112.5	112.5	–
80% to 90%	**104.1**	**85.6**	**18.4**	69.9	68.1	1.8
90% to 100%	**48.2**	**34.8**	**13.4**	102.7	78.0	24.7
Greater than 100%	**1,155.0**	**687.4**	**452.9**	1,336.8	909.8	337.5
Unsecured	**73.6**	**–**	**60.5**	212.7	–	67.4
	1,768.5	**1,166.2**	**574.4**	2,092.4	1,423.0	434.5
Non-default loans with > 1 year until refinancing and all non–loan non-defaulted exposures regardless of term						
Less than 50%	**115.0**	**115.0**	**–**	142.9	142.9	–
50% to 60%	**283.7**	**283.7**	**–**	253.2	253.2	–
60% to 70%	**372.7**	**372.7**	**–**	502.3	502.3	–
70% to 80%	**137.9**	**137.9**	**–**	324.4	324.4	–
80% to 90%	**47.9**	**47.9**	**–**	148.5	148.5	–
90% to 100%	**22.0**	**22.0**	**–**	96.4	96.4	–
Greater than 100%	**55.2**	**19.9**	**–**	227.5	169.9	–
Unsecured	**30.7**	**–**	**–**	81.4	–	–
	1,065.1	**999.1**	**–**	1,776.6	1,637.6	–
	2,833.6	**2,165.3**	**574.4**	3,869.0	3,060.6	434.5

In the table, collateral is constrained to a maximum of 100% of the exposure to each customer to correctly reflect the maximum protection available to the Bank.

There are two cases in the 50-60% LTV band which have had significant impairment provisions applied against them. In one case the provision represents the loss of key rental income combined with swap break costs, in the other the anticipated final losses on completion of the sale of the property.

As at 31 December 2013, £59.3m (2012: £50.0m) of the above are not held as first charge.

Impairment

Corporate customers are placed on a watchlist and treated as impaired when they show signs of unsatisfactory performance and require close monitoring. Strong indicators that a customer should be placed on watchlist include but are not limited to:

- unsatisfactory account operation – both lending facility and current accounts;
- considerable reduction in value of collateral;
- deteriorating balance sheet position and/or material losses/cashflow pressures;
- breach of covenants;
- refinance risk at maturity;
- application of forbearance strategies; and
- business performance is assessed to have deteriorated to the extent that there is a real risk of loss of principal, interest or fees.

After a period of satisfactory performance, and dependent on the Bank's agreement that the triggers which led to inclusion on the watchlist no longer apply, customers may be removed from the watchlist.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

Removal from the watchlist usually requires the customer's management information to show that trading and account performance is achieving the revised plan with objective evidence that this will continue.

The Bank also reviews on a monthly basis, through the Impairment Charge Forum, all higher risk loans (including those accounts subject to forbearance) and considers the potential loss which might arise were the borrowers to fail (notwithstanding that continued trading remains the expectation).

Objective evidence of impairment will include but is not limited to:

- an instalment on a loan account being overdue, or having been in excess of its limit (or being overdrawn without an agreed limit) for 90 days or more;
- an event likely to result in insolvency which may involve bankruptcy, or the appointment of an administrative receiver, liquidator or administrator; or
- if the Bank considers that at some point (normally within the next 12 months) the facility is unlikely to be repaid in full and actions such as an issue of formal demand will be required in order to achieve full repayment.

A credit risk impairment charge is required on some of or the entire shortfall between the security held and the loan balance outstanding and represents an assessment of the likely net loss after realisation of any security.

For credit risk impairment purposes, a property valuation or selling agent's recommendation is discounted to take into account selling and legal costs and also to build in a contingency to cover potential reductions in the selling price based upon the type of security and entity and the existence or otherwise of a contracted sale. In some cases, calculation of the credit risk impairment is based on an up to date assessment (often following an independent business review by a firm of accountants) of likely receivables from the business or a formal estimated outcome statement from an insolvency practitioner where the business has failed.

Provisioning adjustments are also recorded, as appropriate, against loans whose interest terms have changed such that revised future cash flows discounted at the original interest rate are less than the current carrying amount.

The collective unidentified impairment provision (CUIP) provides cover for the performing portfolio using a formulaic approach based on default experience across the portfolio. The unidentified impairment reflects trigger events that have occurred but not yet been identified and cannot therefore be allocated to individual loans.

Audited

	31 December 2013		31 December 2012	
	BaCB	**CoAM**	BaCB	CoAM
Gross loans and advances	**840.8**	**6,504.3**	815.8	8,206.7
of which impaired	**15.6**	**1,977.8**	8.8	2,165.2
Impaired as a % of gross loans and advances	**1.9%**	**30.4%**	1.1%	26.4%
Individual allowance for losses	**0.5**	**698.4**	0.3	426.9
Impairment coverage (excluding collective provisions)	**3.2%**	**35.3%**	3.4%	19.7%
Collective allowance for losses	**5.3**	**40.0**	1.1	20.5

The Bank manages recovery of customer arrears on a gross customer balance basis (excluding credit fair value adjustments and other accounting entries. Gross loans and advances to customers comprises mortgages that were acquired by the Bank at discounts to the amounts that were advanced to the mortgagors, and mortgages that were originated by the Bank. In order to aid comparability with its peers, for internal management reporting purposes the Bank also calculates allowance for losses on the basis of amounts originally advanced to mortgagors, regardless of whether the Bank acquired or originated these mortgages. On this basis the BaCB allowance for losses is £0.5m (2012: £0.3m) and the coverage ratio is 3.2% (2012: 3.6%) and the CoAM allowance for losses is £796.1m (2012: £642.8m) and the coverage ratio is 39.5% (2012: 26.3%).

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

The movements in impaired customer balances during the year are shown below:

Audited

	31 December 2013		31 December 2012	
	BaCB	**CoAM**	BaCB	CoAM
Balance at start of year	**8.4**	**2,447.6**	16.4	2,235.0
Classified as impaired during the year	**15.8**	**552.5**	1.0	564.0
Transferred to unimpaired during year	**(0.9)**	**(3.6)**	(0.6)	(56.1)
Amounts written off	**(0.4)**	**(246.2)**	(0.7)	(79.2)
Net repayments and other	**(7.4)**	**(732.6)**	(7.7)	(216.1)
Balance at the end of year	**15.5**	**2,017.7**	8.4	2,447.6

The level of cover as a percentage of impaired Non-core customer balances has increased to 39.5% in December 2013 from 26.3% in December 2012 following a further increase in the level of impairment provisions.

Forbearance

If the Bank is confident of a customer's ability and commitment to address their financial difficulties, it may agree to grant concessions to the original contractual terms. Such concessions typically include:

- restructuring, waiving or reserving rights in the event of covenant breaches;
- postponement of principal payments;
- restructures of principal payments;
- extension of loan maturities;
- partial or full capitalisation of interest payments; or
- swap restructures.

In addition to the above, other forbearance concessions are considered to be objective evidence of impairment and include:

- a partial write-off of debt, following which the account continues to be classified as impaired for at least six months; or
- a material postponement or forgiveness of interest or 'soft' rates or waiver or reduction of normal fees and charges; the accounts must remain impaired while such favourable terms are being applied.

The table below analyses the exposures subject to forbearance:

Audited

	31 December 2013			31 December 2012		
	Forborne	**Non-forborne**	**Total**	Forborne	Non-forborne	Total
BaCB						
Default	**–**	**1.4**	**1.4**	3.5	2.3	5.8
On watchlist	**8.8**	**5.5**	**14.3**	0.6	2.9	3.5
Neither default nor on watchlist	**1.9**	**1,196.3**	**1,198.2**	14.0	1,502.2	1,516.2
	10.7	**1,203.2**	**1,213.9**	18.1	1,507.4	1,525.5
Corporate CoAM						
Default	**936.5**	**825.7**	**1,762.2**	1,254.4	734.9	1,989.3
On watchlist	**116.2**	**204.8**	**321.0**	363.4	128.5	491.9
Neither default nor on watchlist	**16.3**	**5,293.6**	**5,309.9**	279.0	7,116.3	7,395.3
	1,069.0	**6,324.1**	**7,393.1**	1,896.8	7,979.7	9,876.5
	1,079.7	**7,527.3**	**8,607.0**	1,914.9	9,487.1	11,402.0

Impairment provisions are made for accounts, which are in default and on the watchlist, subject to forbearance.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

For those customers that benefit from ongoing concessions (such as postponement of principal payments), the Bank retains the forbearance status for as long as the concession remains in place. In the event of one-off concessions (such as capitalisation of interest payments), the Bank removes the forbearance status 12 months after their occurrence provided that the loan has been kept up to date during that period and all covenants continue to be met.

1.3.2 Investment securities

At the balance sheet date, the Bank has a total investment securities portfolio of £4,499.4m (2012: £6,928.8m) of which £20.0m (2012: £39.0m) is considered impaired and against which full provisions are held.

The following tables analyse the gross balance by impairment classification and type of investment security:

Audited

	Investment securities				
31 December 2013	**Loans and receivables**	**Available for sale**	**Fair value through income or expense**	**Held for trading**	**Total**
Analysis of balance per note 19					
Gross balance	**23.6**	**2,752.4**	**1,743.4**	**–**	**4,519.4**
Less: allowance for losses	**–**	**(20.0)**	**–**	**–**	**(20.0)**
	23.6	**2,732.4**	**1,743.4**	**–**	**4,499.4**
Analysis of credit risk exposure					
Not impaired	**23.6**	**2,732.4**	**1,743.4**	**–**	**4,499.4**
Impaired	**–**	**20.0**	**–**	**–**	**20.0**
Gross credit risk exposure	**23.6**	**2,752.4**	**1,743.4**	**–**	**4,519.4**
Less:					
Allowance for losses	**–**	**(20.0)**	**–**	**–**	**(20.0)**
Net credit risk exposure	**23.6**	**2,732.4**	**1,743.4**	**–**	**4,499.4**

	Investment securities				
31 December 2012	Loans and receivables	Available for sale	Fair value through income or expense	Held for trading	Total
Analysis of balance per note 19					
Gross balance	295.0	3,828.4	1,845.2	960.2	6,928.8
Less: allowance for losses	–	(39.0)	–	–	(39.0)
	295.0	3,789.4	1,845.2	960.2	6,889.8
Analysis of credit risk exposure					
Not impaired	295.0	3,789.4	1,845.2	960.2	6,889.8
Impaired	–	39.0	–	–	39.0
Gross credit risk exposure	295.0	3,828.4	1,845.2	960.2	6,928.8
Less:					
Allowance for losses	–	(39.0)	–	–	(39.0)
Net credit risk exposure	295.0	3,789.4	1,845.2	960.2	6,889.8

Fair value adjustments relating to expected credit losses on assets obtained on merger with Britannia Building Society in 2009 are no longer shown separately, instead they have been allocated against the relevant assets.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

1.3.2.1 Collateral

Policies are in place with regard to the management and valuation of collateral. Repos and secured lending positions are revalued daily. Margin calls on collateralised swaps are made dependent on the counterparty. Eligible financial collateral for Basel II reporting purposes typically includes gilts held under reverse repo agreements and cash held under both repo agreements and collateralised swap arrangements. At the year end there were no gilts held under reverse repo agreements, but the Bank did hold some non-UK Sovereign Collateral.

Guarantees relied upon are either parental guarantees held against subsidiary exposures within bank groups or sovereign guarantees.

1.3.2.2 Impaired assets

Investment securities are considered past due where the contractual interest or principal payments are in arrears and it is determined that the Bank will be able to collect all principal and interest outstanding according to the contractual terms of the agreements.

Investment securities are considered impaired where it is determined that the Bank will be unable to collect all principal and interest outstanding, according to the contractual terms of the agreements.

At the balance sheet date, the Bank assesses its investment securities for objective evidence that an impairment loss has occurred. Particular consideration is given to evidence of any significant difficulty of the issuer or measurable decrease in the estimated cash flows from the investments.

1.3.2.3 Not impaired assets

The Bank only invests in treasury assets which comply with the credit risk policy and Treasury credit risk control standard. Within the Treasury investment security portfolio 100% (31 December 2012: 99%) of exposures have an external credit rating equivalent to Fitch A or above.

1.3.3 Loans and advances to banks

None of the Bank's exposures to loans and advances to banks are impaired. The Bank considers that its exposures to loans and advances to banks are all of low to medium risk.

1.3.4 Derivative financial instruments

The Bank enters into collateral agreements to mitigate credit risk from derivative counterparties. The majority of the Bank's collateral agreements are bi-lateral. None of the Bank's derivatives are cleared using a central clearing counterparty. Most derivatives that are subject to collateral agreements are collateralised using cash. Some derivatives linked to funding programmes can place government securities, cash, or other eligible securities as collateral as agreed by rating agencies and subject to ratings triggers.

Occasionally the Bank enters into unilateral agreements for certain derivatives; these are used for credit risk mitigation in securitisation structures. There were no unilateral agreements in place at either 31 December 2013 or 31 December 2012.

Audited

	31 December 2013		31 December 2012	
	Derivative notional (net)	**Derivative fair value (net)**	Derivative notional (net)	Derivative fair value (net)
Interest rate				
Bi-lateral collateral agreements	**16,822.8**	**(163.9)**	24,457.6	(327.4)
No collateral agreement	**5,078.6**	**(11.0)**	3,830.7	4.2
Foreign exchange				
Bi-lateral collateral agreements	**651.3**	**6.1**	1,333.2	17.5
No collateral agreement	**1,504.3**	**186.0**	1,635.5	156.9
	24,057.0	**17.2**	31,257.0	(148.8)

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

1.4 Wholesale credit risk Audited

The Bank remains a UK focused retail and commercial operation with limited sovereign exposures to eurozone governments. Limits have been set to enable the management of Treasury credit risk concentrations. These limits are monitored and relate country limits with more granular limits to cover asset class, sector exposures and counterparty groups, to prevent unacceptable concentrations.

As at 31 December 2013 the Bank had a £299.0m (2012: £306.7m) gross exposure to the Government of Finland. It held no other material non-UK sovereign debt (2012: £102.2m).

1.4.1 Direct exposures

During 2013, exposures to financial institutions in European countries materially reduced, with a total gross exposure outstanding at 31 December 2013 of £110.2m (2012: £2,452.6m). After credit risk mitigation, the net exposure was £110.2m (2012: £1,135.7m).

Within the Treasury portfolio there are a number of risk mitigation techniques available including netting and collateralisation agreements. Other methods such as disposal and credit derivatives are used periodically to mitigate the credit risk associated with particular transactions.

Treasury operates a risk based approach which monitors counterparty limits and exposure via a credit risk register. Both the counterparties and assets held are monitored against a Board approved matrix of risk tolerance and associated indicators. The credit risk register is updated for rating actions, market events and financial results as they are announced which may influence a change in risk status and possible escalation requiring management actions and inclusion on the watchlist.

The Treasury risk team reviews the portfolio and watchlists monthly for appropriate risk status bandings and any associated management actions. As at 31 December 2013 there were no red (highest risk) Eurozone exposures outstanding (2012: £nil).

1.4.2 Indirect exposures

Treasury risk management monitoring extends beyond the direct risk incurred through counterparty trading to the underlying exposures which Treasury's counterparties may maintain on their own balance sheets. In analysing each counterparty's secondary exposure, we assess the vulnerability and impact on that firm should it suffer different degrees of losses.

Where secondary sovereign exposure or contagion risk is deemed to undermine the performance of the counterparty, remedial management actions are taken in respect of Treasury's counterparty limits and exposure.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

2. Liquidity risk Unaudited

In plain english:

Liquidity and funding risk is the risk that the Bank cannot pay amounts that it owes when they fall due, or can only do so at excessive cost. The risk can arise either because:

- the Bank has insufficient funds to pay the amounts it owes; or
- even though the Bank has sufficient funds, those funds have been invested and so are not readily available.

The Bank's business faces inherent risks concerning liquidity, particularly if the availability of traditional sources of funding such as retail and corporate deposits and, to a lesser extent, unsecured wholesale funding (these being the principal sources of the Bank's funding) become limited and/or more expensive. This may result in an inability to operate in the ordinary course, and/or a failure to meet liquidity requirements, and/or may adversely impact the Bank's business and/or the implementation of its strategy.

As the Bank's main source of funds is deposits, the Bank faces the risk of not being able to replace funds when they are withdrawn or, if a significant number of depositors withdraw their funds, of not being able to meet its obligations to fund such withdrawals, repay lenders in accordance with its financing arrangements or fulfil commitments to lend. However, despite the steps that the Bank has taken to maintain its levels of total liquidity, as the Bank relies on its customer deposits to provide funding for the Bank, any severe decline in customer confidence in the Bank could increase the amount of deposit withdrawals in a short space of time or over a sustained period.

Given the relative size of the Bank's deposit base as compared with its other sources of funding, the Bank is particularly exposed to any serious loss of confidence by its depositors. If the Bank experiences an unusually high level of withdrawals which exceed what the Bank can manage through liquidity controls and contingency planning, this may have a negative effect on the Bank's business and could, in extreme circumstances, prevent the Bank from meeting its financial obligations as they fall due, meeting its regulatory minimum liquidity requirements or fulfilling its commitments to lend. In these circumstances, the Bank may be subject to a resolution procedure under the Banking Act.

In the year to 31 December 2013, however, the Bank has continued to maintain a sufficiently stable liquidity position, with a liquid asset ratio of 16.0% at the balance sheet date (2012: 14.6%). In addition, during 2013, the Bank proactively managed its liquidity position, maintaining a regulatory liquidity buffer, and has continued to restructure existing exposures to further improve the funding profile and ensure its financial obligations are met as and when they fall due. From a management perspective, liquidity is monitored on a daily basis via a suite of liquidity risk metrics supported by cash flow forecasts and stress tested forecasts.

2.1 Liquidity framework Unaudited

The Bank's liquidity Risk Management Framework comprises:

- a defined risk appetite, controls and governance in the Bank's liquidity management policies;
- articulation of how liquidity risk is identified, measured, monitored and managed in the Individual Liquidity Adequacy Assessment (ILAA) and procedures and governance in place to mitigate the risk;
- liquidity risk quantification and mitigation techniques and processes;
- management actions linked through to stress testing and liquidity planning models, enabling a method of mitigating the effects of a number of stress scenarios for varying periods of time and to ensure that the Bank operates within its agreed risk appetite parameters in all planning models;
- ongoing development and enhancement of the Bank's liquidity risk appetite framework; and
- a process to attribute the cost, benefit and risks of liquidity to specific business lines via the Bank's funds transfer pricing mechanism.

2.2 Liquidity risk Unaudited

The Board's risk appetite for liquidity risk is defined in terms of:

- survival periods which measure the ability of liquid assets to support the Bank's activity over time under a number of stress scenarios;
- adherence to strategic liquidity risk measures; and
- compliance with all regulatory liquidity risk limits.

The stress tests encompass survival across various timescales and a range of adverse liquidity events, both firm specific and market wide, which endeavour to cover all aspects of the liquidity risk to which the Bank is exposed.

The strategic measures approved by the Board include:

- customer loan/deposit ratio, 95% (2012: 92%) – the ratio of gross loans and advances to customers to total customer deposits;
- encumbrance ratio, 27% (2012: 27%) – the ratio of encumbered assets divided by total assets;
- regulatory framework – Net Stable Funding ratio and Internal Liquidity Guidance; and
- internal liquidity stress tests – the survival period of the Bank under a range of stressed scenarios.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

2. Liquidity risk continued

2.3 Liquidity risk management overview Unaudited

Liquidity risk arising from the structure of the balance sheet and stresses occurring from cash withdrawals from customers are managed in line with policies developed by the Liquidity Management Forum (LMF), the Assets and Liabilities Committee (ALCO) and the Board. The Bank's liquidity management policies are reviewed and approved annually by the BRC (on behalf of the Board) and compliance is reviewed by LMF, ALCO and the Board. The Bank's policy is to have sufficient funds available at all times to meet demands from depositors, to fund agreed advances, to meet other commitments as and when they fall due, and to ensure the Board risk appetite is met.

The Bank monitors its liquidity position on a daily basis via liquidity risk metrics. LMF oversees the operational liquidity management. LMF convenes at least once a month but can convene as frequently as required. A range of indicators, details of cash flows and media coverage are monitored to attempt to detect early signs of liquidity risk either in the market or specific to the Bank. The LMF, ALCO and the Board discuss the actual liquidity position and projected position incorporating business plans. More frequent meetings are held if necessary, ie when the markets have a heightened period of stress or liquidity shortage.

The liquidity position is reported at least monthly to ALCO and the Board. The Bank also monitors the adequacy of its controls to provide assurance that liquidity risk is being appropriately managed, and regularly assesses its funding position. This is supported with detailed contingency funding plans and recovery options which are tested and reviewed on a regular basis. The Bank's liquidity management framework is designed in line with FCA and PRA BIPRU regulations and industry guidelines.

2.3.1 Liquid asset portfolios

The Bank calculated its total liquidity resources as at 31 December 2013 as £11,193.4m (2012: £8,657.7m). The table below analyses the Bank's liquidity portfolio by product and liquidity value. Primary liquidity is liquid assets that are eligible under BIPRU 12.7 and secondary liquidity is all other liquid assets (excluding non-buffer assets described below), including self-issued retained securitisations.

	31 December 2013	31 December 2012
Operational balances with central banks	**5,076.3**	5,121.0
Gilts	**789.5**	664.8
Central government and multilateral development bank bonds	**1,112.2**	1,455.1
Total primary liquidity	**6,978.0**	7,240.9
Total secondary liquidity	**4,215.4**	1,416.8
Total liquidity	**11,193.4**	8,657.7
Average balance	**9,357.2**	8,967.7

The Bank uses any combination of these asset pools to manage liquidity, with primary liquidity used predominantly for short term cash flow movements, while secondary liquidity is used for creating longer term or contingent liquidity. Regular realisation through repo transactions and outright sales provide assurance that these asset pools remain sufficiently liquid. The overall quantum of liquidity remained stable in 2013 supported by a large reduction in non-buffer assets over the year (see table below). The secondary liquidity portfolio has been boosted by an increase in own assets eligible for discounting at central banks.

There has been a substantial reduction in non-buffer assets during the period. This reflects the change in funding profile as a result of the Bank's credit ratings downgrades. The sale of non-buffer assets has been used to maintain sufficient levels of primary liquidity.

	31 December 2013	31 December 2012
Short term deposits	**–**	38.4
Other public sector securities	**2.8**	117.5
Floating rate notes	**2.5**	703.0
Fixed rate notes	**–**	999.5
Other securities and commodities	**–**	68.8
Total non-buffer assets	**5.3**	1,927.2

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

2. Liquidity risk continued

2.3.2 Wholesale funding

The Bank uses wholesale funding to supplement retail and commercial deposits by raising longer term funds (over one year in duration) and to diversify the source of funds to support the business plan of the Bank. The Bank has a variety of long term wholesale funding sources outstanding, including securitisations, covered bond and euro medium-term notes, as shown in the table below.

	31 December 2013	31 December 2012
Preference shares, PSBs, and subordinated debt	**196.3**	1,335.3
Secured funding	**4,339.5**	4,262.0
Repos	**2,119.3**	2,483.3
Market borrowing	**56.6**	703.7
MTNs	**884.0**	961.6
Total wholesale funding	**7,595.7**	9,745.9

The following table sets out the Bank's contractual wholesale funding by maturity.

	31 December 2013	31 December 2012
Repayable in less than 1 month	**2,010.3**	1,815.0
Repayable between 1 and 3 months	**67.8**	365.6
Repayable between 3 and 12 months	**157.2**	613.6
Repayable between 1 and 5 years	**1,800.8**	5,093.3
Repayable in more than 5 years	**3,559.6**	1,858.4
Total external funding	**7,595.7**	9,745.9

The credit rating downgrades by the rating agencies in 2013 have led to sub-investment grade ratings on the Bank's senior debt leading to a significant reduction in the demand for these types of instrument.

The credit rating downgrades also resulted in the downgrade of the Bank's covered bond by Fitch and Moody's. Moody's also placed all the notes within the Bank's securitisation programmes on review for downgrade during the year. In January 2014, in order to mitigate the effect of the downgrades and comply with certain contractual obligations, the Bank has implemented back-up servicing arrangements and other changes to comply with the current rating agency criteria. These implementations required the consent of note-holders, which was obtained through separate consent solicitations, launched in December 2013, for each transaction.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

2. Liquidity risk continued

2.4 Liquidity gap Audited

Details of contractual maturities for assets and liabilities underpin the management of liquidity risk. However, in order to reflect more accurately the expected behaviour of the Bank's assets and liabilities, measurement and modelling of the behavioural aspect of each is constructed.

Gross cash flows include interest and other revenue cash flows. The following table is an analysis of:

- gross undiscounted contractual cash flows of financial assets and liabilities held at the balance sheet date; and
- behavioural adjustments that reflect the actual behaviour of customers based on historic cash flow profiles over a period of ten years.

31 December 2013 Contractual cash flows	Carrying value	Gross nominal flow	Less than 1 month	1–3 months	3–12 months	1–5 years	Over 5 years
Assets							
Cash and balances at central banks	5,418.8	5,418.8	5,418.8	–	–	–	–
Loans and advances to banks	1,594.4	1,594.4	1,594.4	–	–	–	–
Loans and advances to customers[1]	30,429.8	44,368.1	1,474.8	452.9	2,810.1	11,852.5	27,777.8
Investment securities							
Loans and receivables	23.6	28.4	7.0	0.1	0.1	2.9	18.3
Available for sale	2,732.4	3,137.3	67.9	137.0	101.9	1,092.4	1,738.1
Fair value through income or expense	1,743.4	1,890.1	6.6	13.7	198.4	1,637.0	34.4
Held for trading	–	–	–	–	–	–	–
Derivative financial instruments	555.8	265.8	2.0	7.7	26.7	23.7	205.7
Amounts owed by other Co-operative Group undertakings	–	–	–	–	–	–	–
Other assets	897.9	–	–	–	–	–	–
Total recognised assets	43,396.1	56,702.9	8,571.5	611.4	3,137.2	14,608.5	29,774.3
Liabilities							
Deposits by banks	2,757.5	2,991.9	1,833.0	41.2	153.3	964.4	–
Customer accounts	32,463.3	33,349.4	21,144.6	1,796.5	2,213.3	8,195.0	–
Customer accounts – capital bonds	538.1	536.4	10.2	94.7	146.4	285.1	–
Debt securities in issue	4,195.3	5,391.0	75.4	34.1	628.1	3,964.0	689.4
Derivative financial instruments	538.6	1,031.2	13.7	34.5	106.6	354.4	522.0
Other borrowed funds	196.3	433.6	–	5.7	17.0	91.0	319.9
Other liabilities	929.7	–	–	–	–	–	–
Total recognised liabilities	41,618.8	43,733.5	23,076.9	2,006.7	3,264.7	13,853.9	1,531.3
Unrecognised loan commitments	4,003.6	4,003.6	3,578.5	–	–	425.1	–
Total liabilities	45,622.4	47,737.1	26,655.4	2,006.7	3,264.7	14,279.0	1,531.3
Behavioural adjustments							
Loans and advances to customers		–	112.0	194.0	1,146.0	7,829.0	(9,281.0)
Customer accounts		–	20,901.0	(977.0)	(6,283.0)	(13,641.0)	–
Net cash flow – behavioural		8,965.8	2,929.1	(2,178.3)	(5,264.5)	(5,482.5)	18,962.0

1. This includes fair value adjustment for hedged risk of £107.6m.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

2. Liquidity risk continued

31 December 2012 Contractual cash flows	Carrying value	Gross nominal flow	Less than 1 month	1–3 months	3–12 months	1–5 years	Over 5 years
Assets							
Cash and balances at central banks	5,433.0	5,433.0	5,433.0	–	–	–	–
Loans and advances to banks	1,904.1	1,904.1	1,654.1	–	250.0	–	–
Loans and advances to customers	33,693.7	47,488.2	1,611.5	407.3	1,709.8	11,341.5	32,418.1
Investment securities							
Loans and receivables	295.0	369.9	0.3	0.3	1.7	16.9	350.7
Available for sale	3,789.4	4,161.1	99.9	187.6	209.4	1,975.2	1,689.0
Fair value though income or expense	1,845.2	1,957.4	3.7	12.6	60.2	1,875.1	5.8
Held for trading	960.2	991.7	1.4	5.0	77.0	881.4	26.9
Derivative financial instruments	818.8	856.0	5.4	19.0	94.1	277.1	460.4
Amounts owed by other Co-operative Group undertakings	56.8	56.8	56.8	–	–	–	–
Other assets	976.6	–	–	–	–	–	–
Total recognised assets	49,772.8	63,218.2	8,866.1	631.8	2,402.2	16,367.2	34,950.9
Liabilities							
Deposits by banks	3,612.0	3,888.1	2,415.6	412.3	551.0	509.2	–
Customer accounts	35,884.4	36,167.4	24,146.9	1,860.6	6,393.0	3,766.9	–
Customer accounts – capital bonds	888.1	886.8	25.5	64.1	255.8	541.4	–
Debt securities in issue	4,713.7	5,860.6	67.0	127.4	214.4	4,737.4	714.4
Derivative financial instruments	967.6	1,650.6	20.0	48.2	180.4	588.2	813.8
Other borrowed funds	1,258.6	2,292.9	7.2	4.5	86.6	748.6	1,446.0
Amounts owed to other Co-operative Group undertakings	190.0	190.0	190.0	–	–	–	–
Other liabilities	408.2	–	–	–	–	–	–
Total recognised liabilities	47,922.6	50,936.4	26,872.2	2,517.1	7,681.2	10,891.7	2,974.2
Unrecognised loan commitments	4,770.3	4,770.3	4,751.2	19.1	–	–	–
Total liabilities	52,692.9	55,706.7	31,623.4	2,536.2	7,681.2	10,891.7	2,974.2
Behavioural adjustments							
Loans and advances to customers		–	122.4	174.5	697.3	7,491.5	(8,485.7)
Customer accounts		–	21,219.3	(570.8)	(2,410.2)	(18,238.3)	–
Net cash flow – behavioural		7,511.5	(1,415.6)	(2,300.7)	(6,991.9)	(5,271.3)	23,491.0

2.5 Encumbrance

The Bank aims to have sufficient eligible and unencumbered assets available to meet the needs of its secured funding programmes. Details of the Bank's encumbered assets are shown in note 41d Fair value of transferred assets and associated liabilities.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

3. Market risk

In plain english:

Market risk is the risk of losses arising due to changes in market prices. The Bank's biggest exposure to market risk is from changes in interest rates. The Bank also has a small exposure to market risk from changes in foreign currency exchange rates.

Market risk is the risk of loss as a result of the value of financial assets or liabilities (including off-balance sheet instruments) being adversely affected by movements in market rates or prices. This loss can be reflected in the near term earnings by changing net interest income, or in the longer term because of changes in the economic value of future cash flows.

The main source of market risk within the Bank is driven by mismatches between the repricing profiles of asset and liability customer products within the Retail and Corporate businesses and certain characteristics embedded within these products and basis risk. Treasury also creates market risk through its various portfolio management activities along with currency risk.

3.1 Interest rate risk

Interest rate risk policy statements, approved by the ERC on behalf of the Board, specify the scope of the Bank's wholesale market activity, market risk limits and delegated authorities. The policy is managed by the Bank Market Risk Forum (BMRF) and ALCO. Their prime task is to assess the interest rate risk inherent in the maturity and repricing characteristics of the Bank's assets and liabilities. The Bank seeks to minimise the volatility of future earnings from interest rate changes and all interest rate risk exposure is removed from the Core and Non-core divisions and consolidated at the centre where it is managed from the Core balance sheet within agreed limits. Treasury is responsible for interest rate risk management for the Bank. The principal analytical techniques involve assessing the impact of different interest rate scenarios and changes in balances over various time periods.

The Board receives reports on the management of balance sheet risk and BMRF and ALCO review the balance sheet risk positions and the utilisation of wholesale market risk limits.

3.1.1 Non-treasury interest rate risk

The Bank (excluding wholesale treasury risk) uses a PV01, gap report and earnings approach for managing interest rate risk, focusing in detail on the sensitivity of assumed changes in interest rates on net interest income for one year.

BMRF monitors the non-trading interest rate risk, which is split between certain wholesale portfolios, banking and investment books, and the rest of the Bank's balance sheet. The following describes the Bank non-trading portfolios, excluding these certain wholesale portfolios. (These positions are managed by Treasury.) All interest rate risk is centralised into Treasury using appropriate transfer pricing rates.

Gap reports are based on defined time periods. ALCO sets guidance limits around the gap, principally that the sum of positions maturing in greater than 12 months and non-sensitive balances (includes non-maturity deposits) are no more than a set limit.

Non-maturity deposits, which are non-interest bearing, are separated into a stable 'core' element, based on a long run average, and the residual balance, which can fluctuate. In the gap report, the residual balance (along with interest bearing non-maturity deposits) is deemed to re-price or mature within one month. The 'core' non-maturity deposits are within the non-sensitive balance on the gap report, along with non-dated capital and other non-sensitive balances. ALCO sets guidance around the treatment of non-sensitive balances to reinvest in fixed rate assets in periods up to five years to smooth the income based upon the prevailing interest rate environment.

Risk limits are formally calculated at each month end. Interest rate risk and effectiveness of hedging is monitored daily using gap positions, incorporating new business requirements. Draw down risk, in particular for fixed rate mortgages, is managed through weekly balance sheet meetings. The asset and liability management team undertakes hedges for interest rate risk using derivative instruments and investment securities which are executed via the Treasury markets team to external wholesale markets, and loans and deposits which are executed internally with the Treasury markets team.

Basis risk is the risk that different assets and liabilities re-price with reference to different indices and at different times. This exposes the Bank to income volatility if indices do not move in a ratio of one to one. The overall exposure to basis risk has remained a net base rate asset throughout 2013 as customers continue to favour variable rate mortgages (where the introductory rate is linked to Bank of England base rate) and a large proportion of the liquidity of the Bank is placed in the Bank of England reserve account. Basis risk is monitored by BMRF and ALCO monthly and action is taken as required, which includes pricing, new products or external hedging.

The table illustrates the greater than 12 month net gap position at the end of the period on the Bank's balances, excluding wholesale treasury and customer currency balances which are managed within the Treasury risk framework. The gap is driven by product pricing and product mix. The gap is calculated by placing all assets and liabilities at the earliest of their re-pricing or maturity date and then summing by time band. The aim is to have assets evenly spread so that the Bank is not exposed to sudden rate movements. The net position shows the amount that the Bank is either over or under invested at a point in time. A £100m positive gap position would equate to the Bank's income increasing by £1m per annum if rates increased by 1%. The maximum sensitivity for the period shown below equates to approximately an £8.0m (2012: £10.9m) decrease in income if rates increased by 1%.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

3. Market risk continued

Net greater than 12 month gap position	**31 December 2013**	31 December 2012
At the period end	**(802)**	(928)
Average for the period	**(376)**	(612)
Maximum sensitivity for the period	**(802)**	(1,090)
Minimum sensitivity for the period	**(45)**	(248)

3.1.2 Treasury interest rate risk Audited

Treasury manage the Bank's liquid asset portfolios and executes derivative instruments with the wholesale markets on behalf of the Bank and its customers. Treasury operates a trading book, however currently there are no exposures as at the end of 2013 (2012: £nil).

The Bank assesses the interest rate risk arising within the liquid asset portfolios via key measures; Value at Risk and PV01, with associated delegated limits. These are supplemented by additional controls such as maturity and stop loss limits.

3.1.2.1 Value at risk (VaR) Audited

VaR measures the daily maximum potential gain or loss due to market volatility within a statistical confidence level of 95% and a one-day holding period. The VaR methodology employed is historical simulation using a time series of one year to latest day and was £0.4m at 31 December 2013 for the treasury portfolios (2012: £0.4m).

A number of limitations should be considered in relation to the VaR model:

- historic data is not necessarily a reliable predictor of future events;
- the model, by definition, does not capture potential losses outside the 95% confidence level, particularly those events that are extreme in nature; and
- VaR is based on exposures at close of business and, therefore, does not necessarily reflect intra-day exposures.

The outputs from the VaR model were reviewed in 2013 to ensure that they were consistent with methodology employed. The Bank does not have PRA VaR model permission and VaR is not used in regulatory reporting. The maturity method is used for reporting general interest rate risk for prudential reporting purposes.

3.1.2.2 PV01 Audited

The Bank also employs PV01 which illustrates the change in valuation on a fixed income portfolio given a 1 basis point increase in rates. A negative PV01 figure relates to a net asset position and will create a loss if rates rise. A positive PV01 figure relates to a net liability position and will create a profit if rates rise. The effects of a 1 basis point increase in interest rates are £0.01m (2012: £0.04m) and a 1 basis point decrease £0.01m (2012: £0.04m).

3.1.3 Swap spread risk Audited

The Bank is also exposed to swap spread risk arising within the liquid asset portfolios whereby a proportion of assets are held in fixed rate government securities and are accompanied by an interest rate swap to hedge against changes in interest rates. However, there remains a risk associated with the possible movement in the spread between sovereign debt yields and swap rates and therefore creates market value volatility. For example the market value falls if the yield on the sovereign debt increases more than swap rates, as the market value loss on the sovereign debt will then be higher than the market value profit on the swap. The risk is only crystallised if the sovereign debt and the associated swap are sold. The market value movements are monitored and the risk is controlled via government versus swap mark to market limits.

3.2 Currency risk Audited

The Bank's treasury foreign exchange activities primarily involve:

- providing a service in meeting the foreign exchange requirements of customers;
- maintaining liquidity in euros and US dollars by raising funds and investing these to generate a return; and
- performing limited intraday trading and overnight positioning in major currencies to generate incremental income.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

3. Market risk continued

The following risks (Operational to Pension) do not form part of the audited accounts and are not audited.

The table below provides an analysis of the Bank's assets and liabilities by currency:

	31 December 2013					31 December 2012				
	£	**$**	**€**	**Other**	**Total**	£	$	€	Other	Total
Assets										
Cash and balances at central banks	**5,418.8**	**–**	**–**	**–**	**5,418.8**	5,433.0	–	–	–	5,433.0
Loans and advances to banks	**1,520.6**	**28.3**	**42.9**	**2.6**	**1,594.4**	1,738.4	38.4	124.5	2.8	1,904.1
Loans and advances to customers	**30,225.8**	**28.9**	**54.8**	**12.7**	**30,322.2**	33,121.3	40.2	153.4	24.6	33,339.5
Fair value adjustments for hedged risk	**107.6**	**–**	**–**	**–**	**107.6**	354.2	–	–	–	354.2
Investment securities										
Loans and receivables	**23.6**	**–**	**–**	**–**	**23.6**	237.7	12.8	44.5	–	295.0
Available for sale	**2,732.4**	**–**	**–**	**–**	**2,732.4**	3,669.4	70.8	49.2	–	3,789.4
At FV through income or expense	**1,743.4**	**–**	**–**	**–**	**1,743.4**	1,821.9	12.3	11.0	–	1,845.2
Held for trading	**–**	**–**	**–**	**–**	**–**	870.2	17.3	72.7	–	960.2
Derivative financial instruments	**515.4**	**–**	**40.4**	**–**	**555.8**	818.6	–	0.2	–	818.8
Equity shares	**5.8**	**–**	**–**	**–**	**5.8**	5.7	–	–	–	5.7
Investments in joint ventures	**4.7**	**–**	**–**	**–**	**4.7**	3.9	–	–	–	3.9
Investment properties	**164.1**	**–**	**–**	**–**	**164.1**	173.0	–	–	–	173.0
Property, plant and equipment	**115.2**	**–**	**–**	**–**	**115.2**	113.4	–	–	–	113.4
Intangible fixed assets	**110.7**	**–**	**–**	**–**	**110.7**	263.2	–	–	–	263.2
Amounts owed by other Co-operative Group undertakings	**–**	**–**	**–**	**–**	**–**	56.8	–	–	–	56.8
Other assets	**478.9**	**–**	**2.0**	**–**	**480.9**	69.7	0.2	0.4	–	70.3
Prepayments and accrued income	**16.5**	**–**	**–**	**–**	**16.5**	14.9	–	–	–	14.9
Current tax assets	**–**	**–**	**–**	**–**	**–**	172.6	–	–	–	172.6
Deferred tax assets	**–**	**–**			**–**	159.6	–	–		159.6
Total assets	**43,183.5**	**57.2**	**140.1**	**15.3**	**43,396.1**	49,097.5	192.0	455.9	27.4	49,772.8
Liabilities										
Deposits by banks	**2,730.0**	**–**	**27.5**	**–**	**2,757.5**	2,995.4	173.5	443.0	0.1	3,612.0
Customer accounts	**32,399.7**	**25.1**	**36.7**	**1.8**	**32,463.3**	35,784.6	47.5	49.7	2.6	35,884.4
Customer accounts – capital bonds	**538.1**	**–**	**–**	**–**	**538.1**	888.1	–	–	–	888.1
Debt securities in issue	**4,174.5**	**–**	**20.8**	**–**	**4,195.3**	4,705.5	–	8.2	–	4,713.7
Derivative financial instruments	**519.0**	**–**	**19.6**	**–**	**538.6**	967.4	–	0.2	–	967.6
Other borrowed funds	**196.3**	**–**	**–**	**–**	**196.3**	1,230.0	–	28.6	–	1,258.6
Amounts owed to other Co-operative Group undertakings	**–**	**–**	**–**	**–**	**–**	190.0	–	–	–	190.0
Other liabilities	**200.9**	**–**	**2.0**	**–**	**202.9**	103.6	0.2	0.2	–	104.0
Accruals and deferred income	**54.1**	**–**	**–**	**–**	**54.1**	20.1	–	–	–	20.1
Provisions for liabilities and charges	**576.0**	**–**	**–**	**–**	**576.0**	162.7	–	–	–	162.7
Current tax liabilities	**4.2**	**–**	**–**	**–**	**4.2**	–	–	–	–	–
Deferred tax liabilities	**92.5**	**–**	**–**	**–**	**92.5**	121.4	–	–	–	121.4
Total liabilities	**41,485.3**	**25.1**	**106.6**	**1.8**	**41,618.8**	47,168.8	221.2	529.9	2.7	47,922.6
Net on balance sheet position	**1,698.2**	**32.1**	**33.5**	**13.5**	**1,777.3**	1,928.7	(29.2)	(74.0)	24.7	1,850.2

At 31 December 2013, the Bank's net currency position was the equivalent of £2.4m (2012: £2.7m) and represented a potential loss of £0.1m given a 3% depreciation in sterling (2012: loss of £0.1m). The Bank manages its currency positions against both an overall limit and individual currency limits.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

4. Operational risk

In plain english:

Operational risk is the risk of loss resulting from inadequate or failed processes, people and systems within the Bank or from external events.

4.1 Operational risk framework

The Bank's approach to the management of operational risk is designed to assist the Bank to safely operate within a Board approved risk appetite, particularly with regards to protecting the volatility of earnings, reducing capital requirements, maintaining the Bank's reputation as a trusted provider of financial services and meeting regulatory expectations. Various elements of the framework were concluded to be ineffective in early 2013 and continues to be strengthened in line with good practice and regulatory guidance.

Operational risks are identified, managed and mitigated through on-going risk management practices including material risk assessments, risk event reporting, operational loss data analysis, a detailed risk control self-assessment process (which is being refreshed), monitoring of key risk metrics, and scenario analysis. Significant operational risks are reported to the ORF, the ERC and the BRC. These meet regularly to monitor the development and effectiveness of the Risk Management Framework and the management of significant risks within the Bank.

4.2 Corporate insurance programme

The Bank has a structured insurance programme designed to transfer the impact of specific operational risks in line with the appetite of the organisation and industry best practice. For example:

- insurance of the Bank's buildings and assets;
- protection of revenue in the event of business interruption;
- protection against impacts of financial crime;
- professional indemnity and Directors and Officers liability cover; and
- motor, employer, product and public liability insurance.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

4.3 Responsibilities

Key executives each have a nominated risk representative who is a member of the ORF and is responsible for ensuring the consistent application of the operational risk framework in their division. The central operational risk team supports the identification, management and reporting of operational risks across the Bank in line with regulatory and business requirements.

The Bank categorises operational risk into a number of distinct themes for internal management, monitoring and reporting; these are as follows:

Operational risk theme	Description
Financial crime risk	The risk of losses resulting from criminal activity relating to fraud or dishonesty; misconduct in or misuse of information relating to a financial market.
Anti-money laundering risk	The risk that the Bank may be used to facilitate the laundering of the proceeds of crime or the financing of terrorist activity.
Legal risk	The risk that: • the Bank is not in compliance with the applicable laws and regulations; • the Bank's contractual arrangements with customers, suppliers or other third parties are not enforceable as intended, are enforced against the Bank in an unexpected way or do not operate as expected; • the Bank's assets are not legally protected (eg intellectual property, real property); and • litigation by or against the Bank is not appropriately managed to protect the Bank's reputation and achieve the best outcome.
People risk	The risk associated with the recruitment, employment and management of individuals within the Bank.
Physical assets and security risk	The risk associated with internal and external threats, either deliberate or accidental, against physical assets, employees and customers that could cause financial and/or non-financial losses, damage to or non-availability of Bank assets.
Business continuity planning risk	The risk that the Bank is unable to continue to deliver products or services at acceptable pre-defined levels following a disruptive incident.
Third party suppliers risk	The risk of financial and non-financial loss associated with all third parties relied upon to provide services to functions which support the performance of the Bank.
New product approval risk	The risk in launching new products or modifying existing ones.
Technology risk	The risk of financial and non-financial impacts resulting from the lack of effective IT systems.
Information risk	The risk associated with the theft, loss, corruption, misuse and inadequate quality of business, customer and employee data across the Bank.
Financial reporting risk	The risk of reputational damage, loss of investor confidence and/or financial loss caused by incorrect financial reporting.
Change risk	The risk of change not being implemented successfully (delivery risks) and/or that the change adversely impacts the Bank's risk profile.

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

5. Reputational risk

In plain english:

Reputational risk is the risk that the Bank's image in the eyes of its customers, its employees and other businesses it works with could be damaged as a result of poor decision making, performance, the impact of operational failures or other external issues.

As part of the assessment and control of reputational risk, the business performance and risk profile across all risk themes are closely monitored and reviewed. The business proactively monitors and manages media, public and customer opinion and works closely with external rating agencies to ensure fair and balanced representation. This approach helps maintain investor, customer and market confidence.

Reputational issues include, but are not limited to:

- the reputational damage arising from downgrades to the Bank's credit ratings;
- being required to raise further capital in the future, which could affect, or be perceived to affect, confidence in the Bank;
- failure to implement the Bank's strategy;
- a reduction in the Bank's customer service levels resulting from cost-cutting to the Bank's Core business and/or the reorientation of the Bank's distribution channels;
- the Bank no longer being owned by The Co-operative Group with the result that the mutual and ethical reputation of The Co-operative Group could conflict with the profit maximisation objective of other holders of Ordinary Shares and the Board's duties to such shareholders;
- any potential impact to the Bank's brand or reputation in the event that the shareholding of The Co-operative Group reduces below its current shareholding;
- the potential risk that the Secretary of State for Business, Innovation and Skills may direct the Bank to change its registered name if, in his opinion, it gives so misleading an indication of the nature of its activities as to be likely to cause harm to the public;
- the risk that the FCA exercises its power to prevent the use of the 'Co-operative' name, or to take other action regarding the Bank's branding, if the FCA considers this desirable to protect consumers, to promote competition in the interests of consumers or to protect the integrity of the UK financial system;
- an impact to the Bank's reputation as a result of an action of The Co-operative Group which adversely impacts the Bank brand;
- any impact to the Bank's reputation as a result of adverse findings following any legal or regulatory investigation into the Bank's conduct, in particular criticism arising from the report of the Treasury select committee when published and the independent Kelly Review into events which led to the announcement of the Bank's Recapitalisation Plan, which is due to report to The Co-operative Group members' Annual General Meeting in May 2014;
- any impact to the Bank's reputation or negative impact on the Bank's brand as a result of adverse findings about The Co-operative Group arising out of investigations into past actions or adverse commentary and organisational disruption to The Co-operative Group as a result of the Myners review of governance of The Co-operative Group;
- failing to appropriately address potential conflicts of interest;
- breaching or facing allegation of having breached legal or regulatory requirements (including money laundering and anti-terrorism financing requirements and conduct risk events such as past business reviews);
- acting or facing allegations of having acted unethically (including having adopted inappropriate sale and trading practices);
- failing or facing allegations of having failed to maintain appropriate standards of customer privacy, customer service and record-keeping;
- technology failures that impact on customer services and accounts;
- internal fraud, such as market manipulation;
- failing to properly identify legal, reputational, credit, liquidity and market risks inherent in products offered; and
- generally poor customer service.

A failure to address these or any other relevant issues appropriately could make customers, depositors and investors unwilling to do business with the Bank, which could adversely affect its business, financial condition and results of operations and could damage its relationships with its regulators. The Bank cannot ensure that it will be successful in avoiding damage to its business from reputational risk.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

6. Strategic and business risk

In plain english:

Strategic and business risk is the risk that the Bank's plans cannot be carried out because of changes, either internal to the company or external (eg recession), in the markets in which it operates.

The difficult situation currently faced by the Bank is unprecedented for this business and heightens the strategic and business risk it currently faces.

To improve its financial and operational performance and capital position the Bank has adopted a new five year plan. The Bank's strategy was developed in a relatively short time-frame, is in the early stages of implementation and its performance and effectiveness is not yet proven. There is a risk that this strategy may still not sufficiently address the Bank's problems or deliver the expected benefits.

The Bank does not have a track record in successfully executing large scale changes and the successful execution of the Bank's strategy requires the simultaneous execution of a number of complex and overlapping changes in a manner that seeks not to negatively impact on the Bank's brand, reputation and customer satisfaction or its relationship with, and ability to retain, its employees.

In addition, the execution of the Bank's strategy has a number of specific risks:

Strategy component	Key risk to strategy
Leveraging the Bank's strong and differentiated brand and leading levels of customer satisfaction.	The implementation of significant cost reductions, branch closures, redundancies and the reorientation of the Bank's distribution network may have a negative impact on the Bank's brand and levels of customer satisfaction which may, in turn, result in customer attrition. The Bank may also be unsuccessful in achieving the required shift in customer behaviour towards self-service and digital banking such that the Bank will fail to meet its cost saving objectives. Actions taken by the Bank in the execution of its strategy may inadvertently be, or may be perceived to be, contrary to the principles of the co-operative movement which could negatively impact on the Bank's brand and its relationship with The Co-operative Group.
Improving revenue in its Core Business in the medium-term through improved pricing of its products, appropriate re-pricing of existing products towards market rates, growing primary account customers in the Bank's key market segments, cross-selling products and growing the volume of higher margin unsecured lending.	The Bank's capital shortfall, credit rating downgrades during 2013 and/or the Bank's disappointing financial results, recent press reporting and public scrutiny of the Bank and the various governmental and regulatory investigations, individually or cumulatively, could, over the longer term, have a negative impact on the Bank's brand and reputation. We may be unable to achieve these improvements in revenue in Core Business as they depend on several factors, including prevailing macroeconomic conditions (including the level of interest rates), the Bank's relative position versus its competitors and the ability of persons working for the Bank to appropriately cross-sell products.
The Bank's high cost-to-income ratio continues to impact on its profitability and its capital position, and reducing its cost base remains a priority for the Bank through various management actions.	These management actions may not happen or be effected when expected or achieve their intended cost benefits. In addition, the reorientation of the Bank's distribution model and its cost reduction programme may negatively impact the Bank's customer service, which may result in customer attrition.
Re-engineering of the Bank's processes and IT platform.	The Bank's processes and controls are currently under remediation. The planned re-engineering of the Bank's IT platform is significant, both in terms of scale and cost, and involves a number of risks. Any failure in systems as a result of not mitigating the IT risks, or in the period before this re-engineering is complete, could negatively affect the Bank's ability to conduct its business, lead to further regulatory focus on the Bank, which in turn may negatively impact the Bank's business and turnaround strategy.

In order to remediate all of the above risks the Bank requires the people and capability to execute its strategy. Ability to recruit and retain the right people is key to the Bank's turnaround plan.

Risks associated with implementation of the Bank's Non-core business strategy

A failure by the Bank to deleverage its Non-core assets in a controlled manner in accordance with its strategy may:

- negatively impact on the Bank's operating results and financial position (in particular, its net interest margin) and, in the longer term, its ability to comply with its regulatory capital requirements (eg through greater than currently expected losses from the run-off or sale of Non-core assets); and
- hinder or restrict the longer term development and growth of the Core business' business, and divert management attention from the Core business.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

7. People risk

In plain english:

People risk is the risk the Bank will be unable to operate as planned because the Bank doesn't have enough employees or employees with the appropriate skills.

People risk is the risk associated with the recruitment, employment and management of individuals within the Bank.

There are seven sub-categories of people risk, as follows:

- inadequate people capability – the risk that the Bank will fail to attract, select, performance manage, engage and retain appropriate or sufficient resources;
- inappropriate behaviour – the risk that employees will act outside of policies, discretions and accepted codes of behaviour without authorisation;
- breach of employment legislation – the risk that the Bank will fail to comply with relevant employment codes and legislation;
- breach of trade union agreements – the risk that the Bank will fail to comply with relevant agreements and/or will face industrial action, resulting in operational losses and damage reputation;
- ineffective organisation design – the risk that the organisational design does not support the business strategy and/or that individuals are not directly engaged by the Bank, are on short term contracts or are not fully aware of the scope or accountability of their role;
- inadequate colleague engagement – the risk that colleagues are not adequately engaged in the course of their work and particularly throughout periods of change, resulting in fraudulent or unauthorised activities or poor customer service; and
- failure to deliver a compliant and timely payroll function – the risk that the Bank will not meet its obligations in respect of its employees and/or any external requirements in respect of payroll provision.

8. Regulatory risk

In plain english:

Regulatory risk is the risk of fines, public censure, limitation on business, or restitution costs arising from failure to understand, interpret, implement and comply with UK and EU regulatory requirements. Demonstrating compliance with all applicable regulatory requirements is essential for the Bank to remain in business.

Management of regulatory risk entails on-going compliance with existing obligations and early identification and effective management of changes in legislative and regulatory requirements that may affect the Bank. Regulatory risk is one of the Principal risks the Bank sets out in its Risk Management Framework. The Principal risks are the key financial and non-financial risk to which the Bank is exposed (the 'Principal risks'). The Principal risk policies and control standards provide the business with guidance on how to achieve strategic objectives whilst managing risk within defined risk appetite tolerances.

The Bank's operations, including its subsidiaries and associates, are subject to a significant body of rules and regulations that are a condition for authorisation to conduct banking and financial services business. These apply to business operations and affect financial returns and include reserve and reporting requirements and prudential and conduct of business regulations. These requirements are set by the relevant central banks and regulatory authorities that supervise the Bank in the jurisdictions in which it operates. The requirements reflect global standards developed by, among others, the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions. They also reflect requirements of or derived from EU legislation.

Changes to regulations

As the Bank must comply with wide-ranging legal and regulatory (including liquidity and capital) requirements and supervision, changes to the legal and regulatory environment may result in additional compliance costs (including the raising of further capital and/or liquidity) and diversion of management time and resources. These changes may negatively affect the Bank's business. In addition, failure to comply with these requirements may result in investigations, disciplinary action, fines, reputational damage and the revocation of the Bank's licences, permissions or authorisations which could have a material negative effect on the Bank's business. Adoption of these changes are owned and managed by the first line. Regulatory risk continues to provide advice and oversight of these activities.

Regulatory risk function

The Regulatory risk function has been organised into five key areas.

Regulatory advice – consulting and intelligence

Regulatory advice is responsible for the provision of advice and subject matter expertise to the business on new regulation, changes to existing regulations and regulatory impact on business change.

Risk management continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

8. Regulatory risk continued

Regulatory affairs and change

The Regulatory affairs and change team serves a dual purpose: coordinating and overseeing the delivery of quality and timely regulatory communications, as well as identifying and managing changes to regulation that the Bank must comply with. The team is responsible for the maintenance of the Regulatory Contact Standard and procedures, which are supported by a repository of key regulatory contact and a regulator action tracker.

Monitoring

The Regulatory monitoring function within regulatory risk exists to provide independent, second line assurance over regulatory conduct risk controls operating across the Bank and assessing whether customers are being treated fairly. This is achieved via the execution of a risk based rolling 12 month monitoring plan which allows monitoring resource to be focused on those areas where the risk of poor customer outcomes is assessed as being the highest. This plan is refreshed on a quarterly basis.

Management information and reporting

The Regulatory risk reporting and MI analysis team exists to ensure that there is appropriate reporting on the current state of regulatory risks and issues facing the Bank and their management. The team facilitates production of regulatory risk reporting to the Regulatory Risk Forum, the ERC and the BRC. The team undertakes the analysis of underlying management information to provide insight into changes in the regulatory risk profile to support and focus monitoring and advice activities.

Central functions

The Central Functions team oversees the regulatory relationships and actions arising with key bank functions including Operational Risk, Treasury, Finance, HR, and IT and has provided subject matter expertise and oversight of key Bank projects, including MMR (Optimum portfolio) and the past business review of the Bank's sale of interest rate hedging products. The team is also developing the Bank's Approved Persons on-boarding, governance and training policies and standards.

Reporting

Regulatory risks are reported to, and overseen by the Regulatory Risk Forum which is a sub-committee of the ERC; its core purpose is to support the Regulatory Risk Director in discharging his responsibilities to the Board and as such is chaired by the Bank's Regulatory Risk Director. Any regulatory risks outside the Bank's appetite are escalated to the ERC and BRC.

9. Conduct risk

In plain english:

Conduct risk is the risk that the Bank's operations will result in unfair treatment of its customers and so the Bank will have to pay compensation.

Conduct risk is the risk that the Bank's behaviours, offerings or interactions may result in unfair outcomes for customers. To reflect the importance placed on conduct risk by the Bank, during 2013 we have specifically recategorised conduct risk as a Principal Risk within our Risk Management Framework. Its effective management helps build trust with customers and other stakeholders and promotes a fair outcome/focused business through the implementation of an appropriate policy and suite of standards properly communicated to trained staff.

The Bank manages conduct risk in a way that is consistent with its overall risk appetite and aligns with its strategy.

The concept of conduct risk is in part derived from elements of the FCA's rules and guidance that are concerned with the conduct of business regulation. However, it also encompasses the principle of treating customers fairly and putting customers at the centre of what we do; it is outcome driven.

Conduct risk may arise from any aspect of the way the Bank's business is conducted, a key criteria for the Bank being whether the outcome is fair for its customers. When assessing conduct risk there will often be a closely linked regulatory requirement.

The Bank's aim is to avoid the conduct of its business resulting in unfair outcomes for its customers and therefore the Bank will manage its conduct risk within its stated risk appetite. Further, the Bank aims to minimise the probability of any such outcomes occurring and ultimately to remedy any material consequences where a risk materialises.

At the end of 2013, the Bank has conduct risk provisions of £438m, to cover the costs relating to PPI mis-selling, breaches of the Consumer Credit Act, interest rate swap mis-selling, and other provisions, further detail of which is provided in note 34 to the accounts.

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

10. Pension risk

In plain english:

Pension risk is the risk that the Bank will be required to pay more than expected into its employees' pensions schemes in order that the schemes can pay the pensions to which its employees, former employees and retirees are entitled as they fall due.

The Co-operative Group Pension Scheme (Pace) is used by all employees in The Co-operative Group, including the Bank. Pace is a hybrid scheme, consisting of both a defined benefit and defined contribution scheme.

Following its separation from The Co-operative Group, the Bank is still a participating member of the Pace scheme. As a multi-employer pension scheme, Pace exposes the Bank to risks associated with current and former employees of other Co-operative Group companies. Risks are identified at the Co-operative Group level, with the impact of any potential changes to contribution assessed under the Bank's Risk Management Framework.

The Bank is also exposed to pension risk through the Britannia pension scheme. In 2009, following the transfer of engagements of Britannia Building Society, CFS Management Services Ltd (a subsidiary of The Co-operative Banking Group Ltd) became principal employer of the scheme. This scheme closed on 6 October 2010 with active members at the date of closure being invited to join Pace.

Pension risk is defined under the Risk Management Framework as the risk to capital and funds from exposure to pension liabilities (to the extent liabilities are not met by scheme assets) and risks inherent in the valuation of scheme liabilities and assets. The Bank is assessing its pension risk appetite and the appropriate measures to help manage pension risk. The Bank has analysed pension risk into seven sub-categories as follows:

- scheme membership – the profile of scheme membership impacts cost and risk;
- market risk – the valuation of pension liabilities is reliant on the level of government gilt yields and inflation. Market fluctuations in these factors impact the value of liabilities;
- investment risk – asset values are vulnerable to volatile asset markets;
- credit risk – concentration of credit risk across counterparty, market sector, geography and asset type may increase risk;
- longevity – valuation of pension liabilities is reliant on scheme member longevity;
- legislation and regulation – pension schemes are highly regulated and complex, changes in legislation and regulation may increase cost and risk; and
- strategy and structure – any changes in corporate strategy or structure may impact on pension risk and cost.

Controls are applied to mitigate these risks and a pension risk report is made to the ERC each month to monitor pension risk and decide if further action is necessary. The report takes account of the risk reporting delivered to pension scheme trustees. The Bank is able to engage directly with the Trustees of the Britannia pension scheme and can influence the Trustees of Pace through its relationship with the sponsor, The Co-operative Group.

The trustee of Pace is primarily responsible for the risk management arrangements for Pace, agreeing suitable contribution rates with the principal employer, investment strategy and taking professional advice as appropriate. The trustee of the Britannia scheme is primarily responsible for the risk management arrangements for the Britannia scheme, agreeing suitable contribution rates with the principal employer, investment strategy and for taking professional advice as appropriate.

The Pace scheme is not sectionalised and operates on a 'last man standing' basis. In the event that other participating employers become insolvent and the full statutory debt is not recovered on insolvency, the Bank would become liable for the remaining liabilities.

The Bank is therefore exposed to potential future increases in required contributions and capital set aside for pension risk.

Further information can be found in note 36 in the Bank financial statements.

Capital management

For the year ended 31 December 2013

All the amounts are stated in £m unless otherwise indicated

Unaudited

The Bank received a letter from the PRA in January 2013 for the attention of the Board, notifying it of a revised Individual Capital Guidance (ICG) and greatly increased Capital Planning Buffer (CPB) to be held exclusively in Core Tier 1 capital. Whilst the Bank had capital sufficient to meet the revised ICG[1], the letter acknowledged that the size of the CPB meant that the Bank would be in breach of this from the outset. The letter requested that the Board prepare, and present to the PRA by the end of April 2013, a credible plan that would restore the Bank's capital strength to an appropriate level and a timeline for delivery.

Accordingly, the Bank initiated a capital planning process (the Pennine Plan) to consider the shortfall and actions to address, and the plan was discussed with the PRA during its evolution.

In March 2013, the Interim Financial Policy Committee (FPC) of the Bank of England recommended that the Prudential Regulation Authority (PRA) should take steps to ensure that all major UK banks and building societies, including the Bank, held capital resources equivalent to at least 7% of their risk-weighted assets (assessed using the Basel III definition of equity capital) by December 2013.

This requirement, together with the Basel III requirement for CET1 to remain above 4.5% at all times and a Leverage Ratio of 3%, were fed into an enhanced version of the Pennine Plan in May (an initial plan having been submitted to the PRA as requested). The levels of expected loss in the corporate lending portfolio and other risks were also reassessed, which indicated that the Bank was likely to breach its ICG requirement later in 2013.

After discussion with the PRA, this work culminated in the Bank and The Co-operative Group announcing on 17 June 2013 that the Bank required additional aggregate CET1 of no less than £1.5bn (of which at least £1bn should be raised in 2013) and the Recapitalisation Plan was launched.

The Recapitalisation Plan consisted of three elements:

- the Liability Management Exercise (LME) to generate c.£1.2bn of new CET1;
- the commitment of The Co-operative Group to contribute £333m of CET1 by the end of 2014; and
- £40m of CET1 generated from 2014 interest savings on the securities surrendered in the LME.

Unaudited

- Core Tier 1 ratio has increased to 9.2% from 7.4% as at 31 December 2012. This reflects a decrease in Core Tier 1 of £45.4m and a decrease in risk weighted assets of £3.9bn
- CRD IV fully-loaded CET1 has increased to 7.2% from 5.0% as at 31 December 2012 and 3.0% as at 30 June 2013
- CRD IV fully-loaded leverage ratio as at 31 December 2013 is 2.4%

The enhanced Pennine Plan was updated to include the CET1 and the non-CET1 capital to be raised as part of the Recapitalisation Plan. The resultant plan did not expect to achieve full compliance with CPB at any time in the five year planning period, but did expect to achieve ICG compliance by the end of the planning period. The required minimum CET1 ratios of 7% in normal conditions and 4.5% under stress were expected to be met in 2013. The completion of the LME raised £1.2bn before costs. As well as the LME, the Bank has made progress in improving the capital position through reducing balance sheet exposures and risk-weighted assets. The 2013 year end CET1 ratio stood at 7.2%.

The higher than anticipated losses reported in these accounts have been factored in to the Bank's latest capital plans, and the Board has concluded that additional CET1 is now required to remain adequately capitalised, to proceed with the Turnaround Plan. On 24 March 2014 the Bank announced that it is in the process of raising additional CET1 as discussed on page 22. The new capital plan, which has been shared with the PRA, forecasts that the Bank will meet the 7% CET1 ratio throughout the planning period. The new capital plan anticipates meeting ICG by the latter part of the planning period, however full compliance with CPB is not anticipated during the planning period. Leverage ratio of 3% is expected to be achieved before the end of the plan.

1. Capital resources would still have been in surplus to ICG had the restatement detailed in note 3 to the financial statements been made at the time.

Capital management continued

For the year ended 31 December 2013

All the amounts are stated in £m unless otherwise indicated

The Bank faces different risks that may adversely impact the ability of the Bank to comply with its regulatory capital requirements, these include:

- worsening economic and market conditions and/or increasing interest rates and/or a fall in house prices could result in the Non-core assets suffering from more than expected impairments which would adversely impact on the Bank's operating results and retained earnings;
- the Bank needs the continuing support of the PRA in accepting and moving forward with its Recapitalisation and Turnaround Plan and to the extent this is not forthcoming or to the extent that the Bank doesn't perform in line with its Plan, additional capital may be required over and above that included in the Plan. This could also be the case if there are increases in regulatory capital requirements as a result of changes to international regulations (eg Basel III) or other changes to legislation or other market wide regulatory requirements or a change in regulatory risk appetite. The Plan assumes additional non-CET1 capital will be raised within the Plan period; and
- the inability of the Bank to deleverage its Non-core Assets in a controlled and capital efficient manner may have a negative impact on the Bank's operating results and financial position (in particular, its net interest margin) and its regulatory capital position. In addition, any greater than expected costs or delays in deleveraging the Non-core Assets may divert funding from and adversely impact the longer term development and growth of the Core Business.

The Bank is not currently compliant with its Individual Capital Guidance, being the PRA's statement as to the regulatory capital it expects the Bank to hold, although the Bank does meet its Pillar 1 requirement.

Reflecting the relatively depressed economic conditions, the Bank's risk appetite includes the requirement, both in June 2013 and now, to hold sufficient capital to meet a moderate downturn in activity, such as is experienced approximately once in every ten years – '1 in 10 stress'. The Bank is currently finalising its ICAAP for submission to the PRA in May 2014 and has not yet prepared analysis to demonstrate whether or not the Bank's planned capital levels will be sufficient to meet its target ratios under more severe stress scenarios.

Historically the Bank contracted with CFSMS, a subsidiary in The Co-operative Banking Group, to build certain assets, including IT developments. In the 2012 Financial Statements these assets were not included in the balance sheet of the Bank and a deduction for intangibles was not made from capital resources. As detailed in note 3 to the Financial Statements the Directors have concluded that the Bank was substantially exposed to the risks and rewards of assets recorded on the books of CFSMS. This has been reflected in the intangibles assets deduction from capital resources as at 31 December 2012. The impact of the restatement is a £234.6m reduction in Core tier 1 and a 1.4% reduction in the Core tier 1 ratio as at 31 December 2012.

In the interim results to 30 June 2013 these intangible assets were on the balance sheet of CFSMS but the share attributable to the Bank was deducted from the Bank's capital resources.

Capital management continued

For the year ended 31 December 2013

All the amounts are stated in £m unless otherwise indicated

Capital resources Audited

	31 December 2013	Restated 31 December 2012
Core Tier 1 capital before regulatory adjustments:		
Permanent share capital	**9.8**	410.0
Retained earnings	**1,118.6**	1,813.4
Minority interests	**33.6**	32.0
Losses for the period	**(738.2)**	(508.1)
Share premium account	**1,049.5**	8.8
Total Core Tier 1 capital before regulatory adjustments	**1,473.3**	1,756.1
Regulatory adjustments from Core Tier 1 capital:		
Intangible assets	**(110.7)**	(262.5)
50% of excess of expected losses over impairment (net of tax)	**(47.5)**	(159.7)
50% of securitisation positions	**(27.3)**	(0.7)
Total Core Tier 1 capital after regulatory adjustments	**1,287.8**	1,333.2
Other Tier 1 capital:		
Non-cumulative irredeemable preference shares	**–**	60.0
Regulatory adjustments from other Tier 1 capital:		
50% of tax on excess of expected losses over impairment	**11.0**	51.8
50% of material holdings	**(2.3)**	(2.0)
Total Tier 1 capital after regulatory adjustments	**1,296.5**	1,443.0
Tier 2 capital before regulatory adjustments:		
Revaluation reserves	**2.0**	2.0
Collective provisions	**0.9**	0.7
Subordinated notes and perpetual subordinated bonds	**196.3**	1,112.1
Excess on limits for Tier 2 capital	**–**	(50.2)
Total Tier 2 capital before regulatory adjustments	**199.2**	1,064.6
Regulatory adjustments from Tier 2 capital:		
50% of excess of expected losses over impairment (gross of tax)	**(58.6)**	(211.5)
50% of securitisation positions	**(27.3)**	(0.7)
50% of material holdings	**(2.3)**	(2.0)
Total Tier 2 capital after regulatory adjustments	**111.0**	850.4
Total capital resources	**1,407.5**	2,293.4

Reconciliation of equity per balance sheet to Core Tier 1 capital

	2013	2012
Total equity per balance sheet	**1,777.3**	1,850.2
Regulatory adjustments:		
Ordinary shares not recognised until cash consideration paid in 2014	**(303.2)**	–
Minority interests	**–**	(0.4)
Retained earnings	**–**	–
Available for sale reserve	**14.1**	(30.0)
Cashflow hedging reserve	**(14.9)**	(63.7)
Core Tier 1 capital before regulatory deductions	**1,473.3**	1,756.1

Capital management continued

For the year ended 31 December 2013

All the amounts are stated in £m unless otherwise indicated

Capital ratios and risk-weighted assets Unaudited

	31 December 2013	Restated 31 December 2012
Capital ratios		
Core Tier 1 ratio	**9.2%**	7.4%
Tier 1 ratio	**9.3%**	8.1%
Total capital ratio	**10.1%**	12.8%
Risk-weighted assets		
Credit risk	**12,734.6**	15,974.8
Market risk	**2.4**	492.6
Operational risk	**1,255.2**	1,441.3
Total risk-weighted assets	**13,992.2**	17,908.7
Segmental analysis of credit risk risk-weighted assets		
Core		
Retail	**2,268.1**	2,410.1
BaCB	**988.4**	1,274.1
Treasury/other	**1,141.0**	1,342.4
	4,397.5	5,026.6
Non-core		
Corporate CoAM	**4,524.2**	6,587.0
Optimum	**3,661.6**	4,188.2
Illius	**151.3**	173.0
	8,337.1	10,948.2
Total credit risk risk-weighted assets	**12,734.6**	15,974.8

Core Tier 1 ratio has increased to 9.2% from 7.4% as at 31 December 2012. This is primarily due to a £3,916m (22%) decrease in risk-weighted assets.

The increase in Core Tier 1 reflects:

- £738.2m regulatory loss after tax, including £688.3m profit arising from the Liability Management Exercise;
- £400.2m reduction in permanent share capital, due to cancellation of shares and issuance of new share capital;
- £1,040.7m increase in share premium arising from the issuance of new share capital;
- £151.8m reduction in intangibles deduction, primarily due to £148.4m write-off; and
- £112.2m reduction in excess of expected loss over impairments.

Additional Tier 1 has reduced from £60.0m to zero following The Co-operative Group acquiring the Bank's preference shares and waiving any rights to income and capital in respect of the preference shares as part of the LME. All Tier 2 subordinated notes and perpetual subordinated bonds as at 31 December 2012 have also been redeemed. £206.0m (£196.3m after costs) of new Tier 2 capital was issued as part of the LME.

The reduction in risk-weighted assets is primarily due to a 30% (£2.3bn) reduction in corporate Non-core and BaCB risk-weighted assets. The change is driven by asset sales and the reassessment of the carrying value of corporate real estate exposures. Slotting models are used to analyse and monitor specialised lending exposures to property which are assigned to PRA supervisory categories with predefined risk weights. A significant proportion of loans have been downgraded with many moving into default. Loans in default have a zero risk-weight (but a 50% expected loss).

Capital management continued

For the year ended 31 December 2013

All the amounts are stated in £m unless otherwise indicated

In addition, Optimum risk-weighted assets have decreased by 13% (£526.6m). On 28 January 2013, the Bank entered into a transaction to transfer a mezzanine portion of the risk in a portfolio of residential mortgage loans to third party investors, via a special purpose vehicle, Calico Finance Number One Limited. As a result of this transaction, risk-weighted assets reduced by c. £1.2bn. An exercise to review the risk weightings of assets at 30 June 2013 increased risk-weighted assets by c. £1.0bn. In addition Optimum risk-weighted assets have decreased due to ongoing reduction in arrears and the continued run-off of the book.

Market risk risk-weighted assets have also decreased by £490.2m, due to the sale of the Bank's held-for-trading assets.

Total excess of expected loss over impairment, a deduction from capital resources, has decreased by £224.4m. Credit impairments have increased significantly, partially offset by higher expected loss driven by corporate downgrades.

CRD IV fully-loaded capital position

	31 December 2013	31 December 2012
Capital ratios		
Common Equity Tier 1 ratio	**7.2%**	5.0%
Tier 1 ratio	**7.2%**	5.0%
Total capital ratio	**8.6%**	9.0%
Capital resources		
Common Equity Tier 1	**1,086.6**	944.6
Tier 1	**1,089.2**	947.1
Total capital	**1,289.9**	1,698.5
Risk-weighted assets	**15,076.1**	18,842.3
Leverage ratio total exposure	**45,584.9**	52,203.3
Leverage ratio	**2.4%**	1.8%

Basel III has been implemented in the EU through the new Capital Requirements Regulation and a further iteration of the Capital Requirements Directive. Together the new rules are known as CRD IV and came into effect from 1 January 2014. The European Banking Authority is providing technical standards relating to CRD IV, some of which are not yet finalised. CRD IV disclosures in this document are based on the Bank's interpretation of published rules. There is a risk that the final content of the technical standards may differ materially from current expectations and that the Bank may become subject to regulatory capital requirements not currently anticipated or provided for.

In the December 2013 PS7/13 Policy Statement PRA announced that, with the exception of available-for-sale unrealised gains, CRD IV deductions and filters would be implemented in full from 1 January 2014 and there would be no transition to full implementation. All CRD IV disclosures above are shown on a fully-loaded basis.

Fully-loaded CET1 has now increased to 7.2% as at 31 December 2013 from 5.0% as at 31 December 2012. This reflects an increase in Common Equity Tier 1 of £142m, arising from statutory loss, LME and lower deductions, and a £3.8bn reduction in risk-weighted assets.

Leverage ratio on a fully-loaded basis has increased to 2.4% from 1.8% as at 31 December 2012. The Leverage ratio is calculated as CRD IV Tier 1 capital divided by adjusted balance sheet exposures. The improvement in the ratio reflects the £142m increase in total Tier 1 capital and a £6.6bn decrease in exposures reflecting the overall deleveraging strategy.

Financial statements

124	Independent auditor's report to the members of The Co-operative Bank plc only
127	The Bank financial statements
134	Notes to the Bank financial statements
220	The Company financial statements
226	Notes to the Company financial statements

Financial statements

Coming up:

This section of our Annual Report covers the financial statements. The Bank is defined as The Co-operative Bank plc and its subsidiary undertakings. The Company is defined as The Co-operative Bank plc. Most of the financial information relates to the Bank. We also have to show the balance sheet of our Company, which you will find right at the end of the section. The Bank financial statements shows all the companies under the control of the Bank added together and you will find these first.

This section includes the following key financial statements:

1. The Bank income statement (page 128).
2. The Bank statement of comprehensive income (page 129).
3. The Bank balance sheet (page 130).
4. The Bank statement of cash flows (page 131).
5. The Bank statement of changes in equity (page 133).
6. The Company balance sheet (page 221).
7. The Company statement of cash flows (page 223).
8. The Company statement of changes in equity (page 225).

The pages following the key financial statements contain notes to the accounts, many of them required by accounting standards and legislation, which are designed to give you more information.

1. The notes to the Bank financial statements (starting on page 134), including;
   a) note 1 – explanation of the basis of preparation and significant accounting policies (starting on page 134).
   b) note 2 – details of critical judgments and estimates (starting on page 147).
2. The notes to the Company financial statements (starting on page 226).

Look out for the blue highlights throughout these pages. We use them to explain the key statements and notes in plain English.

Independent auditor's report to the members of The Co-operative Bank plc only

Opinions and conclusions arising from our audit

1. Our opinion on the financial statements is unmodified

We have audited the financial statements of The Co-operative Bank plc (the 'Company') and its subsidiaries (together, the 'Bank') for the year ended 31 December 2013 set out on pages 127 to 263. In our opinion:

- the financial statements give a true and fair view of the state of the Bank's and of the Company's affairs as at 31 December 2013 and of the Bank's loss for the year then ended;
- the Bank financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union (IFRSs as adopted by the EU);
- the Company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Bank financial statements, Article 4 of the IAS Regulation.

Emphasis of matter – Going concern

In forming our opinion on the financial statements, which is not modified, we have considered the adequacy of the disclosures made in part 1.3 of the Basis of Preparation section of the financial statements concerning the Bank's and Company's ability to continue as a going concern. In that section the Directors set out the risks associated with the successful execution of the Recapitalisation and Turnaround Plans. These conditions indicate the existence of a material uncertainty which may cast significant doubt on the Bank's and Company's ability to continue as a going concern. These financial statements do not include the adjustments that would result if the Bank and Company were unable to continue as a going concern.

2. Our assessment of risks of material misstatement

In arriving at our audit opinion above on the financial statements the risks of material misstatement that had the greatest effect on our audit were as follows:

Going concern

Refer to page 47 (Audit Committee report) and pages 136 to 138 (basis of preparation)

- **The risk:** As described in the basis of preparation on page 137 the going concern status of the Bank is dependent on the Recapitalisation Plan (principally comprising the Liability Management Exercise (LME), 2014 capital contribution from The Co-operative Group and additional Common Equity Tier 1 (CET1) raising) and the Turnaround Plan (refocusing by the Bank on a core relationship banking proposition underpinning the 2014–2018 Plan). The successful execution of the Recapitalisation and Turnaround Plans have risks and uncertainties associated with it which indicate the existence of a material uncertainty which may cast doubt on the ability of the Bank and Company to continue as a going concern and this is therefore considered a key audit risk. Whilst the LME was successfully executed on 20 December 2013, risks and uncertainties remain over the remaining elements of the Recapitalisation and Turnaround Plans including:
  - the ability of The Co-operative Group (via The Co-operative Banking Group Limited) to make the agreed 2014 contributions and to meet its other commitments to the Bank as they fall due;
  - the timing and additional ability to raise additional CET1 and further non-CET1 capital;
  - the continuing support of the PRA; and
  - the ability of the Bank to implement and achieve the results set out in the 2014–2018 Plan, taking account of stresses that could adversely affect the plan such as execution of separation from The Co-operative Group and pension funding arrangements.
- **Our response:** Our audit procedures have included, amongst others, considering the ability of The Co-operative Group to pay the agreed contributions in 2014 and its other commitments to the Bank through an assessment of the Directors' investigations into the position of The Co-operative Group and the resources available to it. When assessing the ability of the Bank to raise further CET1 and non-CET1 capital included in the 2014–2018 Plan we considered the guidance the Bank had received from external advisors. We maintained regular dialogue with the Bank's regulator, the PRA, during the course of our audit procedures. We challenged the latest Board approved 2014–2018 Plan and the sensitivities to which it is subject by reference to our knowledge of the Bank and experience of the wider banking sector. We tested the logic of the key business planning model upon which the 2014–2018 Plan is based and the consistency of the application of key assumptions. We also considered whether the Bank's disclosure in relation to going concern adequately reflected the associated principal risks.

Separation from The Co-operative Group

Refer to page 48 (Audit Committee report), page 153 (critical judgements and estimates) and pages 155 to 156 (financial disclosures)

- **The risk:** The completion of the LME on the 20 December 2013 significantly changed the Company's shareholding structure, with The Co-operative Group retaining a minority stake. This required the Bank to begin to implement steps to separate itself from The Co-operative Group. The accounting for the LME was complex and resulted in significant amounts, including the profit on completion of the LME, being booked in the financial statements. The Directors have also had to exercise significant judgement in assessing and measuring the impacts, in particular the identification of potential obligations (including pension obligations) arising from the future completion of the separation process. This is therefore considered a key audit risk.
- **Our response:** Our audit procedures have included, amongst others, considering whether the accounting for the LME was in accordance with the relevant accounting standards and interpretations. With the assistance of our valuation specialists we challenged the assumptions underpinning the valuations of the shares and financial instruments which were issued by the Company and which were included in the calculation of the profit realised on completion of the LME. We compared key inputs and assessed the reasonableness of cash flow projections based on the Bank's 2014–2018 Plan underpinning the Turnaround Plan. We considered the separation agreements entered into and related documents and evaluated the extent to which potential obligations existed and the appropriateness of the accounting for these, including the assumptions made and key judgements applied. We assessed whether accounting for the current pension arrangements in 2013 as defined contribution plans was appropriate and in accordance with accounting standards. We also assessed the adequacy of disclosure concerning additional liabilities that could arise when the impact on these pension arrangements of separation from The Co-operative Group becomes clearer. We also considered the adequacy of the Bank's disclosures in respect of the LME and the impact of its separation from The Co-operative Group.

Independent auditor's report to the members of The Co-operative Bank plc only continued

Impairment of loans and advances to customers

Refer to page 48 (Audit Committee report), pages 147 to 149 (critical judgements and estimates) and pages 168 to 171 (financial disclosures)

- **The risk:** The assessment of the Bank's provisions for impairment losses against loans and advances to customers is complex, requires significant judgement to be exercised by the Directors and incorporates the use of subjective assumptions. Due to the significance of loans and advances and the related estimation uncertainty, this is considered a key audit risk. The portfolios which give rise to the greatest uncertainty are typically those which are subject to potential collateral shortfalls, in particular the Corporate and Optimum books.
- **Our response:** Our audit procedures have included, amongst others, challenging the methodology behind the assumptions used in the Bank's collective and individual impairment models, such as emergence periods, probabilities of default, recovery rates and discount rates. We considered assumptions in light of our knowledge of the Bank's portfolios and customer profile and standard market practice. We assessed the assumptions in light of actual experience including reference to external collateral valuations, where such valuations were available. When making our assessment, we considered the Directors' strategies for the Non-core portfolios, whether the assumptions as to recoverability of those loans were consistent with those strategies, including the expectations for future cash flows arising from the realisation of security held for individually assessed loans. Our approach included the use of property valuation specialists to challenge assumptions underpinning certain collateral valuations, benchmarking against industry experience and sensitivity analysis of the key assumptions.

We assessed the relevant credit risk data for completeness of capture and accuracy of extraction from the underlying systems. We compared the inputs into the impairment models and tested the logic of the model calculations. We considered the extent to which forbearance had been offered on individual loans and the extent of its incorporation into the impairment models and the impact this had on the provisioning requirements. We also assessed the adequacy of the Bank's disclosures in respect of its exposure to credit risk.

Provisions for customer redress

Refer to page 48 (Audit Committee report), pages 150 to 151 (critical judgements and estimates) and pages 185 to 186 (financial disclosures)

- **The risk:** The assessment of present obligations for customer redress requires significant judgement, due to uncertainties over whether an obligation exists and the subjective assumptions used in the quantification of potential redress levels. Due to the materiality of potential redress for items such as Payment Protection Insurance, breaches of the Consumer Credit Act, Interest Rate Swap mis-selling and mortgage first payments, amongst others, and the difficulty in assessing and measuring obligations from ongoing regulatory and legal matters, this is considered a key audit risk.
- **Our response:** Our audit procedures have included, amongst others, challenging the completeness of identified issues and considering the adequacy of provisions recognised. Our audit focused particularly on the governance process around the identification of possible customer redress items and the integrity of data held. We assessed key assumptions including likely uphold rates, redress levels and operating costs, and compared them to expectations based on the Bank's historical experience, current trends and our own industry knowledge. We also considered the sensitivity of the level of provisions to changes in these assumptions when scoping and performing our audit procedures. We evaluated whether the provisioning methodology was consistent in approach, with sufficient justification for changes in assumptions or for maintenance of consistent assumptions in the year. We also considered whether the Bank's disclosure in relation to customer redress provisions appropriately reflected the application of judgement by the Directors in estimating required provisions and the identification of potential contingent liabilities.

Deferred tax assets

Refer to page 47 (Audit Committee report), page 152 (critical judgements and estimates) and pages 187 to 188 (financial disclosures)

- **The risk:** The application of significant judgement by the Directors is required over the recognition or otherwise of deferred tax assets in respect of assessing the probability and sufficiency of future taxable profits and the likely timing of reversal of existing temporary differences. In light of the 2013 results and the uncertainties outlined in the consideration of going concern risk no deferred tax assets have been recognised. Due to the uncertainty as to the timing and extent of future profitability given the recent losses, this is considered a key audit risk.
- **The response:** Our audit procedures have included, amonst others, considering the Bank's ability to recover deferred tax assets based on the taxable profit projections prepared by the Directors in the context of the Recapitalisation and Turnaround Plans. Our assessment of the Directors' conclusion not to recognise deferred tax assets (reflecting the uncertainties regarding the sufficiency of future taxable profits) was closely linked to our evaluation of the Board approved 2014-2018 Plan and the procedures outlined in the response to our consideration of going concern risk. We have also evaluated the adequacy of the disclosure concerning the application of judgement in not recognising deferred tax assets.

Control environment

Refer to page 48 (Audit Committee report)

- **The risk:** The financial reporting process depends on the correct functioning of the operational and financial IT systems. The Bank's IT infrastructure is complex, with multiple legacy systems which require increased manual inputs and numerous interfaces between product systems and financial reporting systems. The robustness of the financial reporting process is also reliant on the effective functioning of the wider control environment across the Bank, which has had a number of weaknesses in the past. During the year significant strain has been placed upon that control environment, compounded by the activities required in response to the publicised capital shortfall. Given the complexities and weaknesses referred to above, this is an area of significant risk in our audit.
- **Our response:** Our audit approach included an assessment of the quality and effectiveness of internal controls. We planned our audit to place reliance (where appropriate) on internal controls, including general IT controls. Our audit addressed the increased pervasive risk which existed through a higher assessment of inherent risk at the account balance level. Our audit procedures sought to obtain a greater proportion of substantive evidence through increased focus on the manual inputs and reconciliations between financial systems and, for example, sample sizes, such as the number of corporate loans we examined in our evaluation of credit impairment on individually assessed cases. In addition enhanced challenge was applied in performing audit procedures around estimates such as assumptions in the various provisions for customer redress.

We used IT specialists within our audit team for much of our IT procedures which included, amongst others, testing general IT controls around system access and change management and testing controls over computer operations within specific applications which are required to be operating effectively to mitigate the risk of misstatement within the financial statements. Where IT controls were not operating effectively we considered the impact on financial information and, where relevant, extended the scope of our work by identifying and testing compensating controls and reducing our reliance on controls by performing alternative and additional substantive audit procedures.

Independent auditor's report to the members of The Co-operative Bank plc only continued

3. Our application of materiality and an overview of the scope of our audit

The materiality for the financial statements as a whole was set at £50m. This has been determined with reference to a benchmark of Bank loss before taxation, which we consider to be one of the principal considerations for members of the Company in assessing the financial performance of the Bank. Materiality represents 8.5% of Bank loss before taxation and 3.9% of Bank loss before taxation adjusted for the profit from the execution of the Liability Management Exercise as disclosed on the face of the income statement.

We agreed with the Audit Committee to report to it all uncorrected misstatements we identified through our audit with a value in excess of £2m, in addition to other audit misstatements below that threshold that we believe warranted reporting on qualitative grounds.

Audits for group reporting purposes were performed by component auditors at the key reporting components, Unity Trust Bank plc and Britannia International Limited, and by the group team at the other key reporting components. These audits covered 100% of net interest income, loss before taxation, loans and advances to customers and total assets.

The audits undertaken for group reporting purposes at the key reporting components of the Bank were all performed to materiality levels set by the group audit team. These component materiality levels ranged from £35m to £46m.

Detailed audit instructions were sent to the auditors of Unity Trust Bank plc and Britannia International Limited. These instructions covered the significant audit areas that should be covered by these audits (which included the relevant risks of material misstatement detailed above) and set out the information required to be reported back to the group audit team. Component teams also attended group audit planning meetings.

4. Our opinion on other matters prescribed by the Companies Act 2006 is unmodified

In our opinion the information given in the Strategic report and the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

5. We have nothing to report in respect of the matters on which we are required to report by exception

Under ISAs (UK and Ireland) we are required to report to you if, based on the knowledge we acquired during our audit, we have identified other information in the annual report that contains a material inconsistency with either that knowledge or the financial statements, a material misstatement of fact, or that is otherwise misleading.

In particular, we are required to report to you if:

- we have identified material inconsistencies between the knowledge we acquired during our audit and the Directors statement that they 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 Bank's performance, business model and strategy; or
- the Corporate Governance Section of the Annual Report and Accounts describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee

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

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

In addition to our audit of the financial statements, the Directors have engaged us to review their Corporate Governance Statement as if the Company were required to comply with Listing Rules and the Disclosure Rules and Transparency Rules of the Financial Conduct Authority in relation to those matters. Under the terms of our engagement we are required to review:

- the Directors' statement, set out on page 34, in relation to going concern; and
- the part of the Corporate Governance Statement on page 37 relating to the Company's compliance with the nine provisions of the 2010 UK Corporate Governance Code specified for our review.

We have nothing to report in respect of the above responsibilities.

Scope of report and responsibilities

As explained more fully in the Directors' Responsibilities Statement set out on page 59, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate. This report is made solely to the company's members as a body and is subject to important explanations and disclaimers regarding our responsibilities, published on our website at www.kpmg.com/uk/auditscopeukco2013b, which are incorporated into this report as if set out in full and should be read to provide an understanding of the purpose of this report, the work we have undertaken and the basis of our opinions.

John Ellacott
(Senior Statutory Auditor)
For and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
St James' Square Manchester
M2 6DS
10 April 2014

The Bank financial statements

The Bank income statement

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

In plain english:

The Bank income statement shows most of the income earned and expenses incurred during the year for all the companies in the Bank. Other items are shown in the statement of comprehensive income on the next page.

The numbers in brackets are costs or losses. The earnings per share is simply the net profit or loss divided by the weighted average number of shares.

	Notes	2013	2012
Interest receivable and similar income	8	**1,388.4**	1,488.3
Provision for potential customer redress claims	8	**(194.5)**	–
		1,193.9	1,488.3
Interest expense and similar charges	8	**(930.7)**	(922.5)
Net interest income		**263.2**	565.8
Fee and commission income	9	**219.9**	241.4
Provision for potential customer redress claims	9	**(185.1)**	(149.7)
		34.8	91.7
Fee and commission expense	9	**(72.1)**	(64.2)
Net fee and commission (expense)/income		**(37.3)**	27.5
Net trading income	10	**3.8**	14.1
Other operating income	11	**40.4**	33.9
Operating income		**270.1**	641.3
Operating expenses			
Operating expenses	12	**(880.7)**	(697.5)
Intangible asset impairment	23	**(148.4)**	(150.0)
Total operating expenses		**(1,029.1)**	(847.5)
Operating loss before impairment losses		**(759.0)**	(206.2)
Impairment losses on loans and advances	18	**(516.2)**	(474.1)
Impairment gains on investments		**–**	5.4
Operating loss pre Liability Management Exercise		**(1,275.2)**	(674.9)
Profit from Liability Management Exercise	4	**688.3**	–
Operating loss post Liability Management Exercise		**(586.9)**	(674.9)
Share of post tax profits from joint ventures	38	**0.7**	1.2
Loss before taxation		**(586.2)**	(673.7)
Income tax	14	**(161.8)**	165.6
Loss for the financial year		**(748.0)**	(508.1)
Attributable to:			
Equity shareholders	15	**(748.9)**	(509.1)
Minority interests		**0.9**	1.0
		(748.0)	(508.1)
Earnings per share (basic and fully diluted)	15	**(9.43)p**	(6.21)p

In total £411.5m (2012: £149.7m) of conduct and legal provisions have been incurred during the year. This includes £194.5m (2012: £nil) reported within interest receivable and similar income, £185.1m (2012: £149.7m) reported within fee and commission income and £31.9m (2012: £nil) reported within operating expenses.

The notes on pages 134 to 219 form part of these financial statements.

The Bank statement of comprehensive income

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

In plain english:

As well as the net profit or loss reported in the income statement, there are a number of other items not reported in the income statement which are instead shown here. These items are typically unrealised gains and losses arising from revaluing certain financial assets and hedging instruments. This statement starts with the profit or loss we reported in the income statement and then adds/deducts these other amounts to show the overall result (ie the total comprehensive income).

	Equity shareholders 2013	**Minority interests 2013**	**Total 2013**	Equity shareholders 2012	Minority interests 2012	Total 2012
Loss for the financial year	**(748.9)**	**0.9**	**(748.0)**	(509.1)	1.0	(508.1)
Other comprehensive (expense)/income that may be recycled to profit and loss:						
Changes in cashflow hedges						
Net changes in fair value recognised directly in equity	**(53.2)**	**(0.7)**	**(53.9)**	23.5	(0.8)	22.7
Income tax	**14.9**	**0.2**	**15.1**	(9.9)	0.2	(9.7)
Transfers from equity to income or expense	**(13.7)**	**–**	**(13.7)**	(30.9)	(0.1)	(31.0)
Income tax	**3.2**	**–**	**3.2**	13.4	–	13.4
Changes in available for sale assets						
Net changes in fair value recognised directly in equity	**(32.7)**	**–**	**(32.7)**	108.7	–	108.7
Income tax	**7.6**	**–**	**7.6**	(26.2)	–	(26.2)
Transfers from equity to income or expense	**(24.8)**	**–**	**(24.8)**	(95.5)	–	(95.5)
Income tax	**5.6**	**–**	**5.6**	23.5	–	23.5
Revaluation of equity shares	**0.1**	**–**	**0.1**	–	–	–
Income tax	**0.1**	**–**	**0.1**	–	–	–
Defined benefit plan actuarial losses	**–**	**–**	**–**	–	–	–
Income tax	**–**	**–**	**–**	(0.1)	–	(0.1)
Other comprehensive (expense)/income for the financial year, net of income tax	**(92.9)**	**(0.5)**	**(93.4)**	6.5	(0.7)	5.8
Total comprehensive (expense)/income for the financial year	**(841.8)**	**0.4**	**(841.4)**	(502.6)	0.3	(502.3)

The notes on pages 134 to 219 form part of these financial statements.

The Bank balance sheet

At 31 December 2013

All amounts are stated in £m unless otherwise indicated

In plain english:

The Bank balance sheet is a financial snapshot at the end of each year, showing the financial position. It shows all the assets owned by the Bank and how those assets have been funded (liabilities and the equity – the shareholders' investment in the Bank).

You will find more information about the various lines in the Bank balance sheet in the notes to the financial statements that start on page 134.

	Notes	2013	Restated 2012
Assets			
Cash and balances at central banks	16	**5,418.8**	5,433.0
Loans and advances to banks	17	**1,594.4**	1,904.1
Loans and advances to customers	18a	**30,322.2**	33,339.5
Fair value adjustments for hedged risk	18b	**107.6**	354.2
Investment securities – loans and receivables	19a	**23.6**	295.0
Investment securities – available for sale	19b	**2,732.4**	3,789.4
Investment securities – fair value through income or expense	19c	**1,743.4**	1,845.2
Investment securities – held for trading	19d	**–**	960.2
Derivative financial instruments	20	**555.8**	818.8
Equity shares	21	**5.8**	5.7
Investments in joint ventures	38	**4.7**	3.9
Goodwill	22	**–**	–
Investment properties	24	**164.1**	173.0
Property, plant and equipment	25	**115.2**	113.4[1]
Intangible fixed assets	23	**110.7**	263.2[1]
Amounts owed by other Co-operative Group undertakings	39	**–**	56.8[1]
Other assets	26	**480.9**	70.3
Prepayments and accrued income	27	**16.5**	14.9
Current tax assets		**–**	172.6
Deferred tax assets	35	**–**	159.6[2]
Total assets		**43,396.1**	49,772.8
Liabilities			
Deposits by banks	28	**2,757.5**	3,612.0
Customer accounts		**32,463.3**	35,884.4
Customer accounts – capital bonds	29	**538.1**	888.1
Debt securities in issue	30	**4,195.3**	4,713.7
Derivative financial instruments	20	**538.6**	967.6
Other borrowed funds	31	**196.3**	1,258.6
Amounts owed to other Co-operative Group undertakings	39	**–**	190.0[1]
Other liabilities	32	**202.9**	104.0
Accruals and deferred income	33	**54.1**	20.1
Provisions for liabilities and charges	34	**576.0**	162.7
Current tax liabilities		**4.2**	–
Deferred tax liabilities	35	**92.5**	121.4[2]
Total liabilities		**41,618.8**	47,922.6
Capital and reserves attributable to the Bank's equity holders			
Ordinary share capital	40	**12.5**	410.0
Share premium account	40	**1,359.8**	8.8
Retained earnings		**(39.4)**	1,304.3
Available for sale reserve		**(14.1)**	30.0
Capital redemption reserve		**410.0**	–
Cashflow hedging reserve		**14.9**	63.7
		1,743.7	1,816.8
Minority interests		**33.6**	33.4
Total equity		**1,777.3**	1,850.2
Total liabilities and equity		**43,396.1**	49,772.8

1. The 2012 balance sheet comparatives have been restated for intangible fixed assets, property, plant and equipment and amounts owed by other Co-operative Group undertakings as described in note 3.
2. The 2012 balance sheet comparatives have been re-presented to reflect that certain deferred tax liabilities cannot be offset against the deferred tax assets.

Approved by the Board on 10 April 2014:

Richard Pym, Chair
Niall Booker, Chief Executive

The notes on pages 134 to 219 form part of these financial statements.

The Bank statement of cash flows

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

In plain english:

The Bank statement of cash flows shows how we generate cash from our banking business (cash from operational activities), how we have spent cash (investing activities) and how we have borrowed or spent cash to fund our business or pay for our funding (financing activities) for all the companies in our Bank.

As well as showing the overall amount of cash generated or spent in the year, we also show how this movement has affected our cash and cash equivalents (ie the short term deposits that can be converted to cash quickly).

	2013	Restated 2012
Cash flows from operating activities		
Loss before taxation	**(586.2)**	(673.7)
Adjustments for:		
Decrease/(increase) in prepayments and accrued income	**4.7**	(8.2)
Increase/(decrease) in accruals and deferred income	**13.4**	(19.8)
Interest payable in respect of other borrowed funds	**96.0**	81.4
Effect of exchange rate movements	**(0.6)**	10.4
Effect of non-cash pension costs	**–**	0.1
Fair value movement on investment properties	**8.0**	(0.2)
Impairment losses on loans and advances	**517.3**	480.2
Movements on investment impairments	**(18.5)**	(5.4)
Depreciation and amortisation	**33.9**	41.1
Impairment of intangible fixed assets	**142.0**	150.0
Impairment charge to write off goodwill	**–**	0.6
Interest amortisation	**(4.2)**	(6.3)
Fair value movements and amortisation of investment securities	**142.1**	(71.8)
Impairment of property, plant and equipment	**21.2**	–
Loss on disposal of property, plant, equipment and software	**0.5**	0.9
Non-cash effect of LME transaction	**(688.3)**	–
Unwind of fair value adjustments arising on transfer of engagements	**52.1**	(15.2)
Preference dividend	**5.4**	5.6
	(261.2)	(30.3)
(Decrease)/increase in deposits by banks	**(854.5)**	309.3
(Decrease)/increase in customer accounts and capital bonds	**(3,863.2)**	352.6
(Decrease)/increase in debt securities in issue	**(612.8)**	480.3
Decrease/(increase) in loans and advances to banks	**66.9**	(68.2)
Decrease in loans and advances to customers	**2,905.7**	53.2
Increase in amounts owed by other Co-operative Group undertakings	**(47.6)**	(241.6)
Increase in amounts owed to other Co-operative Group undertakings	**58.8**	57.7
Net movement of other assets and other liabilities	**82.7**	(15.3)
Income tax received/(paid)	**45.0**	(4.2)
Net cash flows from operating activities	**(2,480.2)**	893.5
Cash flows from investing activities		
Purchase of tangible and intangible fixed assets	**(55.7)**	(90.4)
Proceeds from sale of fixed assets	**1.7**	1.0
Proceeds from sale of investment property	**1.3**	0.9
Purchase of investment securities	**(4,425.3)**	(4,960.9)
Proceeds from sale and maturity of investment securities	**6,681.2**	2,616.4
Net cash flows from investing activities	**2,203.2**	(2,433.0)
Cash flows from financing activities		
Interest paid on other borrowed funds	**(83.9)**	(87.4)
Repayment of other borrowed funds	**–**	(256.5)
Issuance of other borrowed funds	**–**	235.4
Dividends paid to securitisation holding companies	**–**	(0.3)
Dividends paid to minority interests	**(0.2)**	(0.3)
Preference share dividends paid	**(5.9)**	(5.6)
Capital contribution from parent	**–**	80.0
Cash proceeds relating to the LME	**145.0**	–
Net cash flows from financing activities	**55.0**	(34.7)

The Bank statement of cash flows continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

	2013	Restated 2012
Decrease in cash and cash equivalents	**(222.0)**	(1,574.2)
Cash and cash equivalents at the beginning of the financial year	**6,314.2**	7,888.4
Cash and cash equivalents at the end of the financial year	**6,092.2**	6,314.2
Cash and balances with central banks (note 16)	**5,352.6**	5,393.6
Loans and advances to banks (note 17)	**634.6**	850.6
Short term investments (note 19)	**105.0**	70.0
	6,092.2	6,314.2

The cash flows differ from the Bank balance sheet movements as these movements include:

- the non-cash unwinds of the fair value adjustments arising on the transfer of engagements of Britannia Building Society.
- the restatement of amounts owed by and to other Co-operative Group undertakings.

The notes on pages 134 to 219 form part of these financial statements.

The Bank statement of changes in equity

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

In plain english:

The changes in equity statement shows how the various lines in the equity section of the Bank balance sheet (on page 130) have moved during the year.

The main change is the profit/(loss) for the year along with the raising of capital as a result of the Liability Management Exercise.

	Attributable to equity holders of the Company								
	Share capital	Share premium	Available for sale reserve	Cashflow hedging reserve	Capital redemption reserve	Retained earnings	Total	Minority interest	Total equity
2013									
Balance at the beginning of the year	**410.0**	**8.8**	**30.0**	**63.7**	**–**	**1,304.3**	**1,816.8**	**33.4**	**1,850.2**
Total comprehensive (expense)/income for the year excluding LME	**–**	**–**	**(33.0)**	**(48.8)**	**–**	**(1,437.2)**	**(1,519.0)**	**0.4**	**(1,518.6)**
Total comprehensive (expense)/income for the year – LME	**–**	**–**	**(11.1)**	**–**	**–**	**688.3**	**677.2**	**–**	**677.2**
Total comprehensive (expense)/income for the year	**–**	**–**	**(44.1)**	**(48.8)**	**–**	**(748.9)**	**(841.8)**	**0.4**	**(841.4)**
Transactions with owners recorded directly in equity:									
Liability Management Exercise[1]									
Cancellation of share capital	**(410.0)**	**–**	**–**	**–**	**410.0**	**–**	**–**	**–**	**–**
Issuance of new share capital	**12.5**	**777.5**	**–**	**–**	**–**	**–**	**790.0**	**–**	**790.0**
Transfer of retained earnings to share premium	**–**	**594.8**	**–**	**–**	**–**	**(594.8)**	**–**	**–**	**–**
Transaction costs	**–**	**(21.3)**	**–**	**–**	**–**	**–**	**(21.3)**	**–**	**(21.3)**
Dividend	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**(0.2)**	**(0.2)**
Balance at the end of the year	**12.5**	**1,359.8**	**(14.1)**	**14.9**	**410.0**	**(39.4)**	**1,743.7**	**33.6**	**1,777.3**
2012									
Balance at the beginning of the year	410.0	8.8	19.5	67.6	–	1,733.8	2,239.7	33.4	2,273.1
Total comprehensive income/(expense) for the year	–	–	10.5	(3.9)	–	(509.2)	(502.6)	0.3	(502.3)
Transactions with owners recorded directly in equity:									
Capital contribution	–	–	–	–	–	80.0	80.0	–	80.0
Dividend	–	–	–	–	–	(0.3)	(0.3)	(0.3)	(0.6)
Balance at the end of the year	410.0	8.8	30.0	63.7	–	1,304.3	1,816.8	33.4	1,850.2

1. Further detail of the LME is provided in note 4.

The notes on pages 134 to 219 form part of these financial statements.

Notes to the Bank financial statements

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

Coming up:

The next four notes provide details of the basis of preparation and accounting policies applied in producing these financial statements and the critical judgements therein. In addition, details are provided explaining a prior period restatement and the impact of the Liability Management Exercise completed during the year.

1. Basis of preparation and significant accounting policies

1.1 Basis of preparation

Both the Company financial statements and the Bank financial statements have been prepared and approved by the Directors in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), and as adopted by the European Union (EU).
On including the parent company financial statements here together with the Bank financial statements, the Company is taking advantage of the exemption in Section 408 of the Companies Act 2006 not to present its individual income statement and related notes that form a part of these approved financial statements.

The financial statements have been prepared under the historic cost convention as modified by the revaluation of available for sale financial assets, derivative contracts, investment properties and certain other financial assets and financial liabilities held at fair value. The Bank applies the recognition, measurement and disclosure requirements of IFRS in issue that are endorsed by the EU and are effective for accounting periods beginning on or after 1 January 2013.

The financial statements comprise all audited sections of the accounts. Where indicated, the risk management section on pages 69 to 116 and capital management section on pages 117 to 121 form part of the audited accounts.

Standards and interpretations issued and effective

In preparing this consolidated financial information, the Bank has adopted the following pronouncements during the year that are new or revised:

- Amendments to IFRS 7 (Disclosures Offsetting Financial Assets and Liabilities (2011))
  This amendment requires disclosures to include information that will enable users of an entity's financial statements to evaluate the effect of netting arrangements, on the entity's financial position. The amendment to IFRS 7 has no material impact on the financial statements of the Bank.
- IFRS 13 (Fair Value Measurement (2011))
  This new standard defines fair value and is the single source of fair value measurement and disclosure. The adoption of this new standard resulted in additional disclosures set out in note 41. The primary changes in disclosure resulted from the Bank's additional presentation of fair value tables analysing levels of observable inputs.
- Amended IAS 1 (Presentation of Items of Other Comprehensive Income (2011))
  This amendment's objective is to split the presentation of other comprehensive income into two sections. The different sections will distinguish between items which may or may not be recycled into any future income or expense. The amendment to IAS 1 has no material impact on the financial information of the Bank.
- Revised IAS 19 (Employee Benefits (2011))
  This revision means that actuarial gains or losses will now be immediately recognised within income or expense. Furthermore, the revision replaces the 'expected return on assets' with a net interest amount calculated by applying the discount rate to the net defined benefit liability/asset. The discount rate is determined by reference to market yields on high quality corporate bonds.

  Given the Bank continues to account on a defined contribution basis, for what is now a multi-employer pension scheme, the adoption of this revised standard resulted solely in additional disclosure (see note 36) with no impact to the income statement.

Standards and interpretations issued but not yet effective

- IFRS 9 (Financial Instruments: Classification and Measurement (2010))
  This new standard replaces IAS 39 (Financial Instruments: Recognition and Measurement (2009)). Phase one requires financial assets to be classified as at amortised cost or at fair value.
- Amendments to IFRS 9 (Financial Instruments: Hedge Accounting and Amendments to IFRS 7 and IAS 39 (2013))
  The hedge accounting requirements in IFRS 9 align more closely with risk management, resulting in more useful information to users of financial statements. The requirements also establish a more principle-based approach to hedge accounting and address inconsistencies and weakness in the hedge accounting model in IAS 39.

  The main changes relate to the hedge effectiveness, the eligibility of items as hedged items and hedging instruments.

  The IASB is expected to finalise all phases of IFRS 9 during 2014 with a mandatory effective date of 1 January 2018.

  The amendments will be applied once endorsed by the EU.

  The impact of the standard is likely to be material to the Bank.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Basis of preparation and significant accounting policies continued

- IFRS 10 (Consolidated Financial Statements (2011))
  This new standard establishes principles for the presentation and preparation of consolidated financial information when an entity controls one or more other entities. It supersedes both IAS 27 (Consolidated and Separate Financial Statements (2008)) except where IAS 27 still applies as noted below, and Amended SIC 12 (Consolidation: Special Purpose Entities (2004)). It aims to provide transparency in identifying off balance sheet, parent subsidiary relationships, using a consistent basis for determining the existence and thus consolidation of those underlying entities being controlled by the reporting entity.

  It has been adopted for use within the EU for accounting periods beginning on or after 1 January 2014. An assessment of the impact to the Bank of IFRS 10 has been made, and is considered to be immaterial.

- IFRS 11 (Joint Arrangements (2011))
  This new standard establishes principles for financial reporting by parties to a joint arrangement. It supersedes both IAS 31 (Interests in Joint Ventures (2010)) and Amended SIC 13 (Jointly Controlled Entities: Non-Monetary Contributions by Venturers (2007)). Recognition criteria now distinguish between joint operations and joint ventures on their relative 'rights and obligations' scope. A joint operation interest is accounted for between assets, liabilities, revenue and expense, whilst a joint venture is restricted to equity accounting.

  It has been adopted for use within the EU for accounting periods beginning on or after 1 January 2014. The impact to the Bank of IFRS 11 is likely to be immaterial.

- IFRS 12 (Disclosure of Interests in Other Entities (2011))
  This new standard applies to entities that have an interest in a subsidiary, a joint arrangement, an associate or an unconsolidated structured entity. It aims to provide disclosure transparency on the reporting entity's risks associated with its interests in other entities, in conjunction with IFRS 10's application which determines the existence of such entities.

  It has been adopted for use within the EU for accounting periods beginning on or after 1 January 2014. In accordance with the Bank's position on IFRS 10, the impact to the Bank of the additional disclosure requirements is considered to be immaterial.

- Amended IAS 27 (Consolidated and Separate Financial Statements (2011))
  This amendment occurs as a direct consequence of IFRS 10's issuance, which now acts as the new single authority on consolidation requirements. IAS 27's scope has therefore reduced and focuses more specifically on separate financial information accounting bases. An entity shall therefore prepare its separate financial information using one of two bases; either at cost or in accordance with IFRS 9.

  It has been adopted for use within the EU for accounting periods beginning on or after 1 January 2014. The impact to the Bank of the amendment to IAS 27 is likely to be immaterial.

- Amended IAS 28 (Investments in Associates and Joint Ventures (2011))
  This amendment occurs as a direct consequence of IFRS 11's issuance, which now acts as the new single authority on joint arrangements. IAS 28 changes in order to consistently apply equity accounting methods for both joint ventures and associates. An entity shall therefore use IAS 28's equity accounting method, when accounting for any of IFRS 11's joint arrangements.

  It has been adopted for use within the EU for accounting periods beginning on or after 1 January 2014. The impact to the Bank of the amendment to IAS 28 is likely to be immaterial.

- Amendments to IAS 32 (Offsetting Financial Assets and Financial Liabilities)
  The current offsetting model in IAS 32 requires an entity to offset a financial asset and financial liability only when the entity currently has a legally enforceable right of set-off and intends either to settle on a net basis or to realise the asset and settle the liability simultaneously. This amendment clarifies the position when offsetting financial assets and financial liabilities. The legal right of set-off must be available today and legally enforceable for all counterparties in the normal course of business, as well as in the event of default, insolvency or bankruptcy. The amended disclosures will require more extensive disclosures than are currently required. The disclosures focus on quantitative information about recognised financial instruments that are offset in the balance sheet, as well as those recognised financial instruments that are subject to master netting or similar arrangements irrespective of whether they are offset.

  It has been adopted for use within the EU for accounting periods beginning on or after 1 January 2014. The impact to the Bank of the amendment to IAS 32 is likely to be immaterial.

- Amendment to IAS 36 (Recoverable Amount Disclosures for Non-financial Assets (2013))
  This amendment changes the disclosure requirements required by IAS 36 when the recoverable amount is determined based on fair value less costs of disposal. The amendment removes the requirement to disclose recoverable amount when a cash generating unit (CGU) contains goodwill or indefinite lived intangible assets where there has been no impairment. In addition, the amendment requires additional information about the fair value measurement when the recoverable amount of impaired assets is based on fair value less cost of disposal. The new amendment requires detailed disclosure of how the fair value less costs of disposal has been measured when an impairment loss has been recognised or reversed.

  It has been adopted for use within the EU for accounting periods beginning on or after 1 January 2014. The impact to the Bank of the amendment to IAS 36 is likely to be immaterial.

- Amendment to IAS 39 (Novation of derivatives and continuation of hedge accounting (2013))
  This amendment allows hedge accounting to continue, where a derivative, which has been designated as a hedging instrument, is novated to effect clearing with a central counterparty as a result of laws or regulation, if specific conditions are met.

  It has been adopted for use within the EU for accounting periods beginning on or after 1 January 2014. The impact to the Bank of the amendment to IAS 39 is likely to be immaterial.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Basis of preparation and significant accounting policies continued

- IFRIC 21 (Levies (2013))

  This interpretation gives guidance on the recognition of a liability to pay a levy that is accounted for in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets. A levy is an outflow of resources embodying economic benefits that is imposed by governments on entities in accordance with legislation other than outflows of resources covered by other standards, fines or other penalties that are imposed for breaches of the regulation. The obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation.

  The Bank will adopt this interpretation from 1 January 2014, when recognising the Financial Services Compensation Scheme (FSCS) Levy. The impact of the application will be to increase brought forward reserves at 1 January 2014 by £26.3m as the FSCS Levy will be recognised annually on 1 April, rather than the date upon which the Bank's share of the levy is calculated as a proportion of the total market protected deposit, 31 December.

Other standards and interpretations have been issued but these are not considered to be relevant to the Bank's operations.

1.2 Financial Reporting Council

As indicated in the prospectus issued by the Co-operative Group Limited on 4 November 2013, the Bank has been co-operating with the Conduct Committee of the Financial Reporting Council in respect of its enquiry into the Bank's 2012 annual report and accounts. That enquiry commenced in September 2013.

The Conduct Committee has recently concluded its enquiry on the basis of correspondence with the Company and the inclusion of specific disclosures in the 2013 Annual Report and Accounts.

The relevant disclosures relate to the following matters:

- The Prudential Regulation Authority's assessment of the Bank's capital requirements which were disclosed in the Bank's 4 November 2013 prospectus. Due to the specific circumstances of the Bank similar updated disclosures are included in the 2013 Annual Report and Accounts.
- Clarification of the nature of the acquisition fair value adjustment made in respect of loans acquired in the merger with the Britannia Building Society.
- Comparative fair value disclosures for loans and advances at 31 December 2012 using the revised valuation methodologies applied at 31 December 2013.
- Recognition of the investment in the new core IT banking system as an intangible asset of the Bank as at 31 December 2012 by way of a prior period adjustment and disclosure of the rationale for this change in treatment.

The Conduct Committee has been provided with confirmation that loan impairments at 31 December 2013 have been accounted for in accordance with IAS 39 'Financial Instruments: Recognition and Measurement'. The Committee has indicated that although it accepts this confirmation, it has not expressed a view about the historic progression of impairment losses on loans acquired at a deep discount in the Britannia merger.

1.3 Going concern

a) Introduction

These financial statements are prepared on a going concern basis. The Directors have a reasonable expectation that the Bank will have the resources to continue in business for the foreseeable future, taking into account the matters referred to below.

As discussed earlier in these accounts, in order to address the capital shortfall identified in 2013, the Directors defined:

- A Recapitalisation Plan principally comprising the Liability Management Exercise (LME) and the 2014 capital contribution from The Co-operative Group.
- A Turnaround Plan which involves reshaping and restructuring the business as a core relationship bank.

Both the remaining components of the Recapitalisation Plan and the Turnaround Plan are reflected in the 2014–2018 Plan.

The assessment of the appropriateness of using the going concern basis of accounting has been subject to a thorough process involving analysis and discussion by management, Executive and Board Committees and the Board, in line with our governance processes, and discussion with the PRA. This analysis included a particular focus on the 12 month period ending 30 April 2015. The forecasts included in the 2014–2018 Plan have been subjected to stressed scenarios which the Board considered to be reasonable and appropriate.

Despite the LME, without which the Directors believe the Bank would have been subject to a resolution procedure under the Banking Act of 2009, the Bank is currently below the Individual Capital Guidance (ICG) set by the PRA and it is forecast to remain so for most of the duration of the 2014–2018 planning period.

Total Basel II capital resources as at 31 December 2013 are £1.4bn (31 December 2012: £2.3bn) with core tier 1 capital after regulatory deductions of £1.3bn (31 December 2012 £1.3bn). Following the LME, at 31 December 2013, the Bank's CET1 ratio stands at 7.2% on a Basel III end point basis. However, this is only a relatively small margin above the threshold directed by the PRA that, based on Basel III end point rules, major UK banks should hold CET1 resources of at least 7% of their risk-weighted assets by December 2013, and provides limited protection against unexpected losses.

The annual results for 2013 reflect significant charges which exceed the levels originally anticipated when the Recapitalisation Plan was announced on 4 November 2013. The Directors identified a number of risks as part of that plan but did not anticipate the extent to which those risks would materialise. In November, the Bank stated that it 'expects to report for the end of 2013 a CET1 ratio towards the upper end of previously announced guidance, on 29 August 2013, of below 9% but above the regulatory minimum requirement'. The CET1 ratio of 7.2% at 31 December 2013 is above the requirement but lower than expected and, without additional CET1, would be projected to fall below 7% during the period of the 2014–2018 Plan.

Consequently, as announced on 24 March 2014, additional CET1 needs to be raised in order to deliver the Turnaround Plan. The Directors have put steps in place to raise this additional requirement. Please see page 22 for the latest update in this regard. The PRA has reviewed and accepted the 2014–2018 Plan, including the further capital raising discussed above.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Basis of preparation and significant accounting policies continued

The completion of the LME removed an element of the uncertainty around the going concern status of the Bank. However, whilst an important step, it is not in itself sufficient to recapitalise the Bank. There continues to be material uncertainty around the implementation of both the remaining components of the Recapitalisation Plan and the Turnaround Plan.

b) Recapitalisation Plan

The remaining components of the Recapitalisation Plan comprise:

i. Further cash contributions to the Bank in 2014 of £313m committed by The Co-operative Group (via The Co-operative Banking Group Limited) of which £50m has already been received in 2014. The Co-operative Group has informed the Bank that it has appropriate arrangements in place to enable it to make this further contribution. In this connection, The Co-operative Group has informed the Bank that it is currently in discussions regarding a potential breach of a debt covenant, which it has taken steps to resolve and is confident will be resolved before publication of its accounts scheduled for 17 April 2014. Based on all the information provided by The Co-operative Group, and on investigations made by and on behalf of the Bank, the Bank believes that the incorporation of this contribution into its plans is appropriate.

ii. The generation of interest savings of approximately £40m in 2014 due to the retirement of the subordinated capital securities.

iii. As discussed above, additional CET1 is in the process of being raised. An update on plans in this regard can be seen on page 22.

c) Refocus on Core relationship banking proposition – the Turnaround Plan

The Co-operative Bank remains a strong brand and continues to maintain a loyal customer base. Moving forward, the strategy is to reshape the business as a core relationship bank providing standard business banking and retail banking services to individuals and SMEs. Restructuring the business, including a reduction in head office costs, to drive a significant reduction of the cost base is an important part of the overall strategy.

A key underpin of the reshaping of the business is the reduction in the Non-core banking business and assets, which carry the majority of the impairment risk for the Bank currently. This will reduce the risk-weighted assets of the Bank, thereby improving its CRD IV CET1 and leverage ratios.

d) Liquidity

The Bank has continued to maintain an acceptable liquidity position, above regulatory minima, through the period to 31 December 2013, with a liquid asset ratio of 16.0% at the year end. The Bank continues to proactively manage its liquidity position, maintaining a regulatory liquidity buffer, and has continued to restructure existing exposures to improve the funding profile.

Retail deposits have remained broadly stable year-on-year (£0.2bn reduction), however the Bank recognises that liquidity risk continues to be elevated.

e) Risks and uncertainties

Key risks associated with successful execution of the remaining components of the Recapitalisation Plan and Turnaround Plan include:

i. As referred to in b(i) above, the continued ability of The Co-operative Group (via The Co-operative Banking Group Limited) to make the 2014 contribution and to meet its other commitments to the Bank as they fall due. Note 39 to the accounts details the amounts owed by The Co-operative Group to the Bank. These balances in total exceed that owed by any other single counterparty and would exceed the Bank's risk appetite in the normal course of business. The Board has considered the going concern status of the Group in consideration of the Bank's basis of preparation;

ii. The Co-operative Group is currently considering its ongoing governance arrangements. It is possible that the process of consulting on and implementing any changes in its governance arrangements including any resulting changes in the composition of the Board and/or Executive team may affect the decision making process in the short or longer term and may impact on the actions required to generate the cash necessary to make the 2014 contribution payments as they fall due;

iii. The ability of the Bank to raise the additional equity referred to above, which may require The Co-operative Group (except in limited circumstances, including as described in the summary of the Relationship Agreement on page 41) to grant a waiver in order to raise over £200m of equity, as well as further non-CET1 capital which is assumed in the 2014–2018 Plan;

iv. On 20 December 2013, the Bank began the process of logistically separating from its former parent, The Co-operative Banking Group Limited, and its ultimate former parent, The Co-operative Group, with both of which it shares premises, systems and services. The consideration of execution risk and cost of this work is in its early stages. Initial plans have been drawn up but as the work is complex and time consuming there remains a risk that the costs of executing these separation plans may increase further. In the event that changes to governance arrangements at The Co-operative Group or adverse findings of any of the various enquiries and investigations underway which impact on The Co-operative Group, result in organisational disruption in operations or decision making at The Co-operative Group, the execution risks to the process of logistical separation could increase with an associated risk of increased costs and disruption for the Bank;

v. The Bank participates in The Co-operative Group's defined benefit pension scheme (Pace). A material difference to current estimates of the funding of the pension scheme, or the Bank being forced to pay for a greater proportion than currently envisaged, could cause the Bank to require further capital in addition to that referred to above;

vi. More generally the ability of the Bank to achieve the results set out in the 2014–2018 Plan. In this respect particular challenges include (but are not limited to): ability to achieve the targeted cost savings; ability to retain customers and deposits; the timing and quantum of impacts to capital from the asset reduction exercise; meeting its planned improvements in net interest margin; a possible further deterioration in the quality of the Bank's asset portfolio; unplanned costs from (for example) conduct risk matters, regulatory investigations, IT investment and the ability to maintain the Bank's access at an appropriate cost to liquidity and funding; and

Notes to the Bank financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

1. Basis of preparation and significant accounting policies continued

vii. The Bank needs the continuing support of the PRA in accepting and moving forward with its Recapitalisation Plan and Turnaround Plan. To the extent this is not forthcoming or to the extent that the Bank does not perform in line with its 2014–2018 Plan, additional CET1 may be required over and above that included in that plan in order for the Bank to remain a going concern, and the PRA could exercise its powers under the Banking Act of 2009. This could also be the case if there are increases in regulatory capital requirements as a result of changes to international regulations (eg Basel III) or other changes to legislation or other market wide regulatory requirements or a change in regulatory risk appetite.

f) Conclusion

The Directors have concluded that whilst the completion of the LME puts the Bank in a stronger position, its capital position has been weakened by the crystallisation of certain risks, including conduct and legal risks and the costs of separation, in the 2013 results. This situation, along with the risks set out above, and their consequential effects, represent a material uncertainty which may cast doubt upon the Bank's ability to continue as a going concern. The Bank may, therefore, be unable to continue realising its assets and discharging its liabilities in the normal course of business. Nevertheless, after making enquiries and considering the current forecasts, in particular those for the period up to and including 30 April 2015, the Directors have a reasonable expectation that the Bank will have adequate resources to continue in business over this period. For these reasons, they continue to adopt the going concern basis in preparing these financial statements. This set of financial statements does not include the adjustments that would result if the Bank was unable to continue as a going concern.

1.4 Significant accounting policies

The accounting policies set out below have been applied consistently to all periods, inclusive of assets recognised where the Bank is subject to the substantial risks and rewards of those assets.

1. Business combinations

On 1 August 2009, The Co-operative Bank plc merged with Britannia Building Society, with Britannia transferring their engagements to the Bank.

This business combination has been accounted for applying the requirements of IFRS 3 (Business Combinations (2004)).

The consideration transferred was valued by reference to the members' interests acquired. Financial assets and liabilities which, following the Bank's accounting policies, would be carried at amortised cost, were brought onto the balance sheet at their fair value at acquisition and were subsequently carried at amortised cost using the effective interest rate method. The income statement includes the results of the engagements transferred from Britannia since the date of acquisition.

2. Basis of consolidation

a) Subsidiaries

Subsidiaries are entities controlled by the Company. Control exists whenever the Company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that presently are exercisable are taken into account. The financial information of subsidiaries is included in the consolidated financial information from the date that control commences until the date that control ceases. The financial information has been prepared using uniform accounting policies and is based on the same accounting period as the Company.

Intra-group balances and transactions, and any unrealised gains and losses arising from intra-group transactions, are eliminated in preparing the consolidated financial information.

Special purpose entities (SPEs) are entities that are created to accomplish a narrow and well defined objective; for the Bank this includes:

- various securitisation transactions in which mortgages were sold to SPEs. The equity of these SPEs is not owned by the Company; and
- Covered Bond Limited Liability Partnerships created in order to act as a guarantor for the issue of covered bonds (refer to note 41 on page 218 for further information).

An SPE is consolidated if, based on an evaluation of the substance of its relationship with the Bank and the SPE's risks and rewards, the Company concludes that it controls the SPE.

The following circumstances may indicate a relationship in which, in substance, the Company controls and consequently consolidates an SPE:

- the activities of the SPE are being conducted on behalf of the Company according to its specific business needs so that the Bank obtains benefits from the SPE's operation;
- the Company has the decision making powers to obtain the majority of the benefits of the activities of the SPE;
- the Company has the rights to obtain the majority of the benefits of the SPE and therefore may be exposed to the risks incidental to the activities of the SPE; or
- the Company retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

The above circumstances apply to all Company SPEs. Consequently the Company consolidates each SPE.

The assessment of whether the Company has control over an SPE is carried out at inception. No further assessment of control is carried out unless changes in the structure or terms of the SPE or additional transactions between the Bank and the SPE occur.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Basis of preparation and significant accounting policies continued

b) Interests in joint ventures

A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement, have rights to the net assets of the arrangement. Those parties are called joint venturers. The Bank's interests in joint ventures are accounted for using the equity method. The consolidated financial information includes the Bank's share of the income and expenses and equity movements of equity accounted investees, after adjustments to align the accounting policies with those of the Bank.

3. Revenue recognition

a) Interest income and expense

Interest income and expense is recognised on an effective interest rate (EIR) basis, inclusive of directly attributable incremental transaction costs and fees including arrangement and broker fees, valuation and solicitor costs, discounts and premiums where appropriate and early redemption fees.

The EIR basis spreads the interest income and expense over the expected life of each instrument. The EIR is the rate that, at the inception of the instrument, exactly discounts expected future cash payments and receipts through the expected life of the instrument back to the initial carrying amount. When calculating the EIR, the Bank estimates cash flows considering all contractual terms of the instrument (for example, prepayment options) but does not consider assets' future credit losses except for assets acquired at a deep discount.

For assets acquired at a value significantly below the carrying value in the acquiree's financial information because they have incurred loss, expectations of future loss are higher than at origination, and interest spreads have widened because of deteriorating market conditions, the calculation of EIR is the same as shown above with the exception that the estimates of future cash flows include credit losses.

b) Fees and commissions

Fee and commission income is predominantly made up of arrangement and other fees relating to loans and advances to customers that are included in the effective interest calculation. Commitment fees received are deferred and included in the EIR calculation upon completion or taken in full at the date the commitment period expires and completion does not occur.

All other fee and commission income, such as loan closure fees or arrears fees, not included in the effective interest calculation, is recognised on an accruals basis as the service is provided.

Fees and commissions payable to introducers in respect of obtaining lending business, where these are direct and incremental costs related to the issue of a financial instrument, are included in interest income as part of the effective interest rate.

4. Financial instruments (excluding derivatives)

a) Recognition

The Bank initially recognises loans and advances when they are advanced to customers. Deposits, debt securities issued and other borrowed funds are recognised on the date at which they are originated.

Regular way purchases and sales of financial assets are recognised on the trade date at which the Bank commits to purchase or sell the asset. All other financial assets and liabilities are initially recognised on the trade date at which the Bank becomes a party to the contractual provisions of the instrument.

b) Derecognition

The Bank derecognises a financial asset when the contractual rights to the cash flows from the financial assets expire, or it transfers the rights to receive the contractual cash flows in a transaction in which substantially all of the risks and rewards of ownership of the financial asset are transferred or in which the Bank neither transfers nor retains substantially all of the risks and rewards of ownership and it does not retain control of the financial asset.

When a financial asset is derecognised in its entirety, the difference between the carrying amount and the sum of the consideration received (including any new asset obtained less any new liability assumed), and any cumulative gain or loss that had been recognised in other comprehensive income, is recognised in the income statement.

When available for sale financial assets are derecognised, the cumulative gain or loss, including that previously recognised in reserves, is recognised in the income statement.

A financial liability is derecognised when the obligation is discharged, cancelled or expires. Any difference between the carrying amount of a financial liability derecognised and the consideration paid is recognised through the income statement.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Basis of preparation and significant accounting policies continued

c) Financial assets

i. Overview

The Bank classifies its financial assets (excluding derivatives) as either:

- loans and receivables;
- available for sale; or
- financial assets at fair value through income or expense.

ii. Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and the Bank does not intend to sell immediately or in the near term. These are initially measured at fair value plus transaction costs that are directly attributable to the financial asset. Subsequently, these are measured at amortised cost using the effective interest method. The amortised cost is the amount advanced less principal repayments, plus or minus the cumulative amortisation using the EIR method of any difference between the amount advanced and the maturity amount less impairment provisions for incurred losses.

Loans and receivables mainly comprise loans and advances to banks and customers (except where the Bank has elected to carry the loans and advances to customers at fair value through income or expense as described in accounting policy (4.c) iv. below) and assets reclassified from available for sale (see below)).

iii. Available for sale

Available for sale financial assets are debt securities and equity shares that are not held for trading and are intended to be held for an indefinite period of time. These are initially recognised on their settlement date, measured at fair value based on current bid prices where quoted in an active market. Where the debt securities and equity shares are unlisted the fair values are based on valuation techniques including discounted cashflow analysis, with reference to relevant market rates, and other commonly used valuation techniques. Movements in fair value are recorded in equity as they occur. On disposal, gains and losses recognised previously in equity are transferred to the income statement. In exceptional circumstances, for instance where the market in the securities has become inactive, the Bank has reclassified such assets as loans and receivables.

Any transfer back from loans and receivables, upon reclassification, would be measured at fair value based on current bid prices where quoted in an active market. Where there is no active market or the debt securities or equity shares are unlisted the fair values are based on valuation techniques including discounted cashflow analysis, with reference to relevant market rates, and other commonly used valuation techniques.

iv. Financial assets at fair value through income or expense

These are:

- financial assets designated at fair value through income or expense
  Financial assets designated at fair value are assets which have been designated to eliminate or significantly reduce a measurement and recognition inconsistency or where management specifically manages an asset or liability on that basis, eg capital bonds.

  These assets are measured at fair value based on current bid prices where quoted in an active market. Where there is no active market or the securities are unlisted the fair values are based on valuation techniques including discounted cashflow analysis, with reference to relevant market rates, and other commonly used valuation techniques. Gains and losses arising from changes in the fair value are brought into the income statement within trading income as they arise.

- financial assets held for trading
  Financial assets held for trading are assets which have been principally acquired for the purpose of selling or repurchasing in the near term, or they form part of a portfolio of identified financial instruments that are managed together for which there is evidence of a recent pattern of short term profit taking. These financial assets are recognised on the date of trade, when the Bank enters into contractual arrangements with counterparties to purchase or sell financial instruments, and are normally derecognised when sold. Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently their fair values are remeasured, and gains and losses from changes therein are recognised in the income statement within trading income.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Basis of preparation and significant accounting policies continued

d) Financial liabilities

i. Overview

Financial liabilities are contractual obligations to deliver cash or another financial asset. Financial liabilities are recognised initially at fair value, net of directly attributable transaction costs.

Financial liabilities, other than derivatives and capital bonds, are subsequently measured at amortised cost.

Capital bonds within customer accounts have been designated at fair value through income or expense upon initial recognition in the balance sheet. Changes in fair value are recognised through the income statement.

The capital bonds are economically matched using equity linked derivatives, which do not meet the requirements for hedge accounting. Recording changes in fair value of both the derivatives and the related liabilities through the income statement most closely reflects the economic reality of the transactions. In doing so this accounting treatment eliminates a measurement inconsistency that would otherwise arise from valuing the capital bonds at amortised cost and the derivatives at fair value.

ii. Other borrowed funds

Borrowings are recognised initially at fair value, which equates to issue proceeds net of transaction costs incurred. Borrowings are subsequently stated at amortised cost; any difference between proceeds net of transaction costs and the redemption value is recognised in the income statement over the period of the borrowings using the effective interest method.

The Bank classifies capital instruments as financial liabilities or equity instruments in accordance with the substance of the contractual terms of the instruments. The Bank's preference shares were classified as financial liabilities as they carried the right to a fixed non-cumulative preferential dividend and were subsequently presented in other borrowed funds. The dividends on these preference shares were recognised in the income statement as interest expense on an amortised cost basis using the EIR method.

As part of the LME on 20 December 2013, all the preference shares were transferred to The Co-operative Group (via the Banking Group). The Co-operative Group waived its rights to income and capital under the preference shares. Accordingly, the preference shares have been extinguished as financial liabilities in the 2013 balance sheet even though they have not been redeemed.

iii. Perpetual subordinated bonds

Perpetual subordinated bonds were carried at their nominal value plus any premium and a fair value adjustment for hedged risk where items were designated as part of a fair value hedge relationship. Interest payable on perpetual subordinated bonds was recognised in the income statement using the EIR method.

The perpetual subordinated bonds were cancelled and, therefore, extinguished as financial liabilities on 20 December 2013 as part of the LME.

5. Impairment provisions

a) Assessment

i. Objective evidence

At the balance sheet date, the Bank assesses its financial assets, not at fair value through income or expense, for objective evidence that an impairment loss has been incurred.

Objective evidence that financial assets are impaired can include significant financial difficulty of the borrower, a breach of contract, such as default or delinquency in interest or principal payments, the granting by the Bank to the borrower, for economic and legal reasons relating to the borrower's financial difficulty, a concession that the Bank would not otherwise consider, indications that a borrower or issuer will enter bankruptcy or other financial reorganisation, or the disappearance of an active market for a security.

The Bank considers evidence for impairment for loans and advances at both a specific asset and collective level.

ii. Forbearance

The Bank operates a policy of forbearance which mitigates against borrower default. All such cases are included within its provisioning methodology.

- Residential secured mortgages
  Loans under forbearance are subject to a specific identified impairment assessment.
- Unsecured retail business
  Irrespective of forbearance, impairment is charged in accordance with the identified past due and unidentified loss event approaches described on page 89.
- Corporate business
  All accounts subject to forbearance which are in default and on the watchlist are individually assessed for impairment.

For further information on the Bank's approach to forbearance, its management and execution, see the risk management section on page 98.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Basis of preparation and significant accounting policies continued

b) Scope

i. Individual accounts

All secured loans and advances are assessed for impairment using a range of criteria graded for levels of risk. Accounts at risk of impairment are monitored and impaired where they display clear indicators of underperformance.

All corporate loans on watchlist, or in default, are individually assessed for impairment.

Loans and advances that do not meet the criteria for individual impairment are collectively assessed for impairment (incurred but not yet reported) by grouping together loans and advances of similar risk characteristics.

ii. Collective accounts

a) Retail

When assessing collective impairment for secured retail loans, the Bank estimates incurred losses on mortgages based on the borrower's external credit score or where the loan is specifically identified as being subject to forbearance.

When assessing collective impairment for unsecured retail loans, the Bank estimates losses on loans with delinquency greater than a pre-determined trigger point. In addition, the Bank makes provision on all loans arising from fraud and loans transferred to debt collection agencies. In respect of unsecured loans, the Bank uses statistical modelling of historical trends of probability of default, timing of recoveries and the amount of loss incurred.

The model's results are adjusted for management's judgement as to whether current economic and credit conditions are such that actual losses are likely to differ from those suggested by historical modelling. Once impaired, accounts are subjected to higher levels of impairment according to both their relevant stage of delinquency, ie the number of days in arrears, and their consequent likelihood of ultimately being charged off. Default rates, loss rates and future recoveries are regularly benchmarked against actual outcomes to ensure that they remain appropriate.

b) Corporate

All loans other than those to which a specific provision has been applied are included in the corporate collective calculation. The collective provision applied is to multiply the drawn balance of the loan by an estimated propensity (PD) for the loan to default during a loss emergence period by the estimated Loss Given Default. A 100% propensity to default is applied for all commercial real estate loans where the indexed loan-to-value (LTV) is greater than 100% and to those loans which are due to contractually expire in the next 12 months and the indexed LTV is greater than 65%. All other propensities to default are based on recently observed loan migration experience or regulatory PDs where these are deemed to be more appropriate. Loans which are on watchlist will therefore have a higher PD than those cases in the live book.

c) Measurement

The amount of the loss is the difference between:

- the asset's carrying amount; and
- the present value of estimated future cash flows (discounted at the asset's original or variable EIR for amortised cost assets and at the current market rate for available for sale assets).

Where the debt is secured, the assessment reflects the expected cash flows from the realisation of the security, net of cost to realise, whether or not foreclosure or realisation of the collateral is probable.

d) Impairment of financial assets carried at amortised cost

The amount of the impairment loss on assets carried at amortised cost is recognised immediately through the income statement and a corresponding reduction in the value of the financial asset is recognised through the use of an allowance account.

A write off is made when all or part of a claim is deemed uncollectable or forgiven after all the possible collection procedures have been completed and the amount of loss has been determined. Write offs are charged against previously established provisions for impairment or directly to the income statement.

Any additional recoveries from borrowers, counterparties or other third parties made in future periods are offset against the write off charge in the income statement once they are received.

Provisions are released at the point when it is deemed that following a subsequent event the risk of loss has reduced to the extent that a provision is no longer required.

Notes to the Bank financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

1. Basis of preparation and significant accounting policies continued

e) Impairment of financial assets classified as available for sale

Available for sale assets are assessed at each balance sheet date to see whether there is objective evidence of impairment. In such cases, any impairment losses are recognised by transferring the cumulative loss that has been recognised directly in equity to income or expense.

When a subsequent event causes the amount of impaired loss on available for sale investment securities to decrease, and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed through the income statement.

However any further recovery in fair value of an impaired available for sale equity security is recognised directly in equity.

6. Offsetting

Financial assets and financial liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to do so and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

7. Sale and repurchase agreements

Securities sold subject to repurchase agreements (repos) are reclassified on the balance sheet as pledged assets when the transferee has the right by contract or custom to sell or repledge the assets. The liability to the transferee is also included on the balance sheet, in deposits by banks. The difference between sale and repurchase price is accrued over the life of the agreements using the EIR method.

Securities purchased under agreements to re-sell (reverse repos) are classified as loans and advances to banks on the balance sheet, as appropriate.

8. Derivative financial instruments and hedge accounting

a) Derivatives used for asset and liability management purposes

Derivatives are used to hedge interest and exchange rate exposures related to non-trading positions. Instruments used for hedging purposes include swaps, forward rate agreements, futures, options and combinations of these instruments. The Bank also uses equity derivatives to hedge the equity risks within its capital bonds.

Derivative financial instruments are stated at fair value based on quoted market prices in active markets and, where these are not available, using valuation techniques such as discounted cashflow models. Further information is provided in note 41. All derivatives are carried as assets when the fair value is positive and liabilities when the fair value is negative. The gain or loss on re-measurement to fair value is recognised immediately in the income statement except where derivatives qualify for cashflow hedge accounting.

On initial designation of derivatives and qualifying hedged items as a hedge, the Bank formally documents the relationship between the hedging instrument(s) and hedged item(s) including the risk management objective and strategy in undertaking the hedge transaction together with the method used to assess effectiveness of the hedging relationship.

The Bank makes an assessment, both at the inception of the hedge relationship as well as on an ongoing basis, as to whether the hedging instruments are expected to be ‘highly effective’ on offsetting the changes in fair value or cash flows of the respective hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within a range of 80% to 125%.

i. Cashflow hedges

Where derivatives are designated as hedges of the exposure to variability in cash flows of a recognised asset or liability, or a highly probable forecast transaction, the portion of the fair value gain or loss on the derivative that is determined to be an effective hedge is recognised directly in equity. The ineffective part of any gain or loss is recognised in the income statement immediately.

The accumulated gains and losses recognised in equity are reclassified to the income statement in the periods in which the hedged item will affect income or expense. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss recognised at that time remains in equity until the forecast transaction is eventually recognised in the income statement.

When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was recognised in equity is immediately reclassified to the income statement.

ii. Fair value hedges

Where a derivative is designated as the hedging instrument to hedge the change in fair value of a recognised asset or liability or a firm commitment that could affect income or expense, changes in the value of the derivative are recognised immediately in the income statement together with changes in the fair value of the hedged item that are attributable to the hedged risk.

Fair values are based on quoted market prices in active markets or, where these are not available, using valuation techniques such as discounted cash flow models.

If the derivative expires or is sold, terminated, or exercised, or no longer meets the criteria for fair value hedge accounting, or the designation is revoked, then hedge accounting is prospectively discontinued. Any adjustment up to that point, to a hedged item for which the EIR method is used, is amortised to income or expense as part of the recalculated EIR of the item over its remaining life.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Basis of preparation and significant accounting policies continued

iii. Fair value hedge accounting for a portfolio hedge of interest rate risk

As part of its risk management process the Bank identifies portfolios whose interest rate risk it wishes to hedge. The portfolios may comprise only assets, only liabilities or both assets and liabilities. The Bank analyses each portfolio into repricing time periods based on expected repricing dates, by scheduling cash flows into the periods in which they are expected to occur. Using this analysis, the Bank decides the amount it wishes to hedge and designates as the hedged item an amount of assets or liabilities from each portfolio equal to this.

The Bank measures monthly the change in fair value of the portfolio relating to the risk that is being hedged. Provided that the hedge has been highly effective, the Bank recognises the change in fair value of each hedged item in the income statement with the cumulative movement in its value being shown on the balance sheet as a separate item, fair value adjustment for hedged risk, either within assets or liabilities as appropriate. If the hedge no longer meets the criteria for hedge accounting, this amount is amortised to the income statement over the remaining average useful life of the hedge relationship.

The Bank measures the fair value of each hedging instrument monthly. The value is included in derivative financial instruments in either assets or liabilities as appropriate, with the change in value recorded in the income statement.

Any hedge ineffectiveness is recognised in the income statement as the difference between the change in fair value of the hedged item and the change in fair value of the hedging instrument.

b) Embedded derivatives

A derivative may be embedded in another instrument, known as the host contract. Where the economic characteristics and risks of an embedded derivative are not closely related to those of the host contract (and the host contract is not carried at fair value through income or expense), the embedded derivative is separated from the host and held on balance sheet at fair value.

Movements in fair value are recognised in the income statement, whilst the host contract is accounted for according to the relevant accounting policy for that particular asset or liability.

c) Derivatives used for trading purposes

Derivatives entered into for trading purposes include swaps, forward rate agreements, futures, options and combinations of these instruments. Derivatives used for trading purposes are measured at fair value and any gains or losses are included in the income statement. The use of derivatives and their sale to customers as risk management products as appropriate, is an integral part of the Bank's trading activities.

9. Financial guarantee contracts

Financial guarantees, in respect of intra-group funding and the pension deficit in respect of the Britannia Pension Scheme, are treated as insurance contracts in accordance with IFRS 4 (Insurance Contracts (2004)). In accordance with the standard, the recognised insurance liability is assessed based on the current estimate of forecast future cash flows. If this highlights that the liability is inadequate, the liability is increased and the corresponding charge taken through the income statement.

10. Property, plant and equipment

The Bank recognises assets where it is exposed substantially to all the risks and rewards of those assets.

Acquired computer software licences are capitalised on the basis of cost incurred to acquire and bring the software to use.

Items of property, plant and equipment are stated at cost less any accumulated depreciation and impairment losses. Depreciation is provided on a straight line basis at the following rates, which are estimated to write down the assets to realisable values at the end of their useful lives.

Freehold and long leasehold land and buildings	40–50 years
Freehold and leasehold improvements	10–40 years
Short leasehold buildings	life of lease
Equipment:	
Computer	3–7 years
Furniture and equipment	3–10 years

All items of property, plant and equipment are reviewed for indications of impairment on a regular basis and at each balance sheet date. If impairment is indicated, the asset's recoverable amount (being the greater of fair value less cost to sell and value in use) is estimated. Value in use is calculated by discounting the future cash flows generated from the continuing use of the asset.

If the carrying value of the asset is less than the recoverable amount, an impairment charge is recognised in the income statement.

Gains and losses on disposal of an item of property, plant and equipment are determined by comparing the proceeds from disposal with the carrying amount of property, plant and equipment, and are recognised net within operating expenses in the income statement.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Basis of preparation and significant accounting policies continued

11. Intangible assets

The Bank recognises intangible assets where it is exposed substantially to all the risks and rewards of those assets. Further information on this is available in note 3, where assets held by a Co-operative Group subsidiary have been recognised in 2013 and the 2012 balance sheet restated.

a) Computer software

Computer software is stated at cost less cumulative amortisation and impairment and comprises computer software together with the costs of development of the software.

Acquired computer software licences are capitalised on the basis of cost incurred to acquire and bring the software to use.

Costs that are directly associated with the internal production of software products that will generate future economic benefit are capitalised. Only costs which meet the definition of development costs under IAS 38 (Intangible Assets) are capitalised, with costs being capitalised only if the asset can be reliably measured, will generate future economic benefits and there is an ability to use the asset. Expenditure that is not directly attributable to the development of such assets is recognised in the income statement in the period to which it relates.

The expenditure capitalised includes direct employee costs and an appropriate portion of relevant direct overheads. Amortisation is charged to the income statement on a straight line basis to allocate the cost over the estimated useful life up to a maximum of seven years.

b) Other intangible assets

Other intangible assets are stated at cost less cumulative amortisation and impairment. Amortisation is charged over the useful life of the asset. For core systems, a review of the asset's useful life is carried out and a maximum useful life of up to ten years is applied.

c) Impairment

Intangible assets are assessed for indications of impairment at least annually. If impairment is indicated, the asset's recoverable amount (being the greater of fair value less cost to sell and value in use) is estimated. Value in use is calculated by discounting the future cash flows generated from the continuing use of the asset. If the carrying value of the asset is less than the greater of the value in use and the fair value less costs to sell, an impairment charge is recognised to this value in the income statement. Irrespective of whether there is any indication of impairment, intangible assets in the course of construction are tested for impairment at least annually.

12. Goodwill

All business combinations are accounted for by applying the purchase method. Goodwill represents amounts arising on acquisition of subsidiaries, associates and joint ventures and represents the difference between the cost of the acquisition and the fair value of the identifiable assets, liabilities and contingent liabilities acquired.

If a business combination is achieved without transfer of consideration, the amount of goodwill is calculated by reference to the fair value of the Bank's interest in the acquiree using a valuation technique. The technique involves assessing the future net cash flow of the acquiree and then discounting using a rate that reflects current market assessment of the time value of money and risks specific to the acquiree.

Goodwill is stated at cost less any accumulated impairment losses. Goodwill is not amortised but is tested for impairment on an annual basis. Where impairment is required, the amount is recognised in the income statement and cannot be subsequently reversed.

13. Leases

a) Overview

The Bank enters into leases for land and buildings and operating leases for vehicles and equipment.

Leases for land and buildings are split between leases for the land and leases for the buildings for accounting purposes only. The leases are separately assessed as to whether they are finance or operating leases.

The Bank policy is to provide for the minimum future lease payments on buildings that it does not currently use, net of expected rental income from sub-leases.

The Bank provides for dilapidation when either one of the following obligating events invokes a dilapidation clause within the lease:

- the landlord serves notice requiring the Bank to make good the damage; or,
- wear and tear resulting in dilapidation is present.

b) Assets leased to customers

All leases of assets to customers are finance leases. Income from assets leased to customers is credited to the income statement based on a pattern reflecting a constant periodic rate of return on the net investment in the lease.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Basis of preparation and significant accounting policies continued

c) Assets leased from third parties

i. Finance leases

Finance lease assets are initially recorded at the lower of fair value and the present value of the minimum lease payments, and subsequently in accordance with the relevant policy for the underlying asset. An equal liability is recorded in other liabilities. Interest is allocated to the lease payments so as to record a constant periodic rate of charge on the outstanding liability.

ii. Operating leases

Operating lease payments are charged to the income statement on a straight line basis over the term of the lease and the asset is not recognised on the balance sheet.

14. Investment property

Property held for long term rental yields that is not occupied by the Bank, or property held for capital appreciation, is classified as investment property.

Investment property comprises freehold land and buildings. It is carried at fair value. Fair value is based on current prices in an active market for similar properties in the same location and condition. No depreciation is provided on these properties. Any gain or loss arising from a change in fair value is recognised in the income statement.

If the Bank takes occupancy of an investment property, it is reclassified as property, plant and equipment and its fair value at the date of reclassification becomes its cost for subsequent accounting purposes. Similarly, transfers to the investment property portfolio are made when occupancy by the Bank ceases and the property meets the criteria of an investment property under IAS 40. Prior to such a transfer the property is measured at fair value with any gain or loss recognised in the income statement.

15. Cash and cash equivalents

Cash and cash equivalents comprises cash balances and balances with a maturity of three months or less from the acquisition date, which are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Overdrafts that are repayable on demand and form an integral part of the Bank's cash management are included as a component of cash and cash equivalents for the purpose of the cash flow statement.

16. Income tax

a) Overview

Tax for the year comprises current and deferred tax, which is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in the statement of comprehensive income.

b) Current tax

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

c) Deferred tax

Deferred tax is provided using the balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The amount of deferred tax provided for is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised and is supported by the Board's approved five year plan.

Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

17. Pension costs

a) Co-operative Pension Scheme

The Bank, along with businesses within The Co-operative Group, participates in the Co-operative Pension Scheme (Pace), the assets of which are held in a separate fund administered by trustees. Pace is a non-segregated hybrid scheme, consisting of a defined benefit and a defined contribution section.

Notes to the Bank financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

1. Basis of preparation and significant accounting policies continued

There is therefore currently insufficient information available to consistently and reliably identify the Bank's share of Pace liabilities and employer costs. The pension costs in respect of Pace are therefore accounted for on a defined contribution basis in accordance with IAS 19. The pension costs in respect of this scheme are accounted for by the Bank on a defined contribution basis and recognised as an expense in the income statement as incurred.

b) Britannia Pension Scheme

The Britannia Pension Scheme is a hybrid scheme, consisting of a defined benefit and a defined contribution section, in which three Bank subsidiaries participate. In 2009, following the transfer of engagements of Britannia Building Society, ownership of the Britannia Pension Scheme transferred to CFSMS, a subsidiary undertaking of The Co-operative Banking Group. The pension costs in respect of this scheme are accounted for, by the Bank, on a defined contribution basis and recognised as an expense in the income statement as incurred.

18. Foreign currency

The functional and presentational currency for the Bank is sterling. Transactions in foreign currencies are translated at the foreign exchange rate prevailing at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated to sterling at the foreign exchange rate ruling at that date. Foreign currency differences arising on translation are recognised in the income statement, except for foreign currency differences arising on translation of available for sale equity instruments or a qualifying cashflow hedge, which are recognised directly in the statement of comprehensive income. Foreign exchange differences arising on translation are recognised in the income statement. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair values are translated to sterling at the exchange rates prevailing at the dates the values were determined.

19. Investments in Bank undertakings

Investments in subsidiaries are initially measured at fair value which equates to cost and subsequently valued at cost less impairment.

20. Provisions for liabilities and charges

A provision is recognised in the balance sheet if the Bank has a legal or constructive obligation as a result of a past event and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

Presentation of provisions in the income statement is based on matching the item of risk against its appropriate income or expense. For example, conduct risk on fee income will be presented against the fee income line.

21. Share premium

Share premium is the amount by which the fair value of the consideration received exceeds the nominal value of shares issued. Expenses and commissions paid on the issue of shares are written off against the share premium of the same issue.

2. Critical judgements and estimates

The preparation of financial information requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

The judgements and assumptions that are considered to be the most important to the portrayal of the Bank's financial condition are those relating to loan impairment provisions, conduct risk and legal provisions, restatement of assets held by CFSMS Ltd, intangible and tangible asset impairment, deferred tax, pensions and the Liability Management Exercise.

a. Loan impairment provisions

i. Overview

The loan portfolios are reviewed on a regular basis to assess for impairment. In determining whether an impairment provision should be recorded, judgements are made as to whether there is objective evidence that a financial asset or portfolio of financial assets is impaired as a result of loss events that occurred after recognition of the asset and by the balance sheet date.

The calculation of impairment loss includes expectations of levels of future cash flows, and is based on both the likelihood of a loan or advance being written off and the estimated loss on such a write off.

The changes in impairment provisions for all books of business result from a management review of assumptions, with respect to the determination and operational alignment of the; probability of possession of collateral given default (PPD), treatment of forbearance, length of loss emergence periods, timing of impairment recognition and the formalising of charge off policy. Where required, management also periodically adjust collective provisions for additional risk parameters upon existing individual and collective impairment models.

Further explanation of the treatment of forborne balances is included in the Bank's risk management disclosures in sections 1.3.1.1, 1.3.1.2, and 1.3.1.3 on pages 83 to 99.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

2. Critical judgements and estimates continued

The section below explains the methodology for loan impairment for both the Core and Non-core segments. Only the critical elements of judgement are discussed in detail.

ii. Collective provisions

Loans which have not been individually impaired are assessed for collective impairment. Collective provisions cover losses which have been incurred but not yet identified on loans subject to individual assessment; and for homogeneous groups of loans that are not considered individually significant. Typically Retail lending portfolios are generally assessed for impairment on a collective basis as the portfolios generally consist of large pools of homogenous loans.

a) Core

i) Retail collective

The Bank's collective provision for unsecured retail personal advances is £160.2m (2012: £172.8m). Loans are identified as impaired by taking account of the age of the debt's delinquency, the product type and the regularity of payments made whilst in arrears. The provision is calculated by applying a percentage rate to different categories and ages of impairment debt.

The provision rates reflect the likelihood that the debt in that category/age will be written off or charged off at some point in the future. The rates are based on historical experience and current trends, which incorporate the effects of discounting at the customer interest rate and are subject to regular review. The provision is the product of the rate and the balance for the relevant arrears segment.

The unsecured provisions rely heavily on assumed probabilities of default.

During 2013, the Bank has amended its provisioning methodology to treat accounts that are in arrears for over 180 days as charged off. Loss emergence periods have been extended to 12 months, resulting in a charge to the income statement of £6.9m.

A key estimate within this provisioning model is the discounted percentage provision rate applied to all personal loans subject to impairment. The most significant risk resides with credit card loans. A 5% (percentage point) change across these provision rates would change the collective provision by £26.8m.

ii) BaCB/Other collective

In addition to the above, collective provisions of £5.3m (2012: £1.1m) and £0.6m (2012: £0.8m) are held in the BaCB and Other segment of the Core business respectively.

The method for the BaCB collective provision is identical to the Non-core corporate collective as discussed below.

b) Non-core

i) Corporate collective

The Bank's collective provision against corporate loans in the Non-core division has increased to £40.0m (2012: £20.5m).

The collective provision is calculated using factors such as observed default rates and loss given default. An assessment is made of the likelihood of the assets becoming recognised as impaired in the loss emergence period.

The formula underpinning this methodology relies heavily on assumed probabilities of default:

Drawn Balance (£) x Probability of Default (%) x Loss Given Default (%) x Loss emergence period of nine months (as a fraction of 12 months). The Probability of Default and Loss Given Default are based on observed default propensities and loss events in this portfolio.

Included in the collective provision, for the first time, are watchlist and default loans against which there are no individual provisions. The increase to the charge for the year arising from the inclusion of these loans was £17.2m.

The Loss emergence period estimate has changed from six to nine months. This resulted in an increase of £39.8m in provisions charged.

Changes to the Bank's probability of default and loss given default assumptions during the year have resulted in a £21.9m and £3.3m release to impairment charge respectively.

For property loans with a loan to value (LTV) of greater than 65% which mature in the next 12 months, the probability of default has been changed to 100% rather than using the observed default propensity. This adjustment reflects the estimated loss incurred given the risk that those loans will not be refinanceable.

For assets that have a loan to value equal or greater than 100%, the probability of default has been changed to 100% rather than using the observed default propensity. This is due to the higher risk of default of those loans, given the value of loan collateral.

The two adjustments above have resulted in a £20.3m increase in the impairment charge.

The final movement in the collective provision for the year was a release of £32.6m to the impairment charge due to the change in the corporate balance sheet during the year, primarily due to the deleverage activity.

The total impact of the movements outlined above is a collective impairment charge for the year of £19.5m.

A key estimate within the corporate collective model is the loss emergence period. A movement of one month in this estimate would change the provision by £2.1m. There is a linear relationship between the change in loss emergence period and the change in provision.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

2. Critical judgments and estimates continued

ii) Optimum collective

In addition to the above, collective provisions of £9.4m (2012: £3.1m) are held in the Optimum segment of the Non-core business.

Further explanation of collective residential loan impairment method is included in the Bank's risk management disclosures in section 1.3.1.1 on pages 83 to 89.

iii. Individual provisions

Individual provisions are recorded for loans which are assessed for impairment on an individual basis. Loans considered as individually significant are typically corporate loans.

a) Core

Individual provisions for the Retail, BaCB and Other segments within Core total £10.7m (2012: £9.4m).

b) Non-core

i) Corporate individual

The Bank's impairment provision on individual Non-core corporate totals £698.4m (2012: £426.9m). The provision has increased reflecting the change in Bank strategy which is now focused on accelerating the reduction of its Non-core assets.

Given the uncertainty about the economic recovery, and the increased levels of risk associated with refinancing and interest payment cover currently being experienced in this sector, a significantly higher number of cases meet the definition of being individually impaired. In addition, impairments have been exacerbated by a deterioration of expected future recoveries from impaired loans which are now being managed for exit.

Each corporate account is assessed and allocated a 'risk grade' to enable the Bank to monitor the overall quality of its lending assets. Those of lesser quality, where the lending is potentially at risk and loss provisions may be required, are centrally monitored via a Strategic Asset Review (SAR). SAR was developed in the second half of 2013 to ensure that the agreed case strategy was being assessed alongside specific management actions taken at each stage within laid down procedures and specific provisioning criteria. Provisions represent the likely net loss after realisation of any security.

Total defaulted balances are £1.8bn, of which £1.4bn (78%) are recognised as Commercial Real Estate (CRE). Loan repayments on these accounts are underpinned by a counterparty's ability to generate sufficient cash flows by way of rental income or collateral security on the property. A further £0.2bn (11%) of non-CRE loans are secured on their underlying property, with the result that c. 89% of the defaulted balances are exposed to the value of their collateral. Of the remaining £0.2bn of defaulted balances, almost all are provided for because their Loss Given Defaults are at least 75%.

A key estimate within the corporate individual impairment model is collateral valuation. A 10% movement in this estimate would change the provision by £74m.

The Bank's valuation policy requires all loans on a watchlist or in default to have a full valuation carried out annually, with any subsequent changes to provisions resulting from a new valuation being approved by the Corporate Impairment & Default Group. Valuations are subject to a 10% write down for risks associated with selling costs or other uncertainties (included within the stated sensitivity). These uncertainties arise from business model risk (care homes/hotels) and from valuations being subject to obsolescence arising from changing market conditions. Where there is a firm offer of sale for disposal, the write down is removed as the value of collateral is known.

For further information on corporate credit risk and impairment, see the Bank's risk management disclosures in section 1 on pages 90 to 98.

ii) Optimum individual

The Bank's individual impairment provision on Optimum mortgages is £26.1m (2012: £7.9m). Mortgage accounts are identified as impaired and provided for on an individual basis by taking account of the age of the debt's delinquency.

The Bank classifies as impaired any account with arrears outstanding of one payment past due or in default (6+ months past due, possession, litigation, bankruptcy or Law of Property Act (LPA) receiver appointed).

The Bank has utilised improved management information resulting in a better understanding of the increased probability of possession given default and additional provisions in Optimum of £31.9m.

Estimates of loss emergence periods have been extended to 12 months, as a result of observable data evidencing the need for the increase. The impact of this change resulted in a charge to the income statement of £3.3m.

The Bank has also created a provision in the year to cover maturity risk of customers who are on an interest only product. This represented c.£4m of the provision cover at the year end.

House prices are a key driver of future credit losses in this book. Beneficial HPI movements across 2013, as well as a more positive outlook, have reduced the impairment provision with respect to interest only accounts on the Optimum portfolio by £2m. If house prices were to decline by 5% the increase in Optimum impairment provision would be c. £7.5m.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

2. Critical judgements and estimates continued

b. Conduct risk and legal provisions

i. Overview

The Bank has identified a number of conduct risk and legal issues against which it has raised provisions, based on management's best estimate of the total potential costs to the Bank.

Significant components of the conduct risk and legal provision are potential customer redress in relation to Payment Protection Insurance (PPI), interest rate swaps and breaches of the Consumer Credit Act. The Bank has also made provision for conduct provisions which are individually less significant but together total a charge of £166m during the year.

The calculation of these conduct and legal provisions requires significant judgement by management in determining appropriate assumptions. Key assumptions include basis of redress, operating costs of resolving redress, the level of complaints, uphold rates, proactive contact and response rates and Financial Ombudsman Service referral and uphold rates.

ii. Payment Protection Insurance

An additional provision of £103.0m (2012: £149.7m) has been recorded in respect of potential customer redress relating to past sales of payment protection insurance. The provision is in respect of the total expected cost to the Bank of carrying out this work and paying compensation, making total provisions raised of £347.0m (2012: £244.0m).

The additional provision recorded during the year results from a number of factors. The most significant factors include higher than anticipated customer response rates, uphold rates and average redress on past business reviews. In addition, the provision has increased as a result of greater operating costs resulting from a longer assessment process with greater customer contact and retrospective review of complaints.

There are a number of key assumptions within the calculation of the current provision:

- Level of customer redress
- Administration cost base

Within the level of redress, key assumptions relate to level of inbound complaints, proactive response rate and retrospective redress. The current position, expected movement in position and baseline sensitivities of the key estimates are outlined below:

Bank PPI assumptions table

Description of estimate	Current position	Future expected movement	Sensitivity on current position
Number of inbound valid[1] complaints received	72,000	22,000	1,000 = £1.4m
Number of proactive mailings	27,000	17,000	1,000 = £2.1m
Response rate to proactive mailings	62%	58%	1% = £1.5m
Average uphold rate per valid*[1] complaint	63%	66%	1% = £1.1m
Average redress per upheld complaint	£3,011	£2,869	£100 = £3.3m

1. Valid complaints excludes those complaints for which no PPI policy exists.

These assumptions remain subjective; in particular due to the uncertainty associated with future claims levels. The resulting provision represents management's best estimate of all future expected costs of PPI redress. However, it is possible the eventual outcome may differ from the current estimate and if this were to be material a further provision will be made. The provision also includes an estimate of the Bank's claims handling costs and those costs associated with claims that are subsequently referred to the Financial Ombudsman Service.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

2. Critical judgements and estimates continued

iii. Interest rate swap mis-selling

The Bank previously voluntarily agreed to participate in the FSA's Interest Rate Hedging (IRH) Past Business Review (PBR) and conducted an initial pilot review of sales of interest rate hedging products to small businesses. During the year a full PBR has been performed.

A provision of £33.0m (2012: £nil) for potential interest rate swap mis-selling has been recorded at 31 December 2013.

Calculations on redress have been performed based upon the latest guidance from both the FCA and the Skilled Person. The final redress method has not, however, been confirmed in all cases.

There are a number of key assumptions within the calculation of the current provision:

- Population of in scope swaps
- Methodology to calculate redress provision

Where redress methods change, the value will also change. It has also been assumed that customers who opted out of the initial review of interest rate hedging products will subsequently choose to be placed back in the review, as is their right. The provision assumes that no redress will be required for consequential loss.

iv. Breaches of the technical requirements of the Consumer Credit Act (legal provision)

An amount of £109.5m (2012: £nil) has been recognised to refund interest following identification of a number of breaches of the highly technical requirements of the Consumer Credit Act.

Certain breaches have the effect of triggering periods of non-compliance during which an affected customer is not liable to pay interest.

Interest refunds will therefore need to be made in certain cases where a period of non-compliance has been previously triggered.

Detailed and technical legal analysis has been carried out as to whether breaches of the technical requirements have in fact occurred, the nature of those breaches and the consequences which follow (which differ according to the precise nature of the breach). Such legal analysis by its nature involves judgement and assessment of the particular facts of individual circumstances. The amount of £109.5m which has been provided is the best estimate of the liability based on the legal analysis.

Assumptions for provisioning purposes are that the payment profile of loans was as per those agreed at drawdown. The provision covers all interest paid during non-compliance to the end of 2013. Until loans are returned to a compliant state, the ongoing cost is up to £2.5m per month leading to a possible increase in the total provision in 2014 of c.£25m.

Within the provision, operating costs of £5m are based upon the latest view of delivery timeframes. Changes to the delivery method could increase costs by c.£3m.

v. Other conduct provisions

Other conduct provisions include the following:

- £29.0m for potential customer redress relating to the processing of first payments on certain mortgages;
- £31.0m relating to potential customer redress in relation to mortgage fees;
- £26.1m for alleged failings in the introduction of third party sales of card and identification protection products;
- £22.0m relating to potential customer redress on secured arrears;
- £19.0m for potential customer redress in relation to arrears charges;
- £15.0m relating to provision for potential conduct issues incurred but not reported;
- £13.0m relating to potential customer redress and other costs in relation to mortgage documentation; and
- £10.9m of other conduct provisions.

Key assumptions include basis of redress, operating costs of resolving redress, the level of complaints, uphold rates, proactive contact and response rates and Financial Ombudsman Service referral and uphold rates.

The above provisions have a significant range of highly judgemental outcomes, the most significant of which reside within the provision for alleged failings in the introduction of third party sales of card and identification protection products. Given the Bank has relatively limited levels of actual experience for estimates within this new provision, it carries the inherent risk of forecasting for subjective final outcomes, eg the number of affected customers. A change in the overall estimates for outcomes could increase the provision by £52m.

c. Assets held by CFS Management Services Ltd (CFSMS)

Historically the intangible asset for the core IT banking system replacement had been recorded in the books of CFSMS, (a service company which was a fellow Co-operative Banking Group subsidiary), with appropriate recharge to the Bank via intercompany balances payable. The development of the core IT banking system was funded by the Bank. CFSMS has limited other assets with which to absorb any potential losses that may have arisen due to difficulties in development.

Notes to the Bank financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

2. Critical judgements and estimates continued

The Directors have reviewed and reconsidered the accounting treatment of the intangible asset in development and all other assets held on the balance sheet of CFSMS which were used solely by the Bank. The Directors have concluded that the Bank was substantially exposed to the risks and rewards of these assets and after considering the funding of the asset and CFSMS's lack of assets to absorb losses, the appropriate accounting treatment would be to hold these assets on the balance sheet of the Bank. This has been reflected in the Bank and Company Annual Report and Accounts, both in 2013 and as a 2012 prior year adjustment.

d. Intangible and tangible asset impairment

The Bank holds £110.7m (2012: £263.2m) of intangible assets. The carrying value represents management's best estimate of the value in use of the underlying group of assets measured specifically against a range of future economic conditions.

Future cash flows are a key judgement within the calculation of value in use. If the present value of these cash flows is lower than the carrying amount, impairment is triggered. Current cash flow trends are used as a baseline for future impairment reviews.

The Bank had a strategic programme of investment around the replacement of the core banking system. This asset was built by and held on the balance sheet of CFSMS Limited, until 2013's restatement. In Q2 2013, the Bank reviewed its IT strategy and decided not to complete or implement the majority of the replacement of the core banking platform. £136.4m was therefore written off.

£36.4m of the total balance remains in use and this has been assessed for impairment in light of the current strategic direction and plans of the Bank. Following that review, the asset has been impaired by £12m, making the total write down £148.4m (2012: £150.0m).

The carrying value of the asset at 31 December 2013 is £24.4m and is no longer subject to any specific key sensitivity.

e. Deferred tax

The Bank has reconsidered the deferred tax position in light of the Bank's latest five year plans approved by the Board.

Recognition of deferred tax assets is only possible to the extent it is probable that future taxable profits will be available against which the unused tax losses and other deductible temporary differences can be utilised. In the Bank's interim financial report 2013, the Bank derecognised its deferred tax asset as the five year plan was not formulated or approved as at 28 August 2013. On the basis of the plan approved after the publication of the interim accounts in the audited half year accounts in the prospectus, £103.5m was recognised. The 2013 results contain unexpected losses in particular regarding provisions for customer redress and the costs of the separation of the Bank from The Co-operative Group. These have weakened the capital position of the Bank and therefore the starting point of the plan, and until this is rectified the Directors do not consider the recognition of a deferred tax asset to be appropriate.

The Bank has recognised a deferred tax asset of £nil (2012: £159.6m) and a deferred tax liability of £92.5m (2012: £121.4m), making a net deferred tax liability of £92.5m (2012: £38.2m deferred tax asset). The deferred tax liability has been calculated using a tax rate of 20%.

f. Pensions

i. Defined contribution accounting for the Pace scheme

The Bank participates in The Co-operative Pension Scheme (Pace). Pace is a hybrid scheme, consisting of a defined benefit section and a defined contribution section.

At 31 December 2012 the scheme was a Group plan, since all participating entities were within The Co-operative Group. It was accounted for on a defined contribution basis since there was no contractual agreement or stated Co-operative Group policy for charging the net defined benefit cost for the scheme as a whole to individual Co-operative Group entities. Therefore, the Bank did not recognise its share of the net defined benefit cost. The net defined benefit cost of the pension scheme was recognised fully by the sponsoring employer, which is The Co-operative Group Limited.

On 4 November 2013 The Co-operative Group and the Bank entered into an undertaking pursuant to which The Co-operative Group agreed with the Bank, subject to certain exceptions, not to require the Bank to cease to participate in Pace in connection with the Liability Management Exercise or any subsequent reduction in The Co-operative Group's shareholding in the Bank (including to nil). Should either The Co-operative Group or the Bank so request, the parties will enter into good faith discussions to agree on the separation of Pace, so that the scheme liability properly attributable to the Bank and an equivalent proportion of the scheme's assets would be transferred to a separate tax registered pension scheme.

Neither party shall be under an obligation to agree to any separation of the scheme that would result in a requirement to make material payments to or in respect of the scheme.

Following separation of the Bank from the wider Co-operative Group as a result of the Liability Management Exercise, the Bank is still a participating employer in the Pace scheme and the Pace scheme is considered to be a multi-employer scheme under IAS 19 Employee benefits (revised 2011).

As a multi-employer pension scheme, Pace exposes the participating businesses to actuarial risks associated with the current and former employees of the other Co-operative Group companies. The proportion of Pace liabilities accrued by members whilst employees of Bank are believed to represent a minority of total Pace liabilities. Bank could however be liable for funding a greater proportion of Pace liabilities.

There are for example liabilities in Pace relating to benefits accrued by members whilst employed by CFSMS and working in the Bank's business. On 23 January 2014, following the legal separation of the Bank from the wider Co-operative Group, employment contracts for those employees who spend the majority of their time working on behalf of the Bank were transferred from CFSMS to the Bank. This will increase the number of Bank employees participating in the Pace scheme in 2014.

2. Critical judgements and estimates continued

There may also be 'orphan liabilities' in Pace that do not relate to any current employer in Pace. The extent to which Bank could be liable for funding a greater proportion of Pace liabilities will depend, inter alia, on what position is reached as to the Pace liabilities properly attributable to Bank following discussions with The Co-operative Group. Such discussions are not yet substantively underway.

The Pace scheme is not sectionalised and operates on a 'last man standing' basis. In the event that other participating employers become insolvent and the full statutory debt is not recovered on insolvency, the Bank would become liable for the remaining liabilities.

There is therefore currently insufficient information available to consistently and reliably identify the Bank's share of Pace liabilities and employer costs. For the above reasons the pension costs in respect of Pace are accounted for on a defined contribution basis in accordance with IAS 19 (revised 2011). Pension costs are recognised as an expense in the Bank income statement. Further details of the Pace scheme are provided in note 36 to the Bank's financial statements.

ii. Risks associated with the funding of the scheme's deficits

The current recovery plan ending in 2019 between The Co-operative Group and the Pace scheme trustees may be insufficient to repay the latest valuation of the deficit. Following completion of the 2013 valuation, it is anticipated that a new schedule of contributions and recovery plan will be agreed between The Co-operative Group and the Pace scheme trustee following advice from the Independent scheme actuary. Neither The Co-operative Group nor the Bank is under an obligation to agree any separation of the Pace scheme that would result in material payments to the scheme. However, The Co-operative Group has undertaken to agree with the Bank its proportion of employer contributions in Pace and, if not agreed, the matter will be referred to an independent third party. Accordingly, there is a wide range of outcomes regarding the duration and contribution requirements of a new schedule of contributions which make the overall liability uncertain.

To the best of the Directors' knowledge and belief, having made reasonable enquiries, there is no contractual agreement determining how the deficit recovery contributions are funded by the participants, the Bank has not recognised a liability in respect of any part of the existing deficit funding.

A formal triennial valuation of Pace as at 5 April 2013 is underway but has not yet been completed. When completed it may reveal a significant funding deficit. There is therefore a risk that in future periods the Bank will recognise significant liabilities in respect of the scheme in its accounts.

g. Liability Management Exercise (LME)

The Bank carried out a Liability Management Exercise (LME) on 20 December 2013. Details of the LME can be found in note 4. It has been accounted for in accordance with IFRIC 19 (Extinguishing Financial Liabilities with Equity Instruments).

The existing ordinary share capital of the Bank was extinguished. The then perpetual and dated subordinated debt were extinguished and replaced with new dated subordinated bonds and ordinary shares. The preference shares were transferred to The Co-operative Group (via The Co-operative Banking Group) and waived all rights to income and capital.

The difference between the carrying amount of the extinguished debt and fair value of the consideration (the fair value of new dated subordinated debt and ordinary shares issued) has been recognised in the income statement. In accordance with company law, which requires that share premium is determined by reference to the value of debt extinguished, this income was subsequently transferred from retained earnings to the share premium account.

The key judgement in accounting for the LME relates to the valuation of the Bank, which directly determines the value of new shares issued. The Bank was valued at £790m giving rise to a £688m credit to the income statement. A 10% change in the valuation would give rise to a £79m change in the income statement.

The valuation is highly judgemental and in order to determine an appropriate figure, management calculated a market valuation in line with IFRS 13 (Fair Value Measurement), discounted to take account of market imperfections. The key assumptions in the valuation were the market value of the existing bonds extinguished and the 20% management applied discount for market imperfections due to a relatively thin volume of bond transactions.

This market valuation was compared to a set of internally generated valuation models using the Bank's plan. These models were subjective and were based on assumptions including discount rate and the number of years used in the valuation. These generated a range of valuations of £674m to £1.2bn, depending on the assumptions used. The discounted value of £790m sat at the lower end of this range.

The overall capital position of the Bank is unaffected by a change in the valuation of the Bank as any change in the credit to the income statement is offset by an equal and opposite change in the value of new shares.

3. Restatement

In plain english:

This note provides details of a restatement of the 2012 balance sheet values for tangible, intangible and intercompany assets and the associated impact to the 2012 income statement and statement of cash flows.

Historically the intangible asset for the core IT banking system replacement had been recorded in the books of CFS Management Services Ltd (CFSMS), (a service company which was a fellow Co-operative Banking Group subsidiary), with appropriate recharge to the Bank via intercompany balances payable. The development of the core IT banking system was funded by the Bank. CFSMS had limited other assets with which to absorb any potential losses that may have arisen due to difficulties in development.

The Directors have reviewed and reconsidered the accounting treatment of the intangible asset in development and all other assets held on the balance sheet of CFSMS which were used solely by the Bank. The Directors have concluded that the Bank was substantially exposed to the risks and rewards of these assets and after considering the funding of the asset and CFSMS's lack of assets to absorb losses, the appropriate accounting treatment would be to hold these assets on the balance sheet of the Bank. This has been reflected in the Bank and Company Annual Report and Accounts.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

3. Restatement continued

The effect of the prior year restatement on the Bank is:

Balance sheet

	Note	At 1/1/12 (as reported)	At 1/1/12 (restated)	At 31/12/12 (as reported)	At 31/12/12 (restated)
Assets					
Property, plant and equipment	25	80.1	125.3	64.1	113.4
Intangible fixed assets	23	40.7	359.5	34.9	263.2
Amounts owed by other Co-operative Group undertakings	39	179.2	1.6	256.4	56.8
		300.0	486.4	355.4	433.4
Liabilities					
Amounts owed to other Co-operative Group undertakings	39	132.3	318.7	112.0	190.0

Income statement

There is £nil impact on the 2012 income statement (including the earnings per share presented). However the above restatement does give rise to a restated presentation of items within operating expenses. The impact is shown below:

	Note	31/12/2012 (as reported)	31/12/2012 (restated)
Total operating expenses (before significant items)	12	612.4	612.4
Including:			
Administrative expenses	12	267.7	243.0
Depreciation of property, plant and equipment	12	14.8	22.7
Amortisation of intangible fixed assets	12	6.2	23.0
Impairment of intangible assets	23	–	150.0

In 2013 the cost of the Financial Services Compensation Scheme Levy (FSCS) has been presented within operating expenses. In addition to the impact of the above restatement, the 2012 comparatives have also been represented to include £24.8m of FSCS costs.

Statement of cash flows

The above restatement impacts the presentation of the following items within the statement of cash flows:

	31/12/2012 (as reported)	31/12/2012 (restated)
Net cash flows from operating activities	805.2	893.5
Including:		
Adjustments for:		
Depreciation and amortisation	16.4	41.1
Impairment of intangible fixed assets	–	150.0
Amounts owed by other Co-operative Group undertakings	(77.2)	(241.6)
Amounts owed to other Co-operative Group undertakings	(20.3)	57.7
Net cash flows from investing activities	(2,344.7)	(2,433.0)
Including:		
Purchase of tangible and intangible assets	(1.9)	(90.4)
Proceeds from sale of fixed assets	0.8	1.0
Net cash flows from financing activities	(34.7)	(34.7)
(Decrease) in cash and cash equivalents	(1,574.2)	(1,574.2)

The above impact on amounts owed by/to other Co-operative Group undertakings is calculated in a consistent manner with the treatment of these balances for cash flow purposes as further described in the statement of cash flows.

There is £nil impact on share capital and reserves as a result of the above restatement. The impact on regulatory capital is described in the Capital Management section.

The 2012 balance sheet has also been represented to reflect that certain deferred tax liabilities cannot be offset against the deferred tax assets. This results in an increase to the deferred tax asset and liability previously reported of £121.4m.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

4. Recapitalisation and the Liability Management Exercise

In plain english:

This note provides details of the Liability Management Exercise which was completed in December 2013 and the significant impact it had on the Bank's capital and reserve position.

During the year the Bank carried out a significant refinancing exercise with the aim of increasing the level of capital held. This exercise involved issuing new shares and new debt in exchange for cash and extinguishing existing debt and preference shares. The background to this is discussed in the Capital Management section.

The Bank announced, in November 2013, a Recapitalisation Plan to generate £1.5bn additional CET1, which was discussed with the relevant regulatory bodies. The key objective of the Plan was to strengthen significantly the Bank's CET1 base with the support and participation of certain holders of the Bank's securities and without the need for support from the tax payer.

The £1.5bn Recapitalisation Plan consisted of three elements:

a) The Liability Management Exercise (LME) to generate c.£1.2bn of new CET1;

b) The commitment of The Co-operative Group to contribute £333m of CET1 by the end of 2014; and

c) £40m of CET1 generated in 2014 from interest savings on the securities surrendered in the LME.

The transaction has been accounted for in accordance with IFRIC 19: Extinguishing Financial Liabilities with Equity Instruments.

Details of the Liability Management Exercise

a) The LME

A core part of the Recapitalisation Plan was achieved through successful completion of the LME on 20 December 2013. This involved the following elements:

i. The issuance of £0.2bn of new subordinated debt and £0.6bn of new ordinary shares in exchange for £1.3bn of existing debt and preference shares and additional contributions from bondholders of £0.1bn;

ii. The cancellation of £0.4bn of existing ordinary share capital, which resulted in the creation of a capital redemption reserve of the same value; and

iii. The sale of investment assets that were used as economic hedges for the existing debt, generating a profit of £11.1m. These assets had been accounted for as available for sale, and therefore there was an equivalent reduction in the available for sale reserve.

b) The contribution of £333m by The Co-operative Banking Group. This is due or paid up as follows:

i. £20m paid in December 2013;

ii. £50m paid in January 2014;

iii. £100m due by 30 June 2014; and

iv. £163m due by 31 December 2014.

c) The balance of the £1.5bn is £40m of savings in 2014 generated on securities surrendered as part of the LME

Elements a) and b) together created additional CET1 in the following ways:

i. New ordinary shares – a total of £0.8bn of new ordinary shares were issued to both existing bondholders and The Co-operative Banking Group. This was recorded as share capital and share premium as shown in the table below.

ii. Income – £0.7bn was recognised in the income statement. This arose because the amount of debt extinguished and contributions received (£1.3bn and £0.4bn) was greater than the amount of the new debt and shares issued (£0.2bn and £0.8bn). In accordance with company law, which requires that share premium is determined by reference to the amount of debt extinguished, the element of income relating to new shares issued (£0.6bn) was transferred from retained earnings to share premium.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

4. Recapitalisation and the Liability Management Exercise continued

iii. These increases in CET1 were offset by associated costs of £52m.

The effects of these transactions are shown in the table below and can be seen in the statement of changes in equity on page 133, along with the other borrowed funds and share capital notes on pages 182 and 205.

Overall impact of the recapitalisation transactions

The table below shows the effect of the recapitalisation transactions on profit and reserves. The effect on regulatory capital is shown on pages 119 to 121.

Effect of the Recapitalisation Plan on profit and reserves

		Effect on reserves					
	Profit	Share capital	Share premium	Available for sale reserve	Capital redemption reserve	Retained earnings	Net effect on reserves
Issuance of new debt and ordinary shares in exchange for existing debt and contributions	707.7	12.5	777.5	–	–	707.7	1,497.7
Sale of assets hedging pre-LME debt positions	11.1	–	–	(11.1)	–	11.1	–
Effect of transactions with a profit impact (before costs)	718.8	12.5	777.5	(11.1)	–	718.8	1,497.7
Costs associated with LME transaction	(30.5)	–	(21.3)	–	–	(30.5)	(51.8)
Effect of transactions with a profit impact (after costs)	688.3	12.5	756.2	(11.1)	–	688.3	1,445.9
Other LME transactions (with no profit impact):							
Cancellation of share capital (capital redemption reserve created)	–	(410.0)	–	–	410.0	–	–
Transfer of retained earnings to share premium account	–	–	594.8	–	–	(594.8)	–
Total effect of recapitalisation transactions on profit and reserves	688.3	(397.5)	1,351.0	(11.1)	410.0	93.5	1,445.9

This is discussed in more detail in the Capital Management section on pages 117 to 121.

Coming up:

The next 11 notes are all designed to give more information on our 2013 and 2012 income, expenses and the overall result as shown in the Bank income statement on page 128. You will find tables breaking down the numbers into more detail and offering further explanations.

5. Segmental information

In plain english:

This note breaks down the operating results (summarised in the Bank income statement) and the assets and liabilities (summarised in the Bank balance sheet) into our main business areas. This analysis is designed to help you understand how each segment has performed and how we have allocated our shareholders' capital.

In 2012, the Bank reported its operating segments as Retail, Corporate and Business Banking (CABB) and Other. The Corporate element was split into Core and Non-core. In 2013, as part of the Bank's plan to simplify, de-risk and reshape its business and to address the underlying issues which it faced, the Bank reported its business in two distinct divisions – Core and Non-core. Core represents activity consistent with the strategy and risk appetite of the Bank. This includes the Retail, Business and Commercial Banking (BaCB), Treasury and other segments. Non-core business lines includes activities not congruent with the current strategy of the Bank which are targeted for run down or exit. The comparatives throughout the note have been restated as appropriate.

Revenues are attributed to the segment in which they are generated. Transactions between the reportable segments are on normal commercial terms and internal charges and transfer pricing adjustments have been reflected in each segment.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

5. Segmental information continued

Revenues are attributed to the segment in which they are generated. Transactions between the reportable segments are on normal commercial terms and internal charges and transfer pricing adjustments have been reflected in each segment.

Further detail of the components of the Core and Non-core segments is provided on page 8.

	Core					Non-core				
	Retail	BaCB	Treasury	Other[1]	Total Core	Corporate CoAM	Optimum	Illius	Total Non-core	Total
2013										
Net interest income	428.1	69.5	0.7	8.9	507.2	16.6	(14.3)	(6.1)	(3.8)	503.4
Non-interest income	123.7	14.9	15.3	2.1	156.0	29.3	5.7	0.7	35.7	191.7
Operating income	551.8	84.4	16.0	11.0	663.2	45.9	(8.6)	(5.4)	31.9	695.1
Operating expenses	(504.6)	(64.8)	(38.0)	(5.8)	(613.2)	(46.2)	(21.4)	(4.7)	(72.3)	(685.5)
Impairment losses on loans	(33.0)	(5.9)	–	(1.0)	(39.9)	(446.8)	(29.5)	–	(476.3)	(516.2)
Operating result	14.2	13.7	(22.0)	4.2	10.1	(447.1)	(59.5)	(10.1)	(516.7)	(506.6)
Non-operating costs										(91.6)
Bank separation costs										(39.4)
Intangible asset impairment										(148.4)
PPI and Conduct/legal provisions										(411.5)
Share of post tax profits from joint ventures										0.7
Financial Services Compensation Scheme Levies										(25.6)
Liability Management Exercise										688.3
Fair value amortisation										(52.1)
Loss before taxation										(586.2)
Income tax										(161.8)
Loss for the financial year										(748.0)

The Board relies primarily on net interest income to assess the performance of each segment. As a result interest income is reported on a net basis to the Board. The Bank's activities are primarily in the UK.

1. Included within 'Core – Other' is Unity Trust Bank. Unity Trust Bank operates in the corporate banking and social economy sectors on behalf of trade unions and is consolidated into the Bank's results on the basis of control. On 14 January 2014, it was announced that the Bank is in discussions with the Board of Unity Trust Bank about a potential sale of 26.7% shareholding. Discussions are at an early stage and any decision on a changed ownership structure would be subject to regulatory approval.

Notes to the Bank financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

5. Segmental information continued

	Core					Non-core				
	Retail	BaCB	Treasury	Other	Total Core	Corporate CoAM	Optimum	Illius	Total Non-core	Total
2012										
Net interest income	399.9	63.1	41.2	9.3	513.5	22.7	15.8	(6.2)	32.3	545.8
Non-interest income	135.8	15.3	14.8	1.5	167.4	42.6	7.6	7.8	58.0	225.4
Operating income	535.7	78.4	56.0	10.8	680.9	65.3	23.4	1.6	90.3	771.2
Operating expenses	(444.2)	(51.4)	(20.0)	(7.5)	(523.1)	(34.3)	(22.1)	(3.5)	(59.9)	(583.0)
Impairment losses on loans and advances	(41.4)	(2.0)	–	(1.7)	(45.1)	(424.5)	(4.5)	–	(429.0)	(474.1)
Impairment gains on investments	–	–	5.3	0.1	5.4	–	–	–	–	5.4
Operating result	50.1	25.0	41.3	1.7	118.1	(393.5)	(3.2)	(1.9)	(398.6)	(280.5)
Non-operating costs										(85.1)
Intangible asset impairment										(150.0)
PPI provision										(149.7)
Share of post tax profits from joint ventures										1.2
Financial Services Compensation Scheme Levies										(24.8)
Fair Value amortisation										15.2
Loss before taxation										(673.7)
Income tax										165.6
Loss for the financial year										(508.1)

Notes to the Bank financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

5. Segmental information continued

Reconciliation to statutory income statement	2013	2012
Net interest income		
Total interest margin for reportable segments	**503.4**	545.8
Interest fair value unwind	**(45.7)**	20.0
Provision for customer redress claims	**(194.5)**	–
Net interest income	**263.2**	565.8
Non-interest income		
Total non-interest income for reportable segments	**191.7**	225.4
Interest fair value unwind	**0.3**	(0.2)
Provision for customer redress claims	**(185.1)**	(149.7)
Non-interest income	**6.9**	75.5
Comprising:		
Net fee and commission (expense)/income	**(37.3)**	27.5
Net trading income	**3.8**	14.1
Other operating income	**40.4**	33.9
	6.9	75.5
Operating expenses		
Total operating expenses for reportable segments	**(685.5)**	(583.0)
Interest fair value unwind	**(6.7)**	(4.6)
Non-operating costs	**(91.6)**	(85.1)
Bank separation costs	**(39.4)**	–
Provision for customer redress claims	**(31.9)**	–
Financial Services Compensation Scheme Levies	**(25.6)**	(24.8)
Operating expenses	**(880.7)**	(697.5)
Interest fair value unwind		
Total interest unwind for reportable segments	**(52.1)**	15.2
Interest margin unwind	**45.7**	(20.0)
Non-interest income unwind	**(0.3)**	0.2
Operating expenses unwind	**6.7**	4.6
Interest fair value unwind	**–**	–

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

5. Segmental information continued

	Core					Non-core				
	Retail	**BaCB**	**Treasury**	**Other**	**Total Core**	**Corporate CoAM**	**Optimum**	**Illius**	**Total Non-core**	**Total**
2013										
Segment assets	**16,790.9**	**844.9**	**10,492.7**	**441.0**	**28,569.5**	**5,646.1**	**7,326.1**	**162.2**	**13,134.4**	**41,703.9**
Unallocated assets										**1,557.9**
Total assets for reportable segments										**43,261.8**
Statutory adjustments										**134.3**
Bank total assets										**43,396.1**

	Core					Non-core				
	Retail	**BaCB**	**Treasury**	**Other**	**Total Core**	**Corporate CoAM**	**Optimum**	**Illius**	**Total Non-core**	**Total**
2013										
Segment liabilities	**27,899.3**	**3,479.0**	**7,633.2**	**394.9**	**39,406.4**	**831.0**	**–**	**–**	**831.0**	**40,237.4**
Unallocated liabilities										**603.8**
Total liabilities for reportable segments										**40,841.2**
Statutory adjustments										**777.6**
Bank total liabilities										**41,618.8**

	Core					Non-core				
	Retail	BaCB	Treasury	Other	Total Core	Corporate CoAM	Optimum	Illius	Total Non-core	Total
2012										
Segment assets	17,662.7	936.3	13,170.9	409.4	32,179.3	7,313.7	7,645.2	171.2	15,130.1	47,309.4
Unallocated assets										1,687.3
Total assets for reportable segments										48,996.7
Statutory adjustments										776.1
Bank total assets										49,772.8

	Core					Non-core				
	Retail	BaCB	Treasury	Other	Total Core	Corporate CoAM	Optimum	Illius	Total Non-core	Total
2012										
Segment liabilities	28,141.5	6,041.4	9,884.7	363.9	44,431.5	1,541.4	–	–	1,541.4	45,972.9
Unallocated liabilities										863.9
Total liabilities for reportable segments										46,836.8
Statutory adjustments										1,085.8
Bank total liabilities										47,922.6

Unallocated assets are non-customer assets and liabilities that are not allocated to a particular segment.

Statutory adjustments mainly relate to the reallocation of provisions, accruals and prepayments and the gross up of mark to market values.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

6. Loss before taxation

In plain english:

This note shows the amounts we paid to our auditors, KPMG, for audit and other services during the year.

	2013 £'000	2012 £'000
Loss before taxation is stated after:		
Audit of these financial statements	**339**	367
Amounts receivable by the Company's auditor and its associates in respect of:		
Audit of financial statements of subsidiaries of the Company	**322**	325
Audit related assurance services	**1,201**	28
Other tax advisory services	**–**	–
Other assurance services	**726**	460
Corporate finance services	**–**	–
All other services	**1,868**	1,944
	4,456	3,124

Audit related assurance services include £1.2m relating to work performed on the audited half year accounts, which formed part of The Prospectus, and 'Reporting Accountants' services in relation to the Liability Management Exercise. Other assurance services relates to assurance services relating to the bid for the Lloyds Banking Group branches. A further £1.9m of fees were also paid for other advisory services in relation to the Liability Management Exercise.

7. Directors' emoluments

In plain english:

This note gives a high level summary of Directors' pay. You can see a more detailed breakdown in the Remuneration report.

	2013 £'000	2012 £'000
Executive Directors	**2,152**	479
Non-Executive Directors[1]	**668**	671
Compensation for loss of office[2]	**317**	–
	3,137	1,150

Retirement benefits are accruing to one Director (2012: one) under defined benefit schemes.

The aggregate of emoluments and amounts receivable under incentive schemes of the highest paid Director was £1,733k (2012: £479k). Accrued pension under defined benefit pension schemes at the year end was £nil (2012: £21k).

Executive Directors' emoluments reflect the Bank's share of the overall emoluments receivable from The Co-operative Banking Group for qualifying services.

Non-Executive Directors' emoluments reflect the overall emoluments for all services provided to The Co-operative Banking Group.

Further details of Directors' emoluments are included in the Remuneration Report. The Remuneration report is unaudited.

1. Non-Executive Directors includes fees for Richard Pym (Chairman). Richard Pym receives a basic annual fee of £180,000 per annum. In addition to which the Bank agrees to pay an annual corporate donation as described on page 66. The total of the donations paid to Charities in 2013 of £67,000 is included above.
2. Compensation for loss of office includes £31,000 in relation to Paul Flowers as described on page 67.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

8. Net interest income

In plain english:

This note shows the different elements of interest income and interest expense (a large contributor to our overall result). See page 10 for how the Bank makes money. The numbers in brackets are costs.

	2013	2012
Interest receivable and similar income		
On financial assets not at fair value through income or expense:		
On loans and advances to customers	**1,275.0**	1,390.0
On loans and advances to banks	**29.7**	31.2
On investment securities	**122.5**	149.8
	1,427.2	1,571.0
On financial assets at fair value through income or expense:		
Net interest expense on financial instruments hedging assets	**(114.4)**	(133.4)
Net interest income on financial instruments not in a hedging relationship	**75.6**	50.7
	1,388.4	1,488.3

Included within interest receivable is £14.2m (2012: £17.8m) relating to profit on sale of investment securities – available for sale.

Interest income accrued on impaired financial assets during the year was £43.5m (2012: £48.5m). Interest due to unwinding of discount on impairment provisions relating to impaired financial assets amounted to £10.7m (2012: £7.1m).

The provision for potential customer redress claims recorded against interest income consists of:

	2013	2012
Potential customer redress in relation to breaches of the Consumer Credit Act	**(109.5)**	–
Potential customer redress in relation to past sales of interest rate hedging products	**(33.0)**	–
Potential customer redress in relation to secured arrears	**(22.0)**	–
Provision for potential conduct issues incurred but not reported	**(15.0)**	–
Provision for potential customer redress and other costs in relation to mortgage documentation	**(13.0)**	–
Other redress provisions	**(2.0)**	–
	(194.5)	–

See note 34 for further details of the above provisions.

	2013	2012
Interest expense and similar charges		
On financial liabilities not at fair value through income or expense:		
On customer accounts	**(484.3)**	(506.9)
On bank and other deposits	**(267.0)**	(227.9)
On subordinated liabilities	**(79.1)**	(77.0)
On perpetual secured debt	**(40.2)**	(43.2)
	(870.6)	(855.0)
On financial liabilities at fair value through income or expense:		
Net interest expense on financial instruments hedging liabilities	**(24.1)**	(33.7)
Net interest expense on financial instruments not in a hedging relationship	**(36.0)**	(33.8)
	(930.7)	(922.5)
Net interest income	**263.2**	565.8

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

9. Net fee and commission (expense)/income

In plain english:

This note shows more detail of fees and commissions income and expense.

	2013	2012
Fee and commission income		
On items not at fair value through income or expense	**219.6**	241.2
On trust or fiduciary activities that result from holding or investing in assets on behalf of others	**0.3**	0.2
	219.9	241.4

The provision for potential customer redress claims recorded against net fee and commission income consists of:

	2013	2012
Potential customer redress in relation to past sales of payment protection insurance	**(103.0)**	(149.7)
Potential customer redress in relation to mortgage charges	**(31.0)**	–
Potential customer redress in relation to alleged failings in the introduction of third party sales of card and identity protection products	**(26.1)**	–
Potential customer redress in relation to mortgage arrears fees and charges	**(19.0)**	–
Other redress provisions	**(6.0)**	–
	(185.1)	(149.7)

See note 34 for further details of the above provisions.

	2013	2012
Fee and commission expense		
On items not at fair value through income or expense	**(71.8)**	(63.5)
On items at fair value through income or expense	**(0.3)**	(0.7)
	(72.1)	(64.2)
Net fee and commission (expense)/income	**(37.3)**	27.5

The 2012 comparatives have been re-presented to present a revised split between fee and commission income and fee and commission expense.

10. Net trading income

In plain english:

This note shows more detail of our net trading income. This income arises from products that help our commercial customers manage their foreign exchange and interest rate risks.

	2013	2012
Foreign exchange	**7.3**	5.3
Other interest rate instruments	**(3.5)**	8.8
	3.8	14.1

Foreign exchange net trading income includes gains less losses from spot forward and forward contracts, options, futures and translated foreign currency assets and liabilities.

Other interest rate instruments include the result of transacting in government securities, money market instruments, interest rate and currency swaps, options and other derivatives.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

11. Other operating income

In plain english:

This note shows a breakdown of our other sources of income. Most of our other income is one-off gains from selling investments and loans.

	Note	2013	2012
Profit on sale of investment securities – loans and receivables		**39.1**	15.7
Profit on sale of loans and advances to banks		**–**	9.3
Rent receivable from investment properties	24	**8.4**	8.4
Change in fair value of investment properties	24	**(8.0)**	0.2
Other		**0.9**	0.3
		40.4	33.9

The profit on sale of investment securities arose from the restructuring of a portfolio of assets, as further described in the Detailed Financial Review. Profit on smaller disposals in the normal course of business are included in net interest income.

12. Operating expenses

In plain english:

This note breaks down the costs of running our business – our operating expenses into various categories. We have separated out the more material items during the year in order to provide a better view of the underlying trend. Later on you will find more detail on some of these expenses (eg staff costs).

	Note	2013	Restated 2012
Operating expense			
Staff costs	13	**274.6**	266.5
Administrative expenses		**291.7**	243.0
Depreciation of property, plant and equipment	25	**16.4**	22.7
Amortisation of intangible fixed assets	23	**24.2**	23.0
Impairment of brand intangible fixed assets	23	**2.0**	–
Loss on sale of property, plant and equipment		**0.5**	0.9
Operating lease rentals		**27.4**	28.0
Financial Services Compensation Scheme Levies	34	**25.6**	24.8
Property provisions for liabilities and charges provided in the year	34	**16.7**	0.8
Property provisions for liabilities and charges released during the year	34	**(0.4)**	(0.3)
Other provisions for liabilities and charges provided in the year	34	**35.3**	0.5
Other provisions for liabilities and charges released during the year	34	**(0.3)**	(0.6)
Direct expenses from investment properties that generated rental income in the year		**4.0**	3.0
Direct expenses from investment properties that did not generate rental income in the year		**0.1**	0.1
		717.8	612.4

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

12. Operating expenses continued

The following items are included in operating expenses, which have been incurred outside the ordinary course of business:

	Note	2013	2012
Investment, integration and rationalisation costs		**71.3**	47.0
Bank separation costs	34	**39.4**	–
Provision for customer redress claims relating to processing of first payments on certain mortgages and other redress claims	34	**31.9**	–
Costs incurred in bid for Lloyds Banking Group branches		**10.4**	38.1
Impairment of property, plant and equipment	25	**9.9**	–
		162.9	85.1
Total operating expenses		**880.7**	697.5

Included within investment, integration and rationalisation costs is £2.9m of impairment of intangible fixed assets.

Costs associated with separating the Bank from The Co-operative Group of £39.4m (2012: £nil) have been provided for, as detailed in note 34.

No expenditure has been incurred in respect of the Government's Bank Levy since the relevant aggregate liabilities of the Bank are below the qualifying threshold.

The 2012 comparatives have been restated as described in note 3.

13. Staff costs

In plain english:

This note shows a breakdown of the total cost of employing our staff (including Directors) and the average number of people we employed during the year.

	Note	2013	2012
Wages and salaries		**190.3**	188.0
Social security costs		**14.6**	15.8
Pension costs:			
Defined benefit plans	36	**0.2**	0.2
Defined contribution plans		**28.5**	32.6
Other staff costs		**41.0**	29.9
		274.6	266.5

Average number of employees

The average number of persons working for the Bank during the year is as follows:

	No. of employees 2013	No. of employees 2012
Full time	**5,646**	6,082
Part time	**1,880**	2,025
	7,526	8,107

Up until 20 December 2013, employee activities were undertaken across The Co-operative Banking Group and the figures above reflect the Bank's share of these services.

Employees of the Bank were employed by CFS Management Services Limited (CFSMS) during the year. Staff costs were then recharged to the Bank. With effect from 23 January 2014, Bank employees have had their employment contracts transferred from CFSMS to The Co-operative Bank plc. The transfer was required to support the legal separation of the Bank from The Co-operative Group. This transfer took place under the Transfer of Undertakings (Protection of Employment) Regulations 2006.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

14. Income tax

In plain english:

Income tax is the tax charge on our trading activities during the year. The following note shows the breakdown of income tax between the current tax (the tax we have to pay to or reclaim from HM Revenue & Customs or other companies in the tax group) and the deferred tax (tax that may become payable at some point in the future). It also explains why our tax rate is different from the UK standard corporation tax rate. Tax is usually an expense, so this note shows tax credits in brackets.

	Note	2013	2012
Current tax			
Current year		**(9.9)**	(147.4)
Prior year		**22.8**	(2.5)
Total current tax		**12.9**	(149.9)
Deferred tax			
Current year	35	**(5.3)**	(8.8)
Write off of prior year deferred tax asset	35	**157.5**	–
Prior year	35	**(3.3)**	(6.9)
Total deferred tax		**148.9**	(15.7)
Total tax charge/(credit)		**161.8**	(165.6)

In addition to the above, current tax of £13.2m and deferred tax of £18.2m has been credited to other comprehensive income.

Further information on deferred income tax is presented in note 35. The tax on the Bank's loss before taxation differs from the theoretical amount that would arise using the corporation tax rate in the UK as follows:

	Note	2013	2012
Loss before taxation		**(586.2)**	(673.7)
Tax calculated at a rate of 23.25% (2012: 24.5%)		**(136.3)**	(165.0)
Effects of:			
Write off of prior year deferred tax asset	35	**157.5**	–
Non-taxable income		**(116.3)**	(0.4)
Unrecognised deferred tax		**113.9**	–
Discount of group relief debtor		**56.9**	–
Change in rate of deferred tax		**29.1**	4.5
Expenses not deductible for tax purposes		**25.1**	6.5
Adjustments to tax charge in respect of prior periods		**19.5**	(9.4)
Difference in the tax rate at which current year group relief is expected to be recoverable		**9.6**	–
Depreciation of expenditure not qualifying for capital allowances		**2.5**	1.2
Other differences		**0.3**	(3.0)
		161.8	(165.6)

The tax charge for the year ended 31 December 2013 is higher than expected primarily due to the write-off of prior year deferred tax assets, amounts in the current year for which a deferred tax asset has not been recognised, a discount applied to the group relief debtor and a further reduction in the rate at which deferred tax is recognised.

Expenses not deductible of £25.1m (31 December 2012: £6.5m) includes professional fees incurred on the LME transaction and costs resulting from the separation of the Bank from The Co-operative Group.

Non-taxable income of £116.3m (31 December 2012: £0.4m) includes £115.6m in respect of the gain arising on the LME transaction.

The 2013 adjustments to the tax charge in respect of prior periods of £19.5m include a charge of £24.4m relating to the change in rate at which prior year group relief will be recovered. The 2012 adjustments to the tax credit in respect of prior periods of £9.4m relate to accelerated capital allowances.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

15. Earnings per share

In plain english:

Earnings per share shows the overall profit or loss (shown in brackets) for each share that our shareholders own.

Basic earnings per share is calculated by dividing the net loss attributable to equity shareholders of the Bank by the weighted average number of ordinary shares in issue during the year.

	Note	2013	2012
Loss attributable to equity shareholders of the Bank		**(748.9)**	(509.1)
Ordinary shares in issue (millions)			
At the beginning of the year		**8,200.0**	8,200.0
Shares cancelled	4	**(8,200.0)**	–
Issue of new ordinary shares	4	**250.0**	–
At the end of the year		**250.0**	8,200.0
Weighted average number of ordinary shares in issue (millions)		**7,938.6**	8,200.0
Basic (losses)/earnings per share (expressed in pence per share)		**(9.43)**	(6.21)

250 million new shares were issued as part of the LME which was completed on 20 December 2013.

Coming up:

The next few notes are designed to give you more information on our balance sheet assets. You will find explanations and tables breaking down the numbers into more detail.

16. Cash and balances at central banks

In plain english:

This note details our most liquid assets – cash in our tills and balances with the Bank of England.

	2013	2012
Cash in hand	**274.9**	272.6
Balances with the Bank of England other than mandatory reserve deposits	**5,077.7**	5,121.0
Included in cash and cash equivalents	**5,352.6**	5,393.6
Mandatory reserve deposits with the Bank of England	**66.2**	39.4
	5,418.8	5,433.0

Mandatory reserve deposits are not available for use in the Bank's day-to-day operations, are non-interest bearing and are not included in cash and cash equivalents.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

17. Loans and advances to banks

In plain english:

This note shows cash in transit and the amounts we have lent to other banks to earn interest income.

	2013	2012
Items in course of collection from other banks	**105.1**	103.9
Placements with other banks	**529.5**	746.7
Included in cash and cash equivalents	**634.6**	850.6
Other loans and advances to banks	**959.8**	1,053.5
	1,594.4	1,904.1

18. a) Loans and advances to customers

In plain english:

This note shows the amounts we have lent to customers to earn interest income. Where we have objective evidence that loan amounts will not be repaid, we have made a provision (loan impairment charge) to take account of the likely loss. The cumulative loan impairment charges are shown in this note. Any additional loan impairment charges that arose during the year are shown in the income statement.

	2013	2012
Gross loans and advances	**31,274.6**	33,982.5
Less: allowance for losses	**(952.4)**	(643.0)
	30,322.2	33,339.5

The Bank's loans and advances to customers include £134.2m (2012: £153.6m) of financial assets at fair value through income or expense designated at initial recognition to eliminate or significantly reduce a measurement or recognition inconsistency. Of these, £62.9m (2012: £48.7m) are secured by real estate collateral.

Loans and advances to customers include £10,111.9m (2012: £10,997.3m) securitised under the Bank's securitisation and covered bond programmes. The Bank remains exposed to substantially all of the risks and rewards of ownership of these assets. Included within the Bank's deposits by banks (note 28) are £500.3m (2012: £58.4m) of loans from external third parties and within the Bank's debt securities in issue (note 30) are £3,703.4m (2012: £4,144.5m) of fixed and floating rate notes, all secured on these mortgage assets.

Concentration of exposure

The Bank's exposure is virtually all within the UK. Further information on the concentration of exposure is included within the risk management disclosures.

Notes to the Bank financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

18. a) Loans and advances to customers continued

Allowance for losses on loans and advances

	Core		Non-core		
	Individual	Collective	Individual	Collective	Total
2013					
At the beginning of the year	**9.4**	**175.2**	**434.8**	**23.6**	**643.0**
Charge against profits	**2.4**	**38.0**	**441.3**	**25.8**	**507.5**
Amounts written off	**(0.9)**	**(41.8)**	**(145.1)**	**–**	**(187.8)**
Unwind of discount allowance	**(0.2)**	**(3.6)**	**(6.9)**	**–**	**(10.7)**
Interest charged on impaired loans	**–**	**–**	**0.4**	**–**	**0.4**
At the end of the year	**10.7**	**167.8**	**724.5**	**49.4**	**952.4**

Core provisions are analysed in further detail below:

	Core						
	Retail		BaCB		Other[1]		
	Individual	Collective	Individual	Collective	Individual	Collective	Total Core
2013							
At the beginning of the year	**2.7**	**173.3**	**0.3**	**1.1**	**6.4**	**0.8**	**184.6**
Charge against profits	**0.6**	**32.9**	**0.6**	**5.3**	**1.2**	**(0.2)**	**40.4**
Amounts written off	**(0.5)**	**(40.7)**	**(0.4)**	**(1.1)**	**–**	**–**	**(42.7)**
Unwind of discount allowance	**–**	**(3.6)**	**–**	**–**	**(0.2)**	**–**	**(3.8)**
Interest charged on impaired loans	**–**	**–**	**–**	**–**	**–**	**–**	**–**
At the end of the year	**2.8**	**161.9**	**0.5**	**5.3**	**7.4**	**0.6**	**178.5**

Non-core provisions are analysed in further detail below:

	Non-core				
	Corporate		Optimum		
	Individual	Collective	Individual	Collective	Total Non-core
2013					
At the beginning of the year	**426.9**	**20.5**	**7.9**	**3.1**	**458.4**
Charge against profits	**417.8**	**19.5**	**23.5**	**6.3**	**467.1**
Amounts written off	**(139.8)**	**–**	**(5.3)**	**–**	**(145.1)**
Unwind of discount allowance	**(6.9)**	**–**	**–**	**–**	**(6.9)**
Interest charged on impaired loans	**0.4**	**–**	**–**	**–**	**0.4**
At the end of the year	**698.4**	**40.0**	**26.1**	**9.4**	**773.9**

	Core		Non-core		
	Individual	Collective	Individual	Collective	Total
2012					
At the beginning of the year	8.7	165.4	105.4	12.5	292.0
Charge against profits	3.3	44.0	384.8	11.1	443.2
Amounts written off	(2.5)	(30.8)	(51.9)	–	(85.2)
Unwind of discount allowance	(0.1)	(3.4)	(3.6)	–	(7.1)
Interest charged on impaired loans	–	–	0.1	–	0.1
At the end of the year	9.4	175.2	434.8	23.6	643.0

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

18. a) Loans and advances to customers continued

Core provisions are analysed in further detail below:

	Core						
	Retail		BaCB		Other[1]		Total
	Individual	Collective	Individual	Collective	Individual	Collective	Core
2012							
At the beginning of the year	2.7	163.7	0.2	1.0	5.8	0.7	174.1
Charge against profits	1.2	42.4	0.5	1.5	1.6	0.1	47.3
Amounts written off	(1.2)	(29.4)	(0.4)	(1.4)	(0.9)	–	(33.3)
Unwind of discount allowance	–	(3.4)	–	–	(0.1)	–	(3.5)
Interest charged on impaired loans	–	–	–	–	–	–	–
At the end of the year	2.7	173.3	0.3	1.1	6.4	0.8	184.6

Non-core provisions are analysed in further detail below:

	Non-core				
	Corporate		Optimum		Total
	Individual	Collective	Individual	Collective	Non-core
2012					
At the beginning of the year	99.1	10.5	6.3	2.0	117.9
Charge against profits	377.5	10.0	7.3	1.1	395.9
Amounts written off	(46.2)	–	(5.7)	–	(51.9)
Unwind of discount allowance	(3.6)	–	–	–	(3.6)
Interest charged on impaired loans	0.1	–	–	–	0.1
At the end of the year	426.9	20.5	7.9	3.1	458.4

1. 'Core – Other' relates to Unity Trust Bank.

The net impairment charge in the Bank's income statement is £516.2m (2012: £474.1m). This includes amounts recovered by the Bank of £1.1m (2012: £6.1m) against amounts previously written off. The recoveries have been made from the mortgagors, from other parties involved in the origination or acquisition of the mortgages and from the sale of written off debt (2012 only).

The impairment charge also includes a provision of £9.8m (2012: £37.0m) made against fair value adjustments for hedged risk during the year (as shown in the fair value adjustments for hedged risk tables).

There are a number of reasons for the increase in the overall impairment charge. Firstly, in the first half of 2013, the amount of assets designated as Non-core increased, the Bank has continued to review its loan book on a case-by-case basis and there was a change in the work out approach on a significant number of assets. Secondly, there were further improvements to our credit risk management approach, improving the data on which impairment assessments are made and resulting in increased impairments. This took into account the continuing impacts of the corporate real estate environment, prolonged real wage deflation and the lower apparent crystallisation of losses while base rate continues to be low. Impairments which occur in the ordinary course of the business due to changes in customer circumstances have also been incurred in both the Core and Non-core businesses.

A much smaller impairment charge was recorded in the second half of 2013 as impairments due to changes in customer circumstances continued at similar levels to the first half, offset by reductions in corporate collective provisions as the book continues to be worked out and de-risked and reductions in Optimum and Retail provisions due to improvements in residential property collateral values from strong house price growth.

Notes to the Bank financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

18. a) Loans and advances to customers continued
Loans and advances to customers include finance lease receivables:

	2013	2012
Gross investment in finance leases may be analysed as follows:		
No later than one year	**18.4**	22.2
Later than one year and no later than five years	**55.4**	68.6
Later than five years	**53.6**	73.4
	127.4	164.2
Unearned future finance income on finance leases	**(32.7)**	(44.1)
Net investment in finance leases	**94.7**	120.1
The net investment in finance leases may be analysed as follows:		
No later than one year	**12.8**	15.5
Later than one year and no later than five years	**39.2**	47.9
Later than five years	**42.7**	56.7
	94.7	120.1

There are no unguaranteed residual values for any of the finance leases.

The Bank enters into finance lease and hire purchase arrangements with customers in a wide range of sectors including transport, retail and utilities. The accumulated allowance for uncollectible minimum lease payments receivable is £0.6m (2012: £nil).

18. b) Fair value adjustments for hedged risk
The Bank has entered into interest rate swaps that protect it from changes in interest rates on the floating rate liabilities that fund its portfolio of fixed rate mortgages. Changes in the fair values of these swaps are offset by changes in the fair values of the fixed rate mortgages.

	2013	2012
Gross fair value adjustments for hedged risk	**154.4**	391.2
Less: impairment provision	**(46.8)**	(37.0)
	107.6	354.2

Movements on impairment provision on fair value adjustments for hedged risk are shown below:

	2013	2012
At the beginning of the year	**37.0**	–
Charge against profits	**9.8**	37.0
At the end of the year	**46.8**	37.0

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

19. Investment securities

In plain english:

We hold a number of different investments in the form of securities (ie listed & unlisted shares and bonds). We are obliged to categorise and value these as follows:

- Loans and receivables: These are included in the balance sheet at amortised cost less any impairments.
- Available for sale: These are investments that are not included in another category (above or below). They are revalued at each balance sheet date (marked to market). Any increases in value are taken directly to equity, so do not appear in the income statement (see the statement of comprehensive income).
- Fair value through income or expense: These are investments that we hold short term. They are revalued at each balance sheet date (marked to market). Any increases in value are profits and reductions in value are losses, both of which are recorded in the income statement.
- Held for trading: These were our trading assets, and were revalued daily (mark to market). We no longer hold investment securities for trading purposes.

a) Loans and receivables

	2013	2012
Loans and receivables		
Listed	23.6	295.0
Unlisted	–	–
	23.6	295.0
Less: allowance for losses	–	–
	23.6	295.0
Included in cash and cash equivalents	–	–

The 2012 comparatives have been re-presented to reflect a correction of the analysis of loans and receivables between listed and unlisted securities.

The movement in investment securities – loans and receivables excluding interest amounts is summarised as follows:

	2013	2012
At the beginning of the year	294.7	803.3
Acquisitions	–	–
Disposals and maturities	(283.4)	(582.0)
Exchange adjustments	0.9	(2.8)
Fair value movements through income or expense	(9.2)	–
Amortisation	20.6	73.5
Release of impairment provision	–	2.7
At the end of the year	23.6	294.7

Impairment analysis of investment securities – loans and receivables

	2013	2012
At the beginning of the year	–	2.7
Released during the year	–	(2.7)
Utilised during the year	–	–
At the end of the year	–	–

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

19. Investment securities continued

b) Available for sale

	2013	2012
Available for sale		
Listed	**2,497.2**	3,552.3
Unlisted	**255.2**	276.1
	2,752.4	3,828.4
Less: allowance for losses	**(20.0)**	(39.0)
	2,732.4	3,789.4
Included in cash and cash equivalents	**105.0**	70.0

The movement in investment securities – available for sale excluding interest amounts is summarised as follows:

	2013	2012
At the beginning of the year	**3,775.5**	3,405.5
Acquisitions	**2,346.0**	3,962.8
Disposals and maturities	**(3,271.3)**	(3,608.2)
Exchange adjustments	**(0.9)**	(8.1)
Fair value movements through equity	**(32.7)**	108.7
Fair value movements through income or expense	**(105.0)**	(68.2)
Amortisation	**(13.6)**	(19.7)
Release and utilisation of impairment provision	**18.5**	2.7
At the end of the year	**2,716.5**	3,775.5

Impairment analysis of investment securities – available for sale

	2013	2012
At the beginning of the year	**39.0**	42.5
Released during the year	**–**	(2.7)
Utilised during the year	**(18.5)**	–
Exchange adjustments	**(0.5)**	(0.8)
At the end of the year	**20.0**	39.0

c) Fair value through income or expense

	2013	2012
Fair value through income or expense		
Listed	**1,743.4**	1,845.2
	1,743.4	1,845.2
Less: allowance for losses	**–**	–
	1,743.4	1,845.2
Included in cash and cash equivalents	**–**	–

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

19. Investment securities continued

The movement in investment securities – fair value through income or expense excluding interest amounts is summarised as follows:

	2013	2012
At the beginning of the year	**1,830.6**	339.5
Reclassified to fair value through income or expense	**447.7**	–
Acquisitions	**2,120.9**	1,895.5
Disposals and maturities	**(2,632.9)**	(410.8)
Exchange adjustments	**(0.1)**	(0.1)
Fair value movements through income or expense	**(35.3)**	6.5
At the end of the year	**1,730.9**	1,830.6

d) Held for trading

	2013	2012
Held for trading		
Listed	**–**	960.2
Included in cash and cash equivalents	**–**	–

The movement in investment securities – held for trading excluding interest amounts may be summarised as follows:

	2013	2012
At the beginning of the year	**954.3**	–
Reclassified to fair value through income or expense	**(447.7)**	–
Acquisitions	**30.7**	1,268.8
Disposals and maturities	**(530.9)**	(321.6)
Exchange movements	**0.7**	–
Fair value movements through income or expense	**(7.1)**	7.1
At the end of the year	**–**	954.3

e) Analysis of investment securities by issuer

	2013	2012
Investment securities issued by public bodies:		
Government securities	**3,064.3**	2,184.9
Other public sector securities	**580.5**	2,208.5
	3,644.8	4,393.4
Investment securities issued by other issuers:		
Bank and building society certificates of deposits	**235.2**	225.5
Other debt securities:		
Other floating rate notes	**595.8**	1,975.9
Mortgage backed securities	**23.6**	295.0
	619.4	2,270.9
	4,499.4	6,889.8

Other floating-rate notes (FRNs) relate to sterling denominated FRNs with maturities ranging from one month to 12 years from the balance sheet date.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

20. Derivative financial instruments

In plain english:

A derivative is a financial instrument used to manage risk. Its value changes over time in response to underlying variables such as interest rates or exchange rates. These contracts are for a fixed period. Our derivatives include a variety of financial contracts, many of which are designed to help customers manage their interest rate and currency risks. We also use derivatives ourselves, to manage our own interest rate and foreign currency risk.

The value of the derivative contracts that you can see in our balance sheet is determined by fluctuations in the underlying item. The derivative will appear as an asset if we have benefitted from the contract by the balance sheet date and as a liability if we have not benefitted.

As you can imagine, the value of these derivatives is very volatile as market conditions change on a daily basis.

The Bank has entered, as principal, into various derivatives either as a trading activity, which includes proprietary transactions and customer facilitation, or as a hedging activity for the management of interest rate risk, equity risk and foreign exchange rate risk. Positive and negative fair values have not been netted as the Bank does not have a legal right of offset.

Derivatives held for trading purposes

The trading transactions are wholly interest rate related contracts including swaps, caps and floors, forward rate agreements and exchange traded futures. Trading transactions include derivatives where the Bank enters into a transaction to accommodate a customer together with the corresponding hedge transaction. The Bank no longer holds derivatives for trading purposes.

Non-trading derivatives

Non-trading transactions comprise derivatives held for hedging purposes to manage the asset and liability positions of the Bank. Derivatives used to manage interest rate related positions include swaps, caps and floors, forward rate agreements and exchange traded futures. The foreign exchange rate positions are managed using forward currency transactions and swaps. Equity risk is managed using equity swaps.

During the year the Bank has entered into fair value hedges to mitigate price movements due to interest rate sensitivities.

	2013 Fair value		2012 Fair value	
	Assets	**Liabilities**	Assets	Liabilities
Derivatives held for trading purposes				
Interest rate derivatives:				
Interest rate swaps	**–**	**–**	195.9	(167.2)
Over The Counter (OTC) interest rate options	**–**	**–**	1.4	(1.1)
Total derivative assets/(liabilities) held for trading purposes	**–**	**–**	197.3	(168.3)
Derivatives held for non-trading purposes				
Derivatives designated as cashflow hedges:				
Interest rate swaps	**37.9**	**(56.0)**	120.1	(52.3)
Derivatives designated as fair value hedges:				
Interest rate swaps	**52.5**	**(289.4)**	110.7	(587.0)
Cross currency interest rate swaps	**–**	**(1.5)**	–	(42.6)
Derivatives held for non-trading purposes for which hedge accounting has not been applied:				
Interest rate swaps	**143.3**	**(165.0)**	44.8	(62.9)
Embedded derivatives – options	**56.3**	**–**	60.6	(0.1)
Forward currency transactions	**216.6**	**(24.5)**	222.3	(51.4)
OTC interest rate options	**0.6**	**(2.2)**	–	(2.8)
Equity swaps	**48.6**	**–**	63.0	(0.2)
Total derivative assets/(liabilities) held for non-trading purposes	**555.8**	**(538.6)**	621.5	(799.3)
Total recognised derivative assets/(liabilities)	**555.8**	**(538.6)**	818.8	(967.6)

The derivatives designated as cashflow hedges are interest rate swaps used to hedge interest rate risk in the Bank's Retail operations. Cash flows are hedged by quarterly time periods for durations up to ten years. During the year there were no forecast transactions for which hedge accounting had previously been used but are no longer expected to occur.

In line with industry standards, credit valuation adjustments (CVAs) and debit valuation adjustments (DVAs) are applied to non-collateralised swaps representing the fair value measurement of counterparty risk. The net credit adjustment across the portfolio as at the end of 2013 was £4.4m (2012: £2.8m). CVAs and DVAs are not applied to derivatives that are fully cash collateralised.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

21. Equity shares

In plain english:

As well as the investment securities that we detailed in note 19, we also have a smaller amount of other investments (in shares of companies). These are detailed below.

	2013	2012
Investment securities		
Listed	**0.1**	0.1
Unlisted	**5.7**	5.6
	5.8	5.7
Included above are the following trade investments:		
Vocalink Limited – 4,416,165 ordinary shares of £1 each (2012: 4,416,165)	**5.6**	5.6

Equity shares are classified as available for sale.

22. Goodwill

In plain english:

Goodwill is an asset that arises from business acquisitions. It is the premium that we have paid over the fair value of the business (largely as a result of synergies being created from the combined companies).

	2013	2012
Net book amount		
At the beginning of the year	**–**	0.6
Impairment charge	**–**	(0.6)
At the end of the year	**–**	–

The Bank's goodwill was recognised in 2009 and related to the transfer of engagements of Britannia Building Society.

At 31 December 2012 the Directors assessed the goodwill balance for impairment and concluded that the carrying value should be written down to nil.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

23. Intangible fixed assets

In plain english:

An intangible asset is an asset without any physical substance but which has a long term value to our business. Our intangible assets relate to internally generated software development costs and the stable deposit base that provide a low-cost source of funding that we acquired with Britannia (core deposit intangible). We reduce the balance sheet value of these assets on a systematic basis by way of amortisation, over a period of up to 10 years. Amortisation is recorded in the income statement. We also assess assets for impairment. Impairments are also shown in the income statement.

	2013			Restated 2012		
	Internally generated intangible assets	**Other intangible assets**	**Total**	Internally generated intangible assets	Other intangible assets	Total
Cost						
At the beginning of the year (as reported)[1]	***11.6***	***46.0***	***57.6***	*13.5*	*46.0*	*59.5*
At the beginning of the year	**440.0**	**46.0**	**486.0**	365.6	46.0	411.6
Additions	**13.7**	**–**	**13.7**	76.7	–	76.7
Disposals	**(1.1)**	**–**	**(1.1)**	(2.3)	–	(2.3)
At the end of the year	**452.6**	**46.0**	**498.6**	440.0	46.0	486.0
Accumulated amortisation and impairment						
At the beginning of the year (as reported)[1]	***7.2***	***15.5***	***22.7***	*8.0*	*10.8*	*18.8*
At the beginning of the year	**207.3**	**15.5**	**222.8**	41.3	10.8	52.1
Charge for the year	**19.7**	**4.5**	**24.2**	18.3	4.7	23.0
Impairment	**140.0**	**2.0**	**142.0**	150.0	–	150.0
Disposals	**(1.1)**	**–**	**(1.1)**	(2.3)	–	(2.3)
At the end of the year	**365.9**	**22.0**	**387.9**	207.3	15.5	222.8
Net book value						
At the end of the year	**86.7**	**24.0**	**110.7**	232.7	30.5	263.2
At the beginning of the year	232.7	30.5	263.2	324.3	35.2	359.5

Internally generated intangible assets consist of software development costs. Acquired computer software licences are capitalised on the basis of cost incurred to acquire and bring the software in to use.

Other intangible assets consist of a core deposit intangible of £24.0m (2012: £28.5m) and a brand intangible of £nil (2012: £2.0m). The brand intangible was fully impaired in the year.

Internally generated assets include £83.8m (net book value) (2012: £228.3m) of assets for which the Bank does not hold legal title, but the Directors are of the opinion that the assets meet the accounting criteria of an asset for the Bank. The assets are therefore accounted for on the Bank's balance sheet.

CFS Management Services (CFSMS) (a subsidiary of The Co-operative Banking Group) holds legal title to these assets. The Bank's relationship with CFSMS is described in note 39.

Internally generated assets include £8.5m (2012: £125.0m) of assets in the course of construction.

The Directors consider accounting for assets held by CFSMS a critical accounting judgement. Further details are provided in note 2.

The total impairment charge for internally generated intangibles (shown above), assets in the course of construction and computers and other equipment (shown in property, plant and equipment) is £151.3m, which consists of £148.4m regarding the development of new banking systems and £2.9m of other impairment (included in operating expenses).

1. The 2012 comparatives have been restated as described in note 3.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

24. Investment properties

In plain english:

We hold a number of properties for investment purposes through Illius Properties Limited (a subsidiary of the Bank), either for earning rental income or to make capital gains. These properties are revalued each year to reflect their fair (market) value and any changes in these values each year are recorded as either a gain (profit) or a loss in other operating income in the income statement. The rental income is also included within other operating income in the Bank income statement as shown in note 11.

	Note	**2013**	2012
Fair value			
At the beginning of the year		**173.0**	172.7
Additions – other expenditure		**0.4**	1.0
Disposals		**(1.3)**	(0.9)
Changes in fair value	11	**(8.0)**	0.2
At the end of the year		**164.1**	173.0

All investment properties are held to generate rental income until such time that the Bank considers it appropriate to realise its investment.

Investment properties are carried at fair value, measured under a combination of level 2 and level 3 of the fair value hierarchy (see note 41). Fair value is calculated by using recent valuations of individual assets within the portfolio, index linked to the balance sheet date using the relevant regional house price index, where appropriate.

The reduction in fair value in the portfolio has arisen following the change in valuation methodology from a discounted future cashflow approach to open market value.

The Bank lets investment properties on Assured Shorthold Tenancy agreements, most of which are for contract periods of no more than 12 months. The future minimum lease receipts under non-cancellable operating leases are £1.1m (2012: £1.1m). The Bank has not recognised any contingent rent in the year (2012: £nil). None of the lease agreements are individually significant.

Included in the Bank's other operating income for the year is £8.4m (2012: £8.4m) of rental income relating to investment properties (note 11).

25. Property, plant and equipment

In plain english:

The note below gives a breakdown of the type of assets in use in our business eg branches and computer equipment. We reduce the balance sheet value of these assets on a systematic basis by way of depreciation. Depreciation is therefore an expense in the income statement.

2013	**Land and buildings**	**Leasehold improvements**	**Computers and other equipment**	**Assets in the course of construction**	**Total**
Cost					
At the beginning of the year (restated)	**55.4**	**25.2**	**153.9**	**16.1**	**250.6**
Additions	**27.9**	**–**	**6.9**	**6.8**	**41.6**
Disposals	**(0.3)**	**(0.1)**	**(16.7)**	**–**	**(17.1)**
Impairment	**–**	**–**	**(1.6)**	**(9.2)**	**(10.8)**
At the end of the year	**83.0**	**25.1**	**142.5**	**13.7**	**264.3**
Accumulated depreciation					
At the beginning of the year (restated)	**7.8**	**18.4**	**111.0**	**–**	**137.2**
Charge for the year	**1.1**	**4.2**	**11.1**	**–**	**16.4**
Disposals	**(0.2)**	**(0.1)**	**(14.6)**	**–**	**(14.9)**
Impairment	**9.9**	**–**	**0.5**	**–**	**10.4**
At the end of the year	**18.6**	**22.5**	**108.0**	**–**	**149.1**
Net book value					
At the end of the year	**64.4**	**2.6**	**34.5**	**13.7**	**115.2**
At the beginning of the year	47.6	6.8	42.9	16.1	113.4

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

25. Property, plant and equipment continued

	Restated*				
2012	Land and buildings	Leasehold improvements	Computers and other equipment	Assets in the course of construction	Total
Cost					
*At the beginning of the year (as reported)**	*55.7*	*25.0*	*115.3*	–	*196.0*
At the beginning of the year	55.7	25.3	156.0	14.6	251.6
Additions	–	–	11.2	1.5	12.7
Disposals	(0.3)	(0.1)	(13.3)	–	(13.7)
At the end of the year	55.4	25.2	153.9	16.1	250.6
Accumulated depreciation					
*At the beginning of the year (as reported)**	*6.6*	*13.4*	*95.9*	–	*115.9*
At the beginning of the year	6.6	13.5	106.2	–	126.3
Charge for the year	1.2	5.0	16.5	–	22.7
Disposals	–	(0.1)	(11.7)	–	(11.8)
At the end of the year	7.8	18.4	111.0	–	137.2
Net book value					
At the end of the year	47.6	6.8	42.9	16.1	113.4
At the beginning of the year	49.1	11.8	49.8	14.6	125.3

Computers and other equipment and assets in the course of construction include £44.0m (net book value) (2012: £49.3m) of assets for which the Bank does not hold legal title, but the Directors are of the opinion that the assets meet the accounting criteria of an asset for the Bank. The assets are therefore accounted for on the Bank's balance sheet.

The Directors consider accounting for assets held by CFSMS a critical accounting judgement. Further details are provided in note 2.

* The 2012 comparatives have been restated as described in note 3.

	2013	2012
The net book value of land and buildings comprises:		
Freehold	**63.8**	47.1
Leasehold	**0.6**	0.5
	64.4	47.6

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

26. Other assets

In plain english:

The main component of other assets is amounts owed by The Co-operative Banking Group as a result of the LME.

	2013	2012
Amounts recoverable within one year:		
Trade debtors	**29.7**	59.9
Other assets	**21.4**	10.4
Amounts owed by The Co-operative Group	**23.1**	–
Amounts owed by The Co-operative Banking Group Limited	**303.2**	–
Amounts recoverable after more than one year:		
Amounts owed by The Co-operative Group	**103.5**	–
	480.9	70.3

Amounts owed by The Co-operative Group represents group relief recoverable of £126.6m. The group relief recoverable was recorded in current tax assets in the prior year. The £303.2m owed by The Co-operative Banking Group Limited represents the commitment to contribute £333.0m of CET1 (see note 4) after taking account of £20.0m received on 31 December 2013 and the effect of discounting.

Further details of the related party relationship of the Bank with The Co-operative Group are contained in note 39.

27. Prepayments and accrued income

In plain english:

Prepayments arise when we pay expenses in advance (eg insurance premiums). In effect, the prepaid amount is owed back to us until we incur the expense. Accrued income is income which has been earned but not yet received in cash.

	2013	2012
Other:		
Amounts recoverable within one year	**7.4**	8.5
Amounts recoverable after more than one year	**9.1**	6.4
	16.5	14.9

The 2012 comparatives have been re-presented to correct the analysis between amounts recoverable within and after more than one year.

Coming up:

The next few notes are designed to give you more information on our balance sheet liabilities. You will find explanations and tables breaking down the numbers into more detail.

28. Deposits by banks

In plain english:

Our main source of funding is retail deposits (customer accounts) but we also take deposits from other banks, on which we pay interest. The interest expense is included in the income statement (see the net interest income note 8).

	2013	2012
Items in course of collection	**40.9**	49.1
Deposits from other banks	**2,716.6**	3,562.9
	2,757.5	3,612.0

Included within deposits from other banks are liabilities of £1,028.3m (2012: £1,830.9m) secured on investment securities with a carrying value of £1,004.4m (2012: £1,907.4m) which have been sold under sale and repurchase agreements (note 41).

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

29. Customer accounts – capital bonds

In plain english:

We hold customers' savings in the form of capital bonds upon which we pay out returns that are linked to stock market performance. The Bank uses derivatives to control the cost of this funding (recorded as interest expense in the Bank income statement) by hedging stock market risk.

	2013	2012
Retail	**538.1**	888.1

Capital bonds are fixed term customer accounts with returns based on the movement in an index (eg FTSE 100) over the term of the bond.

The capital bonds have been designated on initial recognition at fair value through income and expense and are carried at fair value.

The fair values for the capital bonds are obtained on a monthly basis from the swap counterparties. These external valuations are reviewed independently using valuation software to ensure the fair values are priced on a consistent basis. None of the change in the fair value of the capital bonds is attributable to changes in the liability's credit risk.

The maximum amount the Bank would contractually be required to pay at maturity for all the capital bonds is £539.2m (2012: £888.7m).

The Bank uses swaps to create economic hedges against all of its capital bonds. The gain on capital bonds in the income statement for the year is £21.3m (2012: £33.0m). However, taking into account changes in fair value of the associated swaps, the net impact to the income statement for the year is a gain of £0.9m (2012: £0.1m).

30. Debt securities in issue

In plain english:

This note gives you more information on our debt securities (bonds and similar instruments) used as part of our wholesale funding programme. The majority are bonds with a variety of fixed and variable interest rates which we use to fund mortgages.

	2013	2012
Certificates of deposit	**5.1**	157.8
Commercial paper	**–**	8.2
Fixed and floating rate notes	**4,190.2**	4,547.7
	4,195.3	4,713.7

The Bank has entered into cross currency interest rate swaps that protect it from changes in exchange rates and interest rates on its debt securities in issue. Changes in the fair values of these swaps are largely offset by changes in the sterling equivalent carrying value of the debt securities in issue.

Debt securities in issue include fixed and floating rate notes, the majority of which are secured on portfolios of variable and fixed rate mortgages. Certain of these notes (securitisations) are redeemable in part from time to time, such redemptions being limited to the net capital received from mortgagors in respect of the underlying assets. There is no obligation for the Bank to make good any shortfall out of general funds. Other notes (covered bonds – secured, certificates of deposit and euro medium term notes – unsecured) require the Bank to repay contractual amounts due on specified maturity dates.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

31. Other borrowed funds

In plain english:

This note describes our long term wholesale funding. This is now all subordinated debt which means that it would rank lower in the pay out order if we were ever to be wound-up.

	2013	2012
Step up callable subordinated notes 2019	–	37.8
60,000,000 9.25% non-cumulative irredeemable preference shares of £1 each	–	60.0
Floating rate subordinated notes 2016	–	21.7
5.625% fixed rate subordinated notes 2021	–	8.7
9.25% fixed rate subordinated notes 2021	–	275.0
7.875% fixed rate subordinated notes 2022	–	235.4
Fixed rate subordinated notes 2024	–	173.7
Fixed rate subordinated notes 2033	–	125.4
Perpetual subordinated bonds	–	292.1
Fixed rate subordinated notes 2023	**206.0**	–
Issue costs, discounts and accrued interest	**(9.7)**	28.8
	196.3	1,258.6

The other borrowed funds balances include fair value adjustments for hedged risk (including merger fair value adjustments) of £nil (2012: £88.9m).

Liability Management Exercise

On 20 December 2013, the Bank completed the Liability Management Exercise (LME). As a consequence of the LME, all perpetual subordinated bonds and other subordinated bonds then outstanding were cancelled and the preference shareholder rights to income and capital were waived. New fixed rate subordinated notes were issued and are due to mature in 2023. Further details are provided below.

Fixed rate subordinated notes 2023

The subordinated notes were issued on 20 December 2013 and mature on 20 December 2023.

The notes are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders will be subordinated in right of payment to the claims of depositors and other creditors of the Bank.

The notes carry an annual interest rate of 11% to maturity. Interest is payable quarterly in arrears.

The notes are admitted to trading on the London Stock Exchange.

Notes to the Bank financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

31. Other borrowed funds continued

On 20 December 2013, the following notes were extinguished:

Step up callable subordinated notes 2019

The notes were issued on 1 April 2004 at a discount of 0.946%.

Floating rate subordinated notes 2016

The unsecured notes were issued on 18 May 2006 at a discount of 0.14%.

5.625% fixed rate subordinated notes 2021

The unsecured notes were issued on 16 November 2006 at a discount of 0.189%.

9.25% fixed rate subordinated notes 2021

On 28 April 2011 the Bank issued £275.0m fixed rate subordinated notes due 2021, at par.

7.875% fixed rate subordinated notes 2022

On 19 December 2012 the Bank issued £235.4m fixed rate subordinated notes due 2022, at par.

Fixed rate subordinated notes 2024

The notes were issued on 17 March 2004 at a discount of 1.148%.

Fixed rate subordinated notes 2033

The notes were issued on 28 March 2002 at a discount of 0.93%.

Perpetual subordinated bonds

Perpetual subordinated bonds (PSBs) with a par value of £110m were issued in 1992 at a discount of 0%. PSBs with a par value of £200m were issued in 2005 at a discount of 0%.

60,000,000 9.25% non-cumulative irredeemable preference shares of £1 each

The preference shares carried the right to a fixed non-cumulative preferential dividend on the capital for the time being paid up. As part of the LME, all the issued preference shares were transferred to The Co-operative Banking Group Limited, which waived all right to income and capital in respect of the preference shares.

Accordingly as there is no longer a present obligation of the Bank to pay dividends or capital on the preference shares £nil liability has been recorded.

32. Other liabilities

In plain english:

This note gives you more detail on other amounts that we owed at the balance sheet date and a breakdown of lease liabilities.

	2013	2012
Amounts falling due within one year:		
ATM creditor	**20.1**	61.5
Amounts owed to subsidiaries of The Co-operative Banking Group Limited	**156.5**	–
Other creditors	**21.5**	37.7
Amounts falling due after one year:		
Other creditors	**4.8**	4.8
	202.9	104.0

Amounts owed to subsidiaries of The Co-operative Banking Group includes £127.8m arising from the accounting for assets held by CFS Management Services Ltd but accounted for on the Bank balance sheet (as described in note 3) and £28.7m reflecting amounts owed in the normal course of business. Further details of the Bank's related party relationship with The Co-operative Banking Group are contained in note 39.

The ATM creditor relates to amounts owed to a third party for the provision of cash for the Bank's ATM machines. It is settled on a daily basis.

All amounts are stated in £m unless otherwise indicated

32. Other liabilities continued

Other creditors of the Bank include finance lease obligations as follows:

	Present value of lease payments		Future minimum lease payments	
	2013	2012	**2013**	2012
Due within one year	**–**	–	**–**	–
Due between one year and five years	**0.1**	0.1	**0.1**	0.1
Due after five years	**1.3**	1.2	**1.6**	1.6
	1.4	1.3	**1.7**	1.7

The future minimum lease payments have been discounted at LIBOR over the term of the lease to give the present value of these payments.

33. Accruals and deferred income

In plain english:

This note breaks down accruals (amounts owed to suppliers etc at the year end) and deferred income (income received in advance of it being earned) between short term and long term liabilities.

	2013	2012
Other:		
Amounts falling due within one year	**53.9**	19.5
Amounts falling due after one year	**0.2**	0.6
	54.1	20.1

Accruals falling due within one year include £18.0m for fees in relation to the LME which will be settled via CFSMS.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

34. Provisions for liabilities and charges

In plain english:

This note shows the potential obligations that we had at the end of the year to make future cash payments for a variety of past occurrences.

Our main provisions are for Payment Protection Insurance compensation, conduct and legal issues, separation costs and the expected cost of the Financial Services Compensation Scheme.

The note also shows new provisions made during the year, which appear as expenses in the Bank income statement.

	Note	**Property**	**FSCS levies**	**PPI**	**Conduct/ legal**	**Other**	**Total**
2013							
At the beginning of the year		**7.3**	**38.6**	**116.0**	**0.2**	**0.6**	**162.7**
Income statement movements:							
Provided in the year – net interest income	8	**–**	**–**	**–**	**194.5**	**–**	**194.5**
Provided in the year – operating expense	12	**16.7**	**25.6**	**–**	**–**	**35.3**	**77.6**
Provided in the year – operating expense – separation costs	12	**–**	**–**	**–**	**–**	**39.4**	**39.4**
Provided in the year – operating expense – other potential customer redress claims	12	**–**	**–**	**–**	**31.9**	**–**	**31.9**
Provided in the year – net fee and commission income	9	**–**	**–**	**103.0**	**82.1**	**–**	**185.1**
Released in the year – operating expense	12	**(0.4)**	**–**	**–**	**–**	**(0.3)**	**(0.7)**
Utilised during the year		**(0.5)**	**(24.6)**	**(85.2)**	**(4.1)**	**(0.1)**	**(114.5)**
At the end of the year		**23.1**	**39.6**	**133.8**	**304.6**	**74.9**	**576.0**
Provisions were analysed as follows:							
Amounts falling due within one year		**10.2**	**13.3**	**113.8**	**304.6**	**74.9**	**516.8**
Amounts falling due after one year		**12.9**	**26.3**	**20.0**	**–**	**–**	**59.2**
		23.1	**39.6**	**133.8**	**304.6**	**74.9**	**576.0**

	Note	Property	FSCS levies	PPI	Conduct/ legal	Other	Total
2012							
At the beginning of the year		6.9	25.0	61.7	7.2	1.2	102.0
Income statement movements:							
Provided in the year – operating expense	12	0.8	24.8	–	0.2	0.3	26.1
Provided in the year – net fee and commission income	9	–	–	149.7	–	–	149.7
Released in the year – operating expense	12	(0.3)	–	–	–	(0.6)	(0.9)
Released in the year – net fee and commission income	9	–	–	–	–	–	–
Utilised during the year		(0.1)	(11.2)	(95.4)	(7.2)	(0.3)	(114.2)
At the end of the year		7.3	38.6	116.0	0.2	0.6	162.7
Provisions were analysed as follows:							
Amounts falling due within one year		3.2	24.9	77.2	0.2	0.6	106.1
Amounts falling due after one year		4.1	13.7	38.8	–	–	56.6
		7.3	38.6	116.0	0.2	0.6	162.7

The Directors consider conduct and legal provisions a critical accounting judgement. Further details are provided in note 2.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

34. Provisions for liabilities and charges continued

Property

The Bank has a number of leasehold properties available for rent. Provisions are made when either the sub-lease income does not cover the rental expense or the property is vacant. The provision is based on the expected outflows during the remaining periods of the leases using a discount rate of 3.5%. In addition, dilapidation provisions are recorded to the extent that the Bank has incurred dilapidations and/or the dilapidation clause within the contract has been invoked. During the year £11.5m (2012: £nil) has been provided for this.

Financial Services Compensation Scheme (FSCS) levies

The FSCS has provided compensation to customers of financial institutions following the collapse of deposit takers in 2008. The compensation paid out to consumers is currently funded through loans from HM Treasury. The Bank will be liable to pay a proportion of the outstanding borrowings that the FSCS has borrowed from HM Treasury. Additionally, the Bank is obliged to pay its share of management expenses and compensation based upon the Bank's proportion of the total market protected deposits at 31 December of each year.

The ultimate FSCS levy to the industry as a result of the 2008 collapses cannot currently be estimated reliably as it is dependent on other factors that may affect amounts payable and the timing of amounts payable, including changes in interest rates, potential recoveries of assets by the FSCS and the level of protected deposits.

The Bank has provided £39.6m (2012: £38.6m) for its share of the levies raised by the FSCS including the interest on the loan from HM Treasury in respect of the levy years to 31 March 2015. The provision includes £27.5m in respect of the interest levy (2012: £27.7m). The Bank's interest levy provision calculation includes estimates of the total FSCS levy in each levy year and estimates of the Bank's market participation in each levy year. During 2012, the FSCS indicated that it expected to raise a capital levy to cover the estimated shortfall in the amounts recovered from the failed banks to repay HM Treasury loans made to the FSCS. The Bank has provided £12.1m (2012: £10.9m) in respect of its share of this levy.

Payment Protection Insurance (PPI)

Provisions have been made in respect of potential customer compensation claims relating to past sales of PPI. Claims are investigated on an individual basis and, where appropriate, compensation payments are made. For a number of years, the Bank, along with many other financial services providers, sold PPI alongside mortgage and non-mortgage credit products. The Bank stopped selling non-mortgage PPI in January 2009 and stopped selling mortgage PPI in March 2012.

The FSA issued a policy statement in August 2010, which amended the 'Disputes Resolution: Complaints' section of the FSA Handbook, setting out new rules for handling complaints, including complaints of PPI mis-selling. The Bank must comply with the policy statement which requires complainants to receive adequate redress and the Bank to deliver fair outcomes and treat customers fairly including non-complainants. An additional provision of £103.0m (2012: £149.7m) has been recognised in the year (note 9), in respect of the total expected cost to the Bank of carrying out this work and paying compensation, making total provisions raised of £347.0m (2012: £244.0m). Refer to note 2 for further detail on PPI.

Conduct/legal provisions

The £194.5m charged through net interest income consists of £109.5m relating to potential customer redress following identification of breaches of the technical requirements of the Consumer Credit Act, £33.0m relating to potential interest rate swap mis-selling, £22.0m relating to potential customer redress on secured arrears, £15.0m relating to potential conduct issues incurred but not reported, £13.0m relating to potential customer redress and other costs in relation to mortgage documentation and £2.0m of other conduct related provisions.

The £31.9m charged through operating expenses consists of £29.0m for potential customer redress relating to the processing of first payments on certain mortgages and £2.9m of other conduct related provisions.

The £82.1m charged through net fee and commission income consists of £31.0m relating to potential customer redress in relation to mortgage fees and charges, £26.1m for failings in the introduction of third party sales of card and identification protection products, £19.0m for potential customer redress in relation to arrears fees and charges and £6.0m of other conduct related provisions. Refer to note 2 for further detail on conduct and legal provisions.

Other

The net £35.0m charged through operating expenses consists of £20.0m in relation to a data quality provision, £7.6m relating to the provision for fraud costs relating to loans and advances to customers and £7.4m relating to other provisions.

In addition, £39.4m has been provided through operating expenses for costs associated with the separation of the Bank from The Co-operative Group.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

35. Deferred tax

In plain english:

This note describes the tax that the Bank may have to pay in future. Deferred tax arises from differences in the way that tax is calculated for accounts purposes and tax purposes.

Deferred taxes are calculated on all temporary differences under the liability method using a tax rate of 20% (2012: 23%).

The movements on the deferred tax accounts are as follows:

		2013			2012		
	Note	**Deferred tax asset**	**Deferred tax liability**	**Total**	Deferred tax asset	Deferred tax liability	Total
Deferred tax at the beginning of the year		**159.6**	**(121.4)**	**38.2**	130.2	(103.8)	26.4
(Charged)/credited to the income statement:							
Current year		**(23.6)**	**28.9**	**5.3**	15.1	(6.3)	8.8
Write off of prior year deferred tax asset	14	**(157.5)**	**–**	**(157.5)**	–	–	–
Prior year		**3.3**	**–**	**3.3**	9.3	(2.4)	6.9
		(177.8)	**28.9**	**(148.9)**	24.4	(8.7)	15.7
Credited/(charged) to other comprehensive income:							
Fair value unwinds		**–**	**–**	**–**	8.9	(8.9)	–
Cashflow hedges		**18.1**	**–**	**18.1**	3.5	–	3.5
Available for sale		**0.1**	**–**	**0.1**	(7.4)	–	(7.4)
		18.2	**–**	**18.2**	5.0	(8.9)	(3.9)
Deferred tax at the end of the year		**–**	**(92.5)**	**(92.5)**	159.6	(121.4)	38.2

The deferred tax asset above includes an offset for those deferred tax liabilities that are permissible to be offset.

The 2012 balance sheet comparatives have been re-presented to reflect that certain deferred tax liabilities cannot be offset against the deferred tax assets.

	2013		2012	
	Deferred tax asset	**Deferred tax liability**	Deferred tax asset	Deferred tax liability
Deferred tax comprises:				
Capital allowances on fixed assets and assets leased to customers	**1.4**	**–**	34.7	–
Fair value adjustments – The Co-operative Bank plc	**–**	**–**	65.6	–
Fair value adjustments – The Co-operative Bank subsidiaries	**–**	**(92.5)**	–	(121.4)
Other temporary differences	**–**	**–**	26.1	–
Tax losses carried forward	**–**	**–**	51.9	–
Pensions and other post-retirement benefits	**–**	**–**	0.9	–
Cashflow hedges	**(0.8)**	**–**	(18.9)	–
Unrealised appreciation on investments	**(0.6)**	**–**	(0.7)	–
	–	**(92.5)**	159.6	(121.4)

Net deferred tax assets expected to be recoverable after one year are £nil (2012: £159.6m).

Other temporary differences for the Bank of £nil (2012: £26.1m) include deferred tax assets/liabilities as a result of loss provisions on mortgage assets held by Special Purpose Entities (SPEs), taxation of SPEs under the securitisation regime and spreading of the tax effect of IFRS transitional adjustments.

The Directors consider the recoverability of deferred tax to be a critical accounting judgement. Further detail is provided in note 2.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

35. Deferred tax continued

The deferred tax charge/(credit) in the income statement comprises:

	2013	2012
Capital allowances on fixed assets and assets leased to customers	**33.3**	(8.8)
Fair value adjustments	**36.7**	42.0
Other temporary differences	**26.1**	1.5
Tax losses carried forward	**51.9**	(50.4)
Pensions and other post-retirement benefits	**0.9**	–
	148.9	(15.7)

Deferred tax assets totalling £271.4m (2012: £nil) have not been recognised where doubt exists over the availability of sufficient future taxable profits. Deferred tax assets from the prior year of £157.5m (2012: £nil) have been written off in the year. In addition, deferred tax assets of £113.9m in respect of the current year have not been recognised.

In the view of the Directors, the depletion of the Bank's capital following a series of charges in 2013 casts additional uncertainty as to the achievability of the Plan and therefore the certainty of future taxable profits. The Directors have concluded that additional capital needs to be raised, and will not consider the recognition of a deferred tax asset until that process is completed. The risks associated with the Bank's Plan are listed on pages 26 to 28.

Reductions in the UK corporation tax rate from 23% to 21% (effective from 1 April 2014) and 20% (effective from 1 April 2015) were substantively enacted on 2 July 2013. This will reduce the Bank's future current tax charge accordingly. The deferred tax liabilities at 31 December 2013 have been calculated based on the rate of 20% substantively enacted at the balance sheet date.

36. Pensions

In plain english:

The Co-operative Group Pension Scheme (Pace) is used by all companies in The Co-operative Group and in which the Bank continues to participate. Pace is a hybrid scheme, consisting of a defined benefit section and a defined contribution section.

Ordinarily, defined benefit schemes appear as an asset (when in surplus) or as a liability (when in deficit) on the balance sheet. However, because there is no reliable basis for identifying the Bank's share of the assets, liabilities and costs we report the scheme as though it were a defined contribution scheme (money purchase). As a result, the pension scheme does not appear on the balance sheet. Instead, we just show the pension contributions as an expense in the income statement.

This note gives you detailed information on the scheme assets, liabilities and all the assumptions we have made in reaching these values. In addition it provides details of the Britannia pension scheme, in which three of the Bank's subsidiaries participate and the Bank's small unfunded scheme.

Pension charge

The pension charge in the income statement at 31 December 2013 was £29.3m (2012: £34.0m) which includes £8m (2012: £10m) as the Bank's contribution to the Pace deficit recovery charge. Of this, £0.6m (2012: £1.2m) is included in operating costs incurred outside the normal course of business.

The Bank was charged £277.8m (2012: £291.3m) of employee related costs by CFSMS, of which approximately £24.8m (2012: £20.1m) was in relation to payments to Pace and £1.0m (2012: £12.3m) was in relation to the Britannia scheme.

The Co-operative Pension Scheme (Pace)

The Bank participates in Pace, a hybrid scheme, consisting of a defined benefit section and a defined contribution section.

At 31 December 2012 the scheme was a group plan, since all participating entities were within The Co-operative Group. It was accounted for on a defined contribution basis since there was no contractual agreement or stated Co-operative Group policy for charging the net defined benefit cost for the scheme as a whole to individual Co-operative Group entities. Therefore, the Bank did not recognise its share of the net defined benefit cost. The net defined benefit cost of the pension scheme was recognised fully by the sponsoring employer, which was the Co-operative Group Limited.

On 4 November 2013, The Co-operative Group and the Bank entered into an undertaking pursuant to which The Co-operative Group agreed with the Bank, subject to certain exceptions, not to require the Bank to cease to participate in Pace in connection with the Liability Management Exercise or any subsequent reduction in The Co-operative Group's shareholding in the Bank (including to nil). Should either The Co-operative Group or the Bank so request, the parties will enter into good faith discussions to agree on the separation of Pace, so that the scheme liability properly attributable to the Bank and an equivalent proportion of the scheme's assets would be transferred to a separate tax registered pension scheme, or a segregated section of Pace. Neither party shall be under an obligation to agree to any separation of the scheme that would result in a requirement to make material payments to or in respect of the scheme.

Separation of Pace will also require the co-operation of the Pace Trustee.

Following separation of the Bank from the wider Co-operative Group as a result of the Liability Management Exercise, the Bank is still a participating employer in the Pace scheme and the Pace scheme is considered to be a multi-employer scheme under IAS 19 Employee benefits (revised 2011).

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

36. Pensions continued

As a multi-employer pension scheme, Pace exposes the participating businesses to actuarial risks associated with the current and former employees of the other Co-operative Group companies. The proportion of Pace liabilities accrued by members whilst employees of the Bank are believed to represent a minority of total Pace liabilities. The Bank could however be liable for funding a greater proportion of Pace liabilities.

There are for example liabilities in Pace relating to benefits accrued by members whilst employed by CFSMS and working in the Bank's business. On 23 January 2014, following the legal separation of the Bank from the wider Co-operative Group, employment contracts for those employees who spend the majority of their time working on behalf of the Bank were transferred from CFSMS to the Bank. This will increase the number of Bank employees participating in the Pace scheme in 2014.

There may also be 'orphan liabilities' in Pace that do not relate to any current employer in Pace. The extent to which the Bank could be liable for funding a greater proportion of Pace liabilities will depend, inter alia, on what position is reached as to the Pace liabilities properly attributable to the Bank following discussions with The Co-operative Group. Such discussions are not yet substantively underway.

There is therefore currently insufficient information available to consistently and reliably identify the Bank's share of Pace liabilities and employer costs. For the above reasons the pension costs in respect of Pace are accounted for on a defined contribution basis in accordance with IAS 19 (revised 2011). Pension costs are recognised as an expense in the Bank income statement on a defined contribution basis as explained below.

The Pace scheme is not sectionalised and operates on a 'last man standing' basis. In the event that other participating employers become insolvent and the full statutory debt is not recovered on insolvency, the Bank would become liable for the remaining liabilities.

There is no agreed allocation of a deficit or surplus on (i) wind up of the Plan, or (ii) the entity's withdrawal from the Plan.

The key aspects of Pace are illustrated below.

Scheme information

Risks arising in Pace are identified at The Co-operative Group level, with the impact of any changes to contribution assessed under the Bank's risk management framework. The Bank is therefore exposed to potential future increases in required contributions and capital held for pension risk. The Pace Trustee, in consultation with The Co-operative Group, is responsible for the risk management arrangements for Pace agreeing suitable contribution rates, investment strategy and for taking appropriate professional advice as required.

Contribution payments

On an accounting basis the Pace scheme is in a surplus of £355.9m at 31 December 2013. Under the current arrangements the Bank does not have an unconditional right of refund of scheme assets on winding up or any right to reduction of contributions as a result of this surplus.

Based on advice from a qualified actuary, the contributions in respect of future service in the defined benefit section, payable by the participating entities were 16.7% of pensionable salaries, up to 6 October 2012. Thereafter, this was reduced to 16.0% of pensionable salaries to reflect an increase in member contributions. The next triennial valuation is currently in progress, the results of which are expected in 2014.

The Bank also pays contributions in respect of the employed members of the defined contribution sections of the scheme of either 2% or 8% of pensionable salaries.

On a funding basis the scheme is in a deficit position. The level of funding for the Pace scheme is agreed between The Co-operative Group and the Pace Trustee. Following the last actuarial triennial valuation in 2010, The Co-operative Group agreed a recovery plan with the Trustee of the scheme to contribute £20m per annum over 8 years to repay the £248m deficit agreed as at 5 April 2010. Although there is no formal allocation of defined benefit liabilities between the participating employers of the scheme, the Bank has paid £8m of the total deficit recovery contributions in 2013.

However the current recovery plan ending in 2019 between The Co-operative Group and the Pace scheme trustees may be insufficient to repay the latest valuation of the deficit. Following completion of the 2013 valuation, a new schedule of contributions and recovery plan will be agreed between The Co-operative Group and the Pace scheme Trustee following advice from the Independent Scheme Actuary. Neither The Co-operative Group, the Trustee, or the Bank is under an obligation to agree any separation of the Pace scheme that would result in material payments to the scheme, however The Co-operative Group has undertaken to agree with the Bank its proportion of employer contributions in Pace and, if not agreed, the matter will be referred to an independent third party. Accordingly, there is a wide range of outcomes regarding the duration and contribution requirements of a new schedule of contributions and recovery plan which make the overall contribution uncertain.

To the best of the Directors' knowledge and belief, having made reasonable enquiries, there is no contractual agreement determining how the funding deficit recovery contributions are funded by the participants, the Bank has not recognised a liability in respect of any part of the existing deficit funding.

A formal triennial valuation of Pace as at 5 April 2013 is underway but has not yet been completed. When completed it may reveal a significant funding deficit and The Co-operative Group and the Bank may discuss the Bank's contribution towards funding this. There is therefore a risk that in future periods the Bank will recognise significant liabilities in respect of the scheme in its accounts.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

36. Pensions continued

The key financial aspects of Pace are illustrated below. These amounts are not recognised within these financial statements and are therefore disclosed below:

Key assumptions of the Pace pension scheme

The key aspects of the Pace scheme are as follows:

	2013	2012
The principal assumptions used to determine the liabilities of the Pace scheme are:		
Discount rate	**4.45%**	4.60%
Rate of increase in salaries	**3.60%**	4.80%
Future pension increases where capped at 5.0% per annum	**3.60%**	3.30%
Future pension increases where capped at 2.5% per annum	**2.50%**	2.50%
Assumptions used to determine net pension cost for the Pace scheme are:		
Discount rate	**4.60%**	4.60%
Rate of increase in salaries	**4.80%**	4.80%

The average life expectancy (in years) for mortality tables used to determine scheme liabilities for the Pace scheme at the 2013 year end is:

	Male	Female
Life expectancy:		
Member currently aged 65 (current life expectancy)	**22.4**	**24.1**
Member currently aged 45 (life expectancy at age 65)	**24.3**	**26.0**

The balance sheet amounts attributable to the entire scheme are as follows:

	2013	2012
Fair value of plan assets	**7,486.5**	6,919.4
Present value of funded obligations	**(7,125.8)**	(6,532.1)
	360.7	387.3
Present value of unfunded obligations	**(4.8)**	(4.5)
	355.9	382.8

The asset allocations at the year end were as follows:

	2013	2012
Equities	**2,398.8**	2,145.0
Liability driven investments	**3,382.6**	3,390.5
Alternative growth	**994.2**	968.7
Property	**308.6**	276.8
Other	**402.3**	138.4

The table below shows the value of the assets in each category which have a quoted market price:

	2013	2012
Equities	**2,395.8**	2,135.7
Liability driven investments	**2,654.9**	2,620.0
Other	**338.2**	104.5

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

36. Pensions continued

Britannia pension scheme

The Britannia scheme is a hybrid scheme, consisting of a defined benefit section and a defined contribution section.

In 2009, following the transfer of engagements of Britannia Building Society, CFSMS, a Co-operative Group subsidiary, became principal employer of the scheme. The scheme closed on 6 October 2012 with active members at the date of closure being invited to join the Co-operative Pension Scheme (Pace) for future pension accrual. No future service contributions are payable to the scheme due to the closure of the scheme to future accrual. The Trustee agreed to wind up the defined contribution section from February 2013, with any remaining members given the option of transferring their funds to an alternative approved pension arrangement, or secured benefits with an insurance contract.

As at 31 December 2013 there is no requirement to pay deficit contributions in respect of the Britannia scheme. The next formal actuarial valuation of the scheme is expected to have an effective date of 5 April 2014.

Three wholly owned subsidiaries of the Bank (Platform, WMS and Britannia International) are participating employers in this scheme, they account for approximately 1% of members.

At 31 December 2012 the scheme was a group plan, since all participating entities were within The Co-operative Group. It was accounted for by the Bank's three participating subsidiaries on a defined contribution basis since there was no contractual agreement or stated Co-operative Group policy for charging the net defined benefit cost for the scheme as a whole to individual Co-operative Group entities. Therefore, the subsidiaries could not recognise their share of the net defined benefit cost. The net defined benefit cost of the pension scheme was recognised fully by the sponsoring employer, CFSMS.

Following separation of the Bank from the wider Co-operative Group as a result of the LME, these wholly owned subsidiaries are still participating employers in the Britannia scheme and the scheme is considered to be a multi-employer scheme under IAS 19 (revised 2011). The Bank does not have sufficient information to reliably and consistently measure its share of the obligation as a result of the minimal level of participation.

Nature of benefits

The funded element of the defined benefit section pays out pensions at retirement based on service to 6 October 2012 and final pay for employees who commenced employment prior to 1 September 2001, when it closed to new members. The unfunded element is a no charge supplementary arrangement for certain Executive Directors. Benefits under the unfunded arrangements are valued on the same assumptions as the funded defined benefits and are disclosed as unfunded obligations.

Scheme information

Risks arising in the Britannia scheme are identified in CFSMS, with the impact of any changes to contribution rates assessed under the Bank's risk management framework. The Bank is therefore exposed to potential future increases in required contributions and capital held for pension risk. The Britannia scheme trustee, is responsible for the risk management arrangements for the scheme, agreeing suitable contribution rates, investment strategy and for taking appropriate professional advice as required.

Indirect participation

In 2013 the Bank paid approximately £1.0m (2012: £12.3m) to CFSMS in relation to Britannia pension costs incurred in respect of CFSMS employees performing services on behalf of the Bank. The pension cost shown in these accounts is the actual contribution paid by the three subsidiaries. A fixed allowance for running expenses of £1.0m per annum is currently payable by CFSMS and recharged to the Bank.

As explained above, on 23 January 2014, following the legal separation of the Bank from the wider Co-operative Group, employment contracts for those employees who spend the majority of their time working on behalf of the Bank were transferred from CFSMS to the Bank and the role and function of CFSMS is now being reviewed. Once the review has been undertaken the accounting for the Britannia pension scheme will be reassessed in 2014.

The key aspects of the defined benefit section of the Britannia scheme are as follows:

	2013	2012
The principal assumptions used to determine the liabilities of the Britannia defined benefit scheme are:		
Discount rate	**4.45%**	4.60%
Rate of increase in salaries	**3.60%**	4.80%
Future pension increases where capped at 5.0% per annum	**3.60%**	3.30%
Future pension increases where capped at 2.5% per annum	**2.50%**	2.50%
Assumptions used to determine net pension cost for the Britannia defined benefit scheme are:		
Discount rate	**4.60%**	4.60%
Rate of increase in salaries	**4.80%**	4.80%

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

36. Pensions continued

The average life expectancy (in years) for mortality tables used to determine defined benefit scheme liabilities for the former Britannia Building Society scheme at the 2013 year end is:

	Male	Female
Life expectancy:		
Member currently aged 65 (current life expectancy)	**22.5**	**24.7**
Member currently aged 45 (life expectancy at age 65)	**24.3**	**26.6**

The amounts recognised in the balance sheet of CFSMS are as follows:

	2013	2012
Fair value of plan assets	**630.7**	602.7
Present value of funded obligations	**(604.2)**	(586.8)
	26.5	15.9
Pension surplus not recognised under IAS 19 (revised 2011)	**(26.5)**	(15.9)
Present value of unfunded obligations	**(3.1)**	(2.9)
	(3.1)	(2.9)

The asset allocations at the year end were as follows:

	2013	2012
Equities	**153.4**	150.7
Liability driven investments	**286.4**	289.3
Alternative growth	**100.6**	84.3
Property	**89.6**	78.4
Other	**0.7**	–

The table below shows the value of the assets in each category which have a quoted market price:

	2013	2012
Equities	**153.4**	150.7
Liability driven investments	**286.4**	289.3
Other	**0.1**	–

Notes to the Bank financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

36. Pensions continued

Bank (unfunded) pension scheme

The Bank also operates a small unfunded pension scheme.

	2013	2012	2011	2010	2009
Rate of increase of pensions in payment	**3.6%**	3.3%	3.3%	3.7%	3.8%
Rate of increase in salaries	**5.1%**	4.8%	4.8%	5.2%	5.3%
Discount rate	**4.7%**	4.6%	4.6%	5.2%	5.6%

The assumptions used by the actuary were the best estimates chosen from a range of possible actuarial assumptions which, due to the timescales covered, may not necessarily be borne out in practice.

The values of the assets and liabilities of the unfunded pension scheme were:

	2013	2012
Present value of unfunded obligations	**(4.0)**	(4.0)
Deficit in scheme	**(4.0)**	(4.0)
Related deferred tax asset	**0.9**	0.9
Net pension liability	**(3.1)**	(3.1)
Analysis of amount charged to income statement:		
Current service cost	**–**	–
Interest on pension scheme liabilities	**0.2**	0.2
	0.2	0.2

Changes in the present value of the scheme liabilities are as follows:

	2013	2012
Opening defined benefit liabilities	**4.0**	3.9
Current service cost	**–**	–
Interest on liabilities	**0.2**	0.2
Actuarial losses	**–**	–
Benefits paid	**(0.2)**	(0.1)
Closing defined benefit liabilities	**4.0**	4.0

Amounts recognised in the statement of comprehensive income:

	2013	2012
Actuarial losses on scheme liabilities during the year	**–**	–
Total scheme losses during the year	**–**	–

The amounts for the current year are as follows:

	2013	2012
Defined benefit obligation	**(4.0)**	(4.0)
Deficit in scheme	**(4.0)**	(4.0)
Experience adjustment on scheme liabilities	**–**	–
Experience adjustment on scheme assets	**–**	–

Notes to the Bank financial statements continued
For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

37. Contingent liabilities and commitments

In plain english:

Contingent liabilities are possible obligations whose existence will be confirmed only by uncertain future events or present obligations where the transfer of economic resources is uncertain and cannot reasonably be measured. Contingent liabilities are not recognised on the balance sheet but are disclosed if the outflow of resources is remote.

The tables below provide the contract amounts and risk weighted amounts of contingent liabilities and commitments. The contract amounts indicate the volume of business outstanding at the balance sheet date and do not represent amounts at risk. The risk weighted amounts have been calculated in accordance with the PRA rules.

The contingent liabilities, as detailed below, arise in the normal course of banking business and it is not practical to quantify their future financial effect.

	Unaudited		Unaudited	
	Contract amount 2013	**Risk weighted amount 2013**	Contract amount 2012	Risk weighted amount 2012
Contingent liabilities:				
Guarantees and irrevocable letters of credit	**86.4**	**45.4**	168.8	120.6
Other commitments:				
Documentary credits and short term trade related transactions	**0.8**	**0.2**	3.7	0.7
Forward asset purchases and forward deposits placed[1]	**570.1**	**152.1**	53.2	0.1
Undrawn formal standby facilities, credit lines and other commitments to lend (includes revocable and irrevocable commitments)[2]	**3,432.8**	**684.3**	4,713.4	1,065.0
	4,003.7	**836.6**	4,770.3	1,065.8

1. Forward asset purchases have significantly increased during the year in order to meet funding requirements.
2. Undrawn loan commitments include revocable commitments which are unused credit card limits of £1,968.1m (2012: £2,048.1m).

Assets pledged

Assets are pledged as collateral under repurchase agreements with other banks. These deposits are not available to finance the Bank's day to day operations. Mandatory reserve deposits are also held with the Bank of England in accordance with statutory requirements.

See note 41.d for further details of assets pledged.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

37. Contingent liabilities and commitments continued

Commitments under operating leases

The Bank leases various properties and equipment under non-cancellable operating lease arrangements. The leases have various terms, ranging from six months to 999 years. None of these leases are individually material and none have any material clauses. The table below discloses the minimum operating lease payments the Bank will be required to make over the remaining lives of the leases.

	Land and buildings 2013	**Equipment 2013**	Land and buildings 2012	Equipment 2012
Falling due:				
Within one year	**18.7**	**–**	21.9	0.3
Between one and five years	**50.7**	**0.4**	63.9	0.5
In five years or more	**70.0**	**–**	79.6	–
	139.4	**0.4**	165.4	0.8

The Bank leases a number of branch and office premises under operating leases. The leases typically run for a period of up to 25 years, with an option to renew the lease after that period. Lease payments are generally reviewed every three to five years to reflect market rentals.

The total value of future minimum sub-lease payments expected to be received under non-cancellable sub-leases for the Bank was £8.0m (2012: £9.1m).

Indemnification agreement

The Bank has an indemnification agreement, accounted for as a guarantee under IFRS 4, with CFSMS in which the Bank has agreed to indemnify CFSMS against all and any liability, loss, damage, costs and expense arising from the agreement (under which CFSMS provides certain assets and services to the Bank). This agreement will remain in place until a new agreement is put in place following the Bank separation as part of the LME.

Conduct issues

Given the high level of scrutiny regarding financial institutions' treatment of customers and business conduct from regulatory bodies, the media and politicians, there is a risk that certain aspects of the Bank's current or historic business, including, amongst other things, mortgages and relationship banking, may be determined by the Financial Conduct Authority (FCA) and other regulatory bodies or the courts as not being conducted in accordance with applicable laws or regulations, or fair and reasonable treatment in their opinion.

In particular, there is currently a significant regulatory focus on the sale practices and reward structures that financial institutions have used when selling financial products. There is a risk that there may be other regulatory investigations and action against the Bank in relation to conduct and other issues that the Bank is not presently aware of, including investigations and actions against it resulting from alleged mis-selling of financial products or the ongoing servicing of those financial products. The nature of any future disputes and legal, regulatory or other investigations or proceedings into such matters cannot be predicted in advance. Furthermore, the outcome of any ongoing disputes and legal, regulatory or other investigations or proceedings is difficult to predict.

Consumer Credit Act issues

The Consumer Credit Act regulates consumer lending and governs the way in which entities, including banks, providing consumer credit to retail customers carry out business. From 1 April 2014 the Financial Services and Markets Act 2000 also applies alongside certain retained provisions of the Consumer Credit Act. The Consumer Credit Act includes very detailed, prescriptive and highly technical requirements for lenders affecting customer documentation and which, in turn, impact how operational processes and IT systems are configured. While the Bank has identified certain instances where its documentation or processes have not been fully compliant with the technical requirements and has provided accordingly, there may be other instances which have not yet been identified. Breaches may have the effect of triggering periods of non-compliance during which an affected customer is not liable to pay interest.

Interest refunds would therefore need to be made in certain cases where a period of non-compliance has been previously triggered. The Bank is considering the operational implementation of the refunding of interest to customers where applicable. The Bank has not yet determined all aspects of such processes. The Bank has made no provision to pay interest on the amount of any refund.

An amount of £109.5m (2012: £nil) has been recognised to refund interest following identification of a number of breaches of the requirements of the Consumer Credit Act. As part of this process of identification, detailed and technical legal analysis has been carried out as to whether breaches of the technical requirements have in fact occurred, the nature of those breaches and the consequences which follow (which differ according to the precise nature of the breach). Such legal analysis by its nature involves judgement and assessment of the facts of particular circumstances. In the event that such legal analysis and judgements are determined to be wrong, the Bank could be exposed to a material additional liability. The amount of £109.5m which has been provided is the best estimate of the liability based on the legal analysis.

Notes to the Bank financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

37. Contingent liabilities and commitments continued

Regulatory and other investigations

The Bank is the subject of multiple regulatory and other investigations and enquiries into events at the Bank and circumstances surrounding them. These include:

- The Treasury Select Committee has been conducting an ongoing review which began in Q2 2013 and has focused on numerous concerns surrounding the Bank. The Committee will publish a report of its findings, the timing of which is not yet known.
- The Sir Christopher Kelly review was announced on 12 July 2013. Sir Christopher was jointly appointed by the Co-operative Group Limited and the Bank to review the events that led to the Bank's capital action plan to address its £1.5bn capital shortfall. It is looking at the decision to merge the Bank with Britannia Building Society in 2009 and the proposed acquisition of the Verde assets of Lloyds Banking Group. It will include an analysis of strategic decision making, management structures, culture, governance and accounting practices and aspects of the role of the Bank's auditors. The intention is for the findings to be publicised at The Co-operative Group's Annual General Meeting in May 2014.
- The Treasury announced by press release on 22 November 2013 that it would conduct an independent investigation into events at The Co-operative Bank plc and the circumstances surrounding them from 2008 including the Verde transaction and Britannia merger. The investigation will include a review of the conduct of regulators and Government but is not anticipated to commence until it is clear that it will not prejudice the outcome of the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) enforcement investigations.
- The PRA announced on 6 January 2014 that it is undertaking an enforcement investigation in relation to the Bank and as part of that investigation will consider the role of former senior managers.
- The FCA announced on 6 January 2014 that it will be undertaking enforcement investigations into events at the Bank. The investigation will look at the decisions and events up to June 2013.

The Bank is co-operating with all the investigating authorities. It is not possible to estimate the financial impact upon the Bank should any adverse findings be made.

Legal proceedings

The Bank is engaged in various other legal proceedings in the United Kingdom involving claims by and against it which arise in the ordinary course of business, including debt collection, mortgage enforcement, consumer claims and contractual disputes. The Bank does not expect the ultimate resolution of any of these proceedings to which the Bank is party to have a material adverse effect on its results of operations, cash flows or the financial position of the Bank. Provisions have been recognised for those cases where the Bank is able reliably to estimate the probable loss where the probable loss is not de minimis. See note 34.

Mortgage securitisation representations and warranties

In connection with the Bank's mortgage securitisations and covered bond transactions described in note 30 (Bank financial statements) and note 24 (Company financial statements), the Bank makes various representations and warranties relating to the mortgage loans, including in relation to ownership, compliance with legislation and origination procedures. If the representations and warranties are breached subject to any applicable materiality determination, the Bank may be required to repurchase the affected mortgage loans or in some circumstances pay compensation to the securitisation vehicle.

There is a risk that a number of the underlying matters giving rise to conduct and legal provisions set out in note 34 could have given rise to breaches of such representations and warranties. Accordingly there is a risk that the Bank may be required to pay compensation to repurchase affected mortgage loans in amounts that may reduce the Bank's liquidity.

The Bank is unable to estimate the extent to which the matters described above will impact it or how future developments may have a material adverse impact on the Bank's net assets, operating results or cash flows in any particular period.

Notes to the Bank financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

37. Contingent liabilities and commitments continued

Pensions

There is uncertainty over the amount that the Bank will have to pay while it continues to participate in Pace. The Bank's obligations to contribute to Pace would increase significantly if another large employer in Pace becomes insolvent while the Bank continues to participate. If the Bank seeks to address these risks by terminating its participation, the default position is that material liabilities in respect of the deficit in Pace will arise. The Co-operative Group and the Bank have agreed at either party's request to enter into good faith discussions to manage this by reaching agreement so that the liabilities properly attributable to the Bank (and an equivalent proportion of assets) would be transferred to a separate scheme, or a segregated section of Pace, on the Bank's exit but, as no arrangements have yet been agreed (and there is a risk that none can be agreed), there is uncertainty over the amount that the Bank will have to pay in the event that it exits Pace. Separation of Pace will also require the co-operation of the Pace Trustees, which may not be forthcoming.

The Pace scheme is not sectionalised and operates on a 'last man standing' basis. In the event that other participating employers become insolvent and the full statutory debt is not recovered on insolvency, the Bank would become liable for the remaining liabilities.

Other pensions risks and uncertainties include the risk to the Bank's capital and funds from the Bank's exposure to scheme liabilities (to the extent liabilities are not met by scheme assets), risks inherent in the valuation of scheme liabilities and assets, risks regarding the split of liabilities between the Bank and other participating employers while the Bank continues to participate in Pace and on exit from Pace and, in respect of the Britannia Scheme, risks on separation from The Co-operative Group.

In respect of the Britannia Scheme, the Bank will need to manage the liabilities that could arise on separation from The Co-operative Group; this will require the co-operation of the Trustees of the Britannia Scheme, which may not be forthcoming.

It is not practicable to provide an estimate of the financial impact of these matters or what effect if any that these matters may have upon the Bank's operative revenues, cash flows or financial position in any period.

Former Britannia Building Society pension scheme guarantee

Following the transfer of engagements of Britannia Building Society in 2009, the Britannia pension scheme transferred to CFSMS. Under the terms of this transfer the Bank entered into a deed of guarantee to provide assurance to the trustees of the pension scheme to support CFSMS in meeting its funding obligations to the scheme should CFSMS be unable to pay its obligations as they fall due. However, The Co-operative Group has undertaken to procure that if CFSMS is not controlled by the Bank, CFSMS will not take or omit to take any action without the Bank's prior agreement if the result would be to increase the Bank's liabilities or contributions in respect of the Britannia Scheme. The most recent actuarial report indicated that the funding deficit in the Britannia Scheme as at 5 April 2013 was £61.0m.

Tax treatment of separation

Until separation of the Bank from The Co-operative Group is complete, and the new arrangements referred to in the CFSMS-Bank Framework Agreement as detailed in note 39 have been entered into, the Bank will continue to be responsible for indemnifying CFSMS under the CFSMS-Bank Services Agreement. It is anticipated that the Bank will become the owner of the assets currently held by CFSMS for the provision of services exclusively to the Bank – it is expected that this will be achieved in a VAT efficient manner, but if this cannot be done, there is a potential VAT cost of £26m on the transfer of the Bank exclusive assets to the Bank.

As detailed in note 3 to the Bank financial statements, the Directors have reviewed and reconsidered the accounting treatment of the intangible asset in development and all other assets held on the balance sheet of CFSMS which were used solely by the Bank. The Directors have concluded that the Bank was substantially exposed to the risks and rewards of these assets and after considering the funding of the asset and CFSMS's lack of assets to absorb losses, the appropriate accounting treatment would be to hold these assets on the balance sheet of the Bank. The Bank has applied an approach to the tax and accounting treatment of the Bank exclusive assets. However, if, and that to the extent that, there is a change to this treatment, there may be an additional tax charge.

There will continue to be VAT charges incurred in respect of any assets that are supplied to the Bank under the CFSMS-Bank Services Agreement or the CFSMS-Bank Framework Agreement (as applicable). As such, the Bank will look to mitigate these VAT charges through the transfer of all or some of such assets to the Bank as soon as possible.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

38. Investments in joint ventures

In plain english:

This note gives information on the Bank's investment in joint ventures. More information on the Bank's subsidiaries (companies controlled by the Bank) can be found in note 24 to the Company financial statements. In the main, our subsidiaries are a mixture of leasing, property investment and specialist mortgage companies.

The Bank's investment in joint ventures is £4.7m (2012: £3.9m).

The Bank owns 49% of the ordinary shares in Britannia Personal Lending Limited, a company registered in England and operating in the UK. The company trades in the business of unsecured personal lending.

The Bank's interest in Britannia Personal Lending Limited is as follows:

	2013	2012
Current assets	**7.7**	11.8
Non current assets	**5.1**	6.6
	12.8	18.4
Current liabilities	**4.4**	10.7
Non current liabilities	**3.7**	3.8
Equity	**4.7**	3.9
	12.8	18.4
Income	**0.9**	1.7
Expenses	**(0.2)**	(0.1)
Profit before tax	**0.7**	1.6
Taxation	**–**	(0.4)
Profit after tax	**0.7**	1.2

Joint ventures are accounted for using the equity method.

The comparatives have been reclassified to reflect the figures per the 2012 statutory accounts of Britannia Personal Lending Limited. This had no effect on the Bank's interest.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

39. Related party transactions

In plain english:

We are required to disclose all the transactions that the Bank has entered into with individuals or companies who have a close relationship with our Bank. The disclosures are designed to help shareholders establish whether those transactions were conducted at arm's length on normal commercial terms.

Parent, subsidiary and ultimate controlling party

Up until 20 December 2013, The Co-operative Banking Group Limited owned approximately 100% of the issued ordinary share capital of the Bank. At 31 December 2012, of the 8.2 billion ordinary shares outstanding in the Bank, 8,199,999,960 were held by The Co-operative Banking Group and 40 were held directly by the Co-operative Group Limited. The ultimate holding organisation was the Co-operative Group Limited.

The ownership structure of the Bank changed on 20 December 2013 as a result of the LME. Further details are provided in note 4. As a result, The Co-operative Banking Group now owns approximately 30% of the Bank. The remaining, approximately 70%, is owned by a number of investors, none of which individually own more than 10%.

At 31 December 2013, the Bank is an associate of, and therefore a related party of, The Co-operative Group as The Co-operative Group owns 30% of the Bank's ordinary shares, has Bank Board representation and there are material transactions between the two companies.

Transactions with The Co-operative Group

The Bank has a significant relationship with The Co-operative Group. As part of the Recapitalisation Plan and in contemplation of the Bank ceasing to be a wholly owned subsidiary of The Co-operative Group, the Bank entered into the following agreements and several other arrangements.

Balances owed by The Co-operative Group to the Bank are shown on page 203. In total these exceed amounts owed by any other single counterparty and would exceed the Bank's risk appetite in the normal course of business. These obligations are currently performing in line with expectations and based on our investigations and the information provided, the Board considers that impairment is not required.

Relationship Agreement

In anticipation of the completion of the LME and the Bank ceasing to be a wholly-owned subsidiary of The Co-operative Group, the Bank entered into a relationship agreement with The Co-operative Group and The Co-operative Banking Group on 4 November 2013 (the Relationship Agreement) to regulate the basis of their ongoing relationship. For more information about the Relationship Agreement see the Corporate Governance Report – Relations with Shareholders.

Co-existence Principles

The Co-existence Principles govern the use of trademarks containing 'Co-operative' or 'Co-op' and other associated trademarks owned by both parties. For more information about the Co-existence Principles see the Corporate Governance Report – Relations with Shareholders.

2014 Commitment Agreement

On 4 November 2013, The Co-operative Banking Group entered into the 2014 commitment agreement with the Bank (the 2014 Commitment Agreement), conditional on the successful implementation of the LME, to subscribe for new ordinary shares in consideration for an irrevocable undertaking to pay £333m (the Undertaking to Pay). The Undertaking to Pay will be satisfied in several tranches, with (i) £20m paid in December 2013, (ii) £50m paid in January 2014, (iii) £100m due by 30 June 2014 and (iv) £163m payable by 31 December 2014.

The Undertaking to Pay provides that should The Co-operative Banking Group fail to meet its obligations under the Undertaking to Pay:

a) The Co-operative Banking Group must pay default interest at 9% p.a. accruing on a daily basis;

b) The Co-operative Banking Group waives all rights in respect of its new ordinary shares;

c) The Co-operative Banking Group and The Co-operative Group waive all rights under the Relationship Agreement;

d) The Co-operative Banking Group must procure the resignation of any nominee directors appointed by it or by The Co-operative Group;

e) The Bank may direct the security trustee to exercise any of its rights under the Intra-group Loan and the associated security; and

f) at the request of the Bank, The Co-operative Banking Group must transfer all or some of its new ordinary shares to a third party or the Bank for nil consideration in accordance with procedures set out in the Commitment Agreement.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

39. Related party transactions continued

Intra-group Loan

On 4 November 2013, the Bank, The Co-operative Banking Group and The Co-operative Group entered into an intra-group loan facility (the Intra-group Loan) whereby The Co-operative Group will make available to The Co-operative Banking Group during 2014 a term loan facility of up to £313m to be utilised by way of advances. The maturity date of the loan facility is 27 July 2019.

The purpose of the Intra-group Loan is to support The Co-operative Banking Group's Undertaking to Pay the Bank the agreed 2014 capital commitment as a result of the LME.

The Co-operative Banking Group has assigned to the Bank its rights against The Co-operative Group in the event that The Co-operative Group fails to provide The Co-operative Banking Group with a loan. A security assignment in respect of the Insurance Proceeds has been entered into between The Co-operative Banking Group and The Co-operative Group as security trustee for itself and the Bank to secure The Co-operative Banking Group's Undertaking to Pay and The Co-operative Banking Group's obligations as borrower under the Intra-group Loan.

Pensions Undertaking

On 4 November 2013, The Co-operative Group and the Bank entered into an undertaking whereby The Co-operative Group agreed with the Bank not to require the Bank to cease to participate in Pace in connection with the LME. The parties also agreed at the request of one of the parties to enter into good faith discussions to reach agreement on the separation of Pace and agree the Bank's proportion of employer contributions in Pace (and if not agreed, the matter will be referred to an independent third party). Further information is provided in note 36.

Transactions with CFSMS

The Bank has a significant relationship with CFS Management Services Limited (CFSMS). CFSMS is a subsidiary of The Co-operative Banking Group and undertakes the provision of supplies and services on behalf of the Bank. This relationship was in place for the whole of the year but will change over 2014 and beyond as the Bank separates from The Co-operative Group. Further details are provided below:

CFSMS-Bank Framework Agreement

On 16 February 2006, the Bank and CFSMS entered into the CFSMS-Bank Services Agreement pursuant to which CFSMS provides assets such as office equipment, materials and office space, and other facilities and services, and consultants who act as secondees to the Bank. The Bank provides CFSMS with an indemnity for all liabilities, losses, damages, costs and expenses of any nature as a result of CFSMS entering into and performing the agreement in respect of the assets, services and personnel provided to the Bank.

As a result of the LME, the Bank and CFSMS intend to replace the CFSMS-Bank Services Agreement with appropriate revised arrangements under a CFSMS-Bank Framework Agreement. Once agreed by the Bank and The Co-operative Group as part of the separation process, the CFSMS-Bank Framework Agreement will establish a flexible contractual framework that will enable the Bank to obtain from CFSMS the existing services and secondees, and procure the supply of third party procured services and assets that CFSMS provides to the Bank under the CFSMS-Bank Service Agreement and will also cover any new services for a transitional period.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

39. Related party transactions continued

Employees

CFSMS has previously employed a significant number of employees which perform tasks on behalf of the Bank (either on a full time or part of their time basis). Staff costs were then recharged to the Bank.

As described in note 13, the employment contracts of most of the employees that perform all of their tasks on behalf of the Bank have been transferred from CFSMS to the Bank with effect from 23 January 2014. Where CFSMS employees continue to provide services to the Bank, this is covered by service agreements between the companies.

The transfer was required to support the legal separation of the Bank from The Co-operative Group. Further transfers will occur in 2014 as the Bank completes its separation.

Tangible and intangible assets

Since its inception in 2006, CFSMS has held legal title to the majority of the tangible and intangible assets of The Co-operative Banking Group. This included the work in progress assets, in particular, the Core IT Banking system replacement. The Bank has previously provided funding for assets via an intercompany mechanism. Once assets were fully constructed and in use, the Bank received a recharge for its proportionate use of the asset.

The Bank has not historically recorded any of these assets on its balance sheet. The Directors have concluded that these assets meet the accounting criteria of an asset for the Bank and have therefore restated the 2012 balance sheet to report these assets (see note 3). Likewise the 2013 balance sheet also includes assets for which CFSMS holds legal title, but which satisfy the accounting criteria of an asset for the Bank.

As part of the separation activity, in 2014, the Bank intends to purchase the legal title of all Bank specific assets currently held by CFSMS.

Other services

During the year, CFSMS also incurred a significant volume of costs on behalf of The Co-operative Banking Group. Costs were then recharged to Banking Group companies, including the Bank, at cost.

Operating costs of £884.3m (2012: £779.7m) were charged to the Bank in this manner. £148.4m (2012: £150.0m) of these recharges related to the impairment of intangible assets relating to the development of new banking systems.

At 31 December 2013, the Bank owed £28.7m to CFSMS (2012: the Bank was owed £199.6m by CFSMS) as a result of the above arrangements.

This balance has moved from being an asset to a liability during the period as a result of assets for which CFSMS hold legal title being recorded on the Bank balance sheet as explained below.

The amounts due to CFSMS of £156.5m (2012: £78.0m) (shown as amounts due to Co-operative Banking Group Undertakings on the following pages) reflect amounts due in the normal course of business of £28.7m (2012: £199.6m) and £127.8m (2012: £277.6m) arising from the accounting treatment for assets for which CFSMS hold legal title, but which meet the accounting criteria of an asset for the Bank. These assets are recorded on the Bank balance sheet. The 2012 balance sheet has also been restated to reflect these assets as described in note 3.

A full review of the significant relationship with CFSMS is in progress as part of the legal separation of the Bank from the wider Co-operative Group. The above indemnification agreement will remain in place until a new agreement is signed as part of legal separation.

Notes to the Bank financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

39. Related party transactions continued

Separation

Prior to the LME, certain functions of the Bank were centralised and carried out by The Co-operative Group. There are two key arrangements in place under which the Bank receives the supply of services, assets and/or personnel:

1. Between 2011 and 2013, the Bank transferred a number of functions and a substantial number of personnel to The Co-operative Group and entered into arrangements whereby The Co-operative Group would provide certain services to the Bank. This project is known as Project Unity. Two key agreements in connection with Project Unity are:
   – the existing IT Services Agreement in relation to the provision of IT services to the Bank and other members of The Co-operative Banking Group; and
   – a Professional Master Services Agreement where the same parties entered into a number of individual service contracts in relation to the provision of other services.
2. CFSMS was established as a direct subsidiary of The Co-operative Banking Group in 2005 to enable economies of scale through the sharing of employees and sourcing of third party services across The Co-operative Banking Group, including the Bank. CFSMS provides services to the Bank under the CFSMS – Bank Services Agreement referred to above, under which the Bank gives a broad indemnity to CFSMS in respect of activities carried out by CFSMS for the Bank.

Following the announcement of the Bank's Recapitalisation Plan in June 2013 (the June Plan), the Bank and The Co-operative Group worked to amend certain provisions of the Project Unity and CFSMS Arrangements. Those amendments were close to finalisation when The Co-operative Group announced on 21 October 2013 that it was in discussion with bondholders, and that many elements of the June Plan would need to change in material respects to reflect the fact that the Bank would no longer be a subsidiary of The Co-operative Group. The change to the June Plan meant that there would be significant cost impacts if the Project Unity and CFSMS Arrangements were to continue in the form originally envisaged. In addition, the Bank did not consider it appropriate for the provision of personnel or supply of certain third party services and assets to the Bank to be housed in an entity that has ceased to be part of the same group as the Bank.

Separation Principles

Accordingly the Bank and The Co-operative Group have been working towards renegotiation of the arrangements under which the Bank receives staff and services from The Co-operative Group. These negotiations are complex and ongoing. Pending finalisation of the revised arrangements, the Bank and The Co-operative Group agreed high level principles (the Separation Principles) to govern their separation discussions.

The Separation Principles include an overarching agreement to act in good faith and, amongst other things:

– until alternative arrangements for Project Unity and the CFSMS Arrangements are agreed, The Co-operative Group will continue to provide services to the Bank under the same terms that such services are currently provided;

– for those costs allocated by The Co-operative Group in its sole discretion, the Bank and The Co-operative Group will take reasonable steps to avoid the Bank incurring costs incremental to those it currently incurs;

– The Co-operative Group and the Bank will mitigate costs arising for The Co-operative Group or the Bank from (i) The Co-operative Group being a less than 50% shareholder of the Bank or (ii) agreed steps taken in connection with the separation process;

– an additional mark-up (of no more than 20%) may be charged by The Co-operative Group for services provided under Project Unity after the LME but not in respect of the first 12 months in respect of all services;

– costs will be allocated between the Bank and The Co-operative Group on an equitable basis; and

– a working group consisting of representatives from the Bank and The Co-operative Group will be established to address and oversee the separation work-stream.

The Co-operative Group and the Bank have also agreed the basis on which Project Unity and the CFSMS Arrangements will be unwound.

Project Unity

As part of separation, the Bank will enter into a new IT Services Agreement (the New IT Service Agreement) and a new Master Services Agreement (the New MSA).

It is intended that the day to day operational management of the services supplied under the New IT Service Agreement is monitored by a Co-operative Group contract manager (as the supplier of services), a Bank contract manager (as a customer), function leads for The Co-operative Group and the Bank and risk, audit and compliance for the Bank. Under the New IT Service Agreement, The Co-operative Group will provide the Bank with the following services: colleague technology services, network services, core services, service management services and change management services.

The New MSA will be a framework agreement intended to establish a flexible contractual arrangement to enable the Bank and CFSMS to obtain certain professional services from The Co-operative Group as agreed from time to time in service contracts. Service contracts will be entered into in relation to secretariat, legal, corporate affairs, marketing, finance, corporate HR, people services, estates, Illius (property management), risk and internal audit.

CFSMS Arrangements

The existing CFSMS–Bank Services Agreement will be terminated once the terms of CFSMS Bank Framework Agreement have been finally agreed.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

39. Related party transactions continued

Balances with other Co-operative Group undertakings

In 2012, the Bank had an asset of amounts owed by other Co-operative Group undertakings of £0.3bn and had a liability of amounts owed to other Co-operative Group undertakings of £0.1bn.

These amounts reflected a mixture of intercompany trading accounts and balances arising out of banking services provided to Co-operative undertakings.

As a result of legal separation, The Co-operative Group and its undertakings are no longer treated as intercompany balances. Therefore, the 2013 Bank balance sheet reports £nil balances for amounts owed to/by other Co-operative Group undertakings.

The following tables present an analysis of the relevant balances as at 31 December 2013 and 31 December 2012 to aid comparability year on year:

Amounts owed by Co-operative Group Undertakings	2013	Restated 2012
The Co-operative Group	–	56.4
The Co-operative Banking Group Ltd	–	–
Subsidiaries of The Co-operative Banking Group Ltd	–	0.4
	–	56.8

Amounts owed to Co-operative Group Undertakings	2013	Restated 2012
The Co-operative Group	–	29.4
The Co-operative Banking Group Ltd	–	–
Subsidiaries of The Co-operative Banking Group Ltd	–	160.6
	–	190.0

The 2012 comparatives have been restated as described in note 3.

The table below provides an analysis of balances with The Co-operative Group and its undertakings at 31 December 2013 and their location within the Bank's balance sheet to aid comparability year on year.

	2013			
	Loans & advances to customers	Other assets	Customer accounts	Other liabilities
The Co-operative Group	110.1	126.6	(26.7)	–
The Co-operative Banking Group Ltd	–	303.2	(49.6)	–
Subsidiaries of The Co-operative Banking Group Ltd	–	–	(16.0)	(156.5)
	110.1	429.8	(92.3)	(156.5)

The following tables show the value of banking transactions with The Co-operative Group and its undertakings during the year.

	Interest and fees received 2013	Interest and fees paid 2013	Interest and fees received 2012	Interest and fees paid 2012
The Co-operative Group	5.0	0.6	4.3	0.2
The Co-operative Banking Group Ltd	–	–	–	–
Subsidiaries of The Co-operative Banking Group Ltd	0.7	–	1.0	–
	5.7	0.6	5.3	0.2

A number of banking transactions are entered into with related parties in the normal course of business on normal commercial terms. These include loans and deposits. Outstanding balances at the year end and related income and expense for the year is presented in the tables above.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

39. Related party transactions continued

Transactions with other related parties

Key management, as defined by IAS 24 (Related Party Disclosures), are considered to be Board and Executive members of the Bank, and Board and Executive members of the Bank's immediate and ultimate holding organisations. The volume of related party transactions with key management is provided below:

Directors, key management personnel and close family members

	2013	2012
Loans outstanding at the beginning of the year	**2.6**	2.2
Net movement	**(2.3)**	0.4
Loans outstanding at the end of the year	**0.3**	2.6
Deposits and investments at the beginning of the year	**2.4**	1.9
Net movement	**(2.2)**	0.5
Deposits and investments at the end of the year	**0.2**	2.4

Directors' loans

	Mortgages 2013	**Personal loans 2013**	**Credit cards 2013**	Mortgages 2012	Personal loans 2012	Credit cards 2012
Number of directors with loan type	**1**	**1**	**1**	5	2	4
Total value of directors' loans	**0.2**	**–**	**–**	1.0	–	–

Key management compensation

	2013	2012
Salaries and short term benefits	**3.4**	3.0
Termination benefits	**0.5**	1.4
	3.9	4.4

Executive Directors' remuneration

A list of the members of the Board of Directors is shown on page 38. The total remuneration of Executive Directors was £2.4m (2012: £0.6m).

Further details of Directors' remuneration are provided in the Remuneration report.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

40. Share capital

In plain english:

This note gives details of the share capital of the Bank. You can see the number of shares and also the amount of share capital (the number of shares multiplied by the nominal value of 5p). Share premium arises where new shares are issued at a price above nominal value.

	No. of shares (millions) 2013	**Share capital 2013**	No. of shares (millions) 2012	Share capital 2012
Issued capital (ordinary shares of 5p each)				
At the beginning of the year	**8,200**	**410.0**	8,200	410.0
Shares cancelled	**(8,200)**	**(410.0)**	–	–
Issue of new ordinary shares	**250**	**12.5**	–	–
At the end of the year	**250**	**12.5**	8,200	410.0
Allotted, called up and fully paid (ordinary shares of 5p each)				
At the beginning of the year	**8,200**	**410.0**	8,200	410.0
Shares cancelled	**(8,200)**	**(410.0)**	–	–
Issue of new ordinary shares	**250**	**12.5**	–	–
At the end of the year	**250**	**12.5**	8,200	410.0
Share premium account				
At the beginning of the year		**8.8**		8.8
Issue of new ordinary shares		**1,351.0**		–
At the end of the year		**1,359.8**		8.8

The ordinary shareholders have one vote for every share held.

See note 4 for details of shares cancelled and issued as a result of the LME.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

41. Fair values of financial assets and liabilities

In plain english:

This note summarises the total assets and liabilities of the Bank and provides information on how each asset/liability is measured. The note also presents a fair value for the assets/liabilities that are not held at fair value on the Bank balance sheet, along with details of the method of calculation.

In addition, the note provides details of the fair value of the transferred assets and associated liabilities within our securitisation vehicles and covered bonds.

The fair values in this note are stated at a specific date and may be significantly different from the amounts which will actually be paid on the maturity or settlement dates of the instruments. As a wide range of valuation techniques are available, it may be inappropriate to compare this fair value information to that of independent market or other financial institutions.

In 2013, the Bank reviewed and improved the methods used to calculate the fair values. The 2012 comparatives (with the exception of fair value adjustment for hedged risk and customer accounts) have been re-calculated accordingly to reflect these changes in methods.

The tables below analyse the balance sheet carrying values of financial assets and liabilities by classification.

Balance sheet categories	Held for trading	Designated at fair value	Loans and receivables	Available for sale	Liabilities at amortised cost	Derivatives in a hedging relationship	Total
2013							
Assets							
Cash and balances at central banks	–	–	5,418.8	–	–	–	5,418.8
Loans and advances to banks	–	–	1,594.4	–	–	–	1,594.4
Loans and advances to customers	–	134.2	30,188.0	–	–	–	30,322.2
Fair value adjustments for hedged risk	–	–	107.6	–	–	–	107.6
Investment securities	–	1,743.4	23.6	2,732.4	–	–	4,499.4
Derivative financial instruments	465.4	–	–	–	–	90.4	555.8
Equity shares	–	–	–	5.8	–	–	5.8
Other assets	–	–	480.9	–	–	–	480.9
Total financial assets	465.4	1,877.6	37,813.3	2,738.2	–	90.4	42,984.9
Non-financial assets							411.2
Total assets							43,396.1
Liabilities							
Deposits by banks	–	–	–	–	2,757.5	–	2,757.5
Customer accounts	–	–	–	–	32,463.3	–	32,463.3
Customer accounts – capital bonds	–	538.1	–	–	–	–	538.1
Debt securities in issue	–	–	–	–	4,195.3	–	4,195.3
Derivative financial instruments	191.7	–	–	–	–	346.9	538.6
Other borrowed funds	–	–	–	–	196.3	–	196.3
Other liabilities	–	–	–	–	202.9	–	202.9
Total financial liabilities	191.7	538.1	–	–	39,815.3	346.9	40,892.0
Non-financial liabilities							726.8
Total liabilities							41,618.8
Capital and reserves							1,777.3
Total liabilities and equity							43,396.1

IAS 39 requires derivative financial instruments that are not in a hedging relationship to be classified as 'held for trading', this definition differs from the definition of 'derivatives held for trading purposes' as shown in note 20.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

41. Fair values of financial assets and liabilities continued

Balance sheet categories	Held for trading	Designated at fair value	Loans and receivables	Available for sale	Liabilities at amortised cost	Derivatives in a hedging relationship	Total
2012							
Assets							
Cash and balances at central banks	–	–	5,433.0	–	–	–	5,433.0
Loans and advances to banks	–	–	1,904.1	–	–	–	1,904.1
Loans and advances to customers	–	153.6	33,185.9	–	–	–	33,339.5
Fair value adjustments for hedged risk	–	–	354.2	–	–	–	354.2
Investment securities	960.2	1,845.2	295.0	3,789.4	–	–	6,889.8
Derivative financial instruments	588.0	–	–	–	–	230.8	818.8
Equity shares	–	–	–	5.7	–	–	5.7
Amounts owed by other Co-operative Group undertakings	–	–	56.8	–	–	–	56.8
Other assets	–	–	70.3	–	–	–	70.3
Total financial assets	1,548.2	1,998.8	41,299.3	3,795.1	–	230.8	48,872.2
Non-financial assets							900.6
Total assets							49,772.8
Liabilities							
Deposits by banks	–	–	–	–	3,612.0	–	3,612.0
Customer accounts	–	–	–	–	35,884.4	–	35,884.4
Customer accounts – capital bonds	–	888.1	–	–	–	–	888.1
Debt securities in issue	–	–	–	–	4,713.7	–	4,713.7
Derivative financial instruments	285.7	–	–	–	–	681.9	967.6
Other borrowed funds	–	–	–	–	1,258.6	–	1,258.6
Amounts owed to other Co-operative Group undertakings	–	–	–	–	190.0	–	190.0
Other liabilities	–	–	–	–	104.0	–	104.0
Total financial liabilities	285.7	888.1	–	–	45,762.7	681.9	47,618.4
Non-financial liabilities							304.2
Total liabilities							47,922.6
Capital and reserves							1,850.2
Total liabilities and equity							49,772.8

The above table has been re-analysed to show all derivatives in a hedging relationship.

The 2012 comparatives have been restated as described in note 3.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

41. Fair values of financial assets and liabilities continued

a) Use of financial instruments

The use of financial instruments is essential to the Bank's business activities, and financial instruments constitute a significant proportion of the Bank's assets and liabilities. The main financial instruments used by the Bank, and the purposes for which they are held, are outlined below:

Loans and advances to customers and customer accounts

The provision of banking facilities to customers is the prime activity of the Bank, and loans and advances to customers and customer accounts are major constituents of the balance sheet. Loans and advances to customers include retail mortgages, corporate loans, credit cards, unsecured retail lending and overdrafts. Customer accounts include retail and corporate current and savings accounts.

Loans and advances to banks and investment securities

Loans and advances to banks and investment securities underpin the Bank's liquidity requirements and generate incremental net interest and trading income. Held for trading investments are traded solely for short term profit, however the Bank has now ceased this type of trade.

Deposits by banks and debt securities in issue

The Bank issues medium term notes within an established euro medium term note programme and also issues certificates of deposit and commercial paper as part of its normal treasury activities. These sources of funds, alongside other borrowed funds, are invested in marketable investment grade debt securities and short term wholesale market placements and are used to fund customer loans.

Other borrowed funds

The Bank utilises a broad spread of long term wholesale funding in the form of fixed rate subordinated debt in addition to funding from ordinary share capital and retained earnings. Refer to note 31 for details of changes to other borrowed funds as a result of the LME.

Derivatives

A derivative is a financial instrument that derives its value from an underlying rate or price such as interest rates, exchange rates and other market prices. Derivatives are an efficient means of managing market risk and limiting counterparty exposure. The Bank uses them mainly for hedging purposes and to meet the needs of customers.

The most frequently used derivative contracts are interest rate swaps, exchange traded futures and options, caps and floors, currency swaps and forward currency transactions. Terms and conditions are determined by using standard industry documentation. Derivatives are subject to the same market and credit risk control procedures as are applied to other wholesale market instruments and are aggregated with other exposures to monitor total counterparty exposure which is managed within approved limits for each counterparty.

Foreign exchange

The Bank undertakes foreign exchange dealing to facilitate customer requirements and to generate incremental income from short term trading in the major currencies. Structured risk and trading related risk are managed formally within position limits which are set by the Assets and Liabilities Committee, to which authority is delegated by the Board.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

41. Fair values of financial assets and liabilities continued

b) Valuation of financial assets and liabilities carried at fair value

The following tables analyse financial assets and liabilities carried at fair value by the three level fair value hierarchy as follows:

- Level 1 – Quoted market prices in active markets
- Level 2 – Valuation techniques using observable inputs
- Level 3 – Valuation techniques using unobservable inputs

	Fair value at end of the reporting period using:			
2013	**Level 1**	**Level 2**	**Level 3**	**Total**
Non-derivative financial assets				
Designated at fair value:				
Loans and advances to customers	–	125.5	8.7	134.2
Investment securities	1,743.4	–	–	1,743.4
Available for sale financial assets:				
Investment securities	2,497.2	235.2	–	2,732.4
Equity shares	0.1	5.7	–	5.8
Derivative financial instruments	–	525.3	30.5	555.8
Non-financial instruments				
Investment properties	–	157.9	6.2	164.1
Total assets carried at fair value	4,240.7	1,049.6	45.4	5,335.7
Non-derivative financial liabilities				
Designated at fair value:				
Customer accounts – capital bonds	–	538.1	–	538.1
Derivative financial instruments	–	477.4	61.2	538.6
Total liabilities carried at fair value	–	1,015.5	61.2	1,076.7

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

41. Fair values of financial assets and liabilities continued

2012	Fair value at end of the reporting period using: Level 1	Level 2	Level 3	Total
Non-derivative financial assets				
Held for trading:				
Investment securities	960.2	–	–	960.2
Designated at fair value:				
Loans and advances to customers	–	142.4	11.2	153.6
Investment securities	1,845.2	–	–	1,845.2
Available for sale financial assets:				
Investment securities	2,184.9	1,604.5	–	3,789.4
Equity shares	0.1	5.6	–	5.7
Derivative financial instruments	–	783.4	35.4	818.8
Non-financial instruments				
Investment properties	–	–	173.0	173.0
Total assets carried at fair value	4,990.4	2,535.9	219.6	7,745.9
Non-derivative financial liabilities				
Designated at fair value:				
Customer accounts – capital bonds	–	888.1	–	888.1
Derivative financial instruments	–	955.2	12.4	967.6
Total liabilities carried at fair value	–	1,843.3	12.4	1,855.7

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

41. Fair values of financial assets and liabilities continued

The carrying values of financial assets and liabilities measured at fair value are determined in compliance with the accounting policies in note 1 and according to the following hierarchy:

Level 1 – Quoted market prices in active markets

Financial instruments with quoted prices for identical instruments in active markets. The best evidence of fair value is a quoted market price in an actively traded market.

Level 2 – Valuation techniques using observable inputs

Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

The valuation techniques used to value these instruments employ only observable market data and relate to the following assets and liabilities:

Loans and advances to customers

Loans and advances to customers include corporate loans of £125.5m (2012: £142.4m) which are fair valued through income or expense using observable inputs. Loans held at fair value are valued at the sum of all future expected cash flows, discounted using a yield curve based on observable market inputs.

Investment securities – available for sale

Fair value is based on available market prices. Where this information is not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics.

Derivative financial instruments

Over-the-counter (ie non-exchange traded) derivatives are valued using valuation models which are based on observable market data. Valuation models calculate the present value of expected future cash flows, based upon 'no arbitrage' principles. The Bank enters into vanilla foreign exchange and interest rate swap derivatives, for which modelling techniques are standard across the industry. Examples of inputs that are generally observable include foreign exchange spot and forward rates, and benchmark interest rate curves.

Investment properties

Investment properties are carried at fair value. For those within level 2, fair value is calculated by using recent valuations of individual assets within the portfolio, indexed linked to the balance sheet date using the relevant regional house price index where appropriate.

Customer accounts – capital bonds

The estimated fair value of customer accounts – capital bonds is based on independent third party valuations using forecast future movements in the appropriate indices.

Equity shares

Equity shares primarily relate to investments held in Vocalink Limited which are unquoted shares. The valuation of these shares is based on the Bank's percentage shareholding and the net asset value of the company according to its most recently published financial statements.

Level 3 – Valuation techniques using unobservable inputs

This is used for financial instruments valued using models where one or more significant inputs are not observable.

The small proportion of financial assets valued based on significant unobservable inputs are analysed as follows:

Loans and advances to customers

Loans and advances to customers include 25 year fixed rate mortgages of £8.7m (2012: £11.2m) which are fair valued through income or expense using unobservable inputs. 25 year fixed rate mortgages are valued using future interest cash flows at the fixed customer rate and estimated schedule of customer repayments. Cash flows are discounted at a credit adjusted discount rate; the credit adjustment is based on the average margin of new long dated (five years or greater) fixed rate business written in the last six months, and subject to quarterly review. The eventual timing of future cash flows may be different from that forecast due to unpredictable customer behaviour, particularly on a 25 year product. The valuation methodology takes account of credit risk and has increased the valuation by £0.8m in 2013 (2012: £0.5m increase). A reasonable change in the assumptions would not result in any material change in the valuation.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

41. Fair values of financial assets and liabilities continued

Derivative financial instruments

Derivative financial instruments in the form of interest rate swaps have been entered into between the Bank and its subsidiaries, and external counterparties.

The purpose of the swaps are to convert the fixed and base rate linked revenue receipts of the pool of mortgage assets to the same LIBOR linked basis as the intercompany loan. Under this swap arrangement the Bank's subsidiaries pay to the swap counterparty, the monthly mortgage revenue receipts of the pool of assets and receives from the swap counterparty LIBOR plus a contractual spread on the same notional balance, the spread being sufficient to cover the intercompany loan and any expenses. The Bank has a 'back to back' swap that is the mirror image of the subsidiaries' swaps.

The swaps are valued based on an assumed amortisation profile of the pool of assets to the bond maturity date (assuming some annual prepayment), an assumed profile of customer receipts over this period, and LIBOR prediction using forward rates. Swap cash flows are discounted to present value using mid-yield curve zero coupon rates, ie no adjustment is made for credit losses, nor for transaction or any other costs.

Investment properties

Investment properties within level 3 are valued by taking the original price, index linked to the balance sheet date using the relevant house price index.

Movements in fair values of instruments with significant unobservable inputs (level 3) were:

	Fair value at the beginning of the year	Purchases and transfers in	Sales and transfers out	Income or expense including impairment	Fair value at the end of the year
2013					
Loans and advances to customers	**11.2**	**–**	**(1.7)**	**(0.8)**	**8.7**
Derivative assets	**35.4**	**12.6**	**(22.6)**	**5.1**	**30.5**
Derivative liabilities	**(12.4)**	**(52.0)**	**0.6**	**2.6**	**(61.2)**
Investment properties	**173.0**	**–**	**(166.6)**	**(0.2)**	**6.2**
	207.2	**(39.4)**	**(190.3)**	**6.7**	**(15.8)**
2012					
Loans and advances to customers	12.4	–	–	(1.2)	11.2
Derivative assets	25.4	–	–	10.0	35.4
Derivative liabilities	(13.3)	–	–	0.9	(12.4)
Investment properties	172.7	1.0	(0.9)	0.2	173.0
	197.2	1.0	(0.9)	9.9	207.2

During the year, the methodology for calculating the fair value of investment properties was amended as explained in note 24. The majority of investment property meets the level 2 fair value hierarchy.

c) Fair values of financial assets and liabilities not carried at fair value

The carrying values of financial instruments measured at amortised cost are determined in compliance with the accounting policies in note 1.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

41. Fair values of financial assets and liabilities continued

The table below sets out a summary of the carrying and fair values of:

- financial assets classified as loans and receivables; and
- financial liabilities classified as held at amortised cost,

unless there is no significant difference between carrying and fair values.

	Carrying value	**Fair value**
2013		
Financial assets		
Loans and receivables		
Loans and advances to banks	**1,594.4**	**1,594.4**
Loans and advances to customers	**30,188.0**	**27,813.0**
Fair value adjustments for hedged risk	**107.6**	**107.6**
Investment securities	**23.6**	**21.4**
Other assets	**480.9**	**480.9**
Financial liabilities		
Financial liabilities at amortised cost		
Deposits by banks	**2,757.5**	**2,757.4**
Customer accounts	**32,463.3**	**32,488.3**
Debt securities in issue	**4,195.3**	**4,702.6**
Other borrowed funds	**196.3**	**234.2**
Other liabilities	**202.9**	**202.9**

	Carrying value	Fair value (as reported)[1]	Fair value (applying 2013 methodology)[2]
2012			
Financial assets			
Loans and receivables			
Loans and advances to banks	1,904.1	1,902.9	1,904.1
Loans and advances to customers	33,185.9	33,222.7	29,827.4
Fair value adjustments for hedged risk	354.2	354.2	354.2
Investment securities	295.0	302.3	297.9
Amounts owed by other Co-operative Group undertakings	56.8	56.8	56.8
Other assets	70.3	70.3	70.3
Financial liabilities			
Financial liabilities at amortised cost			
Deposits by banks	3,612.0	3,626.8	3,614.4
Customer accounts	35,884.4	36,108.4	36,108.4
Debt securities in issue	4,713.7	4,939.7	5,433.5
Other borrowed funds	1,258.6	1,161.3	1,394.1
Amounts owed to other Co-operative Group undertakings	190.0	190.0	190.0
Other liabilities	104.0	104.0	104.0

Amounts owed by other Co-operative Group undertakings has been restated as described in note 3.

1. As reported in the published 2012 report and accounts.
2. In 2013, the Bank reviewed and improved the methods used to calculate the fair values. The 2012 comparatives (with the exception of fair value adjustment for hedged risk and customer accounts) have been recalculated accordingly to reflect these changes in methods. As part of this recalculation, only data that was available at the time of approving the 2012 accounts has been considered.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

41. Fair values of financial assets and liabilities continued

Key considerations in the calculation of fair values for loans and receivables and financial liabilities at amortised cost are as follows:

Loans and advances to banks/deposits by banks

Loans and advances to banks include interbank placements and items in the course of collection.

The amortised cost value of all loans and advances to banks are deemed to be a close approximation of their fair value due to their short maturity. The estimated fair value of fixed interest bearing deposits is based on discounted cash flows using prevailing money market interest rates for debts with similar credit risk and remaining maturity.

Loans and advances to customers

The fair value of loans and advances to customers is calculated by segmenting the overall balance into Retail, Optimum and Corporate.

i. Retail

Fixed rate loans and advances to customers are revalued to fair value based on future interest cash flows (at funding rates) and principal cash flows discounted using an appropriate market rate. Forecast principal repayments are based on redemption at the earlier of maturity or repricing date with some overlay for historical behavioural experience where relevant. The eventual timing of future cash flows may be different from the forecast due to unpredictable customer behaviour. It is assumed there is no fair value adjustment required in respect of interest rate movement on standard variable rate assets.

ii. Optimum

Fair values have been calculated using an origination spread income approach. Under this approach, value is measured by determining discounted expected cash flows, derived using redemption profiles from the portfolio and applying an origination spread which reflects the difference between current market rates for products with similar characteristics and risk profiles and the actual rates the portfolio is generating.

iii. Corporate

As part of the implementation of the Bank's strategy for Non-core assets, certain assets have either already been sold after the year end or plans to sell are well advanced. For these assets, the fair value can therefore be determined from the actual sale price achieved or expected to be received.

For other corporate assets an expected cashflow income approach has been used. Under this approach, value is measured by determining expected cash flows derived using redemption profiles from the portfolio and then considering credit costs, funding costs and tax to derive cash flows which are discounted at an appropriate blended cost of capital.

The fair value of loans and advances to customers is 92% of the carrying value as at 31 December 2013 (2012 when applying 2013 methodology: 90%). The overall fair values are less than par primarily due to two main factors for Non-core loans in particular:

1. Customer interest rates are below the market rate at the balance sheet date until expected maturity or the repricing date, if earlier; and
2. Credit risk adjustments due to incurred and expected future credit losses.

Investment securities

Fair value is based on available market prices. Where this information is not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics.

Customer accounts

The estimated fair value of deposits with no stated maturity, which includes non-interest bearing deposits, is the amount repayable on demand. The estimated fair value of fixed interest bearing deposits and other borrowings without quoted market prices is based on future interest cash flows (at funding rates) and principal cash flows, discounted using an appropriate market rate.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

41. Fair values of financial assets and liabilities continued

Debt securities in issue and other borrowed funds

The aggregate fair values are calculated based on quoted market prices. For those notes where quoted market prices are not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics. Quoted prices may be from inactive markets.

The fair value of debt securities in issue is significantly above the carrying value as a result of the carrying value being net of merger fair value adjustments. The carrying values of debt securities in issue are expected to increase, as the merger fair value adjustments continue to unwind, by £110m in 2014, £150m in 2015, £180m in 2016 and by £60m in 2017.

2012 comparatives (as reported)

The table on page 213 provides the 2012 fair value comparatives as reported in the 2012 Annual Report and Accounts and the 2012 fair value comparatives re-presented using the 2013 methodology (as described above). The most significant difference in fair value arising from the two methodologies is on loans and advances to customers. The following section summarises the methodology adopted for the 2012 Annual Report and Accounts.

At 31 December 2012, the methodology used to estimate the fair value of loans and advances to customers is summarised in note 39 of the financial statements of the 2012 Annual Report and Accounts. The key aspects of this methodology, with reference to the financial instrument risks that have the greatest impact on fair value, are summarised below.

a) Expected lives of financial instruments were based on updated forecasts of prepayment curves, based on recent actual experience in each key portfolio.

b) Interest rate adjustments were calculated on the non-administered rate (fixed and LIBOR/base tracker rates) across the Retail, Optimum and Corporate books. The cash flows on these books were discounted using LIBOR/SONIA yield curves. The interest rate adjustment calculated at 31 December 2012 was £961m (positive), from which the fair value adjustment for hedged risk (£354m) was removed as this was already included in the carrying value of the loans and advances, leaving a total interest rate risk adjustment of £607m (positive).

c) Credit risk adjustments were made based on the expected loss calculations for all the portfolios reported in the FSA004 regulatory returns. The total credit risk adjustment applied was £1,137m (negative), from which the accounting provisions held at 31 December 2012 (£567m) were deducted to leave a total net adjustment of £570m. The credit risk adjustment was also applied to ex-Britannia loans and advances, which were acquired at fair value in 2009, as the credit risk component of the valuation at that time proved to be too small by 31 December 2012. The credit risk adjustment was considered to represent a reasonable proxy for lifetime expected losses plus an unquantified risk premium adjustment.

d) The percentage difference between the fair value and the carrying value of total loans and advances was compared with similar financial institutions and was broadly consistent.

Fair values of financial assets which are not carried at fair value and bases of valuation

Fair values are determined according to the hierarchy set out on page 211.

	Carrying value	Level 1	Level 2	Level 3
2013				
Financial assets				
Loans and receivables				
Loans and advances to customers	**30,188.0**	**–**	**–**	**27,813.0**
Fair value adjustment for hedged risk	**107.6**	**–**	**–**	**107.6**
Investment securities	**23.6**	**21.4**	**–**	**–**
Financial liabilities				
Financial Liabilities at amortised cost				
Customer accounts	**32,463.3**	**–**	**32,488.3**	**–**
Debt securities in issues	**4,195.3**	**892.5**	**3,810.1**	**–**
Other Borrowed funds	**196.3**	**–**	**234.2**	**–**

The carrying amount is a reasonable approximation of fair value for the following assets and liabilities; loans and advances to banks, fair value adjustments for hedged risk, other assets, deposits by banks and other liabilities.

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

41. Fair values of financial assets and liabilities continued

d) Fair value of transferred assets and associated liabilities

Securitisation vehicles

The beneficial ownership of the loans and advances to customers sold to securitisation vehicles by the subsidiaries of the Bank fail the derecognition criteria, and consequently, these loans remain on the balance sheets of the sellers. Each seller therefore recognises a deemed loan financial liability on its balance sheet and an equivalent deemed loan asset is held on each securitisation company's balance sheet. The deemed loans are repaid as and when principal repayments are made by customers against these transferred loans and advances.

The securitisation vehicles have issued fixed and floating rate notes which are secured on the loans and advances to customers. The notes are redeemable in part from time to time, such redemptions being limited to the net capital received from mortgagors in respect of the underlying assets.

The Bank retains substantially all of the risks and rewards of ownership. The Bank benefits to the extent to which surplus income generated by the transferred mortgage portfolios exceeds the administration costs of those mortgages. The Bank continues to bear the credit risk of these mortgage assets.

The results of the securitisation vehicles listed in note 24 of the Company Financial Statements are consolidated into the results of the Bank. The table below shows the carrying values and fair values of the assets transferred to securitisation vehicles and their associated liabilities. The carrying values presented below are the carrying amounts as recorded in the books of the subsidiaries companies, some of these issued notes are held internally by the Company and as such are not shown in the consolidated balance sheet of the Bank.

In 2013, the Bank reviewed and improved the methods used to calculate the fair values. The 2012 comparatives (with the exception of fair value adjustment for hedged risk and customer accounts) have been recalculated accordingly to reflect these changes in methods.

	Carrying amount of transferred assets not derecognised	Carrying amount of associated liabilities	Fair value of transferred assets not derecognised	Fair value of associated liabilities	Net position
2013					
Leek Finance Number Seventeen plc	**588.8**	**624.6**	**490.9**	**619.4**	**(128.5)**
Leek Finance Number Eighteen plc	**703.1**	**762.5**	**592.3**	**748.1**	**(155.8)**
Leek Finance Number Nineteen plc	**680.5**	**749.6**	**573.0**	**737.1**	**(164.1)**
Leek Finance Number Twenty plc	**1,438.2**	**1,413.3**	**1,135.1**	**1,364.0**	**(228.9)**
Leek Finance Number Twenty One plc	**850.1**	**864.1**	**770.1**	**784.6**	**(14.5)**
Leek Finance Number Twenty Two plc	**372.6**	**389.0**	**309.1**	**356.0**	**(46.9)**
Meerbrook Finance Number Six Limited	**–**	**–**	**–**	**–**	**–**
Silk Road Finance Number One plc	**1,466.4**	**1,481.2**	**1,466.4**	**1,486.3**	**(19.9)**
Silk Road Finance Number Two plc	**562.0**	**561.1**	**562.5**	**563.4**	**(0.9)**
Silk Road Finance Number Three plc	**583.1**	**597.9**	**584.2**	**604.6**	**(20.4)**
Cambric Finance Number One plc	**1,339.8**	**1,384.5**	**1,238.8**	**1,310.9**	**(72.1)**
Meerbrook Finance Number Eight Ltd	**625.9**	**635.8**	**616.1**	**601.4**	**14.7**
	9,210.5	**9,463.6**	**8,338.5**	**9,175.8**	**(837.3)**

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

41. Fair values of financial assets and liabilities continued

Transferred assets include securitised gilts and loans and advances to customers that have not been derecognised by the seller. The associated liabilities include the fixed and floating rate notes, bank loans and intercompany loans that specifically relate to the funding for the assets securitised.

The difference between the fair value and carrying value of the mortgages that have been securitised within Leek 17, 18 and 19 is significantly higher than the fair value to carrying value difference for the associated liabilities. This is because it is expected that the notes will be repaid at par at the call date of the Leek liabilities whereas most of the mortgages will continue to be held on the Bank's balance sheet for a significant period after the notes have repaid and these mortgages have an interest rate which is below the equivalent market rate at the balance sheet date for loans of a similar nature.

The securitisation vehicles receive cash daily in relation to the transferred loans and advances and semi-annually for the transferred gilts. These amounts are held within loans and advances to banks until the associated liabilities' payments are due. Payments are made quarterly for all associated liabilities except for the variable funding notes associated with the transferred gilts, which are paid semi-annually. The amounts held within loans and advances to banks are not included in the table above but will be used in part to cover the repayments made on the associated liabilities.

The following table provides the fair value of the transferred assets and associated liabilities for 2012 re-calculated on the basis of the new methodology applied in 2013.

	Carrying amount of transferred assets not derecognised	Carrying amount of transferred liabilities not derecognised	Fair value of transferred assets not derecognised (applying 2013 methodology)	Fair value of associated liabilities	Net position (applying 2013 methodology)
2012 – applying 2013 fair value methodology					
Leek Finance Number Seventeen plc	618.3	648.9	498.8	636.7	(137.9)
Leek Finance Number Eighteen plc	735.0	794.0	598.4	770.7	(172.3)
Leek Finance Number Nineteen plc	713.9	787.0	579.4	774.4	(195.0)
Leek Finance Number Twenty plc	1,514.8	1,488.6	1,112.3	1,491.8	(379.5)
Leek Finance Number Twenty One plc	926.1	944.0	810.5	928.3	(117.8)
Leek Finance Number Twenty Two plc	394.2	411.4	305.0	406.4	(101.4)
Meerbrook Finance Number Six Limited	77.3	58.3	76.8	58.3	18.5
Silk Road Finance Number One plc	1,764.4	1,778.9	1,764.4	1,788.1	(23.7)
Silk Road Finance Number Two plc	697.1	675.3	696.9	681.5	15.4
Silk Road Finance Number Three plc	689.1	699.5	684.1	711.3	(27.2)
Cambric Finance Number One plc	1,644.5	1,684.3	1,525.7	1,679.9	(154.2)
	9,774.7	9,970.2	8,652.3	9,927.4	(1,275.1)

	Carrying amount of transferred assets not derecognised	Carrying amount of associated liabilities	Fair value of transferred assets not derecognised	Fair value of associated liabilities	Net position
2012 – as per published report and accounts					
Leek Finance Number Seventeen plc	618.3	648.9	614.6	636.8	(22.2)
Leek Finance Number Eighteen plc	735.0	794.0	730.9	770.0	(39.1)
Leek Finance Number Nineteen plc	713.9	787.0	708.8	774.4	(65.6)
Leek Finance Number Twenty plc	1,514.8	1,488.6	1,498.4	1,491.8	6.6
Leek Finance Number Twenty One plc	926.1	944.0	916.9	928.3	(11.4)
Leek Finance Number Twenty Two plc	394.2	411.4	391.5	406.4	(14.9)
Meerbrook Finance Number Six Limited	77.3	58.3	76.8	58.3	18.5
Silk Road Finance Number One plc	1,764.4	1,778.9	1,764.4	1,794.2	(29.8)
Silk Road Finance Number Two plc	697.1	675.3	696.9	685.2	11.7
Silk Road Finance Number Three plc	689.1	699.5	684.1	712.9	(28.8)
Cambric Finance Number One plc	1,644.5	1,684.3	1,637.5	1,679.9	(42.4)
	9,774.7	9,970.2	9,720.8	9,938.2	(217.4)

Notes to the Bank financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

41. Fair values of financial assets and liabilities continued

Covered Bond Limited Liability Partnerships

Moorland Covered Bonds LLP was established as a result of a £1.4bn covered bond retained issuance. Loans and advances to customers of £1.9bn were transferred to Moorland Covered Bonds LLP. The transfer was funded by a loan of £1.4bn and capital contribution of £0.5bn. During October 2011 the £1.4bn loan was repaid. Following additional capital contribution repayment and on achieving Regulated Covered Bond status there was a public issuance of notes in November 2011 totalling £0.6bn. As a result of these changes, at the year end the Bank held a loan of £0.6bn (2012: £0.6bn) and a capital contribution of £0.9bn (2012: £1.2bn) with Moorland Covered Bonds LLP.

Moorland Covered Bonds LLP does not have ordinary share capital. The Bank's interest in Moorland Covered Bonds LLP is in substance no different from a wholly owned subsidiary and consequently it is fully consolidated in the Bank accounts. The table below shows the carrying values and fair values of the assets transferred to the covered bond and their associated liabilities:

	Carrying amount of transferred loans and advances to customers	**Carrying amount of fixed and floating rate notes**	**Fair value of transferred loans and advances to customers**	**Fair value of fixed and floating rate notes**	**Net position**
2013					
Moorland Covered Bonds LLP	**1,448.8**	**596.1**	**1,417.9**	**628.4**	**789.5**

The following table provides the fair value of the transferred assets and associated liabilities recalculated on the basis of the new methodology applied in 2013.

	Carrying amount of transferred loans and advances to customers	Carrying amount of fixed and floating rate notes	Fair value of transferred loans and advances to customers	Fair value of fixed and floating rate notes	Net position
2012 – applying 2013 fair value methodology					
Moorland Covered Bonds LLP	1,808.4	595.7	1,782.9	693.8	1,089.1

	Carrying amount of transferred loans and advances to customers	Carrying amount of fixed and floating rate notes	Fair value of transferred loans and advances to customers	Fair value of fixed and floating rate notes	Net position
2012 – as per published report and accounts					
Moorland Covered Bonds LLP	1,808.4	595.7	1,835.8	693.8	1,142.0

Assets pledged

Assets are pledged as collateral under repurchase agreements with other banks. These deposits are not available to finance the Bank's day to day operations.

	Carrying amount of assets not derecognised	**Carrying amount of associated liabilities**	**Fair value of assets not derecognised**	**Fair value of associated liabilities**	**Net position**
2013					
Investment securities sold under repurchase agreements	**1,004.4**	**1,028.3**	**1,022.5**	**1,028.3**	**(5.8)**

	Carrying amount of assets not derecognised	Carrying amount of associated liabilities	Fair value of assets not derecognised	Fair value of associated liabilities	Net position
2012					
Investment securities sold under repurchase agreements	1,907.4	1,830.9	1,907.7	1,827.5	80.2

Associated liabilities are included within deposits by banks.

The Bank has loans and advances to banks of £nil (2012: £250.0m) under reverse sale and repurchase agreements and against which gilts are held with a fair value of £nil (2012: £250.4m). These transactions are conducted under terms that are usual and customary to standard stock lending, securities borrowing and reverse purchase agreements. The Bank is permitted to sell or repledge the assets received as collateral in the absence of their default. The Bank is obliged to return equivalent securities. At 31 December 2013 the fair value of collateral repledged amounted to £nil (2012: £250.4m). The Bank does not adjust for the fair value of securities received under reverse sale and repurchase agreements.

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

42. Post balance sheet events

It is a requirement of IAS 10 (Events after the balance sheet date) that these financial statements reflect events arising after the 31 December 2013. The following events have occurred between 31 December 2013 and 10 April 2014 (the date of approval of these financial statements) and represent 'non adjusting' post balance sheet events:

Employees

During the year, the majority of the Bank's employees had contracts with CFS Management services Limited (CFSMS) and the cost of their services was recharged to subsidiaries, including the Bank. Following the legal separation of the Bank from the wholly owned subsidiary of The Co-operative Group, employment contracts for the majority of these employees transferred from CFSMS to the Bank. The transfer took place under the Transfer of Undertakings (Protection of Employment) Regulations 2006. Further transfers will occur in 2014 as the Bank completes its separation.

Unity Trust Bank plc

The Bank owns a 26.7% shareholding in Unity Trust Bank via a subsidiary undertaking. Unity Trust Bank is considered to be a subsidiary undertaking of the Bank as the Bank elects a majority of the Directors and appoints the Chairman and Managing Director. This provides the power to control.

On 14 January 2014, the Bank announced that it was in discussions with the Board of Unity Trust Bank about a potential sale of its 26.7% shareholding. Discussions are at an early stage and any decision on a changed ownership structure would be subject to regulatory approval.

Britannia International Limited

On 10 January 2014, The Co-operative Bank plc announced that in line with its wider strategy of simplifying the business it is to gradually wind down Britannia International operations over the course of 2014.

External investigations

The Bank has come under greater regulatory scrutiny and expects that environment to continue. The Bank is the subject of multiple regulatory and other investigations and enquiries into events at the Bank and circumstances surrounding them. The investigations announced after the balance sheet date are:

- The FCA announced on 6 January 2014 that it will be undertaking enforcement investigations into events at the Bank. The investigation will look at the decisions and events up to June 2013.
- The PRA announced on 6 January 2014 that it is undertaking an enforcement investigation in relation to the Bank and as part of that investigation will consider the role of former senior managers.
- The Financial Reporting Council (FRC) announced on 20 January 2014 it had launched an investigation under the Accountancy Scheme into the preparation, approval and audit of the financial statements of The Co-operative Bank plc, up to and including the year ended 31 December 2012.

The Company financial statements

The Company balance sheet

At 31 December 2013

All amounts are stated in £m unless otherwise indicated

		2013	Restated 2012
Assets			
Cash and balances at central banks	3	**5,418.8**	5,433.0
Loans and advances to banks	4	**579.9**	1,047.2
Loans and advances to customers	5a	**20,318.2**	22,785.5
Fair value adjustments for hedged risk	5b	**107.6**	354.1
Investment securities – loans and receivables	6a	**83.1**	355.4
Investment securities – available for sale	6b	**2,477.2**	3,563.9
Investment securities – fair value through income or expense	6c	**1,743.4**	1,845.2
Investment securities – held for trading	6d	**–**	960.2
Derivative financial instruments	7	**324.9**	590.9
Equity shares	8	**5.8**	5.7
Investments in Co-operative Bank undertakings	24	**1,453.4**	1,808.5
Goodwill	9	**–**	–
Investment properties	11	**1.9**	1.8
Property, plant and equipment	12	**79.9**	95.5[1]
Intangible fixed assets	10	**109.9**	262.1[1]
Amounts owed by other Co-operative Group undertakings	25	**–**	56.4[1]
Amounts owed by Co-operative Bank undertakings	25	**11,886.8**	12,357.0
Other assets	13	**470.0**	67.3
Prepayments and accrued income	14	**15.7**	14.0
Current tax assets		**–**	154.0
Deferred tax assets	22	**–**	138.8
Total assets		**45,076.5**	51,896.5
Liabilities			
Deposits by banks	15	**2,863.3**	3,552.9
Customer accounts		**31,185.9**	33,750.3
Customer accounts – capital bonds	16	**527.3**	867.2
Debt securities in issue	17	**1,504.2**	1,752.2
Derivative financial instruments	7	**531.0**	922.6
Other borrowed funds	18	**196.3**	1,258.6
Amounts owed to other Co-operative Group undertakings	25	**–**	190.0[1]
Amounts owed to Co-operative Bank undertakings	25	**5,954.3**	7,697.0
Other liabilities	19	**200.5**	99.5
Accruals and deferred income	20	**51.9**	15.5
Provisions for liabilities and charges	21	**487.5**	161.6
Current tax liabilities		**4.4**	–
Total liabilities		**43,506.6**	50,267.4

The Company balance sheet continued

At 31 December 2013

All amounts are stated in £m unless otherwise indicated

		2013	Restated 2012
Capital and reserves attributable to the Company's equity holders			
Ordinary share capital	26	**12.5**	410.0
Share premium account	26	**1,359.8**	8.8
Retained earnings		**(213.2)**	1,116.9
Available for sale reserve		**(14.1)**	30.0
Capital redemption reserve		**410.0**	–
Cashflow hedging reserve		**14.9**	63.4
Total equity		**1,569.9**	1,629.1
Total liabilities and equity		**45,076.5**	51,896.5

1. The 2012 balance sheet comparatives have been restated for intangible fixed assets, property, plant and equipment and amounts owed by other Co-operative Group undertakings as described in note 1.

Approved by the Board on 10 April 2014:

Richard Pym, Chair
Niall Booker, Chief Executive

The notes on pages 226 to 263 form part of these financial statements.

The Company statement of cash flows

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

	2013	Restated 2012
Cash flows from operating activities		
Loss before taxation	**(586.5)**	(735.2)
Adjustments for:		
Decrease/(increase) in prepayments and accrued income	**4.2**	(8.3)
Increase/(decrease) in accruals and deferred income	**15.8**	(17.6)
Interest payable in respect of other borrowed funds	**96.0**	81.4
Effect of exchange rate movements	**(0.6)**	10.4
Effect of non-cash pension costs	**–**	0.1
Fair value of movements on investment properties	**(0.1)**	(0.9)
Impairment losses on loans and advances	**404.9**	261.0
Movements on investment impairments	**(18.5)**	(5.4)
Depreciation and amortisation	**38.7**	43.8
Interest amortisation	**(4.2)**	(6.3)
Fair value movements and amortisation of investment securities	**193.9**	(60.7)
Impairment of property, plant and equipment	**11.3**	–
Impairment charge to write off goodwill	**–**	0.6
Impairment of intangible fixed assets	**142.0**	150.0
Loss on disposal of property, plant, equipment and software	**–**	1.6
Non-cash effect of LME transaction	**(688.3)**	–
Unwind of fair value adjustments arising on transfer of engagements	**(86.4)**	(57.4)
Preference dividend	**5.4**	5.6
	(472.4)	(337.3)
(Decrease)/increase in deposits by banks	**(689.6)**	313.1
(Decrease)/increase in customer accounts and capital bonds	**(2,996.4)**	550.6
(Decrease)/increase in debt securities in issue	**(251.1)**	317.1
Decrease in loans and advances to banks	**184.0**	79.0
Decrease/(increase) in loans and advances to customers	**2,450.5**	(247.1)
Decrease/(increase) in amounts owed by other Co-operative Bank undertakings	**470.2**	(12,357.0)
(Decrease)/increase in amounts owed to other Co-operative Bank undertakings	**(1,742.7)**	7,697.0
(Increase)/decrease in amounts owed by other Co-operative Group undertakings	**(30.9)**	12,502.1
Increase/(decrease) in amounts owed to other Co-operative Group undertakings	**58.8**	(7,271.2)
Net movement of other assets and other liabilities	**21.4**	(58.8)
Income tax received	**56.5**	22.4
Net cash flows from operating activities	**(2,941.7)**	1,209.9
Cash flows from investing activities		
Purchase of tangible and intangible fixed assets	**(26.8)**	(89.7)
Proceeds from sale of fixed assets	**2.2**	0.2
Purchase of investment securities	**(4,100.3)**	(4,730.9)
Proceeds from sale and maturity of investment securities	**6,358.8**	2,442.2
Net movement on investment in Co-operative Bank undertakings	**355.1**	(235.1)
Net cash flows from investing activities	**2,589.0**	(2,613.3)

The Company statement of cash flows continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

	2013	Restated 2012
Cash flows from financing activities		
Interest paid on other borrowed funds	**(83.9)**	(87.4)
Repayment of other borrowed funds	**–**	(256.5)
Issuance of other borrowed funds	**–**	235.4
Preference share dividends paid	**(5.9)**	(5.6)
Capital contribution from parent	**–**	80.0
Cash proceeds relating to the LME	**145.0**	–
Net cash flows from financing activities	**55.2**	(34.1)
Decrease in cash and cash equivalents	**(297.5)**	(1,437.5)
Cash and cash equivalents at the beginning of the financial year	**6,229.4**	7,666.9
Cash and cash equivalents at the end of the financial year	**5,931.9**	6,229.4
Cash and balances with central banks (note 3)	**5,352.6**	5,393.6
Loans and advances to banks (note 4)	**579.3**	835.8
	5,931.9	6,229.4

The 2012 cash flows have been re-analysed, primarily to disclose net movement on investments in Co-operative Bank undertakings separately from net movement of other assets and other liabilities.

The cash flows differ from the Company balance sheet movements as these movements include:

- the non-cash unwinds of the fair value adjustments arising on the transfer of engagements of Britannia Building Society; and
- the restatement of amounts owed by and to other Co-operative Group undertakings.

The notes on pages 226 to 263 form part of these financial statements.

The Company statement of changes in equity

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

	Attributable to equity holders of the Company						
	Share capital	**Share premium**	**Available for sale reserve**	**Cashflow hedging reserve**	**Capital redemption reserve**	**Retained earnings**	**Total equity**
2013							
Balance at the beginning of the year	**410.0**	**8.8**	**30.0**	**63.4**	**–**	**1,116.9**	**1,629.1**
Total comprehensive (expense)/income for the year excluding LME	**–**	**–**	**(33.0)**	**(48.5)**	**–**	**(1,423.6)**	**(1,505.1)**
Total comprehensive (expense)/income for the year – LME	**–**	**–**	**(11.1)**	**–**	**–**	**688.3**	**677.2**
Total comprehensive (expense)/income for the year	**–**	**–**	**(44.1)**	**(48.5)**	**–**	**(735.3)**	**(827.9)**
Transactions with owners recorded directly in equity:							
Liability Management Exercise[1]							
Cancellation of share capital	**(410.0)**	**–**	**–**	**–**	**410.0**	**–**	**–**
Issuance of new share capital	**12.5**	**777.5**	**–**	**–**	**–**	**–**	**790.0**
Transfer of retained earnings to share premium	**–**	**594.8**	**–**	**–**	**–**	**(594.8)**	**–**
Transaction costs	**–**	**(21.3)**	**–**	**–**	**–**	**–**	**(21.3)**
Balance at the end of the year	**12.5**	**1,359.8**	**(14.1)**	**14.9**	**410.0**	**(213.2)**	**1,569.9**
2012							
Balance at the beginning of the year	410.0	8.8	19.5	67.1	–	1,655.0	2,160.4
Total comprehensive income/(expense) for the year	–	–	10.5	(3.7)	–	(588.3)	(581.5)
Transactions with owners recorded directly in equity:							
Capital contribution	–	–	–	–	–	80.0	80.0
Fair value unwinds	–	–	–	–	–	(29.8)	(29.8)
Balance at the end of the year	410.0	8.8	30.0	63.4	–	1,116.9	1,629.1

1. Further detail of the LME is provided in note 4 to the Bank financial statements.

The notes on pages 226 to 263 form part of these financial statements.

Notes to the Company financial statements

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

1. Restatement

Historically the intangible asset for the core IT banking system replacement had been recorded in the books of CFS Management Services Ltd (CFSMS), (a service company which was a fellow Co-operative Banking Group subsidiary), with appropriate recharge to the Company via intercompany balances payable. The development of the core IT banking system was funded by the Bank. CFSMS had limited other assets with which to absorb any potential losses that may have arisen due to difficulties in development.

The Directors have reviewed and reconsidered the accounting treatment of the intangible asset in development and all other assets held on the balance sheet of CFSMS which were used solely by the Company. The Directors have concluded that the Company was substantially exposed to the risks and rewards of these assets and after considering the funding of the asset and CFSMS's lack of assets to absorb losses, the appropriate accounting treatment would be to hold these assets on the balance sheet of the Company. This has been reflected in the Bank and Company Annual Report and Accounts.

The effect of the prior year restatement on the Company is:

Balance sheet

	Note	At 1/1/2012 (as reported)	At 1/1/2012 (restated)	At 31/12/2012 (as reported)	At 31/12/2012 (restated)
Assets					
Property, plant and equipment	12	61.5	106.7	46.2	95.5
Intangible fixed assets	10	39.3	358.1	33.8	262.1
Amounts owed by other Co-operative Group undertakings	25	12,961.2	1.6	12,613.0	56.4
Amounts owed by other Co-operative Bank undertakings	25	–	12,779.1	–	12,357.0
		13,062.0	13,245.5	12,693.0	12,771.0
Liabilities					
Amounts owed to other Co-operative Group undertakings	25	7,461.2	315.8	7,809.0	190.0
Amounts owed to other Co-operative Bank undertakings	25	–	7,328.9	–	7,697.0
		7,461.2	7,644.7	7,809.0	7,887.0

Statement of cash flows

The above restatement impacts the presentation of the following items within the statement of cash flows:

	31/12/2012 (as reported)	31/12/2012 (restated)
Net cash flows from operating activities	886.5	1,209.9
Including:		
Adjustments for:		
Depreciation and amortisation	*19.1*	*43.8*
Impairment of intangible fixed assets	–	*150.0*
Amounts owed by other Co-operative Bank undertakings	–	*(12,357.0)*
Amounts owed to other Co-operative Bank undertakings	–	*7,697.0*
Amounts owed by other Co-operative Group undertakings	*309.5*	*12,502.1*
Amounts owed to other Co-operative Group undertakings	*347.8*	*(7,271.2)*
Net cash flows from investing activities	(2,289.9)	(2,613.3)
Including:		
Purchase of tangible and intangible assets	*(1.2)*	*(89.7)*
Proceeds from sale of fixed assets	–	*0.2*
Net cash flows from financing activities	(34.1)	(34.1)
Decrease in cash and cash equivalents	(1,437.5)	(1,437.5)

The above impact on amounts owed by/to other Co-operative Group undertakings is calculated in a consistent manner with the treatment of these balances for cash flow purposes as further described in the statement of cash flows.

There is £nil impact on share capital and reserves as a result of the above restatement. The impact on regulatory capital is described in the Bank's Capital Management section.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

2. Net loss attributable to equity shareholders of the Company

On including the Company financial statements here together with the Bank financial statements, the Company is taking advantage of the exemption in Section 408 of the Companies Act 2006 not to present its individual income statement and related notes that form a part of these financial statements.

	2013	2012
Net loss attributable to equity shareholders of the Company	**(735.3)**	(588.2)

3. Cash and balances at central banks

	2013	2012
Cash in hand	**274.9**	272.6
Balances with the Bank of England other than mandatory reserve deposits	**5,077.7**	5,121.0
Included in cash and cash equivalents	**5,352.6**	5,393.6
Mandatory reserve deposits with the Bank of England	**66.2**	39.4
	5,418.8	5,433.0

Mandatory reserve deposits are not available for use in the Company's day to day operations, are non-interest bearing and are not included in cash and cash equivalents.

4. Loans and advances to banks

	2013	2012
Items in course of collection from other banks	**105.1**	103.9
Placements with other banks	**474.2**	731.9
Included in cash and cash equivalents	**579.3**	835.8
Other loans and advances to banks	**0.6**	211.4
	579.9	1,047.2

Notes to the Company financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

5. a) Loans and advances to customers

	2013	2012
Gross loans and advances	**20,996.6**	23,203.7
Less: allowance for losses	**(678.4)**	(418.2)
	20,318.2	22,785.5

Loans and advances to customers include £134.2m (2012: £153.6m) of financial assets at fair value through income or expense designated at initial recognition to eliminate or significantly reduce a measurement or recognition inconsistency. Of these, £62.9m (2012: £48.7m) are secured by real estate collateral.

Loans and advances to customers include £10,111.9m (2012: £10,997.3m) securitised under the Bank's securitisation and covered bond programmes. The Company remains exposed to substantially all of the risks and rewards of ownership of these assets. Included within amounts owed by other Co-operative Bank undertakings in the Company are £5,614.1m (2012: £6,297.3m) of floating rate notes issued to the Company and £1,103.4m (2012: £1,014.7m) of other loans, secured on these mortgage assets.

Allowance for losses on loans and advances

	Core		Non-core (corporate)		
	Individual	Collective	Individual	Collective	Total
2013					
At the beginning of the year	**2.8**	**174.4**	**228.5**	**12.5**	**418.2**
Charge against profits	**0.9**	**37.8**	**335.0**	**21.4**	**395.1**
Amounts written off	**(0.7)**	**(41.9)**	**(84.6)**	**–**	**(127.2)**
Unwind of discount allowance	**–**	**(3.6)**	**(4.5)**	**–**	**(8.1)**
Interest charged on impaired loans	**–**	**–**	**0.4**	**–**	**0.4**
At the end of the year	**3.0**	**166.7**	**474.8**	**33.9**	**678.4**

Core provisions are analysed in further detail below:

	Core				
	Retail		BaCB		
	Individual	Collective	Individual	Collective	Total Core
2013					
At the beginning of the year	**2.5**	**173.3**	**0.3**	**1.1**	**177.2**
Charge against profits	**0.3**	**32.5**	**0.6**	**5.3**	**38.7**
Amounts written off	**(0.3)**	**(40.8)**	**(0.4)**	**(1.1)**	**(42.6)**
Unwind of discount allowance	**–**	**(3.6)**	**–**	**–**	**(3.6)**
Interest charged on impaired loans	**–**	**–**	**–**	**–**	**–**
At the end of the year	**2.5**	**161.4**	**0.5**	**5.3**	**169.7**

	Core		Non-core (corporate)		
	Individual	Collective	Individual	Collective	Total
2012					
At the beginning of the year	2.8	164.7	85.9	4.7	258.1
Charge against profits	1.5	43.8	170.9	7.8	224.0
Amounts written off	(1.5)	(30.7)	(25.5)	–	(57.7)
Unwind of discount allowance	–	(3.4)	(2.9)	–	(6.3)
Interest charged on impaired loans	–	–	0.1	–	0.1
At the end of the year	2.8	174.4	228.5	12.5	418.2

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

5. a) Loans and advances to customers continued

Core provisions are analysed in further detail below:

	Core				
	Retail		BaCB		Total Core
	Individual	Collective	Individual	Collective	
2012					
At the beginning of the year	2.6	163.7	0.2	1.0	167.5
Charge against profits	1.0	42.3	0.5	1.5	45.3
Amounts written off	(1.1)	(29.3)	(0.4)	(1.4)	(32.2)
Unwind of discount allowance	–	(3.4)	–	–	(3.4)
Interest charged on impaired loans	–	–	–	–	–
At the end of the year	2.5	173.3	0.3	1.1	177.2

The impairment charge for the Company also includes a provision of £9.8m (2012: £37.0m) made against fair value adjustments for hedged risk during the year (as shown in the fair value adjustments for hedged risk tables).

Loans and advances to customers include finance lease receivables:

	2013	2012
Gross investment in finance leases may be analysed as follows:		
No later than one year	**12.7**	16.2
Later than one year and no later than five years	**35.7**	43.6
Later than five years	**47.4**	66.7
	95.8	126.5
Unearned future finance income on finance leases	**(26.0)**	(34.7)
Net investment in finance leases	**69.8**	91.8
The net investment in finance leases may be analysed as follows:		
No later than one year	**8.9**	11.7
Later than one year and no later than five years	**23.9**	29.0
Later than five years	**37.0**	51.1
	69.8	91.8

There are no unguaranteed residual values for any of the finance leases.

5. b) Fair value adjustments for hedged risk

The Company has entered into interest rate swaps that protect it from changes in interest rates on the floating rate liabilities that fund its portfolio of fixed rate mortgages. Changes in the fair values of these swaps are offset by changes in the fair values of the fixed rate mortgages.

	2013	2012
Gross fair value adjustments for hedged risk	**154.4**	391.1
Less: impairment provision	**(46.8)**	(37.0)
	107.6	354.1

Movements on impairment provision on fair value adjustments for hedged risk are shown below:

	2013	2012
At the beginning of the year	**37.0**	–
Charge against profits	**9.8**	37.0
At the end of the year	**46.8**	37.0

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

6. Investment securities

a) Loans and receivables

	2013	2012
Loans and receivables		
Listed	**83.1**	355.4
Unlisted	**–**	–
	83.1	355.4
Less: allowance for losses	**–**	–
	83.1	355.4
Included in cash and cash equivalents	**–**	–

The 2012 comparatives have been re-presented to reflect a correction of the analysis of loans and receivables between listed and unlisted securities.

The movement in investment securities – loans and receivables excluding interest amounts is summarised as follows:

	2013	2012
At the beginning of the year	**355.1**	864.5
Acquisitions	**–**	–
Disposals and maturities	**(291.0)**	(587.9)
Exchange adjustments	**0.9**	(2.8)
Fair value movements through income or expense	**(9.2)**	–
Amortisation	**27.2**	78.6
Release of impairment provision	**–**	2.7
At the end of the year	**83.0**	355.1

Impairment analysis of investment securities – loans and receivables

	2013	2012
At the beginning of the year	**–**	2.7
Released during the year	**–**	(2.7)
At the end of the year	**–**	–

b) Available for sale

	2013	2012
Available for sale		
Listed	**2,477.2**	3,552.3
Unlisted	**20.0**	50.6
	2,497.2	3,602.9
Less: allowance for losses	**(20.0)**	(39.0)
	2,477.2	3,563.9
Included in cash and cash equivalents	**–**	–

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

6. Investment securities continued

The movement in investment securities – available for sale excluding interest amounts is summarised as follows:

	2013	2012
At the beginning of the year	**3,550.6**	3,090.5
Acquisitions	**1,501.0**	2,617.8
Disposals and maturities	**(2,456.3)**	(2,173.1)
Exchange adjustments	**(0.9)**	(8.1)
Fair value movements through equity	**(32.7)**	108.7
Fair value movements through income or expense	**(105.0)**	(68.2)
Amortisation	**(13.6)**	(19.7)
Release and utilisation of impairment provision	**18.5**	2.7
At the end of the year	**2,461.6**	3,550.6

Impairment analysis of investment securities – available for sale

	2013	2012
At the beginning of the year	**39.0**	42.5
Released during the year	**–**	(2.7)
Utilised during the year	**(18.5)**	–
Exchange adjustments	**(0.5)**	(0.8)
At the end of the year	**20.0**	39.0

c) Fair value through income or expense

	2013	2012
Fair value through income or expense		
Listed	**1,743.4**	1,845.2
	1,743.4	1,845.2
Less: allowance for losses	**–**	–
	1,743.4	1,845.2
Included in cash and cash equivalents	**–**	–

The movement in investment securities – fair value through income or expense excluding interest amounts is summarised as follows:

	2013	2012
At the beginning of the year	**1,830.6**	339.5
Reclassified to fair value through income or expense	**447.7**	–
Acquisitions	**2,120.9**	1,895.5
Disposals and maturities	**(2,632.9)**	(410.8)
Exchange adjustments	**(0.1)**	(0.1)
Fair value movements through income or expense	**(35.3)**	6.5
At the end of the year	**1,730.9**	1,830.6

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

6. Investment securities continued

d) Held for trading

	2013	2012
Held for trading		
Listed	–	960.2
Included in cash and cash equivalents	–	–

The movement in investment securities – held for trading excluding interest amounts is summarised as follows:

	2013	2012
At the beginning of the year	954.3	–
Reclassified to fair value through income or expense	(447.7)	–
Acquisitions	30.7	1,268.8
Disposals and maturities	(530.9)	(321.6)
Exchange movements	0.7	–
Fair value movements through income or expense	(7.1)	7.1
At the end of the year	–	954.3

e) Analysis of investment securities by issuer

	2013	2012
Investment securities issued by public bodies:		
Government securities	3,064.3	2,184.9
Other public sector securities	560.5	2,208.5
	3,624.8	4,393.4
Investment securities issued by other issuers:		
Bank and building society certificates of deposits	–	–
Other debt securities:		
Other floating rate notes	595.8	1,975.9
Mortgage backed securities	83.1	355.4
	678.9	2,331.3
	4,303.7	6,724.7

Other floating-rate notes (FRNs) relate to sterling denominated FRNs with maturities ranging from one month to 12 years from the balance sheet date.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

7. Derivative financial instruments

The Company has entered, as principal, into various derivatives either as a trading activity, which includes proprietary transactions and customer facilitation, or as a hedging activity for the management of interest rate risk, equity risk and foreign exchange rate risk. Positive and negative fair values have not been netted as the Company does not have a legal right of offset.

Derivatives held for trading purposes

The trading transactions are wholly interest rate related contracts including swaps, caps and floors, forward rate agreements and exchange traded futures. Trading transactions include derivatives where the Company enters into a transaction to accommodate a customer together with the corresponding hedge transaction. The Company no longer holds derivatives for trading purposes.

Non-trading derivatives

Non-trading transactions comprise derivatives held for hedging purposes to manage the asset and liability positions of the Company. Derivatives used to manage interest rate related positions include swaps, caps and floors, forward rate agreements and exchange traded futures. The foreign exchange rate positions are managed using forward currency transactions and swaps. Equity risk is managed using equity swaps.

During the year the Company has entered into fair value hedges to mitigate price movements due to interest rate sensitivities.

	2013		2012	
	Fair value		Fair value	
	Assets	**Liabilities**	Assets	Liabilities
2013				
Derivatives held for trading purposes				
Interest rate derivatives:				
Interest rate swaps	**–**	**–**	197.4	(168.6)
Over The Counter (OTC) interest rate options	**–**	**–**	1.4	(1.1)
Total derivative assets/(liabilities) held for trading purposes	**–**	**–**	198.8	(169.7)
Derivatives held for non-trading purposes				
Derivatives designated as cashflow hedges:				
Interest rate swaps	**37.9**	**(56.0)**	120.1	(52.2)
Derivatives designated as fair value hedges:				
Interest rate swaps	**52.5**	**(289.4)**	110.7	(586.0)
Cross currency interest rate swaps	**–**	**(1.5)**	–	(42.6)
Derivatives held for non-trading purposes for which hedge accounting has not been applied:				
Interest rate swaps	**123.4**	**(130.5)**	10.0	(54.2)
Embedded derivatives – options	**56.3**	**–**	60.6	(0.1)
Forward currency transactions	**7.5**	**(1.4)**	28.7	(14.8)
OTC interest rate options	**0.6**	**(2.2)**	–	(2.8)
Equity swaps	**46.7**	**–**	62.0	(0.2)
Credit default swap	**–**	**(50.0)**	–	–
Total derivative assets/(liabilities) held for non-trading purposes	**324.9**	**(531.0)**	392.1	(752.9)
Total recognised derivative assets/(liabilities)	**324.9**	**(531.0)**	590.9	(922.6)

The credit default swap balance arose on 28 January 2013, as the Company entered into a transaction to transfer a mezzanine portion of the risk in a portfolio of residential mortgage loans to third party investors, via a special purpose vehicle, Calico Finance Number One Limited.

Refer to note 20 in the notes to the Bank financial statements for further information on derivatives held by the Bank.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

8. Equity shares

	2013	2012
Investment securities		
Listed	**0.1**	0.1
Unlisted	**5.7**	5.6
	5.8	5.7
Included above are the following trade investments:		
Vocalink Limited – 4,416,165 ordinary shares of £1 each (2012: 4,416,165)	**5.6**	5.6

Equity shares are classified as available for sale.

9. Goodwill

	2013	2012
Net book amount		
At the beginning of the year	**–**	0.6
Impairment charge	**–**	(0.6)
At the end of the year	**–**	–

The Company's goodwill was recognised in 2009 and related to the transfer of engagements of Britannia Building Society.

At 31 December 2012 the Directors assessed the goodwill balance for impairment and concluded that the carrying value should be written down to nil.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

10. Intangible fixed assets

	2013			Restated 2012		
	Internally generated intangible assets	**Other intangible assets**	**Total**	Internally generated intangible assets	Other intangible assets	Total
Cost						
At the beginning of the year (as reported)[1]	**10.0**	**46.0**	**56.0**	12.1	46.0	58.1
At the beginning of the year restated	**438.4**	**46.0**	**484.4**	364.2	46.0	410.2
Additions	**13.5**	**–**	**13.5**	76.5	–	76.5
Disposals	**(0.5)**	**–**	**(0.5)**	(2.3)	–	(2.3)
At the end of the year	**451.4**	**46.0**	**497.4**	438.4	46.0	484.4
Accumulated amortisation and impairment						
At the beginning of the year (as reported)[1]	**6.7**	**15.5**	**22.2**	8.0	10.8	18.8
At the beginning of the year restated	**206.8**	**15.5**	**222.3**	41.3	10.8	52.1
Charge for the year	**19.2**	**4.5**	**23.7**	17.8	4.7	22.5
Impairment	**140.0**	**2.0**	**142.0**	150.0	–	150.0
Disposals	**(0.5)**	**–**	**(0.5)**	(2.3)	–	(2.3)
At the end of the year	**365.5**	**22.0**	**387.5**	206.8	15.5	222.3
Net book value						
At the end of the year	**85.9**	**24.0**	**109.9**	231.6	30.5	262.1
At the beginning of the year	231.6	30.5	262.1	322.9	35.2	358.1

Internally generated intangible assets consist of software development costs. Acquired computer software licences are capitalised on the basis of cost incurred to acquire and bring the software to use.

Other intangible assets consist of a core deposit intangible of £24.0m (2012: £28.5m) and a brand intangible of £nil (2012: £2.0m). The brand intangible was fully impaired in the year.

Internally generated assets include £83.8m (net book value) (2012: £228.3m) of assets for which the Company does not hold legal title, but the Directors are of the opinion that the assets meet the accounting criteria of an asset for the Company. The assets are therefore accounted for on the Company's balance sheet.

CFS Management Services (a subsidiary of The Co-operative Banking Group) holds legal title to these assets. The Company's relationship with CFS Management Services is described in note 39 to the Bank financial statements.

Internally generated assets include £8.5m (2012: £125.0m) of assets in the course of construction.

The Directors consider accounting for assets held by CFSMS a critical accounting judgment. Further details are provided in note 2 to the Bank financial statements.

The total impairment charge for internally generated intangibles (shown above), assets in the course of construction and computers and other equipment (shown in property, plant and equipment) is £151.3m, which consists of £148.4m regarding the development of new banking systems and £2.9m of other impairment (included in operating expenses).

1. The 2012 comparatives have been restated as described in note 1.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

11. Investment properties

	2013	2012
Fair value		
At the beginning of the year	**1.8**	–
Additions – other expenditure	**–**	0.9
Disposals	**–**	–
Changes in fair value	**0.1**	0.9
At the end of the year	**1.9**	1.8

12. Property, plant and equipment

2013	Land and buildings	Leasehold improvements	Computers and other equipment	Assets in the course of construction	Total
Cost					
At the beginning of the year (restated)	**34.5**	**25.1**	**149.4**	**16.1**	**225.1**
Additions	**–**	**–**	**6.5**	**6.8**	**13.3**
Disposals	**(0.3)**	**–**	**(16.1)**	**–**	**(16.4)**
Impairment	**–**	**–**	**(1.6)**	**(9.2)**	**(10.8)**
At the end of the year	**34.2**	**25.1**	**138.2**	**13.7**	**211.2**
Accumulated depreciation					
At the beginning of the year (restated)	**3.8**	**18.3**	**107.5**	**–**	**129.6**
Charge for the year	**0.8**	**4.2**	**10.4**	**–**	**15.4**
Disposals	**(0.2)**	**–**	**(14.0)**	**–**	**(14.2)**
Impairment	**–**	**–**	**0.5**	**–**	**0.5**
At the end of the year	**4.4**	**22.5**	**104.4**	**–**	**131.3**
Net book value					
At the end of the year	**29.8**	**2.6**	**33.8**	**13.7**	**79.9**
At the beginning of the year	30.7	6.8	41.9	16.1	95.5

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

12. Property, plant and equipment continued

2012	Land and buildings	Leasehold improvements	Restated* Computers and other equipment	Assets in the course of construction	Total
Cost					
At the beginning of the year (as reported)*	34.8	24.9	111.1	–	170.8
At the beginning of the year	34.8	25.2	151.8	14.6	226.4
Additions	–	–	10.8	1.5	12.3
Disposals	(0.3)	(0.1)	(13.2)	–	(13.6)
At the end of the year	34.5	25.1	149.4	16.1	225.1
Accumulated depreciation					
At the beginning of the year (as reported)*	3.0	13.3	93.0	–	109.3
At the beginning of the year	3.0	13.4	103.3	–	119.7
Charge for the year	0.8	5.0	15.9	–	21.7
Disposals	–	(0.1)	(11.7)	–	(11.8)
At the end of the year	3.8	18.3	107.5	–	129.6
Net book value					
At the end of the year	30.7	6.8	41.9	16.1	95.5
At the beginning of the year	31.8	11.8	48.5	14.6	106.7

Computers and other equipment and assets in the course of construction include £44.0m (net book value) (2012: £49.3m) of assets for which the Company does not hold legal title, but the Directors are of the opinion that the assets meet the accounting criteria of an asset for the Company. The assets are therefore accounted for on the Company's balance sheet.

The Directors consider accounting for assets held by CFSMS a critical accounting judgment. Further details are provided in note 2 to the Bank financial statements.

* The 2012 comparatives have been restated as described in note 1.

13. Other assets

	2013	2012
Amounts recoverable within one year:		
Trade debtors	**29.7**	59.9
Other assets	**36.5**	7.4
Amounts owed by The Co-operative Group	**7.2**	–
Amounts owed by The Co-operative Banking Group Limited	**303.2**	–
Amounts recoverable after more than one year:		
Amounts owed by The Co-operative Group	**93.4**	–
	470.0	67.3

Amounts owed by The Co-operative Group represents group relief recoverable of £100.6m. The group relief recoverable was recorded in current tax assets in the prior year. Other assets include £17.0m of group relief recoverable from Co-operative Bank undertakings. The £303.2m owed by The Co-operative Banking Group represents the commitment to contribute £333.0m of CET1 (see note 4 to the Bank financial statements) after taking account of £20.0m received on 31 December 2013 and the effect of discounting.

Further details of the Company's related party transactions with The Co-operative Group are contained in note 25.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

14. Prepayments and accrued income

	2013	2012
Other:		
Amounts recoverable within one year	**6.6**	7.5
Amounts recoverable after more than one year	**9.1**	6.5
	15.7	14.0

The 2012 comparatives have been re-presented to correct the analysis between amounts recoverable within and after more than one year.

15. Deposits by banks

	2013	2012
Items in course of collection	**40.9**	49.1
Deposits from other banks	**2,822.4**	3,503.8
	2,863.3	3,552.9

Included within deposits from other banks are liabilities of £1,028.3m (2012: £1,830.9m) secured on investment securities with a carrying value of £1,004.4m (2012: £1,907.4m) which have been sold under sale and repurchase agreements (note 27).

16. Customer accounts – capital bonds

	2013	2012
Retail	**527.3**	867.2

Capital bonds are fixed term customer accounts with returns based on the movement in an index (eg FTSE100) over the term of the bond.

The capital bonds have been designated on initial recognition at fair value through income and expense and are carried at fair value.

The fair values for the capital bonds are obtained on a monthly basis from the swap counterparties. These external valuations are reviewed independently using valuation software to ensure the fair values are priced on a consistent basis. None of the change in the fair value of the capital bonds is attributable to changes in the liability’s credit risk.

Notes to the Company financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

17. Debt securities in issue

	2013	2012
Certificates of deposit	5.1	157.8
Commercial paper	–	8.2
Fixed and floating rate notes	1,499.1	1,586.2
	1,504.2	1,752.2

The Company has entered into cross currency interest rate swaps that protect it from changes in exchange rates and interest rates on its debt securities in issue. Changes in the fair values of these swaps are largely offset by changes in the sterling equivalent carrying value of the debt securities in issue.

The notes, covered bonds-secured, certificates of deposits and euro medium term notes unsecured require the Bank to repay contractual amounts due on specified maturity dates.

18. Other borrowed funds

	2013	2012
Step up callable subordinated notes 2019	–	37.8
60,000,000 9.25% non-cumulative irredeemable preference shares of £1 each	–	60.0
Floating rate subordinated notes 2016	–	21.7
5.625% fixed rate subordinated notes 2021	–	8.7
9.25% fixed rate subordinated notes 2021	–	275.0
7.875% fixed rate subordinated notes 2022	–	235.4
Fixed rate subordinated notes 2024	–	173.7
Fixed rate subordinated notes 2033	–	125.4
Perpetual subordinated bonds	–	292.1
Fixed rate subordinated notes 2023	206.0	–
Issue costs, discounts and accrued interest	(9.7)	28.8
	196.3	1,258.6

The other borrowed funds balances include fair value adjustments for hedged risk (including merger fair value adjustments) of £nil (2012: £88.9m).

Details of the Company's other borrowed funds are as set out in note 31 to the Bank financial statements.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

19. Other liabilities

	2013	2012
Amounts falling due within one year:		
ATM creditor	20.1	61.5
Amounts owed to subsidiaries of The Co-operative Banking Group Limited	156.5	–
Other creditors	19.3	33.5
Amounts falling due after one year:		
Other creditors	4.6	4.5
	200.5	99.5

Other creditors of the Company include finance lease obligations. Details of these are as set out in note 32 to the Bank financial statements.

Amounts owed to subsidiaries of The Co-operative Banking Group includes £127.8m arising from the accounting for assets held by CFS Management Services Limited but accounted for on the Company balance sheet (as described in note 1) and £28.7m reflects amounts due in the normal course of business. Further details of the Company's related party transactions with The Co-operative Banking Group are contained in note 25.

The ATM creditor relates to amounts owed to a third party for the provision of cash for the Bank's ATM machines. It is settled on a daily basis.

20. Accruals and deferred income

	2013	2012
Other:		
Amounts falling due within one year	51.9	15.0
Amounts falling due after one year	–	0.5
	51.9	15.5

Accruals falling due within one year include £18.0m for fees in relation to the LME which will be settled in CFSMS.

21. Provisions for liabilities and charges

2013	Property	FSCS levies	PPI	Conduct/ legal	Other	Total
At the beginning of the year	7.2	38.4	116.0	–	–	161.6
Income statement movements:						
Provided in the year – net interest income	–	–	–	172.5	–	172.5
Provided in the year – operating expense	15.3	25.5	–	2.9	30.6	74.3
Provided in the year – operating expense – separation costs	–	–	–	–	39.4	39.4
Provided in the year – net fee and commission income	–	–	103.0	51.1	–	154.1
Released in the year – operating expense	(0.4)	–	–	–	–	(0.4)
Utilised during the year	(0.5)	(24.4)	(85.2)	(3.9)	–	(114.0)
At the end of the year	21.6	39.5	133.8	222.6	70.0	487.5
Provisions were analysed as follows:						
Amounts falling due within one year	9.0	13.2	113.8	222.6	70.0	428.6
Amounts falling due after one year	12.6	26.3	20.0	–	–	58.9
	21.6	39.5	133.8	222.6	70.0	487.5

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

21. Provisions for liabilities and charges continued

2012	Property	FSCS levies	PPI	Conduct/ legal	Other	Total
At the beginning of the year	6.8	24.9	61.7	–	–	93.4
Income statement movements:						
Provided in the year – operating expense	0.8	24.7	–	–	–	25.5
Provided in the year – net fee and commission income	–	–	149.7	–	–	149.7
Released in the year – operating expense	(0.3)	–	–	–	–	(0.3)
Utilised during the year	(0.1)	(11.2)	(95.4)	–	–	(106.7)
At the end of the year	7.2	38.4	116.0	–	–	161.6
Provisions were analysed as follows:						
Amounts falling due within one year	3.1	24.8	77.2	–	–	105.1
Amounts falling due after one year	4.1	13.6	38.8	–	–	56.5
	7.2	38.4	116.0	–	–	161.6

The Directors consider conduct and legal provisions a critical accounting judgement. Further details are provided in note 2 to the Bank financial statements.

Details of the Company's property provisions, FSCS levy and PPI provision are as set out in note 34 to the Bank financial statements.

Conduct/legal provisions

The £172.5m charged through net interest income consists of £109.5m relating to potential customer redress following identification of breaches of the Consumer Credit Act, £33.0m relating to potential interest rate swap mis-selling, £15.0m relating to potential conduct issues incurred but not reported, £13.0m relating to potential customer redress and other costs in relation to mortgage documentation and £2.0m of other conduct related provisions.

The £51.1m charged through net fee and commission income consists of £26.1m for alleged failings in the introduction of third party sales of card and identification protection products, £19.0m for potential customer redress in relation to arrears fees and charges and £6.0m of other conduct related provisions.

£2.9m has been charged through operating expenses relating to other conduct related provisions.

Refer to note 2 to the Bank financial statements for further detail on conduct and legal provisions.

Other

The £30.6m charged through operating expenses consists of £20.0m in relation to a data quality provision, £7.6m relating to the provision for fraud costs relating to loans and advances to customers and £3.0m relating to other provisions.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

22. Deferred tax

Deferred taxes are calculated on all temporary differences under the liability method using a tax rate of 20% (2012: 23%).

The movements on the deferred tax asset accounts are as follows:

	2013	2012
Deferred tax at the beginning of the year	**138.8**	110.3
(Charged)/credited to the income statement:		
Current year	**(20.9)**	14.1
Write off of prior year deferred tax asset	**(139.2)**	–
Prior year	**3.1**	9.4
	(157.0)	23.5
Credited/(charged) to other comprehensive income:		
Fair value unwinds	**–**	8.9
Cashflow hedges	**18.1**	3.5
Available for sale	**0.1**	(7.4)
	18.2	5.0
Deferred tax at the end of the year	**–**	138.8
Components of net deferred tax:		
Deferred tax asset	**1.4**	158.4
Deferred tax liability	**(1.4)**	(19.6)
	–	138.8

The deferred tax asset above includes an offset for those deferred tax liabilities that are permissible to be offset.

Net deferred tax assets expected to be recoverable after one year are £nil (2012: £138.8m).

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

22. Deferred tax continued

	2013	2012
Deferred tax comprises:		
Capital allowances on fixed assets and assets leased to customers	**1.4**	38.3
Fair value adjustments	**–**	65.6
Other temporary differences	**–**	1.7
Tax losses carried forward	**–**	51.9
Pensions and other post-retirement benefits	**–**	0.9
Cashflow hedges	**(0.8)**	(18.9)
Unrealised appreciation on investments	**(0.6)**	(0.7)
	–	138.8

The deferred tax charge/(credit) in the income statement comprises:

	2013	2012
Capital allowances on fixed assets and assets leased to customers	**36.9**	(8.3)
Fair value adjustments	**65.6**	33.3
Other temporary differences	**1.7**	1.9
Tax losses carried forward	**51.9**	(50.4)
Pensions and other post-retirement benefits	**0.9**	–
	157.0	(23.5)

Deferred tax assets totalling £262.6m (2012: £nil) have not been recognised where doubt exists over the availability of sufficient future taxable profits.

Deferred tax assets from the prior year of £139.2m (2012: £nil) have been written off in the year. In addition, deferred tax assets of £123.4m in respect of the current year have not been recognised.

In the view of the Directors, the depletion of the Company's capital following a series of charges in 2013 casts additional uncertainty as to the achievability of the Plan and therefore the certainty of future taxable profits. The Directors have concluded that additional capital needs to be raised. The risks associated with the Company's plan are listed on pages 26 to 28.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

23. Contingent liabilities and commitments

The tables below provide the contract amounts and risk weighted amounts of contingent liabilities and commitments. The contract amounts indicate the volume of business outstanding at the balance sheet date and do not represent amounts at risk. The risk weighted amounts have been calculated in accordance with the PRA rules.

The contingent liabilities, as detailed below, arise in the normal course of banking business and it is not practical to quantify their future financial effect.

		Unaudited		Unaudited
	Contract amount 2013	**Risk weighted amount 2013**	Contract amount 2012	Risk weighted amount 2012
Contingent liabilities:				
Guarantees and irrevocable letters of credit	**86.1**	**45.2**	168.2	120.3
Other commitments:				
Documentary credits and short term trade related transactions	**0.8**	**0.2**	3.7	0.7
Forward asset purchases and forward deposits placed[1]	**650.5**	**168.1**	53.2	0.1
Undrawn formal standby facilities, credit lines and other commitments to lend (includes revocable and irrevocable commitments)[2]	**3,391.1**	**642.4**	4,565.5	1,061.0
	4,042.4	**810.7**	4,622.4	1,061.8

1. Forward asset purchases have significantly increased during the year in order to meet funding requirements.
2. Undrawn loan commitments include revocable commitments which are unused credit card limits of £1,968.1m (2012: £2,048.1m).

Assets pledged

Assets are pledged as collateral under repurchase agreements with other banks. These deposits are not available to finance the Company's day-to-day operations. Mandatory reserve deposits are also held with the Bank of England in accordance with statutory requirements.

See note 27.d) in the Company financial statements for further details of assets pledged.

Commitments under operating leases

The Company leases various properties and equipment under non-cancellable operating lease arrangements. The leases have various terms, ranging from six months to 999 years. None of these leases are individually material and none have any material clauses. The table below discloses the minimum operating lease payments the Company will be required to make over the remaining lives of the leases.

	Land and buildings 2013	**Equipment 2013**	Land and buildings 2012	Equipment 2012
Falling due:				
Within one year	**19.6**	**–**	22.6	0.3
Between one and five years	**51.2**	**0.4**	65.3	0.5
In five years or more	**56.4**	**–**	66.0	–
	127.2	**0.4**	153.9	0.8

The Company leases a number of branch and office premises under operating leases. The leases typically run for a period of up to 25 years, with an option to renew the lease after that period. Lease payments are generally reviewed every three to five years to reflect market rentals.

The total value of future minimum sub-lease payments expected to be received under non-cancellable sub-leases for the Company was £8.0m (2012: £9.1m).

Notes to the Company financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

23. Contingent liabilities and commitments continued

Indemnification

The Bank has an indemnification agreement, accounted for as a guarantee under IFRS 4, with CFSMS in which the Bank has agreed to indemnify CFSMS against all and any liability, loss, damage, costs and expense arising from the agreement (under which CFSMS provides certain assets and services to Bank). This agreement will remain in place until a new agreement is put in place following separation as part of the LME.

Conduct issues

Given the high level of scrutiny regarding financial institutions' treatment of customers and business conduct from regulatory bodies, the media and politicians, there is a risk that certain aspects of the Bank's current or historic business, including, amongst other things, mortgages and relationship banking, may be determined by the Financial Conduct Authority (FCA) and other regulatory bodies or the courts as not being conducted in accordance with applicable laws or regulations, or fair and reasonable treatment in their opinion.

In particular, there is currently a significant regulatory focus on the sale practices and reward structures that financial institutions have used when selling financial products. There is a risk that there may be other regulatory investigations and action against the Company in relation to conduct and other issues that the Bank is not presently aware of, including investigations and actions against it resulting from alleged mis-selling of financial products or the ongoing servicing of those financial products. The nature of any future disputes and legal, regulatory or other investigations or proceedings into such matters cannot be predicted in advance. Furthermore, the outcome of any ongoing disputes and legal, regulatory or other investigations or proceedings is difficult to predict.

Consumer Credit Act issues

The Consumer Credit Act regulates consumer lending and governs the way in which entities, including banks, providing consumer credit to retail customers carry out business. From 1 April 2014 the Financial Services and Markets Act 2000 also applies alongside certain retained provisions of the Consumer Credit Act. The Consumer Credit Act includes very detailed, prescriptive and highly technical requirements for lenders affecting customer documentation and which, in turn, impact how operational processes and IT systems are configured. While the Bank has identified certain instances where its documentation or processes have not been fully compliant with the technical requirements and has provided accordingly, there may be other instances which have not yet been identified. Breaches may have the effect of triggering periods of non-compliance during which an affected customer is not liable to pay interest.

Interest refunds would therefore need to be made in certain cases where a period of non-compliance has been previously triggered. The Bank is considering the operational implementation of the refunding of interest to customers where applicable. The Bank has not yet determined all aspects of such processes. The Bank has made no provisions to pay interest on the amount of any refund.

An amount of £109.5m (2012: £nil) has been recognised to refund interest following identification of a number of breaches of the requirements of the Consumer Credit Act. As part of this process of identification, detailed and technical legal analysis has been carried out as to whether breaches of the technical requirements have in fact occurred, the nature of those breaches and the consequences which follow (which differ according to the precise nature of the breach). Such legal analysis by its nature involves judgement and assessment of the facts of particular circumstances. In the event that such legal analysis and judgements are determined to be wrong, the Company could be exposed to a material additional liability. The amount of £109.5m which has been provided is the best estimate of the liability based on legal analysis.

Regulatory and other investigations

The Company is the subject of multiple regulatory and other investigations and enquiries into events at the Company and circumstances surrounding them. These include:

- The Treasury Select Committee has been conducting an ongoing review which began in Q2 2013 and has focused on numerous concerns surrounding the Bank. The Committee will publish a report of its findings, the timing of which is not known.
- The Sir Christopher Kelly review was announced on 12 July 2013. Sir Christopher was jointly appointed by the Co-operative Group Limited and the Bank to review the events that led to the Bank's capital action plan to address its £1.5bn capital shortfall. It is looking at the decision to merge the Bank with the Britannia Building Society in 2009 and the proposed acquisition of the Verde assets of Lloyds Banking Group. It will include an analysis of strategic decision making, management structures, culture, governance and accounting practices and aspects of the role of the Bank's Auditors. The intention is for the findings to be publicised at The Co-operative Group's Annual General Meeting in May 2014.
- The Treasury announced by press release on 22 November 2013 that it would conduct an independent investigation into events at The Co-operative Bank plc and the circumstances surrounding them from 2008 including the Verde transaction and Britannia merger. The investigation will include a review of the conduct of regulators and Government but is not anticipated to commence until it is clear that it will not prejudice the outcome of the FCA and PRA enforcement investigations.
- The PRA announced on 6 January 2014 that it is undertaking an enforcement investigation in relation to the Company and as part of that investigation will consider the role of former senior managers.
- The FCA announced on 6 January 2014 that it will be undertaking enforcement investigations into events at the Company. The investigation will look at the decisions and events up to June 2013.

The Bank is co-operating with all the investigating authorities. It is not possible to estimate the financial impact upon the Company should any adverse findings be made.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

23. Contingent liabilities and commitments continued

Legal proceedings

The Bank is engaged in various other legal proceedings in the United Kingdom involving claims by and against it which arise in the ordinary course of business, including debt collection, mortgage enforcement, consumer claims and contractual disputes. The Bank does not expect the ultimate resolution of any of these proceedings to which the Bank is party to have a material adverse effect on its results of operations, cash flows or the financial position of the Bank and has not disclosed the contingent liabilities associated with these claims. Provisions have been recognised for those cases where the Bank is able reliably to estimate the probable loss where the probable loss is not de minimis. See note 34 to the Bank financial statements.

Mortgage securitisation representations and warranties

In connection with the Company's mortgage securitisations and covered bond transactions described in note 24 (Company financial statements) and note 30 (Bank financial statements), the Company makes various representations and warranties relating to the mortgage loans, including in relation to ownership, compliance with legislation and origination procedures. If the representations and warranties are breached subject to any applicable materiality determination, the Company may be required to repurchase the affected mortgage loans or in some circumstances pay compensation to the securitisation vehicle.

There is a risk that a number of the underlying matters giving rise to the conduct and legal provisions set out in note 21 to the Company financial statements could have given rise to breaches of such representations and warranties. Accordingly there is a risk that the Company may be required to pay compensation or repurchase affected mortgage loans in amounts that may reduce the Company's liquidity.

The Company is unable to estimate the extent to which the matters described above will impact it or how future developments may have a material adverse impact on the Company's net assets, operating results or cash flows in any particular period.

Pensions

There is uncertainty over the amount that the Bank will have to pay while it continues to participate in Pace. The Bank's obligations to contribute to Pace would increase significantly if another large employer in Pace becomes insolvent while the Bank continues to participate. If the Bank seeks to address these risks by terminating its participation, the default position is that material liabilities in respect of the deficit in Pace will arise. The Co-operative Group and the Bank have agreed to enter into good faith discussions to manage this by reaching agreement so that the liabilities properly attributable to the Bank (and an equivalent proportion of assets) would be transferred to a separate scheme, or a segregated section of Pace, on the Bank's exit but, as no arrangements have yet been agreed (and there is a risk that none can be agreed), there is uncertainty over the amount that the Bank will have to pay in the event that it exits Pace.

The Pace scheme is not sectionalised and operates on a 'last man standing' basis. In the event that other participating employers become insolvent and the full statutory debt is not recovered on insolvency, the Bank would become liable for the remaining liabilities.

Other pensions risks and uncertainties include the risk to the Bank's capital and funds from the Bank's exposure to scheme liabilities (to the extent liabilities are not met by scheme assets), risks inherent in the valuation of scheme liabilities and assets, risks regarding the split of liabilities between the Bank and other participating employers while the Bank continues to participate in Pace and on exit from Pace and, in respect of the Britannia Scheme, risks on separation from The Co-operative Group.

It is not practicable to provide an estimate of the financial impact of these matters or what effect if any that these matters may have upon the Bank's operative revenues, cash flows or financial position in any period.

Former Britannia Building Society pension scheme guarantee

Following the transfer of engagements of Britannia Building Society, the Britannia pension scheme transferred to CFSMS. Under the terms of this transfer the Company entered into a deed of guarantee to provide assurance to the trustees of the pension scheme to support CFSMS in meeting its funding obligations to the scheme should CFSMS be unable to pay its obligations as they fall due. However, The Co-operative Group has undertaken to procure that if CFSMS is not controlled by the Bank, CFSMS will not take or omit to take any action without the Bank's prior agreement if the result would be to increase the Bank's liabilities or contributions in respect of the Britannia Scheme. The most recent actuarial report indicated that the funding deficit in the Britannia Scheme as at 5 April 2013 was £61.0m.

The Bank will need to manage the liabilities that could arise on separation from The Co-operative Group; this will require the co-operation of the Trustees of the Britannia Scheme, which may not be forthcoming.

Tax treatment of separation

Until separation of the Bank from The Co-operative Group is complete, and the new arrangements referred to in the CFSMS-Bank Framework Agreement as detailed in note 39 to the Bank's financial statements have been entered into, the Bank will continue to be responsible for indemnifying CFSMS under the CFSMS-Bank Services Agreement. It is anticipated that the Bank will become the owner of the assets currently held by CFSMS for the provision of services exclusively to the Bank – it is expected that this will be achieved in a VAT efficient manner, but if this cannot be done, there is a potential VAT cost of approximately £26m on the transfer of the Bank exclusive assets to the Bank.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

23. Contingent liabilities and commitments continued

As detailed in note 3 to the Bank financial statements, the Directors have reviewed and reconsidered the accounting treatment of the intangible asset in development and all other assets held on the balance sheet of CFSMS which were used solely by the Bank. The Directors have concluded that the Bank was substantially exposed to the risks and rewards of these assets and after considering the funding of the asset and CFSMS's lack of assets to absorb losses, the appropriate accounting treatment would be to hold these assets on the balance sheet of the Bank. The Bank has applied an approach to the tax and accounting treatment of the Bank exclusive assets. However, if, and that to the extent that, there is a change to this treatment, there may be an additional tax charge.

There will continue to be VAT charges incurred in respect of any assets that are supplied to the Bank under the CFSMS-Bank Services Agreement or the CFSMS-Bank Framework Agreement (as applicable). As such, the Bank will look to mitigate these VAT charges through the transfer of all or some of such assets to the Bank as soon as possible.

24. Investments in Co-operative Bank undertakings

Investments in equity shares and loans of subsidiary undertakings are financial assets.

	2013			2012		
	Ordinary shares	**Capital contributions**	**Total**	Ordinary shares	Capital contributions	Total
At the beginning of the year	**569.5**	**1,239.0**	**1,808.5**	569.7	1,003.7	1,573.4
Additions	**–**	**–**	**–**	–	1,185.0	1,185.0
Repayments	**–**	**(355.1)**	**(355.1)**	(0.2)	(949.7)	(949.9)
At the end of the year	**569.5**	**883.9**	**1,453.4**	569.5	1,239.0	1,808.5

Subsidiary undertakings

The Company has, except in the case of Unity Trust Bank plc, a direct interest in the ordinary share capital of the following principal subsidiary undertakings trading in the businesses indicated. All subsidiary undertakings are included in the Bank results.

Principal subsidiary undertakings which are registered in England and operating in the UK:

		% Shareholding 2013	% Shareholding 2012
Unity Trust Bank plc			
(held through subsidiary undertaking)	Banking	**27%**	27%
Co-operative Commercial Limited	Investment company	**100%**	100%
First Roodhill Leasing Limited	Leasing	**100%**	100%
Second Roodhill Leasing Limited	Leasing	**100%**	100%
Third Roodhill Leasing Limited	Leasing	**100%**	100%
Fourth Roodhill Leasing Limited	Leasing	**100%**	100%
Britannia Treasury Services Limited	Holding company	**100%**	100%
Britannia Asset Management Limited	Holding company	**100%**	100%
Britannia Development and Management Company Limited	Property investment	**100%**	100%
Illius Properties Limited	Property investment	**100%**	100%
Moorland Covered Bonds LLP	Mortgage acquisition and guarantor of covered bonds	**100%**	100%
Southside Regeneration Limited	Property holding company	**100%**	0%

Unity Trust Bank plc is considered to be a subsidiary undertaking of The Co-operative Bank plc as The Co-operative Bank plc elects a majority of the Directors and appoints the Chair and Managing Director. This provides the power to control. See note 42 of the Bank financial statements for details of the relationship with Unity Trust Bank.

Investments in equity shares and loans with subsidiary undertakings are shown net of impairments.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

24. Investments in Co-operative Bank undertakings continued

Britannia Treasury Services Limited has the following principal wholly owned subsidiary undertakings, registered in England, operating in the UK and trading in the businesses indicated:

Mortgage Agency Services Number One Limited	Mortgage and syndicated lending
Mortgage Agency Services Number Two Limited	Mortgage lending
Mortgage Agency Services Number Four Limited	Mortgage lending
Mortgage Agency Services Number Five Limited	Mortgage lending
Mortgage Agency Services Number Six Limited	Mortgage lending
Western Mortgage Services Limited	Mortgage book administration
Platform Group Holdings Limited	Holding company

Platform Group Holdings Limited has the following principal wholly owned subsidiary undertakings, registered in England, operating in the UK and trading in the businesses indicated:

Platform Consumer Services Limited	Mortgage lending
Platform Funding Limited	Mortgage origination
Platform Home Loans Limited	Mortgage origination and servicing

Platform Consumer Services Limited is the only direct subsidiary of Platform Group Holdings Limited.

Registered in the Isle of Man and operating overseas:

Britannia International Limited	Deposit taking

On 10 January 2014, The Co-operative Bank plc announced that in line with its wider strategy of simplifying the business it is to gradually wind down Britannia International operations over the course of 2014.

Registered in Scotland and operating in the UK:

Britannia Life Direct Limited	Direct sales of financial services

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

24. Investments in Co-operative Bank undertakings continued

Securitisation vehicles

The results of the following securitisation vehicles are consolidated into the results of the Bank:

Leek Finance Number Seventeen plc	Securitisation company
Leek Finance Number Eighteen plc	Securitisation company
Leek Finance Number Nineteen plc	Securitisation company
Leek Finance Number Twenty plc	Securitisation company
Leek Finance Number Twenty One plc	Securitisation company
Leek Finance Number Twenty Two plc	Securitisation company
Meerbrook Finance Number One Limited	Securitisation company
Meerbrook Finance Number Two Limited	Securitisation company
Meerbrook Finance Number Three Limited	Securitisation company
Meerbrook Finance Number Four Limited	Securitisation company
Meerbrook Finance Number Six Limited	Securitisation company
Meerbrook Finance Number Eight Limited	Securitisation company
Silk Road Finance Number One plc	Securitisation company
Silk Road Finance Number Two plc	Securitisation company
Silk Road Finance Number Three plc	Securitisation company
Cambric Finance Number One plc	Securitisation company
Calico Finance Number One Limited	Securitisation company

All securitisation vehicles are registered in England and operate in the UK, with the exception of Calico Finance Number One Limited, which is registered and operates in the Republic of Ireland.

All of the above companies are related parties to the Company. See note 25 for the related party disclosures.

See note 41 to the Bank financial statements for further details of securitisation vehicles.

25. Related party transactions

Parent, subsidiary and ultimate controlling party

Up until 20 December 2013, The Co-operative Banking Group Limited owned approximately 100% of the issued ordinary share capital of the Company. The ultimate holding organisation was the Co-operative Group Limited. At 31 December 2012, of the 8.2 billion ordinary shares outstanding in the Company, 8,199,999,960 were held by The Co-operative Banking Group and 40 were held directly by Group. The ultimate holding organisation was the Co-operative Group Limited.

The ownership structure of the Company changed on 20 December 2013 as a result of the LME. Further details are provided in note 4 of the Bank financial statements. As a result The Co-operative Banking Group now owns approximately 30% of the Company. The remaining, approximately 70%, is owned by a number of investors, none of which individually own more than 10%.

At 31 December 2013, the Bank is an associate of, and therefore a related party of, The Co-operative Group as The Co-operative Group owns 30% of the Bank's ordinary shares, has Bank Board representation and there are material transactions between the two companies.

Further details of subsidiary undertakings are disclosed in note 24 to the Company financial statements.

Transactions with The Co-operative Group

The Bank has a significant relationship with The Co-operative Group. As part of the Recapitalisation Plan and in contemplation of the Bank ceasing to be a wholly owned subsidiary of The Co-operative Group, the Bank entered into the agreements and several other arrangements with The Co-operative Group. Further details of the transactions with The Co-operative Group are disclosed in note 39 to the Bank financial statements.

Transactions with CFSMS

The Company has a significant relationship with CFS Management Services Limited (CFSMS). CFSMS is a subsidiary of The Co-operative Banking Group and undertakes the provision of supplies and services on behalf of the Company. This relationship was in place for the whole of the year but will change over 2014 and beyond as the Bank separates from The Co-operative Group.

Further details of transactions with CFSMS are disclosed in note 39 to the Bank financial statements.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

25. Related party transactions continued

Balances with other Co-operative Group undertakings

In 2012, the Company balance sheet presented amounts owed by other Co-operative Group undertakings of £12.6bn and amounts owed to other Co-operative Group undertakings of £7.8bn.

As a result of legal separation, The Co-operative Group and its undertakings are no longer treated as intercompany balances. At 31 December 2013, the Company balance sheet reports £nil balances for amounts owed to/by other Co-operative Group undertakings. The 2012 amounts owed to/by The Co-operative Group undertakings have been represented to show the split between balances with The Co-operative Group undertakings and The Co-operative Bank plc undertakings. Balances with The Co-operative Bank plc undertakings have been disclosed separately on the balance sheet as a result of the distinction arising from the change in ownership structure.

The following tables present an analysis of the relevant balances as at 31 December 2013 and 31 December 2012 to aid comparability year on year:

Amounts owed by other Co-operative Group undertakings	2013	Restated 2012
The Co-operative Group	–	56.4
The Co-operative Banking Group Ltd	–	–
Subsidiaries of The Co-operative Banking Group Ltd	–	–
	–	56.4

Amounts owed to other Co-operative Group undertakings	2013	Restated 2012
The Co-operative Group	–	29.4
The Co-operative Banking Group Ltd	–	–
Subsidiaries of The Co-operative Banking Group Ltd	–	160.6
	–	190.0

Amounts owed by Co-operative Bank undertakings	2013	2012
Amounts owed by Co-operative Bank subsidiaries (excluding special purpose entities)	4,801.8	4,638.6
Amounts owed by Co-operative Bank subsidiaries – special purpose entities	7,085.0	7,718.4
	11,886.8	12,357.0

Amounts owed to Co-operative Bank undertakings	2013	2012
Amounts owed to Co-operative Bank subsidiaries (excluding special purpose entities)	2,047.8	3,854.0
Amounts owed to Co-operative Bank subsidiaries – special purpose entities	3,906.5	3,843.0
	5,954.3	7,697.0

The 2012 comparatives have been restated as described in note 1 of the Company financial statements.

Interest accrues on outstanding balances at a transfer price rate agreed between the Company and its subsidiaries.

In addition to the above balances with special purpose entities (SPEs), the Company holds floating rate notes in Leek Finance Number Seventeen plc of £14.3m (2012: £14.3m), in Leek Finance Number Eighteen plc of £19.5m (2012: £19.8m) and in Leek Finance Number Nineteen plc of £23.6m (2012: £25.2m) included within investment securities – available for sale.

The loans owed to the SPEs comprise cash balances deposited with the Company.

There are no formal repayment terms with subsidiary companies.

The table below provides an analysis of where the balances with The Co-operative Group and its undertakings are included in the 2013 balance sheet to aid comparability year on year.

2013	Loans & advances to customers	Other assets	Customer Accounts	Other liabilities
The Co-operative Group	110.1	100.6	(26.7)	–
The Co-operative Banking Group Ltd	–	303.2	(49.6)	–
Subsidiaries of The Co-operative Banking Group Ltd	–	–	(16.0)	(156.5)
	110.1	403.8	(92.3)	(156.5)

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

25. Related party transactions continued

The following tables show the value of transactions with The Co-operative Bank plc undertakings during the year.

2013	Interest and fees paid to Company	Interest and fees received from Company	Staff recharges paid to Company	Rent received from Company	Administration recharge paid to Company
Transactions with Co-operative Bank subsidiaries (excluding special purpose entities)	**61.4**	**60.9**	**9.3**	**0.6**	**8.0**
Transactions with Co-operative Bank subsidiaries – special purpose entities	**112.2**	**105.5**	**–**	**–**	**–**
2012					
Transactions with Co-operative Bank subsidiaries (excluding special purpose entities)	84.3	66.6	14.5	0.6	8.3
Transactions with Co-operative Bank subsidiaries – special purpose entities	111.3	118.0	–	–	–

Transactions with Directors, key management personnel and close family

Details of the Company's transactions with Directors, key management personnel and close family are as set out in note 39 to the Bank financial statements.

26. Share capital

	No. of shares (millions) 2013	Share capital 2013	No. of shares (millions) 2012	Share capital 2012
Issued capital (ordinary shares of 5p each)				
At the beginning of the year	**8,200**	**410.0**	8,200	410.0
Shares cancelled	**(8,200)**	**(410.0)**	–	–
Issue of new ordinary shares	**250**	**12.5**	–	–
At the end of the year	**250**	**12.5**	8,200	410.0
Allotted, called up and fully paid (ordinary shares of 5p each)				
At the beginning of the year	**8,200**	**410.0**	8,200	410.0
Shares cancelled	**(8,200)**	**(410.0)**	–	–
Issue of new ordinary shares	**250**	**12.5**	–	–
At the end of the year	**250**	**12.5**	8,200	410.0
Share premium account				
At the beginning of the year		**8.8**		8.8
Issue of new ordinary shares		**1,351.0**		–
At the end of the year		**1,359.8**		8.8

The ordinary shareholders have one vote for every share held.

Refer to note 4 of the Bank financial statements for details of shares cancelled and issued as a result of the LME.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

27. Fair values of financial assets and liabilities

The fair values in this note are stated at a specific date and may be significantly different from the amounts which will actually be paid on the maturity or settlement dates of the instruments. As a wide range of valuation techniques are available, it may be inappropriate to compare this fair value information to that of independent market or other financial institutions.

The tables below analyse the balance sheet carrying values of financial assets and liabilities by classification.

Balance sheet categories	Held for trading	Designated at fair value	Loans and receivables	Available for sale	Liabilities at amortised cost	Derivatives in a hedging relationship	Total
2013							
Assets							
Cash and balances at central banks	–	–	5,418.8	–	–	–	5,418.8
Loans and advances to banks	–	–	579.9	–	–	–	579.9
Loans and advances to customers	–	134.2	20,184.0	–	–	–	20,318.2
Fair value adjustments for hedged risk	–	–	107.6	–	–	–	107.6
Investment securities	–	1,743.4	83.1	2,477.2	–	–	4,303.7
Derivative financial instruments	234.5	–	–	–	–	90.4	324.9
Equity shares	–	–	–	5.8	–	–	5.8
Amounts owed by Co-operative Bank undertakings	–	–	11,886.8	–	–	–	11,886.8
Other assets	–	–	470.0	–	–	–	470.0
Total financial assets	234.5	1,877.6	38,730.2	2,483.0	–	90.4	43,415.7
Non-financial assets							1,660.8
Total assets							45,076.5
Liabilities							
Deposits by banks	–	–	–	–	2,863.3	–	2,863.3
Customer accounts	–	–	–	–	31,185.9	–	31,185.9
Customer accounts – capital bonds	–	527.3	–	–	–	–	527.3
Debt securities in issue	–	–	–	–	1,504.2	–	1,504.2
Derivative financial instruments	184.0	–	–	–	–	347.0	531.0
Other borrowed funds	–	–	–	–	196.3	–	196.3
Amounts owed to Co-operative Bank undertakings	–	1,466.4	–	–	4,487.9	–	5,954.3
Other liabilities	–	–	–	–	200.5	–	200.5
Total financial liabilities	184.0	1,993.7	–	–	40,438.1	347.0	42,962.8
Non-financial liabilities							543.8
Total liabilities							43,506.6
Capital and reserves							1,569.9
Total liabilities and equity							45,076.5

IAS 39 requires derivative financial instruments that are not in a hedging relationship to be classified as 'held for trading', this definition differs from the definition of 'derivatives held for trading purposes' as shown in note 7.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

27. Fair values of financial assets and liabilities continued

Balance sheet categories	Held for trading	Designated at fair value	Loans and receivables	Available for sale	Liabilities at amortised cost	Derivatives in a hedging relationship	Total
2012							
Assets							
Cash and balances at central banks	–	–	5,433.0	–	–	–	5,433.0
Loans and advances to banks	–	–	1,047.2	–	–	–	1,047.2
Loans and advances to customers	–	153.6	22,631.9	–	–	–	22,785.5
Fair value adjustments for hedged risk	–	–	354.1	–	–	–	354.1
Investment securities	960.2	1,845.2	355.4	3,563.9	–	–	6,724.7
Derivative financial instruments	360.1	–	–	–	–	230.8	590.9
Equity shares	–	–	–	5.7	–	–	5.7
Amounts owed by other Co-operative Group undertakings	–	–	56.4	–	–	–	56.4
Amounts owed by Co-operative Bank undertakings	–	–	12,357.0	–	–	–	12,357.0
Other assets	–	–	67.3	–	–	–	67.3
Total financial assets	1,320.3	1,998.8	42,302.3	3,569.6	–	230.8	49,421.8
Non-financial assets							2,474.7
Total assets							51,896.5
Liabilities							
Deposits by banks	–	–	–	–	3,552.9	–	3,552.9
Customer accounts	–	–	–	–	33,750.3	–	33,750.3
Customer accounts – capital bonds	–	867.2	–	–	–	–	867.2
Debt securities in issue	–	–	–	–	1,752.2	–	1,752.2
Derivative financial instruments	241.8	–	–	–	–	680.8	922.6
Other borrowed funds	–	–	–	–	1,258.6	–	1,258.6
Amounts owed to other Co-operative Group undertakings	–	–	–	–	190.0	–	190.0
Amounts owed to Co-operative Bank undertakings	–	1,764.4	–	–	5,932.6	–	7,697.0
Other liabilities	–	–	–	–	99.5	–	99.5
Total financial liabilities	241.8	2,631.6	–	–	46,536.1	680.8	50,090.3
Non-financial liabilities							177.1
Total liabilities							50,267.4
Capital and reserves							1,629.1
Total liabilities and equity							51,896.5

The above table has been re-analysed to show all derivatives in a hedging relationship.

Amounts owed by other Co-operative Group undertakings have been restated as described in note 1.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

27. Fair values of financial assets and liabilities continued

a) Use of financial instruments

Refer to note 41.a) in the Bank financial statements for details of the use of financial instruments by the Company.

b) Valuation of financial assets and liabilities carried at fair value

The following tables analyse financial assets and liabilities carried at fair value by the three level fair value hierarchy defined as follows:

- Level 1 – Quoted market prices in active markets
- Level 2 – Valuation techniques using observable inputs
- Level 3 – Valuation techniques using unobservable inputs

	Fair value at end of the reporting period using:			
2013	**Level 1**	**Level 2**	**Level 3**	**Total**
Non-derivative financial assets				
Designated at fair value:				
Loans and advances to customers	**–**	**125.5**	**8.7**	**134.2**
Investment securities	**1,743.4**	**–**	**–**	**1,743.4**
Available for sale financial assets:				
Investment securities	**2,477.2**	**–**	**–**	**2,477.2**
Equity shares	**0.1**	**5.7**	**–**	**5.8**
Derivative financial instruments	**–**	**314.3**	**10.6**	**324.9**
Non-financial assets				
Investment properties	**–**	**–**	**1.9**	**1.9**
Total assets carried at fair value	**4,220.7**	**445.5**	**21.2**	**4,687.4**
Non-derivative financial liabilities				
Designated at fair value:				
Customer accounts – capital bonds	**–**	**527.3**	**–**	**527.3**
Amounts owed to Co-operative Bank undertakings	**–**	**–**	**1,466.4**	**1,466.4**
Derivative financial instruments	**–**	**454.9**	**76.1**	**531.0**
Total liabilities carried at fair value	**–**	**982.2**	**1,542.5**	**2,524.7**

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

27. Fair values of financial assets and liabilities continued

2012	Fair value at end of the reporting period using: Level 1	Level 2	Level 3	Total
Non-derivative financial assets				
Held for trading:				
Investment securities	960.2	–	–	960.2
Designated at fair value:				
Loans and advances to customers	–	142.4	11.2	153.6
Investment securities	1,845.2	–	–	1,845.2
Available for sale financial assets:				
Investment securities	2,184.9	1,379.0	–	3,563.9
Equity shares	0.1	5.6	–	5.7
Derivative financial instruments	–	580.0	10.9	590.9
Non-financial assets				
Investment properties	–	–	1.8	1.8
Total assets carried at fair value	4,990.4	2,107.0	23.9	7,121.3
Non-derivative financial liabilities				
Designated at fair value:				
Customer accounts – capital bonds	–	867.2	–	867.2
Amounts owed to Co-operative Bank undertakings	–	–	1,764.4	1,764.4
Derivative financial instruments	–	909.7	12.9	922.6
Total liabilities carried at fair value	–	1,776.9	1,777.3	3,554.2

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

27. Fair values of financial assets and liabilities continued

The carrying values of financial instruments measured at fair value are determined in compliance with the accounting policies (in note 1 to the Bank Financial Statements) and according to the following hierarchy:

Level 1 – Quoted market prices in active markets

Financial instruments with quoted prices for identical instruments in active markets. The best evidence of fair value is a quoted market price in an actively traded market.

Level 2 – Valuation techniques using observable inputs

Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

The valuation techniques used to value these instruments employ only observable market data and relate to the following assets and liabilities:

Loans and advances to customers

Loans and advances to customers include corporate loans of £125.5m (2012: £142.4m) which are fair valued through income or expense using observable inputs. Loans held at fair value are valued at the sum of all future expected cash flows, discounted using a yield curve based on observable market inputs.

Investment securities – available for sale

Fair value is based on available market prices. Where this information is not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics.

Derivative financial instruments

Over-the-counter (ie non-exchange traded) derivatives are valued using valuation models which are based on observable market data. Valuation models calculate the present value of expected future cash flows, based upon 'no arbitrage' principles. The Bank enters into vanilla foreign exchange and interest rate swap derivatives, for which modelling techniques are standard across the industry. Examples of inputs that are generally observable include foreign exchange spot and forward rates, and benchmark interest rate curves.

Investment properties

Investment properties are carried at fair value. Fair value is calculated by using recent valuations of individual assets within the portfolio, index linked to the balance sheet date using the relevant house price index where appropriate.

Customer accounts – capital bonds

The estimated fair value of customer accounts – capital bonds is based on independent third party valuations using forecast future movements in the appropriate indices.

Level 3 – Valuation techniques using unobservable inputs

This is used for financial instruments valued using models where one or more significant inputs are not observable.

The small proportion of financial assets valued based on significant unobservable inputs are analysed as follows:

Loans and advances to customers

Loans and advances to customers include 25 year fixed rate mortgages of £8.7m (2012: £11.2m) which are fair valued through income or expense using unobservable inputs. 25 year fixed rate mortgages are valued using future interest cash flows at the fixed customer rate and estimated schedule of customer repayments. Cash flows are discounted at a credit adjusted discount rate; the credit adjustment is based on the average margin of new long dated (five years or greater) fixed rate business written in the last six months, and subject to quarterly review. The eventual timing of future cash flows may be different from that forecast due to unpredictable customer behaviour, particularly on a 25 year product. The valuation methodology takes account of credit risk and has increased the valuation by £0.8m in 2013 (2012: £0.5m increase). A reasonable change in the assumptions would not result in any material change in the valuation.

27. Fair values of financial assets and liabilities continued

Equity shares

Equity shares primarily relate to investments held in Vocalink Limited which are unquoted shares. The valuation of these shares is based on the Company's percentage shareholding and the net asset value of the Company according to its most recently published financial statements.

Amounts owed to Co-operative Bank undertakings

Amounts owed to Co-operative Bank undertakings are to the Silk Road Finance Number One plc (Silk Rd 1) subsidiary, relating to the legal transfer of loans and advances on securitisation. The amounts are fair valued to eliminate an accounting mismatch of the swap derivative discussed below.

Revaluation of the £1,466.4m (2012: £1,764.4m) mortgage pool from carrying to fair value is based on assumed timing of future mortgage capital and revenue receipts, discounted to present value using a credit adjusted discount rate.

The amortisation profile is based on a redemption profile, assuming some annual prepayment, which is extended to the earlier of the mortgage maturity date or the step-up date, the earliest contractual maturity of the debt securities in issue when the balance outstanding on the notes may be repaid, this falls on 21 March 2015. Similarly, the revenue receipts are calculated based on the redemption profile, but extended until the earlier of the mortgage maturity date or the step-up date. For fixed rate mortgages, revenue receipts are based on fixed customer rates within the assumed amortisation profile. For tracker, SVR and discount products, revenue receipts are assumed to be based on forward Bank of England base rates plus the product margins. Fixed and tracker mortgages are assumed to revert to SVR at the end of any offer period. All mortgages in the mortgage pool were originated pre 31 December 2007.

Derivative financial instruments

Derivative financial instruments in the form of interest rate swaps have been entered into between the Bank and its subsidiaries, and external counterparties.

The purpose of the swaps is to convert the fixed and base rate linked revenue receipts of the pool of mortgage assets to the same LIBOR linked basis as the intercompany loan. Under this swap arrangement the Bank's subsidiaries pay to the swap counterparty, the monthly mortgage revenue receipts of the pool of assets and receives from the swap counterparty LIBOR plus a contractual spread on the same notional balance; the spread being sufficient to cover the intercompany loan and any expenses. The Bank has a 'back to back' swap that is the mirror image of the subsidiaries' swaps.

The swaps are valued based on an assumed amortisation profile of the pool of assets to the bond maturity date (assuming some annual prepayment), an assumed profile of customer receipts over this period, and LIBOR prediction using forward rates. Swap cash flows are discounted to present value using mid-yield curve zero coupon rates, ie no adjustment is made for credit losses, nor for transaction or any other costs.

In addition derivative liabilities include a credit default swap. The credit default swap balance has arisen, as on 28 January 2013, the Company entered into a transaction to transfer a mezzanine portion of the risk in a portfolio of residential mortgage loans to third party investors, via a special purpose vehicle, Calico Finance Number One Limited. The valuation takes on market MBS spreads, less the original traded spread multiplied by the notional, and the duration, then discounted. These spreads include the probability of default.

Investment properties

Investment properties are carried at fair value. Fair value is calculated by using recent valuations of individual assets within the portfolio, index linked to the balance sheet date using the relevant regional house price index, where appropriate.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

27. Fair values of financial assets and liabilities continued

Movements in fair values of instruments with significant unobservable inputs (level 3) were:

	Fair value at the beginning of the year	Purchases and transfers in	Sales and transfers out	Income or expense including impairment	Fair value at the end of the year
2013					
Loans and advances to customers	**11.2**	**–**	**(1.7)**	**(0.8)**	**8.7**
Derivative assets	**10.9**	**–**	**(0.6)**	**0.3**	**10.6**
Derivative liabilities	**(12.9)**	**(58.2)**	**–**	**(5.0)**	**(76.1)**
Amounts owed to Co-operative Bank undertakings	**(1,764.4)**	**–**	**299.7**	**(1.7)**	**(1,466.4)**
Investment properties	**1.8**	**–**	**–**	**0.1**	**1.9**
	(1,753.4)	**(58.2)**	**297.4**	**(7.1)**	**(1,521.3)**
2012					
Loans and advances to customers	12.4	–	–	(1.2)	11.2
Derivative assets	9.5	–	–	1.4	10.9
Derivative liabilities	(9.9)	–	–	(3.0)	(12.9)
Amounts owed to Co-operative Bank undertakings	(2,130.6)	–	361.8	4.4	(1,764.4)
Investment properties	–	0.9	–	0.9	1.8
	(2,118.6)	0.9	361.8	2.5	(1,753.4)

c) Fair values of financial assets and liabilities not carried at fair value

The carrying values of financial assets and liabilities measured at amortised cost are determined in compliance with the accounting policies in note 1 to the Bank financial statement.

The table below sets out a summary of the carrying and fair values of:

- financial assets classified as loans and receivables; and
- financial liabilities classified as held at amortised cost,

unless there is no significant difference between carrying and fair values.

	Carrying value	Fair value
2013		
Financial assets		
Loans and receivables		
Loans and advances to banks	**579.9**	**579.9**
Loans and advances to customers	**20,184.0**	**18,726.8**
Fair value adjustments for hedged risk	**107.6**	**107.6**
Investment securities	**83.1**	**93.3**
Amounts owed by Co-operative Bank undertakings	**11,886.8**	**11,445.8**
Other assets	**470.0**	**470.0**
Financial liabilities		
Financial liabilities at amortised cost		
Deposits by banks	**2,863.3**	**2,863.1**
Customer accounts	**31,185.9**	**31,210.9**
Debt securities in issue	**1,504.2**	**1,523.4**
Other borrowed funds	**196.3**	**234.2**
Amounts owed to Co-operative Bank undertakings	**4,487.9**	**4,486.7**

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

27. Fair values of financial assets and liabilities continued

	Carrying value	Fair Value (as reported)[1]	Fair Value (applying 2013 methodology)[2]
2012			
Financial assets			
Loans and receivables			
Loans and advances to banks	1,047.2	1,046.0	1,047.2
Loans and advances to customers	22,631.9	22,487.6	21,067.4
Fair value adjustments for hedged risk	354.1	354.1	354.1
Investment securities	355.4	380.2	297.9
Amounts owed by other Co-operative Group undertakings	56.4	56.4	56.4
Amounts owed by Co-operative Bank undertakings	12,357.0	12,319.0	12,003.2
Financial liabilities			
Financial liabilities at amortised cost			
Deposits by banks	3,552.9	3,567.7	3,555.2
Customer accounts	33,750.3	33,969.4	33,969.4
Debt securities in issue	1,752.2	1,799.8	1,889.1
Other borrowed funds	1,258.6	1,161.3	1,394.1
Amounts owed to other Co-operative Group undertakings	190.0	190.0	190.0
Amounts owed to Co-operative Bank undertakings	5,932.6	6,003.6	5,950.8

Amounts owed by other Co-operative Group undertakings has been restated as described in note 1 to the Company financial statements.

1. As reported in the 2012 published Report and Accounts.
2. In 2013, the Bank reviewed and improved the methods used to calculate the fair values. The 2012 comparatives (with the exception of fair value adjustment for hedged risk) have been re-presented accordingly to reflect these changes in methods.

Key considerations in the calculation of fair values for loans and receivables and financial liabilities at amortised cost are as follows:

Loans and advances to banks/deposits by banks

Loans and advances to banks include interbank placements and items in the course of collection.

The amortised cost value of all loans and advances to banks are deemed to be a close approximation of their fair value due to their short maturity. The estimated fair value of fixed interest bearing deposits is based on discounted cash flows using prevailing money market interest rates for debts with similar credit risk and remaining maturity.

Loans and advances to customers

The fair value of loans and advances to customers is calculated by segmenting the overall balance into Retail and Corporate.

i. Retail

Fixed rate loans and advances to customers are revalued to fair value based on future interest cash flows (at funding rates) and principal cash flows discounted using an appropriate market rate. Forecast principal repayments are based on redemption at the earlier of maturity or repricing date with some overlay for historical behavioural experience where relevant. The eventual timing of future cash flows may be different from the forecast due to unpredictable customer behaviour. It is assumed there is no fair value adjustment required in respect of interest rate movement on standard variable rate assets.

ii. Corporate

As part of the implementation of the Company's exit strategy, certain assets have either already been sold during the year or plans to sell are well advanced. For these assets, the fair value can therefore be determined from the actual sale price achieved or expected to be received.

For other Corporate assets an expected cashflow derived income approach using redemption profile has been used. Under this approach, value is measured by determining expected cash flows from the portfolio and then considering credit costs, funding costs and tax to derive equity cash flows which are discounted at an appropriate blended cost of capital.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

27. Fair values of financial assets and liabilities continued

Investment securities

Fair value is based on available market prices. Where this information is not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics.

Amounts owed by Co-operative Bank undertakings

Amounts owed by Co-operative Bank undertakings include debt securities and subordinated debt held in the Bank's own securitisation vehicles. Fair value is based on available market prices, where these are not available quoted market prices for similar debt securities, with adjustments to take into account the subordination of the particular loan note, have been used to estimate fair value.

Customer accounts

The estimated fair value of deposits with no stated maturity, which includes non-interest bearing deposits, is the amount repayable on demand. The estimated fair value of fixed interest bearing deposits and other borrowings without quoted market prices is based on future interest cash flows (at funding rates) and principal cash flows, discounted using an appropriate market rate.

Debt securities in issue and other borrowed funds

The aggregate fair values are calculated based on quoted market prices. For those notes where quoted market prices are not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics.

The fair value of debt securities in issue is significantly above the carrying value as a result of the carrying value being net of merger fair value adjustments. The carrying values of debt securities in issue are expected to increase, as the merger fair value adjustments continue to unwind, by £110m in 2014, £150m in 2015, £180m in 2016 and by £60m in 2017.

2012 comparatives (as reported)

The above table provides the 2012 fair value comparatives as reported in the 2012 Annual Report and Accounts and the 2012 fair value comparatives re-presented using the 2013 methodology (as described above). The most significant difference in fair value arising from the two methodologies is on Loans and advances to customers. The following section summarises the methodology adopted for the 2012 Annual Report and Accounts.

At 31 December 2012, the methodology used to estimate the fair value of loans and advances to customers is summarised in note 39 of the financial statements of the 2012 Annual Report and Accounts. The key aspects of this methodology, with reference to the financial instrument risks that have the greatest impact on fair value, are summarised below.

a) Expected lives of financial instruments were based on updated forecasts of prepayment curves, based on recent actual experience in each key portfolio.

b) Interest rate adjustments were calculated on the non-administered rate (fixed and LIBOR/base tracker rates) books across the Retail; Optimum and Corporate books. The cash flows on these books were discounted using LIBOR/SONIA yield curves. The interest rate adjustment calculated at 31 December 2012 was £961m (positive), from which the fair value adjustment for hedged risk (£354m) was removed as this was already included in the carrying value of the loans and advances, leaving a total interest rate risk adjustment of £607m (positive).

c) Credit risk adjustments were made based on the expected loss calculations for all the portfolios reported in the FSA004 regulatory returns. The total credit risk adjustment applied was £1,137m (negative), from which the accounting provisions held at 31 December 2012 (£567m) were deducted to leave a total net adjustment of £570m. The credit risk adjustment was also applied to ex-Britannia loans and advances, which were acquired at fair value in 2009, as the credit risk component of the valuation at that time proved to be too small by 31 December 2012. The credit risk adjustment was considered to represent a reasonable proxy for lifetime expected losses plus an unquantified risk premium adjustment.

d) The percentage difference between the fair value and the carrying value of total loans and advances was compared with similar financial institutions and was broadly consistent. There were no significant observations arising from this review.

Amounts owed to Co-operative Bank undertakings

Amounts owed to other Co-operative Bank undertakings relate to deemed loans owed to the Bank's own securitisation vehicles; these have been modelled using expected cash flows, based on redemption profiles, discounted at a market rate.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

27. Fair values of financial assets and liabilities continued

Fair values of financial assets which are not carried at fair value and bases of valuation.

Fair values are determined according to the hierarchy set out on page 254.

	Carrying value	Level 1	Level 2	Level 3
2013				
Financial assets				
Loans and receivables				
Loans and advances to customers	**20,184.0**	**–**	**–**	**18,726.8**
Fair value adjustment for hedged risk	**107.6**	**–**	**–**	**107.6**
Investment securities	**83.1**	**21.5**	**71.8**	**–**
Amounts owed by Co-operative Bank undertakings	**11,886.8**	**–**	**6,266.1**	**5,179.7**
Financial liabilities				
Financial liabilities at amortised cost				
Customer accounts	**31,185.9**	**–**	**31,210.9**	**–**
Debt securities in issue	**1,504.2**	**892.5**	**630.9**	**–**
Other borrowed funds	**196.3**	**–**	**234.2**	**–**
Amounts owed to Co-operative Bank undertakings	**4,487.9**	**–**	**–**	**4,486.7**

The carrying amount is a reasonable approximation of fair value for the following assets and liabilities; loans and advances to banks, fair value adjustments for hedged risk, other assets, deposits by banks and other liabilities.

d) Assets pledged

Assets are pledged as collateral under repurchase agreements with other banks. These deposits are not available to finance the Company's day to day operations.

	Carrying amount of assets not derecognised	Carrying amount of associated liabilities	Fair value of assets not derecognised	Fair value of associated liabilities	Net position
2013					
Investment securities sold under repurchase agreements	**1,004.4**	**1,028.3**	**1,022.5**	**1,028.3**	**(5.8)**
Amounts owed by Co-operative Bank undertakings sold under repurchase agreements	**3,967.3**	**1,968.2**	**2,558.9**	**1,968.2**	**590.7**

	Carrying amount of assets not derecognised	Carrying amount of associated liabilities	Fair value of assets not derecognised	Fair value of associated liabilities	Net position
2012					
Investment securities sold under repurchase agreements	1,907.4	1,830.9	1,907.7	1,827.5	80.2
Amounts owed by Co-operative Bank undertakings sold under repurchase agreements	1,324.6	896.7	1,301.6	911.7	389.9

Associated liabilities are included within deposits by banks.

The Company has loans and advances to banks of £nil (2012: £250.0m) under reverse sale and repurchase agreements and against which gilts are held with a fair value of £nil (2012: £250.4m). These transactions are conducted under terms that are usual and customary to standard stock lending, securities borrowing and reverse purchase agreements. The Company is permitted to sell or repledge the assets received as collateral in the absence of their default. The Company is obliged to return equivalent securities. At 31 December 2013 the fair value of collateral repledged amounted to £nil (2012: £250.4m). The Company does not adjust for the fair value of securities received under reverse sale and repurchase agreements.

Notes to the Company financial statements continued

For the year ended 31 December 2013

All amounts are stated in £m unless otherwise indicated

28. Company analysis of credit risk exposure

2013	Loans and advances to banks	Loans and advances to customers	Investment securities: Loans and receivables	Investment securities: Available for sale	Investment securities: Fair value through income or expense	Investment securities: Held for trading	Derivative financial instruments	Total
Analysis of balance in note	**4**	**5**	**6**	**6**	**6**	**6**	**7**	
Gross balance	**579.9**	**20,996.6**	**83.1**	**2,497.2**	**1,743.4**	**–**	**324.9**	**26,225.1**
Less: allowance for losses	**–**	**(678.4)**	**–**	**(20.0)**	**–**	**–**	**–**	**(698.4)**
	579.9	**20,318.2**	**83.1**	**2,477.2**	**1,743.4**	**–**	**324.9**	**25,526.7**
Analysis of credit risk exposure								
Not impaired	**579.9**	**19,392.5**	**83.1**	**2,477.2**	**1,743.4**	**–**	**317.9**	**24,594.0**
Impaired	**–**	**1,604.1**	**–**	**20.0**	**–**	**–**	**7.0**	**1,631.1**
	579.9	**20,996.6**	**83.1**	**2,497.2**	**1,743.4**	**–**	**324.9**	**26,225.1**
Credit commitments	**650.5**	**3,519.8**	**–**	**–**	**–**	**–**	**–**	**4,170.3**
Gross credit risk exposure	**1,230.4**	**24,516.4**	**83.1**	**2,497.2**	**1,743.4**	**–**	**324.9**	**30,395.4**
Less: allowance for losses	**–**	**(678.4)**	**–**	**(20.0)**	**–**	**–**	**–**	**(698.4)**
Net credit risk exposure	**1,230.4**	**23,838.0**	**83.1**	**2,477.2**	**1,743.4**	**–**	**324.9**	**29,697.0**

2012	Loans and advances to banks	Loans and advances to customers	Investment securities: Loans and receivables	Investment securities: Available for sale	Investment securities: Fair value through income or expense	Investment securities: Held for trading	Derivative financial instruments	Total
Analysis of balance in note	4	5	6	6	6	6	7	
Gross balance	1,047.2	23,203.7	355.4	3,602.9	1,845.2	960.2	590.9	31,605.5
Less: allowance for losses	–	(418.2)	–	(39.0)	–	–	–	(457.2)
	1,047.2	22,785.5	355.4	3,563.9	1,845.2	960.2	590.9	31,148.3
Analysis of credit risk exposure								
Not impaired	1,047.2	21,932.0	355.4	3,563.9	1,845.2	960.2	590.9	30,294.8
Impaired	–	1,271.7	–	39.0	–	–	–	1,310.7
	1,047.2	23,203.7	355.4	3,602.9	1,845.2	960.2	590.9	31,605.5
Credit commitments	54.1	4,736.5	–	–	–	–	–	4,790.6
Gross credit risk exposure	1,101.3	27,940.2	355.4	3,602.9	1,845.2	960.2	590.9	36,396.1
Less: allowance for losses	–	(418.2)	–	(39.0)	–	–	–	(457.2)
Net credit risk exposure	1,101.3	27,522.0	355.4	3,563.9	1,845.2	960.2	590.9	35,938.9

Previously, the credit fair value adjustments have been disclosed separately in the above table; the table has now been revised to set off the credit fair value adjustments within the not impaired and impaired gross balances, to better show their gross carrying values in the Company.

Until the second half of 2013, The Co-operative Banking Group maintained common governance, organisational and risk management structures, which had been developed and implemented across its subsidiaries including the Bank.

In 2013 the Bank put in place its own revised, updated and independent Risk Management Framework and policies, which have been adopted by the Bank Executive and the Board. The Bank's new risk management framework reflects the previous system in many respects, but it continues to be refined to meet the Bank's specific requirements.

As a result of the new Risk Management Framework, the Bank is now solely responsible for determining its principal risks, and the level of acceptable risks, as stipulated in the Bank's risk appetite statement, thus ensuring that there is an adequate system of risk management so that the levels of capital and liquidity held are consistent with the risk profile of the business.

The risk management disclosures on pages 69 to 116 apply to the Company where relevant and therefore no additional disclosures are included in this note.

Notes to the Company financial statements continued
For the year ended 31 December 2013
All amounts are stated in £m unless otherwise indicated

29. Post balance sheet events

It is a requirement of IAS 10 (Events after the balance sheet date) that these financial statements reflect events arising after 31 December 2013. The following events have occurred between 31 December 2013 and 10 April 2014 (the date of approval of these financial statements) and represent 'non adjusting' post balance sheet events:

Employees

During the year, the majority of the Bank's employees had contracts with CFS Management Services Limited (CFSMS) and the cost of their services was recharged to subsidiaries, including the Bank. Following the legal separation of the Bank from the wholly owned subsidiary of The Co-operative Group, employment contracts for the majority of these employees transferred from CFSMS to the Bank. The transfer took place under the Transfer of Undertakings (Protection of Employment) Regulations 2006. Further transfers will occur in 2014 as the Bank completes its separation.

External investigations

The Bank has come under greater regulatory scrutiny and expects that environment to continue. The Bank is the subject of multiple regulatory and other investigations and enquiries into events at the Bank and circumstances surrounding them. The investigations announced after the balance sheet date are:

- The FCA announced on 6 January 2014 that it will be undertaking enforcement investigations into events at the Bank. The investigation will look at the decisions and events up to June 2013;
- The PRA announced on 6 January 2014 that it is undertaking an enforcement investigation in relation to the Bank and as part of that investigation will consider the role of former senior managers; and
- The Financial Reporting Council announced on 20 January 2014 it had launched an investigation under the Accountancy Scheme into the preparation, approval and audit of the financial statements of The Co-operative Bank plc, up to and including the year ended 31 December 2012.

Other information

265 Shareholder information
266 Glossary
274 Forward-looking statements
275 Appendix 1

Shareholder information

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Glossary

For the year ended 31 December 2013

The following glossary defines terminology used within the Bank's and Company's Annual Report and Accounts to assist the reader and to facilitate comparison with publications by other financial institutions:

Terminology	Definition
Almost prime	Almost prime lending is lending to borrowers with very low levels of adverse credit history.
Arrears	Customers are said to be in arrears or non-performing when they are behind in fulfilling their obligations with the result that an outstanding loan is unpaid or overdue. Corporate customers may also be considered non-performing prior to being behind in fulfilling their obligations. This can happen when a significant restructuring exercise begins.
Automated Valuation Model (AVM)	A valuation model used specifically for low loan to value (LTV) remortgages. Performance of AVMs is monitored on a regular basis to ensure their ongoing accuracy.
Banking Group	The Co-operative Banking Group Ltd and its subsidiaries, which included the Bank until legal separation occurred on 20 December 2013.
Basel II	A statement of best practice issued by the Basel Committee on Banking Supervision, that defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses. Basel II became law in the EU Capital Requirements Directive, and was implemented in the UK via the FSA Handbook.
Basel III	A strengthening of the requirements laid out in Basel II, to be phased into the Bank from 2014 ahead of full implementation by 2022. Basel III is implemented within the European Union (including the UK) through CRD IV
Basis points (bps)	One hundredth of a percent (0.01%), so 100 basis points is 1%. Used in quoting movements in interest rates or yields on securities.
BIPRU	The prudential sourcebook for banks, building societies and investment firms which sets out the PRA's requirements for capital and liquidity.
BaCB (Business and Commercial Banking)	The core segment of the Bank which specialises in lending to businesses.
Buy to let	A commercial practice of buying a property to let to tenants, rather than to live in.
Capital bonds	Fixed term customer accounts with returns based on the movement in an index (eg FTSE 100) over the term of the bond.
Capital ratio	Total of Tier 1 capital plus Tier 2 capital, all divided by risk weighted assets.
Capital Requirements Directive (CRD IV)	This encompasses both the Capital Requirements Directive and Capital Requirements Regulation (CRR) as well as the PRA's Policy Statement PS7/13: Strengthening capital standards. CRD IV implements Basel III within the European Union (including the UK) and is a strengthening of the requirements laid out in Basel II.
Capital resources	Capital held, allowable under regulatory rules, less certain regulatory adjustments and deductions that are required to be made. Capital includes retained earnings, share premium and minority interests.
Carrying value	The value of an asset or liability as it appears in the balance sheet. For each asset or liability, the value is based on either of the amortised cost or fair value principles.
Certificates of deposit (CDs)	Debt issued by banks, savings and loan associations to individual investors with terms ranging from a few months to several years. Longer term CDs tend to bear a higher interest rate. At the expiration of the term, investors may (subject to penalties) withdraw both the principal and the accrued interest.
CFS Management Services Ltd (CFSMS)	CFS Management Services Ltd (CFSMS) provides supplies and services on behalf of subsidiary undertakings within The Co-operative Banking Group.
Charged off	When all economical avenues to recover an unsecured debt have been exhausted, the Bank permanently closes the loan account, ie it is charged off. This final step sits at the end of a time frame within which the Bank attempts to manage the debt's recovery and differs from a 'write down' in terms of its fixed position in time (see Write down).
Collateral	A borrower's pledge, usually a property, which acts as security for repayment of the loan (see Secured lending).
Collateralised swap	A swap, whose volatility is secured (collateralised) by way of exchanging cash deposits (see Swaps).
Colleague engagement	An internal survey, measuring the level of the Bank's employees' engagement.
Collectively assessed for impairment	Impairment is measured collectively where a portfolio comprises assets with a homogenous risk and where appropriate statistical techniques are available.
Commercial Paper	An unsecured promissory note issued to finance short term credit needs. It specifies the face amount paid to investors on the maturity date.
Commercial real estate	Commercial real estate includes office buildings, industrial property, malls, retail stores, shopping centres, multifamily housing buildings, warehouses, and industrial properties.

Glossary continued
For the year ended 31 December 2013

Terminology	Definition
Common Equity Tier 1	A CRD IV regulatory measure of financial (capital) strength. Common Equity Tier 1 capital is the highest quality of capital and comprises share capital and associated share premium, and general reserves from retained profits. The book values of goodwill and intangible assets as well as other regulatory adjustments, including the full amount of expected loss over provisions, are deducted from Common Equity Tier 1 capital for the purposes of capital adequacy.
Conduct risk	The risk that the Bank's behaviours, offerings or interactions will result in unfair outcomes for customers.
Contagion risk	An international financial market term which describes a corrupting or harmful influence, spreading effects of shocks from one counterparty to another.
Co-operative Asset Management (CoAM)	The segment that comprises non-core assets managed for run down or exit.
Co-operative Banking Group (CBG)	The Co-operative Banking Group Ltd and its subsidiaries, which included the Bank until legal separation occurred on 20 December 2013.
Core business	Lines of business that are consistent with the Bank's strategy and risk appetite.
Corporate core segment	The segment that comprises corporate banking, business banking and business services in line with the Bank's strategy and risk appetite.
Cost of risk	Impairment charges (amounts provided for non-performing loans) expressed as a percentage of average loans during the year.
Cost to income ratio	Operating expenses divided by operating income.
Counterparty	In any financial contract, the person or institution entering the contract on the opposite side of the transaction is called a counterparty.
Covered bonds	Debt securities backed by a portfolio of mortgages that are segregated from the issuer's other assets solely for the benefit of the holders of the covered bonds. The Bank issues covered bonds as part of its funding activities.
Credit default swap	An arrangement whereby the credit risk of an asset (the reference asset) is transferred from the buyer to the seller of protection. A credit default swap is a contract where the protection seller receives premium or interest related payments in return for contracting to make payments to the protection buyer upon a defined credit event. Credit events normally include bankruptcy, payment default on a reference asset or assets, or downgrades by a credit rating agency.
Credit impairment	Impairment charges on loans and advances to customers.
Credit risk	The current or prospective risk to earnings and capital arising from a borrower's failure to meet the terms of any contract with the Bank or their failure to perform as agreed.
Currency swap	An arrangement in which two parties exchange specific principal amounts of different currencies at inception and subsequently interest payments on the principal amounts. Often one party will pay a fixed rate of interest, while the other will pay a floating rate (though there are also fixed-fixed and floating-floating arrangements). At the maturity of the swap, the principal amounts are usually re-exchanged.
Credit valuation adjustments (CVAs)	Adjustments to the fair values of derivative assets to reflect the creditworthiness of the counterparty.
Customer deposits	Money deposited by all individuals and companies that are not credit institutions. Such funds are recorded as liabilities in the Bank's balance sheet under customer accounts or financial liabilities designated at fair value.
Customer funding ratio	Customer deposits divided by customer loans. This is the reverse equation of the customer loan to deposit ratio (see Customer loan to deposit ratio).
Customer loan to deposit ratio	Customer loans divided by customer deposits. This is the reverse equation of the customer funding ratio (see Customer funding ratio).
Debt securities in issue	Transferable certificates of indebtedness of the Bank to the bearer of the certificates. These are liabilities of the Bank and include certificates of deposit, commercial paper and fixed and floating rate notes.
Default	Circumstances in which the probability of default is taken at 100% for the purposes of the calculation of regulatory capital and compliance with Basel II. This is defined as when a borrower reaches a predefined arrears status where a borrower is considered unlikely to repay the credit obligation in full without the lender taking action.
Deleverage the balance sheet	Strategic reduction of the Bank's risk asset base leading to improved capital management.

Glossary continued
For the year ended 31 December 2013

Terminology	**Definition**
Delinquency	A customer in arrears is also said to be in a state of delinquency. When a customer is in arrears, his entire outstanding balance is said to be delinquent, meaning that delinquent balances are the total outstanding loans on which payments are overdue (see Arrears).
Derivative	A financial instrument that has a value, based on the expected future price movements of the instrument to which it is linked, such as a share or a currency.
Effective interest rate method (EIR)	The method used to measure the carrying value of certain financial assets or liabilities and to allocate associated interest income or expense over the relevant period.
Encumbrance	Encumbrance is an impediment to use of assets, for example a claim against a property by another party. Encumbrance usually impacts the transferability of the asset and restrict its free use until the encumbrance is removed.
Ethical Policy	A method developed since 1992 by which the Bank engages with its customers in relation to ethics.
Eurozone	The geographical area containing countries whose economies function using the European single currency.
Expected charge off rate	The expected level of a portfolio's loans that may be written off as bad debt.
Expected loss	A measure of anticipated loss for exposures captured under an internal ratings based credit risk approach. The expected loss amount is the exposure from a potential default of a counterparty or dilution over a one year period to the amount outstanding at default.
Exposure at default (EAD)	A Basel II Pillar 1 parameter the amount estimated to be outstanding at the time of default – EAD calculated under the standardised approach is always reported post credit conversion factors and provisions. Under the IRB approach the EAD includes undrawn commitments after credit conversion factors.
External audit	An independent opinion, by an external firm, on the Bank and Company's financial statements.
External credit rating	A financial indicator of risk, assigned by credit rating agencies, to potential investors in the Bank.
Fair value adjustments	Fair value adjustments are the remaining balance sheet adjustments for the assets/liabilities acquired on the merger of the Bank and Britannia Building Society on 1 August 2009.
Fair value amortisation	The amortisation of the remaining interest risk related fair value adjustments for the assets/liabilities acquired on the merger of the Bank and Britannia Building Society on 1 August 2009 (see Interest rate risk).
Financial Conduct Authority (FCA)	The FSA was replaced as the UK's financial regulator on 1 April 2013 by two new regulatory bodies: the PRA and the FCA. The FCA is responsible for the regulation of conduct in retail, as well as wholesale, financial markets and the infrastructure that supports those markets.
Financial instruments	Any document with monetary value. Examples include cash and cash equivalents, but also securities such as bonds and stocks which have value and may be traded in exchange for money.
Financial Services Authority (FSA)	An independent non-governmental body, given statutory powers by the Financial Services and Markets Act 2000, which regulated the financial services industry. It was replaced as the UK's financial regulator on 1 April 2013 by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).
Financial Services Compensation Scheme (FSCS)	The UK's compensation fund of last resort for customers of authorised financial services firms. The FSCS may pay compensation to customers if a firm is unable, or likely to be unable, to pay claims against it, usually because it has stopped trading or has been declared in default. The FSCS is funded by the financial services industry. Every firm authorised by the PRA is obliged to pay an annual levy, which goes towards its running costs and compensation payments.
Floating rate notes (FRNs)	Investments with a variable interest rate. The adjustments to the interest rate are usually made every three to six months and are tied (or float) to a certain money market index.
Forbearance	The Bank, for reasons relating to the actual or apparent financial stress of a borrower, grants a concession whether temporarily or permanently to that borrower. A concession may involve restructuring the contractual terms of a debt (such as an extension of the maturity date or any weakening of the security structure or adjustment/non enforcement of covenants) or payment in some form other than cash, such as an equity interest in the borrower.
Foreclosure	The legal process by which a lender, eg the Bank, obtains a court order in order to terminate a borrower's equitable right of redemption. This legal action is required when a borrower has materially failed to comply with the agreed terms and conditions of the loan, eg by defaulting (see Forbearance).
Forward rate agreement	A legal contract, governing the terms and conditions of a forward or future, in which the buyer pays a fixed rate of interest to the seller in return for the seller's floating rate (see Forwards, Futures and Swaps).
Forwards	Non-standardised contracts, traded over the counter, between two parties to buy or sell financial instruments at a specified future time at a price agreed today (see Over The Counter).

Glossary continued

For the year ended 31 December 2013

Terminology	**Definition**
Funding for Lending	The Bank of England and HM Treasury launched the Funding for Lending Scheme (FLS) on 13 July 2012. It is designed to boost lending to households and businesses. It works by allowing participating banks and building societies to borrow from the Bank of England for up to four years. As security against that lending, participating banks will provide assets, such as business or mortgage loans, to the Bank of England. Banks will be able to borrow during the 18 months from 1 August 2012 until 31 January 2014.
Futures	Standardised contracts, traded on an exchange, between two parties to buy or sell financial instruments at a specified future time at a price agreed today.
Gap	The Bank's net exposure to variable elements being managed within its market risk, eg interest rate movements (see Market risk).
Hedging	A technique used by the Bank to offset risks on one instrument by purchasing a second instrument that is expected to perform in the opposite way.
Impaired loans	Loans where the Bank does not expect to collect all the contractual cash flows or expects to collect them later than they are contractually due.
Impairment allowance	A loss allowance held on the balance sheet as a result of the raising of a charge against profit for the incurred loss inherent in the lending book. An impairment loss allowance may be either individual or collective.
Individual Capital Guidance (ICG)	The PRA's statement as to the regulatory capital it expects the Bank to hold.
Individual Liquidity Adequacy Assessment (ILAA)	The Bank's assessment of its liquidity risks, controls and quantification of liquid assets required to survive severe financial shocks through the use of stress tests prescribed by the PRA (see Liquidity risk).
Individual Liquidity Guidance (ILG)	A PRA guidance on the required amount and composition of the liquid assets buffer that should be held by a firm. This guidance arises once the firm's Individual Liquidity Adequacy Assessment (ILAA) has been conducted.
Individually assessed for impairment	Impairment is measured individually for assets that are individually significant.
Individually significant	Large value loans that exceed a balance threshold established by the Bank, above which it is deemed appropriate to impair accounts on an individual basis.
Interest rate risk	The variability in value borne by an interest bearing asset, such as a loan or a bond, due to variability of interest rates. In general, as rates rise, the price of a fixed rate bond will fall, and vice versa.
Internal audit	The examination of the Company's records and reports by its employees. Internal audits are usually intended to prevent fraud and to ensure compliance with Board directives and management policies.
Internal Capital Adequacy Assessment Process (ICAAP)	The Bank's own assessment, as part of Basel II requirements, of the levels of capital that it needs to hold in respect of its regulatory capital requirements (for credit, market and operational risks) and for other risks including stress events.
Internal rating grade (IRG)	The grading of credit risk resulting from the internal ratings based approach (IRB).
Internal ratings based approach (IRB)	A Basel II approach for measuring exposure to credit risks. IRB approaches are more sophisticated and risk sensitive than the Standardised Approach and may be Foundation or Advanced. IRB approaches may only be used with PRA permission.
Investment grade	A debt security, treasury bill or similar instrument with a credit rating measured by external agencies of AAA to BBB.
Legal separation	The process by which the Bank was legally separated from The Co-operative Group.
Leverage ratio	A CRD IV measure, calculated as the ratio of Tier 1 capital to total exposures. Total exposures include on-balance sheet items, off-balance sheet items and derivatives. The leverage ratio is a supplementary measure to the risk-based capital requirements and is intended to constrain the build-up of excess leverage in the banking sector.
Liability Management Exercise (LME)	The process by which the Bank successfully raised c.£1.2bn of capital in 2013. This was effected by the transfer of preference shares and extinguishment of multiple subordinated liabilities, followed by the recognition of a single tranche of subordinated debt.
LIBOR (London Interbank Offered Rate)	The interest rate participating banks offer to other banks for loans on the London market.
Lifetime expected loss	The losses that the Bank expects to incur over the lifetime of portfolios of mortgage assets which were acquired on merger with Britannia Building Society. This is different from expected loss (see Expected loss) which is based on assets expected to default in the next 12 months.
Limited Liability Partnership (LLP)	An LLP provides each of its individual partners protection against personal liability for certain partnership liabilities.

Glossary continued

For the year ended 31 December 2013

Terminology	**Definition**
Liquid Asset Buffer	A range of assets from which the Bank can manage its liquidity risk. These assets have relatively short maturity dates.
Liquidity and funding risk	The risk that the Bank's resources will prove inadequate to meet its liabilities as they contractually fall due or as a result of any contingent or discretionary cash outflows that may occur in times of stress. It arises from mismatch of timings of cash flows generated from the Bank's assets and liabilities (including derivatives).
Loan to value (LTV)	A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Bank calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a quarterly basis to reflect changes in the house price index (HPI).
Loss emergence period	The time taken, expressed in months, for a loss event on a loan to become observed by the Bank.
Loss given default	An estimate of the actual loss that would occur in the event of default expressed as a percentage of the Exposure at Default (EAD).
Loss provisions	Provisions held against assets on the balance sheet as a result of the raising of a charge against profit for the incurred loss inherent in the lending book. The allowance represents management's best estimate of losses incurred in the loan portfolio at the balance sheet date.
Low to medium credit risk	Within not impaired, low to medium credit risk has been defined as exposures where the probability of default (PD) is 1% or below over a one year time horizon for exposures on an internal ratings based (IRB) approach under Basel II, and slotting category strong/good for specialised lending exposures under the slotting approach (see Slotting).
Lower Tier 2	Lower Tier 2 capital comprises the Bank's long term subordinated debt.
Malus	A facility whereby the Remuneration Committee may reduce the amount of any deferred bonus payable in the event that any of the underpins to the incentive plans are not met or where business and/or individual performance otherwise requires.
Management expenses and compensation cost	The specific elements of both operating and financing cost which form the basis of the Financial Services Compensation Scheme (see Financial Services Compensation Scheme (FSCS)).
Mandatory reserve deposits	Mandatory reserve deposits are deposited with the Bank of England and are not available for use in the Bank's day to day operations. They are non-interest bearing and are not included in cash and cash equivalents.
Market risk	Risk that the values of assets and liabilities, earnings and/or capital may change as a result of changes in market prices of financial instruments. The majority of the Bank's market risk arises from changes in interest rates.
Medium term notes (MTN)	Flexible medium term corporate debt instruments, offered by the Bank to investors through a dealer. Investors can choose from differing maturities, ranging from nine months to 30 years.
Medium to high credit risk	Within not impaired, medium to high credit risk has been defined as a probability of default (PD) of greater than 1% over a one year time horizon for exposure on internal ratings based (IRB) approach under Basel II, and slotting category weak/satisfactory for specialised lending exposures under the slotting approach (see Slotting).
Merger	Any combination of two or more business enterprises into a single enterprise. In the Bank, this specifically refers to the merger of the Bank with Britannia Building Society on 1 August 2009 (see Transfer of engagements).
Mortgage backed securities	Securities that represent interests in a group of mortgages. Investors in these securities have the right to cash received from future interest and/or principal mortgage payments.
Multilateral Development Banks (MDBs)	Supranational institutions which provide financial support and professional advice for economic and social development activities in developing countries. The term MDBs typically refers to the World Bank Group and Regional Development Banks.
Net interest income	The difference between interest received on assets and interest paid on liabilities after taking into account the effect of derivatives.
Net present value (NPV)	The present value of the expected future cash in and out flows on an asset or liability.
Non-conforming	Loans originated by Platform prior to 2009 and those acquired by Britannia Treasury Services, with similar risk profiles to Almost prime (see Almost prime).
Non-core business	Lines of business not congruent with the Bank's current strategy, are managed for value and are targeted for run down and exit, and contain the majority of impairment risk. Included in non-core is Corporate non-core business, Optimum (closed book of residential mortgages originated through intermediaries and previously purchased mortgage portfolios) and Illius (the residential property company).
Operational risk	The risk of loss resulting from inadequate or failed internal processes, people and systems or external events. This encompasses the effectiveness of risk management techniques and controls to minimise these losses.

Glossary continued
For the year ended 31 December 2013

Terminology	Definition
Optimum	A sub-segment within CoAM which is a closed book of residential mortgages originated through intermediaries and previously purchased mortgage portfolios.
Options	Instruments which convey the rights, but not the obligations, to engage in future transactions.
Over The Counter (OTC)	Contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary. They offer flexibility because, unlike standardised exchange traded products, they can be tailored to fit specific needs.
Overnight Indexed Swap (OIS)	A rate reflecting the overnight interest typically earned or paid on the Bank's collateralised swaps. The OIS rate is used for valuing the discounted cash flows of collateralised swaps.
Past due	When a counterparty has failed to make a payment when contractually due.
Pension risk	The risk to Bank capital and Company funds from exposure to pension scheme liabilities and risks inherent in the valuation of scheme liabilities and assets.
Preference shares	The preference shares have been cancelled as part of the LME. They were fixed interest shares, non-cumulative and irredeemable.
Prime	Prime mortgages are mainstream residential loans, which typically have a higher credit quality and fit standard underwriting processes. As such, they are likely to have a good credit history and pass a standard affordability assessment at the point of origination.
Probability of default (PD)	The likelihood that a loan will not be repaid and will fall into default. PD may be calculated for each customer who has a loan (normally applicable to wholesale customers) or for a portfolio of customers with similar attributes (normally applicable to retail customers). To calculate PD, the Bank assesses the credit quality of borrowers and other counterparties and assigns them an internal risk rating. Bonds with no maturity date that do not require the issuer to redeem.
Project Verde	The bid to purchase the Verde business from the Lloyds Banking Group. Also referred to as Project Mars.
Prudential Regulation Authority (PRA)	The FSA was replaced as the UK's financial regulator on 1 April 2013 with two new regulatory bodies: the PRA and the FCA. The PRA a subsidiary of the Bank of England, is responsible for promoting the stable and prudent operation of the financial system through regulation of all deposit-taking institutions, insurers and investment banks.
Recapitalisation Plan	The process by which the Bank is improving its capital position in line with regulatory guidance.
Recovery and Resolution Plan	The FSA required all UK deposit takers and large investment firms to draw up a Recovery and Resolution Plan by 31 December 2012. The Recovery Plan assesses and documents the recovery options available in situations of financial stress or negative financial shocks, either market-wide or idiosyncratic. The Resolution Plan will provide authorities with sufficient information to enable them to determine a detailed roadmap to resolve a failed financial institution, without resorting to government (effectively taxpayer) support.
Remuneration Code	The Remuneration Code, issued by the Financial Services Authority, sets out the standards that banks, building societies and other financial institutions have to meet when setting pay and bonus awards for their staff. It aims to ensure that firms' remuneration practices are consistent with effective risk management.
Repo/Reverse repo	A repurchase agreement that allows a borrower to use a financial security as collateral for a cash loan at a fixed rate of interest. In a repo, the borrower agrees to sell a security to the lender subject to a commitment to repurchase the asset at a specified price on a given date. For the party selling the security (and agreeing to repurchase it in the future) it is a repo; for the party on the other end of the transaction (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement or reverse repo.
Reputational risk	The risk associated with an issue which could in some way be damaging to the brand of the Bank either through its strategic decisions, business performance, an operational failure or external perception.
Retail segments	The core and non-core segments that comprise customer focused products and services for individuals, sole traders and small partnerships. This includes mortgages, credit cards, consumer loans, current accounts and savings products.
Return on Equity	The ratio of profit for the year (after tax) to shareholders equity, expressed as a percentage.
Return on Risk Weighted Exposure Amount (RRWEA)	The return on Bank's assets and exposures weighted according to risk. The measure is one of the performance metrics set by the Remuneration and Appointments Committee when assessing targets in the long term incentive plan.
Risk appetite	The articulation of the level of risk that the Bank is willing to accept (or not accept) in order to safeguard the interests of the members whilst achieving its business objectives.

Glossary continued
For the year ended 31 December 2013

Terminology	Definition
Risk weighted amount	Risk weightings are established in accordance with Basel II as implemented by the FSA. Risk weighted amounts are the carrying value of the Bank's assets, adjusted by the risk weightings, to reflect the degrees of risk they represent.
Risk weighted assets	A measure of a bank's assets adjusted for their associated risks. Risk weightings are established in accordance with Basel II.
Secondary sovereign exposure	Direct exposure to something other than sovereign debt that has itself a direct exposure to sovereign debt.
Secured lending	Lending in which the borrower pledges retail or commercial property as collateral for the loan, which then becomes a secured debt owed to the Bank. In the event that the borrower defaults, the Bank may take possession of the asset used as collateral and may sell it to regain some or the entire amount originally lent to the borrower.
Securitisation	A process by which a portfolio of retail mortgages is used to back the issuance of new securities by an SPE. The Bank has established securitisation structures as part of its funding and capital management activities (see Special purpose entities (SPEs)).
Senior unsecured debt	Debt that has priority ahead of all other unsecured or subordinated debt for payment in the event of default.
Slotting	The regulatory defined approach used for rating the risk level of Corporate lending using a broad scope of financial, political and transactional factors. The regulatory slotting categories are listed as follows: • 'Standardised' businesses lack sufficient information upon which detailed credit analysis can be undertaken for which models have yet to be developed; • 'Strong' businesses have little competition, high demand, significant governmental support and enforceable collateral; • 'Good' businesses have limited competition, stable demand, good governmental support and enforceable collateral; • 'Satisfactory' businesses have a broad competition base with limited levels of demand, governmental support and collateral; • 'Weak' businesses operate at a disadvantage to competition, display a declining trend of demand, with no governmental support and no clear collateral; and • 'Default' businesses are considered unlikely to repay their credit obligations (see Impaired loans).
SME customers	Small and medium sized businesses engaging with the Bank as customers.
SONIA	Sterling OverNight Index Average (SONIA). Yield curves used by the Bank for swap arrangements. These are based on overnight indexed rates.
Sovereign debt	Bonds issued by and loans given to central banks and local governments, governmental bodies and other government-related bodies.
Sovereign exposure	The Bank's exposure to the total financial obligations incurred by all governmental bodies of any nation.
Special purpose entities (SPEs)	Entities that are created to accomplish a narrow and well defined objective. For the Bank this includes: • various securitisation transactions in which mortgages were sold to SPEs. The equity of these SPEs is not owned by the Bank; and • Covered Bond Limited Liability Partnerships created in order to act as guarantors for issues of covered bonds.
Specialised lending	Lending in which the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise.
Standardised category	Customers who have not defaulted, and for the purposes of the capital calculations are not rated with the regulatory approved rating model.
Standard Variable Rate (SVR)	A variable and basic rate of interest charged on a mortgage. This may change in reaction to market conditions resulting in monthly repayments going up or down.
Statutory loss	The loss stated in accordance with the requirements of the UK Companies Act 2006, which incorporates the requirements of International Financial Reporting Standards (IFRS).
Strategic Asset Review	The process by which the Bank centrally monitors risk on its corporate loan assets in line with agreed strategy and governance parameters.
Strategic and business risk	Risk arising from changes to the Bank's business and the environment in which it operates, specifically the risk of not being able to carry out the Bank's business plan and desired strategy.

Glossary continued
For the year ended 31 December 2013

Terminology	Definition
Subordinated debt/liabilities	Liabilities which, in the event of insolvency or liquidation of the Bank, are subordinated to the claims of depositors and other creditors of the Bank.
Swaps	An agreement between the Bank and a counterparty in which one stream of future payments is exchanged for another stream, based on a specified principal amount. For example, interest rate swaps often involve exchanging a fixed receipt for a floating receipt, which is linked to an interest rate (most often LIBOR). The Bank's use of swaps helps to manage periodic market risk on its financial instruments.
Term deposit	A deposit balance that cannot be withdrawn before a date specified at the time of deposit.
the Bank	The Co-operative Bank and its subsidiaries.
the Banking Group	See 'The Co-operative Banking Group'.
the Board	The Board of Directors. They manage the Bank's business performance in line with its purpose, givens, vision and values.
the Company	The Co-operative Bank as a standalone entity.
The Co-operative Banking Group	The Co-operative Banking Group Ltd and its subsidiaries, which included the Bank until legal separation occurred on 20 December 2013.
The Co-operative Group	The former ultimate parent company of the Bank, pre legal separation.
Tier 1	A regulatory measure of financial (capital) strength. Tier 1 is divided into Core Tier 1 and other Tier 1 capital. Core Tier 1 capital comprises share capital and associated share premium, and general reserves from retained profits. The book values of goodwill and intangible assets are deducted from Core Tier 1 capital and other regulatory adjustments may be made for the purposes of capital adequacy. Qualifying capital instruments such as perpetual subordinated bonds are included in other Tier 1 capital.
Tier 1 ratio	Tier 1 capital divided by risk weighted assets.
Tier 2	Tier 2 capital comprises the Bank's property valuation reserve, preference shares, qualifying subordinated notes and collective impairment allowance (for exposures treated on a Basel II standardised basis). Certain regulatory deductions may be made for the purposes of assessing capital adequacy.
Transfer of engagements	On 1 August 2009, Britannia Building Society merged with The Co-operative Bank plc by a transfer of engagements between the building society and the Bank under the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 (see Merger).
Treasury segment	The treasury segment's responsibilities usually include capital management, risk management, strategic planning and investor relations.
Unaudited	Financial information that has not been subjected to the audit procedures undertaken by the Bank's external auditor.
Unfunded pension scheme	Pension scheme which has liabilities and no assets. The Bank will pay the liabilities of the scheme as they fall due.
Unsecured lending	Lending for which there is no collateral for the loan.
Verde business	Separated part of the Retail business of the Lloyds Banking Group.
Value at risk (VaR)	VaR measures the daily maximum potential gain or loss due to market volatility within a statistical confidence level of 95% and a one day holding period. The VaR methodology employed is historical simulation using a time series of one year to latest day.
Watchlist	A list of counterparties, drawn up by the Bank once it has elected to closely monitor the performance of loans subject to significant credit risk.
Wholesale	Wholesale banking is the provision of loans to corporate customers and institutional customers and services to other banks and financial institutions.
Write down	After an advance has been identified as impaired and is subject to an impairment allowance, the stage may be reached whereby it is concluded that there is no realistic prospect of further recovery. Write downs will occur when, and to the extent that, the whole or part of a debt is considered irrecoverable. This action can occur at any time in the debt's life (see Charge off).

Forward-looking Statements

Certain terms

The term the 'Bank' means The Co-operative Bank plc together with its consolidated subsidiaries. The term 'Company', refers to The Co-operative Bank plc. The term 'Co-operative Group' refers to the Co-operative Group Limited. The term 'Banking Group' means The Co-operative Banking Group Limited.

In this report the abbreviations '£m' represent millions of pounds sterling.

Unless otherwise stated, the income statement analyse and compare the 12 months to 31 December 2013 to the corresponding 12 months of 2012 and balance sheet comparisons, related to the corresponding position as at 31 December 2012. Unless otherwise stated, all disclosed figures relate to continuing operations. Relevant terms that are used in this document but are not defined under applicable regulatory guidance or International Financial Reporting Standards (IFRS) are explained in Non-IFRS measures below.

Non-IFRS measures

Certain non IFRS measures are provided within the Annual Report and Accounts. These can be found mainly (but not exclusively) on the Detailed Financial Review and the Detailed Key Performance Indicators pages.

Restatement

Furthermore, certain 2012 balance sheet items and capital ratios have been restated. For further information, see Note 3 to the Bank financial statements.

Forward-looking statements

This document contains certain forward-looking statements with respect to certain of the Bank's strategy, plans and its current goals and expectations relating to its future financial condition and operating performance. The Bank cautions readers that no forward-looking statement is a guarantee of future performance and that actual results could differ materially from those contained in the forward-looking statements. These forward-looking statements can be identified by the fact that they do not relate only to historical or current facts. Forward-looking statements sometimes use words such as 'may', 'will', 'seek', 'continue', 'aim', 'anticipate', 'target', 'projected', 'expect', 'estimate', 'intend', 'plan', 'goal', 'believe', 'achieve', 'predict', 'should' or in each case, their negative or other variations or comparable terminology, or by discussion of strategy, plans, objectives, goals, future events or intentions. These forward-looking statements include all matters that are not historical facts. Examples of forward-looking statements include, among others, statements regarding the Bank's future financial position, income growth, assets, impairment charges, business strategy, capital ratios, leverage, payment of dividends, the industry in which the Bank operates, projected costs, commitments in connection with the Recapitalisation Plan and the Bank's 4-5 year turnaround plan, estimates of capital expenditures and plans and objectives for future operations and other statements that are not historical fact.

By their nature, forward-looking statements involve risk and uncertainty because they relate to events and depend on circumstances that may or may not occur in the future, for example, macroeconomic and business conditions, the effects of continued volatility in credit markets, market related risks such as changes in interest rates and foreign exchange rates, effects of changes in valuation of credit market exposures, changes in values of issued notes, the policies and actions of governmental and regulatory authorities (including requirements regarding capital and Group structures and the potential for one or more countries exiting the Eurozone), changes in legislation, the further development of standards and interpretations under IFRS and prudential interpretation and application of standards under IFRS, the outcome of current and future legal competition, a number of such factors being beyond the Bank's control. As a result, the Bank's actual future results may differ materially from the plans, goals and expectations set forth in the Bank's forward-looking statements. Forward-looking statements are not guarantees of future performance. In addition, even if the Bank's results of operations, financial condition, and the development of the financial services industry are consistent with the forward-looking statements in this document, those results or developments may not be indicative of results or developments in subsequent periods.

Readers are advised to read, in particular, the Principal Risks and Uncertainties section in the Strategic Report starting on page 6 for a summary of factors that could affect the Bank's future performance. In light of these risks, uncertainties and assumptions, the events and targets described in the forward-looking statements in this document may not occur.

Any forward-looking statements made in this document speak only as of the date they are made except as required by the FCA, the PRA, the LSE or applicable law. The Bank expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in the Bank's expectations with regard thereto or any change in events, conditions or circumstances on which such statement is based. The reader should, however, consult any additional disclosures that the Bank has made or may make in documents it has published or may publish via the Regulatory News Service of the LSE.

Appendix 1
EDTF recommendations
For the year ended 31 December 2013
Source: http://www.financialstabilityboard.org/publications/r_121029.pdf

Type of risk	Recommendation	Disclosure	Section in Pillar 3	Section in risk management	Other sections of the accounts
General	1	Risk to which the business is exposed.	7		Strategic Review
	2	Definition of risk terminology, principals and appetite.	4, 7		Strategic Review
	3	Top and emerging risks and the changes during the reporting period.	7	Other risks 4 to 10	Strategic Review
	4	Analysis of future regulatory developments affecting our business model and the Bank's profitability.	6		
Risk governance and risk management	5	The Bank's risk management organisation, process and key functions.	4		Strategic Review
	6	Risk culture and risk governance and ownership.	4		Strategic Review
	7	Key risks, risk appetite and risk management.	4, 7		Strategic Review
	8	Stress testing and the underlying assumptions.	8	Liquidity risk 2	Strategic Review
Capital adequacy	9	Minimum Pillar 3 disclosure requirements.	5		
	10	Reconciliation of accounting balance sheet to regulatory balance sheet.	Table 8a, 1.2		
	11	Flow statement of movements in regulatory capital since the previous reporting period including changes in common Equity Tier 1, Tier 1 and Tier 2 capital.	5		
	12	Discussion of targeted level of capital and how this will be established.	2, 5, 6		Capital management
	13	Analysis of risk weighted assets.	5.3		Capital management
	14	Analysis of capital requirements for each Basel asset class.	Table 5a		
	15	Analysis of credit risk for each Basel asset class.	5, 7		
	16	Flow statements reconciling the movements in risk weighted assets for each risk weighted asset type.	Table 6		Capital management
	17	Discussion of Basel credit risk model performance.	7.2.6, 7.2.13		
Liquidity and funding	18	Analysis of the Bank's liquid asset buffer.	7.3	Liquidity risk 2.3.1	
	19	Encumbered and unencumbered assets analysed by balance sheet category.			Note 41. Fair values
	20	Consolidated total assets, liabilities and off balance sheet commitments analysed by remaining contract maturity at the balance sheet date.		Liquidity risk 2.4	
	21	Analysis of the Bank's sources of funding.		Liquidity risk 2.3	
Market risk	22	Relationship between the market risk measures for trading and non-trading portfolios and the balance sheet.		Market risk 3.1	
	23	Discussion of trading significant trading and non-trading market risk factors.	7.4	Market risk 3.1	
	24	VaR assumptions, limitations and validation.		Market risk 3.1.2.1	
	25	Description of the primary risk management techniques employed by the Bank.		Market risk 3	
Credit risk	26	Analysis of the aggregate credit risk exposures.		Credit risk 1.2, 1.3, 1.4	
	27	Describe the policies for identifying impaired and non performing loans.	7	Credit risk 1.3	
	28	Reconciliation of the opening and closing balances of non-performing or impaired loans in the period.		Credit risk 1.3	Note 18. Loans and advances to customers
	29	Analysis of counterparty credit risk that arises from derivative transactions.	7.2.1	Credit risk 1.3.4	
	30	Discussion of credit risk mitigation, including collateral held for all sources of risk.		Credit risk 1.3	
Other risk	31	Description of other risks.	7	Other risks 4 to 10	
	32	Discussion of publicly known risk events.	7	Introduction to risk management	Note 34. Provisions for liabilities and charges, Note 37. Contingent liabilities and commitments

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