The Co-operative Bank plc
Financial Statements 2012

The **co-operative**
Here for you for life

Part of The **co-operative** banking group

Contents

This is the **Directors' report** for The Co-operative Bank plc (Bank). It explains in detail how the Bank has performed during 2012 and sets out a fair review of the business, a balanced and comprehensive analysis of performance, the use of financial and non-financial key performance indicators to explain the progress made, a description of the principal risks and uncertainties faced by the business and an indication of likely future developments.

In preparing the report, the Bank has had regard to the guidance issued by the Financial Reporting Council (formerly the Accounting Standards Board) in its Reporting Statement on narrative reporting. It is intended to provide Shareholders of the Bank and members of the Co-operative Group with a greater understanding of the Bank, its position in the market and its prospects.

In setting out the Bank's main risks and uncertainties, and likely future developments, this report and accounts contains statements which, by their nature, cannot be considered indications of likelihood or certainty. The statements are based on the knowledge and information available at the date of preparation of the Directors' report, and what are believed to be reasonable judgments, and these statements should not be construed as a profit forecast.

About us: a guide to the Co-operative Bank

Who we are

The Co-operative Bank plc is part of the Co-operative Banking Group, providing a **range of financial products and services** to personal and business banking customers across the UK.

The Co-operative Bank plc currently operates under its own brand as well as those of **smile, Platform** and **Britannia**. We offer our services through **339 branches** and **22 corporate banking centres** and via telephone, online and mobile banking.

We are a **leader in the field of ethical investment** and corporate social responsibility. Our customer driven ethical strategy was the first of its kind in our industry and we pursue an active strategy of community involvement.

How do we measure our performance?

The Bank measures its performance over four key areas: **financial**, **customer**, **people** and **process**. This approach reflects our co-operative difference and helps to ensure that a broad range of stakeholder interests and implications are considered in decision making.

The Board reviews performance evidence against the key performance indicators and our risk appetite.

The following table summarises our performance in 2012 against these key indicators:

Financial

Financial measures focus on profitability and underlying financial strength:

Profit before tax
This is a key measure of our performance and is discussed in the business and financial review.

Loan:deposit ratio
A measure which shows the strength of our liquidity through the ratio of customer assets to customer liabilities.

Core Tier 1 ratio
A key industry measure of financial strength.

Profit before tax

2012	2011
£(673.7)m	£54.2m

Loan:deposit ratio

2012	2011
92%	94%

Core Tier 1 ratio

2012	2011
8.8%	9.6%

Customer

Customer measures address the key relationships through which we sustain and grow our business:

Customer advocacy
We aimed to be 8.5% above the level of advocacy achieved by our competitors. We use an external survey to monitor advocacy of customers across the Retail businesses, relative to appropriate peer groups.

Number of primary current account customers
A primary current account customer is defined as one who holds one of our standard current accounts and credits their account with an average of at least £800 per month.

Customer advocacy

2012	2011
+ 9.7%	+10.3%

Primary current account customers

2012	2011
637,000	589,000

People

People measures reflect the importance of internal engagement:

Colleague engagement
In 2012 we adopted the same survey, timing and methodology for measuring colleague engagement as currently adopted across the other Group businesses. 'Talkback' is now the group-wide colleague engagement measurement tool used to effectively capture and analyse colleague perceptions.

Colleague engagement

2012	2011
68%	n/a

Process

Process measures focus on the efficiency of our business in delivering services to our customers:

Cost:income ratio
This is an efficiency measure reflecting costs in the business in relation to its income.

Cost:income ratio

2012	2011
73.7%	66.2%

Chair's statement

Overview

Like many financial organisations, we are still adjusting to the 'new normal' of protracted low interest rates, anaemic economic recovery and the complex challenges facing the banking and wider financial sector in general.

I opened last year's Chair's statement for the financial accounts by writing about how eventful the past 12 months had been. This has remained the case during 2012. Government action on regulation and governance for the industry and a growing sense of frustration from the public about lack of trust in their banks has meant that this year has been one of the busiest and most challenging we have ever encountered in our history.

I should start by saying that we recognise our reported loss in 2012 is disappointing. There are a number of exceptional factors in the form of corporate impairment losses and PPI costs, but we are also undergoing transformational restructuring as part of the outcome of our strategic review which is focused on enhancing the strength of our core bank. However, as the business moves through this change and we concentrate on leveraging the strength of our brand in relationship banking services for both retail and business customers, I am confident that our continued focus on what is right for our customers and members will provide a strong platform for future growth.

This is reflected in the financials of our core business. Although the issue of trust remained a key theme for the industry in 2012, we have seen the strength of our co-operative model become the catalyst for another jump in new business activity with over 100,000 customers joining us in the summer alone and switching their primary banking relationship to us. This steady growth in our customer base continues, our core business remains profitable and our balance sheet remains robust with good capital ratios, which we will take measures to continue to strengthen, and high levels of liquidity.

With the economic backdrop still fragile, there are no doubt more challenges ahead. However, our commitment to deliver customers and members the right products through industry leading customer service and underpinned by our ethical policy provide us with a strong platform for the future.

Customers

During these continued difficult times we have remained focused on our customers and members; we have never forgotten who we work for or why we are here as a co-operative bank. This year, we were the first bank to remove sales related bonuses, replacing them with customer centric service incentives. I am delighted that other banks saw fit to follow suit.

Our customer advocacy levels remain at rates to which other high street banks can only aspire. The advocacy of our 8,000 plus colleagues also remains at high levels, with our 'Talkback' colleague engagement survey results reaffirming our commitment to our compelling model of operation.

Performance

Although recent 'flight to trust' headlines and statements have allowed us to show more people who we are and what makes us different, we have not been immune from the economic conditions and the impact on our financial performance can be seen in this report. Our financial performance is unsatisfactory compared to previous years and we do not take reporting an operating loss lightly, but our focus on providing the best service to our customers has not altered, and we are confident that our co-operative business model and our strategic focus on growing our core business will see us through the tough times in the UK economy that show no sign of ending anytime soon.

Our strategy to strengthen our retail and business banking operations is backed up by our reported core operating profit of £96.8m (2011: £137.3m)

Growing our business

During 2012, we announced a heads of terms agreement with Lloyds Banking Group for the purchase of 632 branches and associated assets (Verde). We have talked before about the significance of this deal for the Bank and the wider Co-operative Group and we remain committed towards reaching an agreement.

Business changes

As we prepare for the next phase of the Verde transaction, we are also experiencing changes across our Bank in the form of transformation projects that will see the strengthening of our structures and governance. Our risk management framework has undergone a significant review with a new model now in place that will improve all elements of risk management related to our operations. We have made a number of new appointments in the past 12 months and I am delighted to welcome Richard Coates to the Board, as our new Chair of the Audit Committee in 2013. Peter Harvey, who has been with us since the Britannia merger, has become Deputy Chair, replacing Rodney Baker-Bates who retired in July. Paul Hewitt also leaves us after nine years on the Board. I wish Rodney and Paul well and thank them for all the work they have done during their tenure. We will also shortly be welcoming Graeme Hardie to the Bank Board and are in the process of strengthening the management team.

Our way of doing business

In my role as Chair I am responsible for ensuring that the Board operates in an effective way that is right for our members and those with a stake in our business. This involves putting a robust framework in place which supports the decision making process of Board members while at the same time ensuring we adhere to our governance structure. You will find details of the governance structure and arrangements on page 13.

Our continuing commitment to ethical banking, supporting our communities and 'doing the right thing' has never been more pertinent than today. In 2012 we launched the 'Lend with Care' scheme which has, within its first year, seen millions of pounds in social loans awarded to co-operatives and small businesses in the developing world. I am proud to chair an organisation that has done so much to help those who need it most. At Co-operative Group level our community fund continues to benefit local areas across the UK, with 2,709 groups benefiting during 2012.

Towards the end of 2012, we announced a new model for our membership which will see a much clearer structure for Co-operative members who trade with Banking Group businesses. The process in food stores has always been a straightforward one, and now our millions of bank customers will benefit from an equally straightforward system that rewards their commitment to trading with the Group.

Looking forward

We fully acknowledge our financial performance is disappointing despite the best efforts of all those who work for and with us. On a broader note prospects for the sector are unlikely to improve in the near future and our Bank faces further challenges around cost reduction and controlling impairment risk as we look to build on the sustainability of our core banking operations. However, we have much to look forward to as we strengthen our profitable core business, enhance our retail offer and simplify our high street presence under one Co-operative brand.

During 2012 we saw a steady stream of new customers come to us looking for a different level of service from a name they can trust. We believe this will continue, as people see there is an alternative to the big high street names.

Paul Flowers, Chair

Chief Executive's overview

The banking environment

It is no exaggeration to say that the past 12 months have been some of the most turbulent in British banking. While we have not been involved in some of the more high profile issues affecting the industry, we have not been immune to many of the challenges facing it as we strive to become the compelling co-operative alternative on the high street.

Our overall financial performance, whilst undoubtedly disappointing, reflects this challenge. The outcome of an ongoing strategic review designed to build on where our co-operative approach has a competitive edge in the market has seen us, in line with the banking sector in general, segment some activities as non-core business and concentrate on managing them for value and targeted for run-down or exit. Our focus is therefore on building on the strength of our brand as a relationship bank in both the retail and business space whilst at the same time de-risking the non-core assets to further strengthen the balance sheet. These non-core activities, particularly the non-prime residential mortgages and commercial real estate assets originating predominately from the non-member Britannia business acquired in 2009, contain the majority of the impairment risk for the Bank and substantial increases in provision have been made for these corporate impairments for the second half of 2012 in light of the continued and persistent weakness in the economy.

However, below these overall results sits a more positive financial picture for the core business. Our core business delivered a solid result characterised by industry leading levels of customer service, a high degree of current account switching from other banks, low levels of impairment and the Co-operative's unique customer led ethical policy. Our core business remains profitable, while our balance sheet is robust. However, we are not complacent about our financial strength and our strategic focus for the medium term is directed at implementing measures to enhance the strength of our capital ratios. In addition to a risk mitigation transaction executed since the year end, these include strengthening the management team and engaging a major investment bank to support on a range of balance sheet deleverage options. Further to the signing of the sale and purchase agreement for the sale of the Co-operative Banking Group's life insurance business which, subject to regulatory approval, is expected to generate a significant release of capital, the strategic review will encompass a review of the scale and composition of the financial services group. Such measures recognise the ongoing uncertain economic environment and the steps required to bolster the balance sheet for the benefits of our customers and members.

There is no doubt that the economy in this country remains fragile. We have seen a double dip recession this year and the fallout from the banking crisis continues. Against this, we remain a resilient, member owned and customer centred organisation which continues to enjoy excellent levels of customer advocacy, employee engagement and a growing primary current account base. As such, we believe we have a solid platform to broaden our reach and appeal in the UK banking sector, either through acquisition of the Lloyd's Verde assets or through continued organic growth.

Performance

Although we have protected ourselves from a number of potential banking pitfalls, and our exposure to peripheral European debt remains low, this has been a challenging year for the business. Whilst our core business delivered a solid result, the overall results reflect a number of charges relating to corporate impairment, further PPI provision and our own transformation programme which have significantly impacted profits across our business.

We are reporting an overall operating loss of £280.5m (2011: profit of £141.1m) and a loss before tax of £673.7m (2011 profit of £54.2m). In addition to further PPI provision and re-visiting the value ascribed to investments made to date in our transformation plan, we have increased the level of provisioning for impaired loans in light of weak economic recovery prospects relating primarily to commercial real estate assets originating from the Britannia book of business. As a result, these factors led to a significant increase in overall provisions which will inevitably impact on the overall short term profitability of the business. Against this, our core business reported a £96.8m operating profit, which although down on 2011 is a creditable performance in difficult economic circumstances and provides a strong platform for future growth.

These results are disappointing, but are framed by the outcome of a recent strategic review designed to build on the strength of the Bank's core retail and business operations and at the same time increase our focus on de-risking the non-core assets in order to further strengthen the balance sheet. This review, supported by a strengthened management team and premier league advisory partners, will deliver capital benefits from a range of initiatives including a review of the composition of our wider Banking Group and the deleveraging of our balance sheet. The Bank's underlying financial strength remains intact and we will continue our strategy for growth in areas where we can evidence a compelling co-operative solution, supporting retail and business customers and offering them products and services that are right for them.

Our customers

We remain unwavering in our commitment to our customers, offering them products and services that are right for them. In addition to removing our sales related performance bonuses this year, we also put in place a range of initiatives during 2012 that really demonstrate our commitment to great customer service. This included removing overdraft fees for the first three months of 2012 and giving first time buyers a helping hand with our flexible mortgage products. We have also stepped up our digital access to customer accounts with the launch of our mobile banking application on iPhone, BlackBerry and Android handsets. Customers can access their account information and locate branches and ATMs. Development of this product will continue in 2013.

In 2012 we provided £2bn of direct new retail lending, with 55% relating to house purchase and just under a third going to first time buyers. We have also seen record numbers of customers switch to our current accounts, with over 100,000 new customers joining us over the summer and an 8.2% increase in new primary account customers in the year. To support customers with switching, our £1,000 overdraft buffer has helped take the pain out of the process.

Our service and product credentials were reaffirmed when we won a Which? Customer Service Award, and 'Best Current Account' at the Moneysupermarket awards. As well as external plaudits we have continued to see high levels of customer advocacy with a 9.7% advantage over our top five competitors.

Project Verde

We believe the ethos of our business provides a solid platform to broaden our reach and appeal in the UK banking sector, whether that is through the Lloyd's deal (referred to as Project Verde) or through continued organic growth. Project Verde would see the equivalent of ten years' growth in one business deal and the transaction would see us take a 7% market share of UK personal current accounts, with around 1,000 branches UK wide. We remain in active discussions with Lloyds Banking Group regarding the sale of its Verde business and both parties remain committed towards reaching an agreement. We have always been clear that any deal of this nature is complex and must satisfy the exacting interests of our customers and members.

Sustainability

We are more than just a bank; we are a co-operative and run our business for our members. This year our sustainability credentials were recognised through the accolade of Europe's Most Sustainable Bank for a third consecutive year. Alongside the Community and Environmental Responsibility award in Management Today's Most Admired Companies Survey 2012, we have much to be proud of. The way we approach every opportunity allows us to rightly boast about our sustainability credentials. Each year we turn away millions of pounds of business from countries and organisations that do not fit our ethical operating framework.

Outlook

There is little doubt that the economic climate will continue to cause concern in the year ahead and, like our customers and the banking industry in general, we will face further challenges as we navigate this. However, we remain a resilient organisation driven by developing deep relationships with our customers over the long term. We believe this customer relationship model provides us with a strong platform moving forward and will enable us to continue to broaden our appeal in 2013 and beyond.

Barry Tootell, Chief Executive

Business and financial review

Overview

	2012 £m	2011 £m	Change £m
Core	**96.8**	137.3	(45.0)
Non-core	**(377.3)**	3.8	(381.1)
Operating result	**(280.5)**	141.1	(421.6)
(Loss)/profit before taxation	**(673.7)**	54.2	(727.9)

During the last six months, forecasts for the UK economic outlook have been revised with significant recovery now not expected until 2018. This prolonged economic downturn (the longest in a century) has been a major factor in 2012 being an extremely challenging year for the Co-operative Bank ('the Bank'), reflected in its statutory loss of £673.7m (2011: profit of £54.2m). The outcome of an ongoing strategic review has seen the Bank, in line with the banking sector in general, segment some activities as non-core business and concentrate on managing them for value and targeted for run down or exit. The strategy is designed to both build on the strength of the Bank's core retail and business banking operations, where it can evidence a compelling co-operative alternative to its peer group, whilst at the same time de-risking the non-core assets in order to further strengthen the balance sheet.

The core business, reflecting the current strategy and risk appetite of the Bank, delivered an operating profit of £96.8m (2011: £137.3m), which, while lower than 2011, provides a solid platform for future growth. The non-core business, those activities not congruent with the current strategy, which are managed for value and targeted for run down or exit, generated an operating loss of £377.3m (2011: profit of £3.8m). As a result, the combined operating loss was £280.5m (2011: profit of £141.1m).

As a result of the financial performance noted above, the Core Tier 1 ratio has reduced to 8.8% (2011: 9.6%). Since the year end, the Bank has completed a securitisation transaction to reduce risk on the balance sheet, which has improved the Core Tier 1 ratio by 0.4%, and which would increase the year end ratio to 9.2% on a pro forma basis. This transaction is one of a range of actions targeted, as part of a strategic review, at improving our capital strength. The completion in 2013 of the sale of the Life and Savings business owned by the Co-operative Banking Group should, subject to regulatory approval, further strengthen the capital position.

Going forward, as the Bank deleverages the balance sheet (facilitated by the additional impairment charges taken in 2012), we will build upon the strength of the core business through a simplification agenda, conservative credit risk appetite and long term growth strategy focused on our core relationship banking franchises in the retail and business banking space. This includes the review of the branch network, to ensure that it meets the needs of our customers and is operating in the most efficient and cost-effective way, together with the unification of the network under one single Co-operative brand. These measures, combined with the potential acquisition of Lloyds Banking Group branches ('Project Verde'), will ensure that we make solid progress towards our clear strategic goal of becoming the compelling co-operative alternative.

The deterioration in the result for the year was principally driven by the following factors:

- Credit impairment on non-core assets: in light of the continued and persistent weakness in the economy, the directors have reassessed the carrying value of the customer loan portfolios of the Bank. This has resulted in an impairment charge of £351.1m during the year (2011: £23.1m), principally relating to the non-core Corporate business. The non-core business contains the majority of the impairment risk for the Bank. It includes non-prime residential mortgages and commercial real estate assets, which originated from the non-member Britannia business prior to merger;
- Intangible asset impairment: the directors have re-evaluated the carrying value of the investment made to date in developing our new banking platform, and have concluded that a write down of £150.0m is required. The impact of the continuing and prolonged economic downturn on the future value stream from the new banking platform now indicates that the carrying value should be reduced;
- PPI: in line with the rest of the banking industry, the Bank saw a continued increase in the volume of PPI complaints in 2012. As a result, the charge of £40.0m reported at the half year has been increased by a further £109.7m, to cover the anticipated cost of customer redress. This increases the total estimated cost of redress to £244.0m;
- Continued economic downturn: the reduction in operating profit within the core business from £137.3m in 2011 to £96.8m in 2012 was broadly attributable to the continued economic downturn. Margins remain under pressure as the result of prolonged low interest rates.

Liquidity remains strong. The loan to deposit ratio was 92% at the year end (2011: 94%), illustrating that lending remains more than sufficiently funded by deposits.

Financial performance

	2012 £m	2011 £m	Change £m
Income	**771.2**	817.6	(46.4)
Operating costs – steady state	**(568.2)**	(548.2)	(20.0)
Operating costs – strategic initiatives	**(14.8)**	(13.4)	(1.4)
Impairment losses	**(468.7)**	(114.9)	(353.8)
Operating result	**(280.5)**	141.1	(421.6)
Significant items	**(85.1)**	(53.3)	(31.8)
Intangible asset impairment	**(150.0)**	–	(150.0)
PPI provision	**(149.7)**	(90.0)	(59.7)
Share of post tax profits from joint ventures	**1.2**	0.2	1.0
Financial Services Compensation Scheme levies	**(24.8)**	(14.5)	(10.3)
Fair value amortisation	**15.2**	86.3	(71.1)
(Loss)/profit before taxation and distributions	**(673.7)**	69.8	(743.5)
Membership dividend	**–**	(15.6)	15.6
(Loss)/profit before taxation	**(673.7)**	54.2	(727.9)

The overall operating result fell to a loss of £280.5m in 2012 from a profit of £141.1m in 2011. The core business delivered an operating profit of £96.8m (2011: £137.3m), which, while lower than 2011, provides a solid platform for future growth. The non-core business generated an operating loss of £377.3m (2011: profit of £3.8m). The loss before taxation was £673.7m (2011: profit of £54.2m).

2012 income (excluding fair value amortisation) fell by £46.4m, reflecting the cost of retained and incremental funding raised during the year in the continuing challenging market conditions. The reduction in income arose principally in the non-core business, with income levels in the core business £11.9m higher than 2011. Total income included gains on a number of Treasury transactions of £43.0m (2011: £37.2m). 2011 income also included a non-recurring benefit of £20.0m, relating to a reduction in the total credit risk expected over the life of the Optimum book.

Operating costs (excluding fair value amortisation and strategic investment costs) of £568.2m were £20.0m higher than 2011. Excluding the impact of inflation this is an increase of less than 1%. In part due to depressed income levels, we recognise that our cost to income ratio remains above industry benchmarks. Cost management is a key area of focus, and a number of initiatives continue. We have already announced plans to merge branches where we have multiple sites within close proximity. However, as a mutual, with a strong customer service ethic, we may not pursue the lowest costs at the expense of poor customer service.

As reported at the half year, impairment losses continue to reflect the strains on our customers' ability to service their loans and these challenges have intensified in the second half of the year, particularly in the corporate sector. As previously noted, in light of the current strategic review, with meaningful economic recovery now not expected until 2018, the directors have reconsidered the carrying value of the Bank's loans, which has led to a substantial impairment charge of £468.7m in the year, principally relating to the non-core Corporate business.

The loss before taxation of £673.7m (2011: profit of £54.2m) was after a recharge for intangible asset impairment of £150.0m (2011: £nil). As reported at the half year, while the Bank has been pursuing Project Verde, progress on the transformation plan has been restrained and spend reduced in those areas where Project Verde could impact the plans of the Bank, to minimise the risk of redundant investment. The Bank has revisited the value ascribed to the investments made in developing the new banking systems, and has written down the carrying value of the asset by £150.0m. In the event of concluding the sale and purchase agreement with Lloyds, the Bank will revisit the value ascribed to the investments made in the transformation plan to date. Should the deal with Lloyds not conclude successfully, the intention is to reinvigorate the project, with further investment made to complete the development of the systems that will then be used to drive the business forwards.

Significant items of £47.0m (2011: £53.3m) were incurred during the year, primarily associated with the investment in the Bank's transformation and integration programmes. In addition, a further £38.1m of transaction costs were incurred in relation to Project Verde.

A provision for PPI claims of £149.7m was made during the year (2011: £90.0m). As previously noted, during 2012 there has been an increase in the volume of complaints received, and as a result the provision held has been increased to cover the anticipated customer redress and associated costs. This increases the total estimated cost to £244.0m.

The Financial Services Compensation Scheme levy increased from £14.5m in 2011 to £24.8m in 2012. This was principally because the scheme has now started to charge the banking industry for the capital losses incurred in supporting failed institutions. Previously the scheme only charged the sector for the interest on its support.

The loss before taxation of £673.7m was after a benefit of £15.2m (2011: £86.3m) arising on fair value amortisation. Since the merger with Britannia Building Society, the profile of these net releases to the income statement has gradually fallen, in line with expectations, and the reduction during the year reflects this trend.

Balance sheet

Despite the year's profit performance and difficult external conditions, the underlying core business remains strong. The balance sheet has been actively managed to ensure a balance between margin, capital and liquidity. Total assets increased slightly compared with December 2011. The Bank has maintained its focus on supporting its customers: £2.6bn has been lent to Retail mortgage customers (2011: £1.4bn) while loans to businesses totalled £1.3bn (2011: £1.2bn).

Retail asset balances remained stable, at £17.7bn (2011: £17.7bn), while Corporate core assets increased marginally from £5.2bn at the end of 2011 to £5.4bn at the end of 2012, reflecting the new lending undertaken in the year. The non-core asset portfolios reduced as planned during the year, with net non-core Corporate balances falling from £3.3bn to £2.8bn, and the Optimum portfolio reducing from £8.0bn to £7.6bn. Retail and Corporate deposits remained relatively stable when compared to the prior year.

The year end loan to deposit ratio was strong, at 92% (2011: 94%).

The Bank has continued to access the capital markets, as part of its diversified funding sources. Early in the third quarter of 2012, £650m was raised via its third 'Silk Road' prime mortgage securitisation since the merger with Britannia Building Society in 2009, and the Bank raised an additional €500m of senior unsecured debt in the final quarter. The exposure of the Bank to peripheral eurozone debt is low and has had little direct impact on its business.

The capital position has been impacted by the statutory loss for the year, with a Core Tier 1 ratio of 8.8% (2011: 9.6%). The total capital ratio was 14.4% (2011: 14.7%), with a Tier 1 ratio of 9.4% (2011: 10.1%). Further detail on the capital position of the Bank can be found in the capital management section on page 80. As noted above, since the year end, the Bank has completed a securitisation transaction to reduce risk on the balance sheet, which would improve the year end Core Tier 1 ratio to 9.2% on a pro forma basis.

Our businesses

	2012 £m	2011 £m	Change £m
Retail	**50.1**	92.1	(42.0)
Corporate and Business Banking – core	**3.7**	12.5	(8.8)
Treasury/other	**43.0**	32.7	10.3
Core operating result	**96.8**	137.3	(40.5)
Non-core	**(377.3)**	3.8	(381.1)
Operating result	**(280.5)**	141.1	(421.6)

The Bank is managed through two distinct divisions.

The 'Core' business represents activity consistent with the strategy and risk appetite for the Bank. This includes the Retail, core Corporate and Business Banking, and Treasury/other segments.

The Retail Banking business (trading as the Co-operative Bank, Britannia and **smile**) offers a range of financial products and services to individuals and households throughout the UK. Retail also includes Platform (the intermediary mortgage business).

Core Corporate and Business Banking comprises corporate banking, business banking, and business services, and effectively consists of all the key business to business elements of the Bank.

Included in the Treasury/other segment are the results of the treasury activities of the business and the results of Unity Trust Bank.

'Non-Core' business lines include activities not congruent with the current strategy of the Bank, which are managed for value and targeted for run down or exit. These non-core lines contain the majority of the impairment risk for the Bank, and predominantly include the Corporate non-core, Optimum (the closed book of intermediary and acquired loan book assets) and Illius (the residential property company) businesses which originated from the non-member Britannia business prior to merger.

Business and financial review continued

Retail

	2012 £m	2011 £m	Change £m
Net interest income	**399.9**	400.5	(0.6)
Non-interest income	**135.8**	149.5	(13.7)
Net income	**535.7**	550.0	(14.3)
Operating costs – steady state	**(434.6)**	(414.0)	(20.6)
Operating costs – strategic initiatives	**(9.6)**	(9.5)	(0.1)
Impairment losses	**(41.4)**	(34.4)	(7.0)
Operating result	**50.1**	92.1	(42.0)

The Retail operating result for 2012 of £50.1m was £42.0m lower than 2011.

Interest income decreased by £0.6m compared to 2011, as improving asset margins were offset by increased costs of retail deposits in a highly competitive market.

Non-interest income fell by £13.7m year on year as a result of reduced revenue from legacy insurance products, merchant interchange fees and cash advances on credit cards. We no longer sell third party general insurance products through our branches, only co-operative products. All new business insurance income is now included within the Bank's fellow subsidiary general insurance business.

Underlying credit performance on secured retail lending continued to improve, reflecting a conservative approach to risk. Despite the ongoing difficulties within the UK economy, asset quality has been maintained with levels of late residential mortgage arrears (>2.5% of balance) unchanged at 0.3%. The Bank remains focused on delivering high quality mortgage assets, with 61.0% loan to value ratio on new lending and 44.3% across the portfolio. However, in the context of the prolonged economic environment further impairment provisions have been required, principally against unsecured balances.

Asset balances remained stable, with the Bank's increased share of new lending offsetting limited demand for credit in the market. 55% of the £2bn of direct new lending in 2012 related to house purchases, of which just under a third was provided to first time buyers. Liquidity remains very strong, with a loan to deposit ratio in line with the previous year.

Corporate and Business Banking – core

	2012 £m	2011 £m	Change £m
Net interest income	**108.4**	101.7	6.7
Non-interest income	**55.2**	51.5	3.7
Net income	**163.6**	153.2	10.4
Operating costs – steady state	**(77.3)**	(77.1)	(0.2)
Operating costs – strategic initiatives	**(2.7)**	(2.1)	(0.6)
Impairment losses	**(79.9)**	(61.5)	(18.4)
Operating result	**3.7**	12.5	(8.8)

Our core Corporate and Business Banking operation delivered an operating profit of £3.7m during 2012, £8.8m lower than 2011 (2011: £12.5m) reflecting higher impairment charges, which have been partly offset by a £10.4m growth in income.

Net interest income, at £108.4m, increased by £6.7m mainly as a result of improved asset margins partially offset by increased costs of fixed term deposits. Other income increased by £3.7m driven by higher core business activity levels.

As a result of continued weak growth and an uncertain economic environment, the impairment charges rose from £61.5m in 2011 to £79.9m in 2012, mainly due to a strengthening of collective provisions.

The business has continued to lend, supporting existing customers and winning selective, high quality new business. We also saw a marked increase in new business banking account applications as testament to the strength of our relationship banking proposition.

Treasury/other businesses

The main component of the Treasury/other business segment, the Treasury operation, has continued to deliver on its core responsibilities of ensuring a strong liquidity base, providing diverse sources of wholesale funding to the Bank, managing market risk and delivering an appropriate return on the investment portfolio.

Net interest income was negatively impacted by increased investment in highly liquid, low risk assets in line with our cautious risk appetite. In addition, net interest income reflects the impact of additional term funding, which included a covered bond issuance towards the end of 2011, the 'Silk Road' prime mortgage securitisation and a senior unsecured debt issuance in the second half of 2012.

Non-interest income was favourably impacted by a restructuring of certain Lower Tier 2 securities in December 2012, generating a benefit of £18.0m. The Treasury result further benefited from gains on the sale of Treasury assets of £25.0m (2011: £37.2m) as part of reshaping the investment portfolio.

Non-core business

	2012 £m	2011 £m	Change £m
Net interest income	**(13.0)**	46.2	(59.2)
Non-interest income	**18.1**	17.2	0.9
Net income	**5.1**	63.4	(58.3)
Operating costs – steady state	**(30.5)**	(35.4)	4.9
Operating costs – strategic initiatives	**(0.8)**	(1.1)	0.3
Impairment losses	**(351.1)**	(23.1)	(328.0)
Operating result	**(377.3)**	3.8	(381.1)

The non-core operating result for 2012 was a loss of £377.3m (2011: profit of £3.8m). This comprised a loss of £372.2m (2011: loss of £50.0m) for the non-core Corporate portfolio, a £3.2m loss (2011: profit of £56.9m) for Optimum and a £1.9m loss (2011: loss of £3.1m) for Illius. As previously noted, in light of any real economic recovery now not expected till 2018, the impact of difficult trading conditions for some of our customers and to reflect the risks associated with higher loan to value assets, the directors have reconsidered the carrying value of the Bank's loans, which has led to the significant additional impairment charges principally relating to the non-core Corporate business.

Non-core Corporate

The non-core Corporate business delivered an operating loss of £372.2m (2011: loss of £50.0m) in 2012. The significant increase in operating loss predominantly reflected the additional impairment charges noted above, which are concentrated in commercial real estate exposures. Approximately £200m of the increase in impairments arose in a relatively small number of major loans in the second half of the year. The remainder of the increase was mainly due to the impact of the prolonged poor economic outlook on our provisioning estimates. Income has reduced reflecting the higher funding costs borne by this portfolio with little opportunity to increase asset margins to offset this.

We are developing the strategy for the management of this portfolio to optimise its capital consumption and profitability through a variety of deleverage, risk transfer and asset sale options.

Optimum

In 2012, the Optimum portfolio, a closed book of intermediary and acquired mortgage book assets, reduced in size, as planned, from £8.0bn to £7.6bn, and delivered a loss of £3.2m (2011: profit of £56.9m). The fall in profitability this year was due to the increase in the cost of funding of this book of assets, partly associated with the relatively long expected lives of much of this book, and also to a lesser extent reflected the additional impairment charges noted above. The 2011 result also included a non-recurring benefit of £20.0m.

Despite the ongoing difficulties within the UK economy, asset quality has improved modestly with levels of late residential mortgage arrears (>2.5% of balance) reducing from 3.59% in 2011 to 2.72% at the end of 2012.

Support for customers

Recent media attention on a number of issues for the industry has led to a further increase in customers turning to the Bank. The number of customers who consider the Co-operative Bank their main bank, key to the continued overall growth of the business, has increased further, with the number of primary current accounts increasing by 8.2% during 2012.

During these difficult times, the Bank has maintained its focus on supporting its customers. £2.8bn was lent to Retail mortgage customers during the year (2011: £1.6bn), while £1.3bn (2011: £1.2bn) was lent to businesses. The Bank has provided additional support for first time buyers at the end of the stamp duty holiday by removing upfront fees on a range of mortgage products and offering a 90% LTV mortgage. The Co-operative Bank was the first major bank to focus its targets for the branch network staff on customer service, rather than sales.

It is our intention to participate in the funding for lending scheme in 2013 in line with our core relationship banking strategy.

Since the launch of the Bank's mobile banking service this summer, take up has exceeded expectations and this now has over 100,000 users, with each customer accessing the application four times a week on average.

The potential mis-selling of derivatives to corporate and business banking customers has been much publicised during 2012. The Bank voluntarily joined the FSA review of these sales and will be carrying out further work in the next stage of the FSA review. The Bank sold only small numbers of simple products to its customers to help them manage interest rate risk. While the review is still in course, the directors believe that should any sales be found to be inappropriate, redress payments would not be material.

The Bank continues to focus on building a relationship banking business where the customer is at the heart of everything. Customer advocacy levels remain strong, testifying to the high degree of trust placed in the Bank by its customers. As at December 2012, advocacy levels for the Co-operative Banking Group were 9.7% higher than the average of the top five competitors for the business. Which? members have rated the customer service provided by the Bank better than any of the major high street banks and building societies, and the Bank won a number of awards at the Moneywise Customer Service Awards in 2012.

The Bank's commitment to sustainability has again been recognised. For the third year running the Bank has been named 'Europe's most sustainable Bank' by the Financial Times. The Bank was also recognised as the leader in Management Today's Most Admired Companies survey 2012 for Community and Environmental Responsibility.

Outlook

Prospects for the sector are unlikely to improve in the near future, and the Bank faces formidable challenges. Recent indications are that any meaningful economic recovery will be delayed for a number of years, offering little scope to improve margins and requiring a reduction in costs as well as control of impairment risk. The Bank remains committed to a strategy for growth as well as de-risking the non-core assets. We are working to strengthen our profitable core business, enhance our retail offer and simplify our high street presence under one Co-operative brand. In the short term, while market conditions remain difficult, we will re-double our focus on cost management, improving our capital strength, deleveraging the balance sheet and controlling impairment risk by actively managing our non-core business for value.

In the meantime, as part of broadening our reach and appeal in the UK banking sector, the Bank continues to pursue the opportunity to acquire the Verde business from Lloyds Banking Group. The Bank remains confident in its long term strategy to deliver a compelling co-operative alternative on the high street founded on strong relationships with its customers, the unified brand and the transformation of the branch network, which provide a solid platform for future growth in its core relationship banking operations.

Social goals

Social goals have been firmly embedded in our approach to business since our inception and, amid increasing calls for more responsible business, continue to earn consumer trust. As part of the Co-operative Group, our members expect that not only do ethics remain at our core but that we continue to deliver a world-class social goals programme.

In 2012, the UN International Year of Co-operatives, our co-operative and ethics-led approach continued to stand us apart. We were recognised with a raft of awards and commendations, not least the Financial Times Award for the Most Sustainable Bank in Europe – for the third year running, a Queens Award for Enterprise in Sustainable Development, and a top rank in Business in the Community's Corporate Responsibility Index.

Our principles in practice

We have always had a purpose beyond profit. As part of the Co-operative Group, we are distinct from other major UK businesses in that we are owned by our members, and are held accountable to them through our democratic structure.

The Group's Ethical Plan sets out its commitments to social responsibility and sustainability, with targets across eight priority areas. We review these annually with our democratically elected members through the Group Values and Principles Committee to ensure that we continue to show the way forward for corporate sustainable development in the UK.

For over 15 years we've produced an annual Sustainability Report. Our reporting is renowned for its openness and honesty, and accolades in 2012 place us amongst the most respected reporters worldwide.

Performance overview

Responsible banking

We recognise that responsible banking is crucial for sustainable development and we are the only UK bank to operate a customer-led Ethical Policy.

Since the launch of the policy in 1992, we have declined over £1.2bn of lending to business activities which our customers deem unethical. At the same time, we're dedicated to supporting progressive social and environmental projects. In particular, by the end of 2012, we had committed £827.6m of our £1bn fund for renewable energy and energy efficiency schemes.

The home and motor insurance products we sell, wherein the underlying investments are screened against the Bank's Ethical Policy, continue to set the bar for ethical insurance in the UK. And through our range of charity credit cards our customers donated £1.25m to charity in 2012.

Our commitment to social inclusion extends through our range of products and services, from accounts for prisoners to our support for small businesses in deprived areas. We continue to be the only bank in the UK to offer a current account for credit union members, in partnership with the Association of British Credit Unions Ltd and provide facilities to 60% of the credit union sector.

In 2012, our reputation for responsible banking led to recognition from the general public as both the UK's most trusted bank[1] and as the leader amongst financial services businesses for social responsibility[2].

Keeping communities thriving

Together with members and colleagues, in 2012, the Co-operative supported over 10,000 initiatives in our communities; that's the equivalent of one initiative every hour of every day, all year long.

The Co-operative Membership Community Fund supports local groups and voluntary organisations throughout the UK, by awarding small grants. In 2012, we saw a significant increase in both the number of awards made and the amount donated, with 2,709 groups benefitting.

In 2012, over 46,000 Co-operative Group colleagues and members voted for The Carer's Trust to be our Charity of the Year partner. Throughout 2013, colleagues and members will be working with us to raise money to help 20,000 young adult carers across the UK.

Supporting co-operatives

At the end of 2012, over 1,000 co-operative businesses had benefited from the services of The Co-operative Enterprise Hub. The Hub, which delivers a unique professional business advisory and training service for co-operatives, expanded its remit in 2012 to enable renewable energy co-operatives to access specialist support. Also in 2012 the Hub launched The Co-operative Community Shares Fund, to help communities raise finance through community share offers.

In 2012, we also launched an inspiring street gallery, graphic novel and film to take the message of co-operation to new audiences.

1 YouGov SixthSense, 'Trust in Financial Services', April 2012. 2,060 representative UK adults (aged 18+).

2 Research is conducted on behalf of the Co-operative Group on a quarterly basis and is based on unprompted responses from a nationally representative sample of approximately 6,000 members of the general public (aged 18+).

Inspiring young people

The Co-operative's Inspiring Young People programme aims to benefit one million young people by 2014, and we are helping to bring about a cultural shift in the way that young people are viewed and treated in the UK.

Within the programme, Skills4Schools promotes two education initiatives, Number Partners and Fit4finance, to improve numeracy and financial literacy among primary and secondary school pupils.

Green Schools Revolution brings inspiring and engaging activities on key sustainability themes to school classrooms. With over 5,200 schools registered, we are well on our way to achieve our target to engage 6,000 schools by 2014.

The Co-operative Group is also working to progress its Co-operative Academies, delivering an innovative curriculum, with a values-led ethos. This forms part of wider work supporting Co-operative Schools, of which there are 388.

Protecting the environment

In line with customer expectations our Ethical Policy establishes that we will not lend to businesses or projects that do not meet our environmental standards, and we have declined £76m of finance to such projects in 2012. At the same time, within our £1bn commitment to fund energy efficiency and renewables, we have set a target to dedicate £100m to small scale community renewable opportunities.

Our Clean Energy Revolution campaign seeks to end the use of unconventional fuels and inspire community energy growth, where communities own, control and benefit from their own renewable energy projects.

2012 was particularly noteworthy for the Government announcement that mandatory greenhouse gas reporting would become a reality for UK quoted companies in 2013. The Co-operative has long campaigned for the introduction of such regulation and will continue to lobby for such mandation to apply to all large businesses.

The Group is on track to achieve its target of 50% reduction in direct greenhouse gas emissions by 2020, as reported in the Co-operative Group Annual Report and Accounts. Further, construction of the Group's new flagship office building in Manchester was completed in 2012, setting new standards in sustainable design, construction and operation.

In 2012, The Co-operative Bank re-achieved certification to the ISO 14001 standard and we are still the only financial services organisation in the world to achieve this leading standard across all business activities and products.

Tackling global poverty

We continue to strive for a fairer world, where basic human needs are met and rights respected. We support microfinance institutions in 28 countries across the globe with a £25m fund to provide small loans to people in some of the world's poorest countries. Our charity credit cards have enabled customers to raise a staggering £718,206 in 2012 for organisations tackling global poverty and human rights issues, such as Oxfam and Amnesty International. And in line with our customer-led Ethical Policy, we declined £27m of finance for business activities which conflicted with our statements on human rights and labour standards in 2012.

In partnership with CARE International UK, the Co-operative Group supports lendwithcare.org, which allows people in the UK to lend directly to entrepreneurs in the developing world, helping them work their way out of poverty. As at the end of 2012 £1.6m had been lent, and our aim is to facilitate over 100,000 loans by the end of 2013. And through The Global Development Co-operative, we're increasing funding to support co-operatives in the developing world, providing low cost loans for capital and infrastructure projects.

The Board

Non-Executive Directors:

Paul Flowers (BA (Hons), Cd'EO (Geneva), FRSA, FCIBS, FRGS)
Age 62. Joined the Board in 2009 and appointed Chair in 2010. Deputy Chair of Co-operative Group Limited. Superintendent Methodist Minister. Member of the Co-operative Group North Regional Board. Chair of Co-operative Banking Group Limited.

Duncan Bowdler (BSc (Hons) Biochemistry)
Age 54. Joined the Board in 2009. Trade and Legislation Manager. Member of the Co-operative Group North West and North Midlands Regional Board. Non-Executive Director of Co-operative Group Limited and Co-operative Banking Group Limited.

Richard Coates (BSc (Econ), FCA)
Age 61. Joined the Board in 2013. Non-Executive Director of Police Mutual Assurance Society. Non-Executive Director of Co-operative Banking Group Limited.

David Davies (BSc (Econ), FIA)
Age 65. Joined the Board in 2003, appointed Deputy Chair in 2010 and together with the other Deputy Chair, Peter Harvey, fulfils the role of Senior Independent Director. Qualified actuary. Chair of Pace Pension Scheme and Nortel Networks Pension Scheme in the UK. Non-Executive Director of Interglobal Insurance Company Limited. Non-Executive Director of Co-operative Banking Group Limited, Co-operative Insurance Society Limited and CIS General Insurance Limited.

Anne Gunther (BSc (Hons), MBA, ACIB, FCIBS)
Age 58. Joined the Board in 2011. A career retail banker, most recently as Chief Executive of Standard Life Bank and then Chief Executive of Norwich and Peterborough Building Society to secure its merger with the Yorkshire Building Society. Chair of Warwick Business School. Non-Executive Director MBNA Limited and Non-Executive Director of (NEW) Devon NHS Clinical Commissioning Group. Non-Executive Director of Co-operative Banking Group Limited.

Peter Harvey (ACIB, Dip FS)
Age 57. Joined the Board in 2009 appointed Deputy Chair in 2012 and together with the other Deputy Chair, David Davies, fulfils the role of Senior Independent Director. Non-Executive Director of Marshalls Holdings Limited. Non-Executive Director of Co-operative Banking Group Limited.

Merlyn Lowther (BSc (Hons), MBA, FCIB)
Age 59. Joined the Board in 2011. Chief Cashier of the Bank of England from 1999 to 2004. Non-Executive Director of Schroders plc. Trustee of the Winston Churchill Memorial Trust and The Henry Smith Charity. Non-Executive Director of Co-operative Banking Group Limited.

Peter Marks CBE
Age 63. Joined the Board in 2009. Group Chief Executive of Co-operative Group Limited. Named Orange Leader of the Year 2009 in the National Business Awards. Entire working life spent within the Co-operative Movement. Instrumental in bringing about a number of major co-operative mergers over the past decade, as well as the Group's acquisition of the Somerfield supermarket chain. Non-Executive Director of Thomas Cook Group plc. Non-Executive Director of Co-operative Banking Group Limited.

Bob Newton (BSc, FIA, CDir)
Age 63. Joined the Board in 2007. Over 40 years' experience in the financial services industry. Chair of Silentair Group Limited. Non-Executive Director of UIA (Insurance) Limited and Reclaim Fund Limited. Non-Executive Director of Co-operative Banking Group Limited. Chair of Co-operative Insurance Society Limited and CIS General Insurance Limited.

Ben Reid OBE (FCCA)
Age 58. Joined the Board in 2009. Chief Executive of The Midcounties Co-operative and also Chair of Walsall Healthcare NHS Trust. Non-Executive Director of Co-operative Group Limited and Co-operative Banking Group Limited.

Len Wardle (BA)
Age 68. Joined the Board in 2002. Chair of Co-operative Group Limited and member of the South East Regional Board. Held management positions in local government and latterly was a Fellow at the University of Surrey in the School of Management. Director of Communicate Mutuality Limited. Non-Executive Director of Co-operative Banking Group Limited.

Martyn Wates (ACA, ATII, BA (Hons))
Age 46. Joined the Board in 2007. Has held various senior finance positions within the Co-operative Movement. Chief Executive of the Co-operative Group's Specialist Businesses Group and Deputy Chief Executive Officer of the Co-operative Group. Director of various internal subsidiaries and Non-Executive Director of Co-operative Banking Group Limited.

Executive Director:

Barry Tootell (BA (Hons), FCA)
Age 51. Joined the Board in 2008. Chief Executive Officer. Qualified accountant with over 20 years of banking experience and was previously Chief Financial Officer. Executive director of Co-operative Banking Group Limited, Co-operative Insurance Society Limited and CIS General Insurance Limited.

Corporate governance

Introduction from the Chair

In order to meet its vision of becoming the compelling co-operative alternative and differentiate itself within the banking market the Board believes corporate governance now, more than ever, to be key to the effectiveness of the Bank.

During 2012 the Board has continued to provide leadership, challenge, guidance and support to the Executive and management. The Board focused on a number of things including:

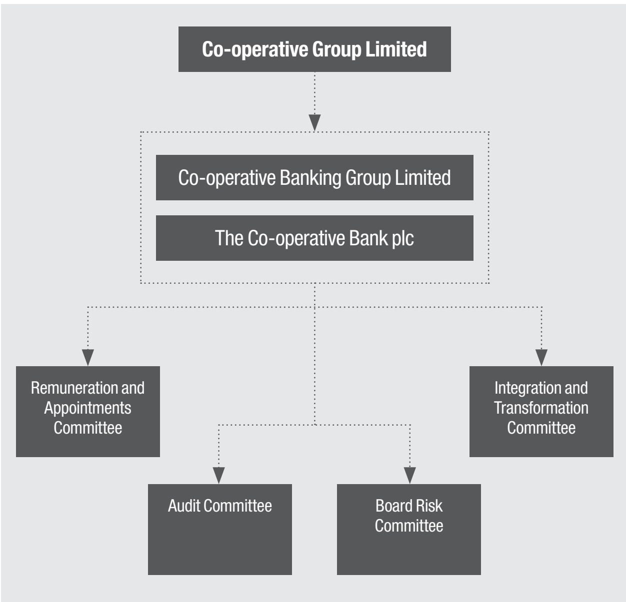
- the implications for the Bank of the potential acquisition of 632 branches from Lloyds Banking Group (Verde);
- the risk management framework;
- the Internal Capital Adequacy Assessment Process (ICAAP);
- Recovery and Resolution Planning (RRP);
- Payment Protection Insurance (PPI);
- packaged accounts; and
- capital markets funding.

A number of steps have been taken to improve corporate governance within the Bank including a review of the composition of the Board of directors, and, as a result of the work undertaken on the Bank's risk management framework, a review of the Board committees' terms of reference. A revised schedule of matters reserved for the Board will be implemented in 2013 alongside revised financial delegated authorities. This will assist the delivery of good governance not only in the boardroom but across the entire business.

Paul Flowers, Chair

Governance structures

The Bank is a subsidiary of the Co-operative Banking Group Limited (the Banking Group) and its ultimate parent organisation is the Co-operative Group Limited (Co-operative Group) which is an Industrial and Provident Society that is jointly owned and democratically controlled by its members.



Relations with members

The Bank has two equity shareholders. The majority of the shares are held by the Banking Group, which is a wholly owned subsidiary of the Co-operative Group. The remainder of the shares are held directly by The Co-operative Group.

The Bank has approximately 2,500 preference shareholders. The preference shares are fixed-interest shares and are non-cumulative and irredeemable. The preference shareholders are entitled to attend the AGM, but the shares only hold speaking or voting rights if and when the dividend has been in arrears for six months or more, or if a resolution is to be proposed at a general meeting abrogating or varying any of their respective rights or privileges, or for the winding up of the Bank or other return of capital and then only on such resolution.

Compliance with the UK Corporate Governance Code

The Board believes that during the year, with the exception of the composition of the Board and the Audit Committee (as explained below), it has fully complied with the principles and provisions of the UK Corporate Governance Code (the Code) appropriate to the democratic structures of the Bank and its parent organisations; the Banking Group and Co-operative Group. The Audit Committee composition now fulfils the requirements of the Code and steps are being taken to recruit additional Non-Executive Directors to the Bank Board to ensure ongoing compliance with the Code.

Leadership

Role and responsibilities of the Board

The Board is responsible for the long term success of the Bank within a framework of controls which enables risk to be assessed and managed. It is responsible for setting strategy, maintaining the policy and decision making framework within which this strategy is implemented which ensures that the necessary financial and human resources are in place to meet strategic aims, monitoring performance against key financial and non-financial indicators, overseeing the system of risk management and for setting values and standards in governance matters.

The responsibility of the Board is to direct the business of the Bank and in particular to:

- ensure that the Bank's affairs are conducted and managed in accordance with its articles of association, the best interests of its stakeholders and co-operative values and principles;
- establish arrangements to ensure the information presented in the annual report and accounts is fair, balanced and understandable;
- agree objectives, policies and strategies, and monitor the performance of executive management;
- approve the annual budget and business plan;
- approve the annual report, financial statements and dividends;
- monitor, utilising various committees, the key significant risks facing the Bank;
- establish Board committees and agree their terms of reference; and
- approve the delegated financial authorities.

Corporate governance continued

Appointment and re-appointment of directors

The directors that serve on the Banking Group Board also sit on the Bank Board to provide common leadership of the financial services business. Whilst appointments to the Board are formally made by the Co-operative Group Board, for the recruitment of independent Non-Executive Directors, external recruitment consultants, Warren Partners, are retained and an interview panel comprising Bank Non-Executive Directors, recommend appointments to the Co-operative Group Board.

All Non-Executive Directors are eligible for reappointment at the end of each term of office. The Co-operative Group Board, being party to agreements with the independent professional Non-Executive Directors for services to the Banking Group and its subsidiaries, including the Bank, may resolve to re-appoint at or before the date their contracts expire for a further three year term. It is the normal policy of the Board not to allow an independent professional Non-Executive Director to serve for more than nine years in aggregate.

Two directors left the Bank Board during the year; Rodney Baker-Bates, who had joined the Bank following the merger with Britannia Building Society, retired on 31 July, and after nine years service, Paul Hewitt left on 21 September. David Davies, who was appointed to the Bank Board in 2003, announced that he will be retiring in 2013. Upon his retirement as Chief Executive of the Co-operative Group, Peter Marks will step down from the Bank Board on 18 May 2013.

Under the articles of association, one third of the Board is required to retire by rotation at the conclusion of the Annual General Meeting (AGM). In accordance with the articles of association, therefore, three directors will retire by rotation in 2013, Duncan Bowdler, Peter Harvey and Bob Newton and all offer themselves for re-election at the 2013 AGM.

Richard Coates has been appointed to the Board since the conclusion of the last AGM on 15 May 2012, which makes him eligible for re-appointment at the 2013 AGM.

The notice of the AGM can be found on page 134. All directors due for re-election continue to demonstrate commitment to their roles. (See schedule of attendance on page 15.)

Board composition

The names of the members of the Board, their biographies and details of length of service are set out on page 12. They were in office for the full period unless otherwise stated.

During the year the composition of the Bank Board was reviewed to strengthen the balance of independent representation and to ensure the appropriate skills and experience were in place to support the long term strategy. Following the review, it was agreed that in future the Board of the Bank would comprise 14 directors being the Chief Executive Officer, the Chief Financial Officer, four representatives from the Co-operative Group and eight independent Non-Executive Directors.

Of the 12 directors sitting on the Bank's Board of directors at the end of 2012 there were 11 Non-Executive Directors and one executive director. Of the 11 Non-Executive Directors four are elected members of the Co-operative Group Board, two are Co-operative Group Executives and five are independent and recruited for their specific financial services experience and expertise. In addition to the appointment of Richard Coates as an independent Non-Executive Director a search is being undertaken for three additional independent Non-Executive Directors. In February 2013 the Bank announced that Graeme Hardie would be joining the Board as an independent Non-Executive Director with an expected joining date of May 2013.

Following signature of heads of terms for the acquisition of the Verde business, it is recognised that the executive appointments to the Board will be reviewed in due course. Barry Tootell is the Chief Executive of the Bank and is appointed to the Board as a director. The existing Chief Financial Officer, James Mack, has announced his resignation and will be leaving the business in 2013. He is not a director therefore there is an executive director vacancy on the Board.

Independence

The Code requires at least half of the Board, excluding the Chair, to be independent Non-Executive Directors. Although not currently compliant with this requirement the Board is taking steps to recruit three additional new independent Non-Executive Directors, as referred to above, to improve the Board's independence and ensure compliance with the Code.

At the end of the year five independent Non-Executive Directors (excluding the Chair) sat on the Board: David Davies, Peter Harvey, Bob Newton, Anne Gunther and Merlyn Lowther. Rodney Baker-Bates was an independent professional Non-Executive Director until his retirement.

All the independent non-executives have considerable experience and make valuable contributions to the operation of the Bank. The independent Non-Executive Directors constructively challenge and help develop proposals on strategy and bring strong, independent judgment, 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.

The role of the Chair

The Chair is a Non-Executive Director and leads the Board in the determination of its strategy and in the achievement of its objectives. The Chair takes personal responsibility for organising the business of the Board, ensuring its effectiveness and setting its agenda. The Chair has no involvement in the running of the day to day business of the Bank. The Chair facilitates the effective contribution of directors, constructive relations between the executive and Non-Executive Directors, ensures directors receive accurate, timely and clear information and ensures that there is effective communication with members.

The division of responsibilities between the Chair and the Chief Executive is clearly defined and has been approved by the Board.

The current Chair is Paul Flowers who is an elected member of the Co-operative Group Board. The two Deputy Chairs are David Davies and Peter Harvey (who replaced Rodney Baker-Bates), both of whom are independent Non-Executive Directors. The Deputy Chairs together fill the role of Senior Independent Director. The Deputy Chair vacancy which will arise on the departure of David Davies in 2013 will be filled by Merlyn Lowther who is also an independent Non-Executive Director. Details of the Chair's and Deputy Chairs' professional commitments are included in the biographies on page 12. The Board is satisfied that these responsibilities do not interfere with the performance of the Chair or Deputy Chairs' duties for the Bank.

The role of the Chief Executive and the Executive

The Chief Executive 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.

It is the responsibility of the Executive to achieve the business objectives as agreed by the Board. The Executive, under the leadership of the Chief Executive, are responsible for the management of the Bank.

The secretary to the Board

The secretary is professionally qualified and is responsible for advising the Board through the Chair on all governance matters. The directors have access to the advice and services of the secretary. The articles of association and the schedule of matters reserved to the Board for decision provide that the appointment and removal of the secretary is a matter for the Board.

How the Board operates

Meetings

The Board meets on a monthly basis and it met 15 times in 2012 including three meetings held specifically to consider the acquisition of the Verde business. The Board is scheduled to meet for 12 Board meetings and to hold two strategy meetings in 2013. The strategy meetings will be attended by senior executives and will consider performance and longer term planning. If necessary, the Board also holds private sessions in the absence of executive directors. Members of the Executive and senior management 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 at times.

Details of attendance at Board meetings are noted below.

Information to Directors

Recognising the need for a more secure, cost effective alternative to paper Board packs and in line with the Bank's strong stance on environmental ethics, an electronic Board paper solution was trialled with directors and key meeting attendees at the beginning of the year. Following a positive response from directors, the distribution of hard copy Board packs was phased out completely by June 2012.

Directors and key attendees of all Boards and committees now use electronic tablets as their primary method of receipt of papers and this is being further developed to include areas such as supporting material, training and calendar management.

Board and committee papers are now available for directors to access ordinarily eight days before each meeting. This provides the opportunity for directors to prepare fully for meetings. The minutes of all meetings are available to all directors via their electronic tablets.

Attendance

The following table sets out the frequency of, and attendance at, the Board and Board committee meetings for 2012 by directors:

Directors	**Bank Board**	**Audit Committee**	**Board Risk Committee**	**Exposures Committee**	**Integration and Transformation Committee**	**Remuneration and Appointments Committee**
Number of meetings held	15	11	13	8	9	8
Paul Flowers	15 (15)				8 (9)	8 (8)
Duncan Bowdler	15 (15)	10 (11)		8 (8)		
David Davies	15 (15)		11 (13)			7 (8)
Anne Gunther	15 (15)		13 (13)	8 (8)	1 (1)	1 (1)
Peter Harvey	15 (15)	9 (11)	1 (1)	8 (8)		
Merlyn Lowther	15 (15)		13 (13)		4 (5)	
Peter Marks	12 (15)					6 (8)
Bob Newton	14 (15)	10 (11)	9 (13)		8 (9)	
Ben Reid	12 (15)	9 (11)				
Barry Tootell	15 (15)					
Len Wardle	12 (15)			6 (8)		8 (8)
Martyn Wates	14 (15)					
Former directors						
Rodney Baker-Bates	9 (9)					4 (4)
Paul Hewitt	11 (12)	7 (7)	7 (9)		7 (7)	

The number in brackets indicates the total number of meetings the director was eligible to attend during the year. In the case of a director being unable to attend a meeting, the Chair has received a satisfactory reason for their absence.

Board committees

With the agreement of the Financial Services Authority (FSA), the Board has delegated certain responsibilities to a number of committees, all of which have written terms of reference covering the authority delegated to it by the Board. Each of these committees has a role in ensuring the effectiveness of the Bank and its subsidiaries. In accordance with the Code, the terms of reference for all the committees can be found at http://www.co-operativebankinggroup.co.uk.

During 2012, work continued on the Banking Group risk governance framework policy which sets out how the Banking Group and its subsidiaries, including the Bank, manage risk in pursuit of their business objectives. As part of the work undertaken there was a review of the governance committees operating within the Banking Group, both at Board committee level and below, and as a result of the review, the terms of reference for the Audit Committee, Board Risk Committee and Remuneration and Appointments Committee were revised.

Audit Committee

Information on the Audit Committee is found on page 18.

Remuneration and Appointments Committee

Information on the Remuneration and Appointments Committee is found on page 20.

Corporate governance continued

Board Risk Committee

The Board Risk Committee comprises four members and the Chair is Merlyn Lowther. During the year the committee comprised:

Merlyn Lowther	Chair (appointed Chair on 18 January 2012)
David Davies	
Bob Newton	
Anne Gunther	(appointed 18 January 2012)
Peter Harvey	(resigned 22 February 2012)
Paul Hewitt	(resigned 21 September 2012)

Paul Hewitt stood down from the committee following his resignation as a Board member. Peter Harvey was appointed as the interim Chair on 8 September 2011 and on 18 January 2012 Merlyn Lowther formally took on the role of Chair. Peter Harvey resigned from the committee on 22 February 2012. The make up of the committee will again be reviewed following the appointment of additional independent Non-Executive Directors to the Board. The committee met 13 times during the financial year.

The main responsibilities of the committee are set out in its terms of reference and include consideration of the management and control of all significant risks, including technical, operational, business model and external risks. The committee's terms of reference were revised and approved on 18 April 2012 in line with the evolving risk management framework policy.

In accordance with its terms of reference during 2012 the committee reviewed the development and embedding of the risk management framework and the work on risk culture and sought assurance that an appropriate risk culture prevailed in the organisation. The committee also reviewed, challenged and recommended to the Board approval of risk appetite, limits and tolerances. A number of key prudential regulatory requirements for the Bank were reviewed including the Internal Capital Adequacy Assessment Process (ICAAP) and Individual Liquidity Adequacy Assessment (ILAA). The committee reviewed reverse stress testing including the methodology and the results. The committee has discussed and reviewed the development of the Recovery and Resolution Plan (RRP).

During 2012, the committee met regularly to review and assess the risks associated with the two major projects that are underway within the Co-operative Banking Group in respect of the sale of the life business and the acquisition of the Verde business from Lloyds Banking Group. Due to the heavy schedule, additional meetings were arranged so that the committee could fully consider and discuss these transactions and provide appropriate focus.

During the year the committee has reviewed its own effectiveness. The results of the review will be used to assist in the development of the effectiveness of the committee under its revised terms of reference.

Exposures Committee

During the year the committee comprised four members and the Chair was Peter Harvey:

Peter Harvey	Chair
Anne Gunther	
Duncan Bowdler	
Len Wardle	

The committee met eight times during the financial year and its main responsibilities, as set out in its terms of reference were to sanction large counterparty transactions, manage large exposure positions and consider risk management of exposures.

During the year, pursuant to the implementation of the new risk management framework, the role of the Exposures Committee was reviewed. Its responsibilities, as set out in its terms of reference, were reallocated to other Board and executive committees and therefore the Exposures Committee ceased meeting in September 2012.

Integration and Transformation Committee

The committee comprises four members and the Chair is Bob Newton. During the year the committee comprised:

Bob Newton	Chair
Paul Flowers	
Anne Gunther	(appointed 10 October 2012)
Merlyn Lowther	(appointed 18 April 2012)
Paul Hewitt	(resigned 21 September 2012)

The main responsibilities of the committee are set out in its terms of reference. The committee considers integration issues across the Bank and Banking Group and met nine times in 2012.

Following the commencement of negotiations to acquire Verde the committee's terms of reference were reviewed to broaden its scope and the name was changed from the Transformation Committee. The committee has reviewed its effectiveness during the year. This review recognised that the terms of reference will require amendment in 2013 to refine the scope of the committee and reflect the position at that time.

Board effectiveness

Board statement on diversity

The Board takes the issue of diversity seriously and actively promotes policies and practices of equality of opportunity, regardless of age, disability, ethnicity, gender, religion or belief or sexual orientation.

The Bank Board recognises that having members from different backgrounds and with different skills is key to being a challenging and effective Board and believes that by having a diverse Board it will:

- help the Board represent the views of the wider co-operative membership;
- bring a broad range of skills and knowledge to the Board;
- support good governance through challenge and discussion from a diverse range of viewpoints;
- uphold the co-operative values and principles of honesty, openness, equality and equity; and
- gain a leadership position in the UK with regards to good governance and Board composition.

The Board policy includes all aspects of diversity, and in particular, responds to the revised UK Corporate Governance Code published in September 2012, which addresses the recommendations by Lord Davies in his 'Women on Boards' report published in February 2011. The policy aims to address the representation of women on the Board by setting interim targets for the percentage of female directors serving on the Board which are agreed and will be regularly reviewed by the Board. The policy also aims for a Board composition to reflect the diverse composition of the UK population based on the most recent UK Census results.

Currently, interim targets have been set for the Bank Board to comprise of a minimum of 33% of females by 2016, and to comprise of a minimum of 40% of females by 2018. Of the 12 directors appointed to the Bank Board at the end of 2012, two of these were women. Anne Gunther and Merlyn Lowther were appointed to its Board in 2011 and at the end of 2012 women represented 17% of the Board. All recruitment to the Bank Board will take into consideration the Board's policy on diversity.

Performance evaluation

The Code requires the Board to undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

The Board last underwent an external evaluation exercise of its effectiveness at the end of 2010, the only significant recommendation (in respect of the size and composition of the Board) has been addressed during 2011/2012. The next external review is planned for 2013.

An internal self assessment of Board effectiveness took place during the year. The outcome was considered in a separate session of the Board to give time for appropriate discussion of the results of the self assessment. Key issues included the provision of competitor information and the adequacy of succession planning. These areas continue to be under review.

Each year, the Board committees undergo internal self assessment of their effectiveness. In 2012, all the key Board committees including both Audit and Board Risk Committees carried out self assessment exercises.

Each year, one third of the Board directors are subject to a peer evaluation selected on length of service from first appointment to the Board, subject to having served at least one year on the Board as at 30 June. Such an exercise took place in 2012. The responses to the peer evaluation questionnaires provided the basis of one to one discussions with the Chair of the Board.

Induction and continuing professional development

In line with recommendations of the Code, the Bank has reviewed the induction programme for new directors and all newly elected directors are required to undertake a structured induction programme. This is designed to include key corporate governance and business information, including briefing sessions with the Executive on the strategy and performance of key business areas.

A Board learning and development policy is in place to support all Non-Executive Directors. Following discussion at Board to prioritise collective training and development, thematic learning and development sessions for the whole Board have taken place.

Specific training has been organised for Board committees including the Remuneration and Appointments Committee, the Audit Committee, the Exposures Committee and the Board Risk Committee. In addition, one to one support has been provided to a number of directors.

Directors receive information on the operation of the Board's Committees, including the powers delegated to the committees, corporate governance practices and procedures and the powers reserved to the Executive together with the latest financial information. This is supplemented by meetings with key senior executives where appropriate, together with in depth training and round table sessions on specific areas.

An electronic 'reading room' is available as a resource bank to enable directors to access, revisit and review copies of presentations and materials from the more formal development sessions.

Individual learning and development records are issued to all Non-Executive Directors summarising activity through the year and individual learning plans have been put in place in order to construct the framework for individual and collective learning and development.

The Chair 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 Group and their responsibilities as directors.

Succession planning

As part of its annual performance evaluation the Board considers its composition and the balance of skills in the boardroom. When vacancies arise on the Board, directors are consulted prior to commencement of a search to fill a vacancy to ensure the skills and experience being sought from any new appointee enhance the Board composition.

Conflicts of interests

The Board has a conflicts of interests policy. The policy outlines how conflicts will be dealt with and the process for directors to follow when notifying the Bank of an actual or potential conflict. When deciding whether to authorise a conflict or a potential conflict of interest, only those that have no interest in the matter under consideration are able to take part in the decision.

The Board has considered the current external appointments of all directors which may give rise to a situational conflict and has authorised potential conflicts where appropriate.

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 ordinary shares in the Bank or the Banking Group or in Co-operative Group Limited, which is the ultimate holding organisation, or in any other entity controlled by the Co-operative Group. As disclosed in his biography on page 12, Bob Newton is a Non-Executive Director of UIA (Insurance) Limited. UIA (Insurance) Limited holds 200,000 preference shares in the Bank.

Insurance and indemnities

The Bank maintains appropriate directors' and officers' liability insurance cover through the ultimate parent organisation, in respect of legal action against its directors and officers. This constitutes a 'qualifying third party indemnity provision' for the purposes of s236 of the Companies Act 2006 and applied to all of the Bank's directors serving during the financial year. The insurance cover was reviewed and renewed in 2012.

The directors, the secretary and any of the Group's approved persons under the Financial Services and Markets Act 2000 from time to time have entered into a contract of indemnity with the Group in respect of certain liabilities they may incur whilst discharging their functions.

Professional advice and Board support

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

Corporate governance continued

Audit

Audit Committee
Composition

The committee is appointed by the Board, comprises four members and, for the majority of 2012, was chaired by Paul Hewitt. Peter Harvey was appointed interim Chair on 22 September 2012 and will be replaced in 2013 by Richard Coates. During the year the committee comprised:

Paul Hewitt	Chair (resigned 21 September 2012)
Peter Harvey	(appointed Chair on 22 September 2012)
Duncan Bowdler	
Ben Reid	
Bob Newton	

In compliance with the terms of reference, Paul Hewitt and Ben Reid brought recent and relevant financial experience and in addition Ben Reid chaired the Co-operative Group's Audit and Risk Committee until 4 November 2012. Duncan Bowdler is a member of the Co-operative Group's Audit and Risk Committee and Bob Newton is also a member of the Co-operative Banking Group's Board Risk Committee. The committee's terms of reference were reviewed and approved on 11 July 2012.

Bob Newton and Peter Harvey are considered to be independent members of the committee. Paul Hewitt stood down from the committee when he ceased to be a director and consequently, for the period until Richard Coates was appointed in 2013, a majority of the committee members were not considered independent as required by the UK Corporate Governance Code. The composition of the committee will again be reviewed following the appointment of additional independent Non-Executive Directors to the Board.

In accordance with the terms of reference members of the executive and management regularly attend meetings of the committee.

Role of the committee
The main responsibilities of the committee are set out in its terms of reference which are available on our website http://www.co-operativebankinggroup.co.uk and include to:

- review and discuss with management and auditors the preliminary results, interim information and annual financial statements of the Bank before submission to the Board;
- review, prior to its consideration by the Board, the external auditor's reports to the directors and management's response;
- consider any necessary disclosure implications from the process that has been applied by the Board to deal with material internal control aspects of any significant problems disclosed in the financial statements;
- obtain assurance that the Bank is compliant with relevant regulation; and
- review and approve the scope of the annual regulatory monitoring plan, taking into account the regulatory risks identified from time to time.

Committee focus during 2012
The committee met 11 times during the financial year. During 2012 the committee focused on:

- the appropriateness of the accounting judgments in the 2012 annual report and the 2012 interim report. The key judgments for the Bank were:
  1. value in use calculations on the replacement of the core banking system. This asset is held on the balance sheet of CFSMS and recharged to the Bank. The committee considered the estimated costs and benefits of the system and discussed the implementation plan with members of the Executive. The debate centered around robustness of plans and sensitivity of the numbers to highly judgmental issues such as implementation date, discount rate and costs to complete.
  2. PPI provision. The committee reviewed a detailed paper and discussed with the Director of Retail Banking the level of the provision and the judgments made in calculating the provision. These judgments, including uphold rates, average payouts and past business review cohorts were benchmarked against actual data and peer group statistics.
  3. credit impairment, particularly in the corporate area. Levels of credit impairment in the bank in 2012 were significant. The committee received detailed calculations of impairment across all areas of the bank. For corporate impairment, members of the committee reviewed and challenged in detail, following review by management from finance, risk, the credit teams, internal and external audit (in line with the three lines of defence model described in the risk management section), all items on the watchlist, all items with attached forbearance and all items considered high risk (ie due to loan to value or interest cover ratios). This represented over 30% of the portfolio. The committee considered the level of exposure to BPIIGS countries and does not consider this to be material. The committee will review impairment on a quarterly basis and is satisfied that current lending is in line with a conservative risk appetite.
  4. going concern. The Audit Committee took particular care to review the going concern status of the organisation in depth. Profit, capital and liquidity forecasting were debated along with the proposed actions to improve the position.
- the control environment, particularly in IT, Finance and Treasury;
- areas receiving a red graded audit report, where the executive responsible was required to attend the meeting to answer the committee's questions. The committee monitored the action plans associated with these audit reports;
- in the run up to and following the signing of heads of terms for the Verde acquisition, the committee held four meetings specifically to discuss the transaction, focusing on the scope and findings of the due diligence and independent assurance work;
- reviewing the arrangements in place to ensure that the internal audit team working on the Banking Group, including the Bank, continued to operate in accordance with best practice.

Additionally the committee received regular reports from KPMG and representatives from KPMG were consulted throughout the debates in each meeting. The committee also met with internal audit four times and KPMG five times. Two of the meetings with the external auditors took place without the presence of internal audit.

Annual review of effectiveness
Following the committee effectiveness review in 2012 it was decided to increase the frequency of meetings from four to six to allow sufficient time to deal with the very full agendas, particularly at half-year and year-end. Given the busy schedule, the committee members recognised the need to retain focus on the Audit Committee training plan and accordingly a programme of activity for 2012 and 2013 has been agreed and adhered to.

Training for committee members
The committee received formal presentations as part of the committee members' learning and development programme which covered forthcoming changes to accounting standards and assurance frameworks.

Members of the committee undertook a visit to the Treasury dealing room at the London office and members were also invited to attend training on corporate governance and risk management responsibilities.

In addition committee members have access to the Audit Committee Institute for background information and guidance on the role and responsibilities of Audit Committee members. New committee members are also provided with an induction.

External audit
The current auditor is KPMG Audit Plc. In line with good corporate governance, a tender process took place during 2011 to consider the appointment of the external auditors to the Co-operative Group, including the Banking Group and the Bank and KPMG Audit Plc was selected and approved at the AGM.

In accordance with Section 489 of the Companies Act 2006, a resolution for the appointment and remuneration of the auditors are proposed at the next AGM and set out on page 134.

Independence, objectivity and fees
The Audit Committee has put in place safeguards to ensure that the independence of the audit is not compromised including a policy on the conduct of non-audit services from the external auditors. The external auditors are permitted to provide some non-audit services that are not, and are not perceived to be, in conflict with their independence. The Audit Committee receives at each meeting a report providing details of assignments (and related financial fees) carried out by the external auditors of the Bank in addition to their statutory audit work. The pre-approval of the committee is required for services above certain thresholds determined by the committee.

In addition, the following assignments are prohibited from being performed by the external auditors:

- bookkeeping or other services related to the accounting records or financial statements;
- financial information systems design and implementation;
- actuarial services;
- Internal Audit outsourcing services;
- management functions or human resources; and
- any other services that the Audit Committee may determine.

Details of fees paid to the auditor for audit services, audit related services and other non-audit services is provided in note 2 to the accounts which includes an analysis of the nature of non-audit spend.

Performance
The committee undertakes a formal annual assessment of the performance of the external auditor, through questionnaires completed by senior managers and directors.

Internal Audit
The Internal Audit function is an independent function which reports to the Audit Committee. Its primary role is to provide assurance over the adequacy and effectiveness of the internal control framework including risk management practices.

Internal Audit seeks to discharge the responsibilities set down in its charter by completing a risk based internal audit plan, reviewing the processes which ensure that the key business risks are effectively managed by key controls.

Internal Audit also acts as a source of constructive advice and best practice on control, working with senior management to deliver its responsibility to improve the processes by which business risks are identified and managed.

Internal Audit reports are submitted to, and significant issues discussed at, the Audit Committee.

Risk management
The Board and executive management have primary responsibility for identifying the key business risks facing the Bank and for approving the Bank's risk strategy and level of acceptable risk which is articulated through its statement of risk appetite. The risk management framework, which is approved and reviewed by the Bank Board, outlines the approach taken to ensure a robust risk management process is in place throughout the Bank.

During 2012 the Banking Group undertook a wide ranging review of its risk management framework which resulted in significant change in its organisational design. The work on the risk management framework to date has included a redesign of the way the Bank classifies the risks it faces, the way risk appetite is established and the structure and application of the authority delegated by the Board to manage the risk within the agreed appetite.

The Board accepts that there are risks which could impact on the achievement of the Bank's business objectives, but endeavours through positive risk management strategies as outlined in the risk management framework, to manage these in a manner that optimises returns within the confines of the business' risk appetite, whilst protecting members' interests and reserves.

Further information on the Bank's approach to risk management is given on page 54 and details of KPIs are on page 2.

Internal control
Internal controls are the activities undertaken by management, the Board and other parties to enhance risk management and increase the probability that established objectives and goals will be achieved. The Board has overall responsibility for the Bank's system of internal controls which aim to ensure effective and efficient operations, quality of internal and external reporting, safeguarding of the Bank's assets and compliance with laws and regulations. The Bank operates a three lines of defence governance model to ensure appropriate responsibility and accountability are maintained whilst recognising that the system is designed to manage rather than eliminate risk of failure to achieve business objectives, it can only provide reasonable and not absolute assurance against material misstatement or loss.

The Bank's internal control framework is designed to create an attitude of taking acceptable business risk within clearly defined limits which includes:

- an organisational governance structure with clear lines of responsibility, delegation of authority and reporting requirements;
- checks and balances to ensure that business processes operate efficiently reducing the risk posed to the organisation whilst adhering to organisational values;
- comprehensive systems of financial reporting. The annual budget and long term plan of the Bank and of each division are reviewed and approved by the Board;
- a code of business conduct covering relations with customers, shareholders, colleagues, suppliers, community and competitors;
- a whistleblowing policy and procedure which provides for any employee to report, in confidence, suspected serious malpractice;
- internal audit, risk and compliance functions that review the system of internal control; and
- a control self assessment process designed to fully support the annual review of the effectiveness of the system of internal control and enable continual monitoring and improvement of the internal control environment.

Remuneration report

Committee Chair's summary

"The committee will continue to focus on the linking of reward to business and individual performance and the strengthening of co-operative values which include a strong belief in the stewardship of all the Society's resources, and, therefore which are consistent with and promote effective risk management."

Important principles which make Co-operative Bank Remuneration Policy distinctive from other PLCs include:
- levels of variable pay (annual and long term bonus) opportunity are modest, consistently set at levels lower than in comparably sized PLCs;
- the construct of both the annual and long term bonus plans is based on a balanced scorecard that includes significant non-financial measures which ensure that there is no encouragement of inappropriate risk taking;
- balanced scorecard linked to co-operative values and principles;

Key considerations for this year have included:
- payment of zero awards under the 2012 annual incentive plan, the 2010–12 long term plan and deferred payments due to 2012 and cumulative financial targets not being achieved;
- continuation of dialogue with the Financial Services Authority (FSA) in connection with our current and future remuneration practices. All remuneration arrangements and practices in place are compliant with the FSA Remuneration Code; and
- focus on risk adjustment and remuneration policies which promote effective risk management.

The committee's responsibility is to determine and oversee remuneration policy that seeks to retain and motivate talented individuals, align with co-operative values and principles, and comply with best practice and FSA Remuneration Code requirements.

The committee reviews the ongoing appropriateness and relevance of remuneration policy and takes into account many factors including the need for remuneration to be structured so as to link rewards to business and individual performance.

With regard to future remuneration policy, the committee believes annual and long term incentive schemes to be appropriate and as such will motivate the senior executives to achieve short to medium and long term business objectives.

Ex post risk adjustment; the cancellation or reduction of variable remuneration through malus (for example clawback of an award for an executive action which leads to customer detriment) will be a major area of focus for the committee as we review our future remuneration policies and practices.

In our report, we give further details on our remuneration policy and an overview of senior executive remuneration for 2012.

Anne Gunther, Chair
Co-operative Banking Group Remuneration and Appointments Committee

Introduction

In the interest of good governance the Co-operative Bank (the Bank) uses as a guideline for its remuneration disclosure, the requirements applicable to listed companies, as set out in schedule 8 of the Large and Medium Sized Companies and Groups (Accounts and Reports) Regulations 2008 (incorporated into the Companies Act 2006). This remuneration report will be subject to an advisory vote by shareholders of the Bank at its Annual General Meeting to be held on 18 May 2013.

This report provides details of the remuneration of both the senior executives (including executive directors and executive committee members) and the Non-Executive Directors.

In recognition of the draft requirements that the UK Government's Department for Business, Innovation & Skills (BIS) has recently consulted on, the Bank has incorporated emerging practice within its remuneration report.

The remuneration report is presented by the Board and contains the following information:

Policy section:
- a description of the role of the Remuneration and Appointments Committee;
- a summary of the Bank's remuneration policy, including statements of policy in relation to senior executives' remuneration;
- a policy table with supporting notes showing each element of senior executives' remuneration;
- details of the terms of the service contracts and exit payment policy;
- considerations elsewhere in the Bank.

Implementation section:
- details of the current terms of office and total remuneration of each senior executive and Non-Executive Director for the 2012 financial year;
- remuneration governance.

Policy section

Role of the committee
The committee's terms of reference were last revised and approved by the Bank's Board on 5 September 2011.

The committee's principal terms of reference are to:

- determine the policy on remuneration and other main terms and conditions of employment of senior executives;
- oversee contractual arrangements for the senior executives and approve the principal terms and conditions of employment of such senior executives;
- review remuneration using comparisons against the agreed market policy for the senior executives;
- make recommendations on senior executive appointments and the terms and conditions relating to these;
- review and agree the remuneration policy and outcomes in respect of all designated code staff under the FSA Remuneration Code;
- approve any relevant incentive schemes, ensure that they are in line with current market practice and the FSA Remuneration Code, and authorise payments under any incentive schemes in line with their rules; and
- 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.

The Co-operative Group Remuneration and Appointments Committee governs remuneration in respect of the role of the Bank's Chief Executive.

The terms of reference for the committee are available on The Co-operative Banking Group website.

The committee members are all Non-Executive Directors. 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.

To ensure that it receives independent advice on remuneration matters, the committee retained New Bridge Street (an Aon Hewitt company) as its advisers during 2012. New Bridge Street has supplied survey data and advised on market trends and other general remuneration issues. Other than specialist advice in relation to remuneration matters, New Bridge Street does not provide other services to the Bank. Addleshaw Goddard LLP was also retained to provide legal advice to the committee with respect to senior executives' service contracts.

Policy on senior executive remuneration

In determining the remuneration policy for senior executives, the committee has considered a number of factors including:

- the importance of attracting, retaining and motivating senior executives of the appropriate calibre to further the success of the Bank;
- the linking of reward to business and individual performance and the application of co-operative values, which include a strong belief in responsible stewardship of all the Bank's resources and prudent management of risk;
- the alignment of the interests of senior executives with those of the wider Group and its members;
- pay practices and conditions of all employees throughout the Bank;
- the motivational impact of incentive arrangements to ensure that they are effective and do not adversely impact matters such as governance, environmental and social issues;
- in conjunction with the Group Remuneration and Appointments Committee ensuring that pay practices are coherent with those in the Co-operative Group as a whole; and
- ensuring appropriate compliance with the FSA Remuneration Code.

The current policy is to pay senior executives base salaries around the market median, when compared with other organisations of comparable size and complexity in relevant business sectors. The committee supports the principle of performance related pay and operates an annual incentive plan (AIP) and a long term incentive plan (LTIP) which, together, mean that over 50% of the remuneration package is performance related. The committee does not consider it appropriate to adhere to the size of variable pay typically available in PLCs and accordingly the amounts payable under these plans are lower than in comparable PLCs. Together, the AIP and LTIP represent total variable remuneration, with awards under the LTIP comprising the deferred element of variable remuneration as required by the FSA.

The committee considers that a successful remuneration policy needs to be sufficiently flexible to take account of future changes in the Bank's business environment, and in market remuneration practice. Accordingly, the committee keeps the Bank's remuneration policy under review. In particular, the absence of highly 'geared' incentive plans (schemes which pay out significant multiples of base salary when compared with some practices in the PLC sector) is consistent with prudent risk management.

The committee notes that the remuneration practices already adopted by the Bank, in addition to being good business practice, have been endorsed by the FSA through its Remuneration Code. However, the committee will continue to strive for further improvements in its executive remuneration arrangements as best practice evolves.

Policy Table

The main components of senior executive remuneration are summarised in the table below:

Element	Overview	How each element supports the strategic objectives of business	High level details	Clawback provision	Change in approach since last disclosure
Base salary [1]	To provide a competitive base salary to attract and retain talented leaders.	Payment for day to day role and responsibilities, individual performance objectives aligned to overarching business strategy.	Reviewed annually. Targeted around market median. Future increases based on performance results.	N	N
Benefits [2]	To provide benefits in line with normal market practice.	Competitive benefits proposition ensures talent is attracted/retained and able to undertake duties.	Car allowance, medical and life insurance.	N	N
Pension [3]	To provide competitive pension and protection benefits to attract and retain talented leaders.	Retains skills and experiences within the business.	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 Group) and/or an allowance designed so that the total value of the pension element is broadly the same as the value of the defined benefit pension plan. (See page 22.)	N	Y – Group-wide change in pension policy, applicable to all colleagues including senior executives
Annual incentive plan [4]	To incentivise and reward the delivery of superior annual performance, based on the Bank's annual business objectives and co-operative values.	Motivates delivery of business results aligned to the Board agreed balanced scorecard. Inclusion of financial and non-financial targets.	Up to 60% of salary based on The Co-operative Banking Group annual financial and non-financial targets. Incentive opportunity is below the market norm in comparable PLCs. (See page 22.)	Y	N
Long term incentive plan [5]	To incentivise and reward the delivery of superior long term performance, based on the Co-operative Group's objectives and values, and to retain talent.	Encourages long term, sustained performance; motivates delivery of long term business results aligned to the Board agreed balanced scorecard. Inclusion of financial and non-financial targets.	Awards up to 100% of salary for the Bank Chief Executive and 75% for other senior executives based on stretching three-year Group financial and non-financial targets. Incentive opportunity is below the market norm in comparable PLCs. (See page 23.)	Y	N

Remuneration report continued

Policy notes to the policy table:

1 Base salary

It is the committee's policy to ensure that the base salary for each senior executive is appropriate and competitive for the responsibilities involved and experience required. Base salaries for senior executives are reviewed by the committee, usually annually, having regard to competitive market practice, business and individual performance during the financial year and salary levels throughout the Bank. Comparative pay data is used carefully, recognising the potential for an upward ratchet in remuneration caused by over reliance on such data. The normal month for salary review is January. Base salary policy is generally the same for senior executives and all other employees, in the Bank.

2 Benefits

It is the committee's policy to ensure that the benefits for each senior executive are appropriate and competitive in regard to market practice. As is commonplace there are a number of benefits which relate to hierarchy and at managerial grades healthcare benefit and car allowance would be applicable. There are Bank-wide benefits which are generally the same for senior executives and all other employees, in the Bank, for example Employee Member Dividend and staff discounts.

3 Pensions

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

The Group harmonised pension arrangements for all employees from 6 October 2012 following completion of a major strategic review. As a result the arrangement is as follows:

- all schemes, other than Pace, were closed to future pension accrual. Defined benefits built up to this date continue to be linked to final pensionable salary at a member's date of leaving or retirement, whichever is earlier.
- Pace remains open for future pension accrual. Two new defined contribution sections were introduced called Pace Essential and Pace Extra and the defined benefit section was renamed Pace Complete.
- members of Pace Essential, into which all eligible employees will be automatically enrolled, currently pay 1% of pay and the employer pays 2%. Members of Pace Extra, which is available to all employees, currently pay 4% of pay and the employer pays 8%.
- all employees can choose to join Pace Complete once they have completed two or more consecutive year's 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).
- if death occurs in service all sections provide a lump sum benefit and Pace Complete also provides dependants' pensions.

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. Prior to 6 October 2012 members of Pace contributed 6% of their pensionable salary. The employer pays the balance of the cost of providing defined benefits.

All members of Pace have the choice of making pension contributions by salary sacrifice.

Furthermore, in the light of the pension tax changes applying to registered schemes from 6 April 2011, Group executive pension policy was revised. Where an executive 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 (16.7% prior to October 2012). Executives 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 executives in order to provide total life cover of 4 x salary when aggregated with benefits from Pace.

Prior to October 2012 different pension arrangements were in place for some Bank colleagues. Following the merger with Britannia Building Society on 1 August 2009, colleagues who at that date were members of the Britannia Pension Scheme ('the Britannia Scheme') continued in membership of the Britannia Scheme. From 1 August 2009 until 6 October 2012 only the defined contribution section of the Britannia Scheme was available to new employees of the financial services' businesses.

The Britannia Scheme, which is also a registered occupational pension scheme, provides benefits under two sections:

- a closed defined benefit section, which provides pensions based on an accrual of 1/80th, 1/60th or up to 1/30th for executives, of final pensionable salary for each year of pensionable service; or
- a defined contribution section with an employer contribution rate of 4%, 6% or 8% depending on the level of member contribution.

Members of the Britannia Scheme contributed 2% to 8% of their pensionable salary, depending on the relevant section.

Prior to the merger on 1 August 2009, the Director, Integration & Change had a contractual arrangement under which he accrued pension benefits in an unfunded employer financed retirement benefits scheme (EFRBS). The EFRBS is in place to provide pension benefits that exceed the lifetime allowance. Benefits up to the lifetime allowance will be provided from the Britannia Scheme. The arrangement was adjusted from 1 August 2011 so that the rate of future pension accrual made available under the Britannia Scheme was aligned to that provided by Pace, with no further accrual in the EFRBS.

4 Annual incentive plan

The annual incentive policy is designed to incentivise and reward senior executives for the achievement of the annual business plan as encapsulated in the balanced scorecard.

Each senior executive is eligible to participate in an annual incentive plan. The committee reviews and sets bonus targets and levels of eligibility annually. Each senior executive is eligible to receive a payment of up to 60% of base salary, although target payment levels are 35% of base salary.

The annual incentive is based on a mixture of financial and non-financial measures. The table below sets out the measures and the weighting of each measure used in 2012.

Balanced scorecard	Metric	Weighting
Financial	Profit Before Tax (PBT)	50%
	Return on Risk Weighted Exposure Amount (RRWEA)	20%
Colleague	Colleague engagement	10%
Customer	Customer satisfaction	10%
Risk	Adherence with risk management framework and risk appetite (as established by the CBG Board)	10%

The balanced scorecard approach represents best practice as set out in the FSA Remuneration Code. This approach and underlying policy is approved by the FSA and aligned to the goals of the business.

All balanced scorecard performance measures and results are audited by an external firm of accountants.

The Chief Executive's AIP is based 2/3rds on the above Banking Group's targets; the balance is based on targets for the wider Co-operative Group: profit (70%), corporate responsibility (10%), colleague engagement (10%) and customer satisfaction (10%).

In addition to achieving performance against the balanced scorecard measures (including the Chief Executive's group AIP element), four further underpins must be achieved before any payment is made. These are as follows:

1. A threshold profit level must be achieved before any element becomes payable.
2. The Bank must stay within its required liquidity range as agreed by The Co-operative Banking Group Board.
3. The Bank must stay above its required minimum capital level as agreed by The Co-operative Banking Group Board.
4. There should be no material breaches of risk in accordance with the risk appetite as agreed by The Co-operative Banking Group Board. The Chief Risk Officer is required to provide an annual report to the committee before bonus payments are signed off.

Additional deferral is also required by the FSA Code: 50% of any AIP earned is paid in March or April following the year end, while the remaining 50%, will be held in an alternative instrument for an additional six months, subject to additional performance conditions. A Contingent Capital Award (CCA) is leveraged as an alternative instrument and constructed as a non tradeable bond with maturity after six months, contingent on specified conditions.

The committee chose profit as the main driver of the annual incentive as it is a good indicator of overall business success being driven by income, impairment, costs and overall operational effectiveness, but the committee believes that other non-financial factors and co-operative values are also important. Non-financial measures are based upon independent external surveys.

AIPs do differ for senior executives in both quantum and scheme architecture from the general management population.

Clawback
In respect of annual incentive payments a clawback provision will apply in line with developing market practice. This enables the committee to seek to recoup part or all of an annual incentive payment by reference to subsequent business performance or individual behaviour of a senior executive. This also applies to any payment in respect of long term incentive.

The Bank also operates malus, a provision where the value of deferred remuneration can be adjusted downwards to take account of specified conditions eg in an instance of an executive action which leads to customer detriment.

5 Long term incentive plan (LTIP)
A Co-operative Group-wide LTIP continues to represent deferred remuneration under the FSA Remuneration Code. The purpose of this plan is to focus senior managers on the achievement and delivery of the medium to long term strategic goals for The Co-operative Group whilst protecting long term firm-wide sustainability.

Eligibility to participate is restricted to senior managers only as it is this group that is responsible for delivering the strategy as set by the Group Board. Opportunity to participate is based on individual performance, criticality and role undertaken.

The scheme and participation in the scheme is reviewed and approved annually by the committee.

Senior executives participate in the LTIP, using cumulative targets over a three year period, as the committee believes this arrangement aligns senior executives with the long term interests of members and aids retention of talent. The maximum payment is 100% of base salary for the Bank's Chief Executive and 75% for other senior executives. The actual amount of award vesting is subject to the achievement of the long term performance measures.

The committee set the following performance metrics and weightings for the 2012–14 plan cycle.

Metric	Weighting
Cumulative Group profit, subject to a minimum level of average Return on Net Operating Assets (RONOA), over the three year performance period	50%
Return on Risk Weighted Exposure Amount (RRWEA)	20%
Group corporate responsibility	10%
Colleague engagement	10%
Customer satisfaction	10%

The committee chose profit as the main driver of the long term incentive as it is a good indicator of overall business success being driven by sales, costs and operational effectiveness, but the committee believes that other non-financial factors and co-operative values are also important. Non-financial measures are based upon independent external surveys. The inclusion of RRWEA meets with FSA requirements on appropriate focus on risk, this measure only being included for Remuneration Code staff.

All balanced scorecard performance measures and results are audited by externally appointed auditors.

Additionally for Remuneration Code staff, the financial and risk underpins applicable to the AIP also apply to the LTIP, ie the four underpins must be met for any LTIP to become payable. These underpins are to provide appropriate risk adjustment and to be compliant with the FSA Remuneration Code.

Additional deferral is required by the FSA Remuneration Code: at the point of vesting, 50%, will be held in an alternative instrument for an additional six months, subject to additional performance conditions (ie for 50% of the LTIP award the total deferral period from grant is three and a half years).

Service contracts and exit payment policy

It is the Bank's policy that the notice period in senior executives' service contracts should not exceed one year. All senior executives have contracts which can be terminated by one year's notice. In the event of termination, the standard payment due to a senior executive would be based on the value of one year's base salary and other contractual benefits. In some circumstances, such as organisational changes as a result of a merger or acquisition, termination payments to colleagues leaving the Bank have been enhanced. In such cases, the formula for the calculation of termination payments to senior executives has also received some enhancement.

In normal circumstances, it is the committee's policy to apply service contracts for any newly recruited senior executives in a similar form to the model that has been developed for existing senior executives.

Remuneration report continued

FSA Remuneration Code

FSA Remuneration Code principles fully apply to all senior executives and all remuneration arrangements and practices in place are compliant with the Remuneration Code.

Code staff remuneration

Code staff are defined by the FSA as those staff having a material impact on a firm's risk profile, including a person who performs a significant influence function for a firm, a senior manager and a risk taker.

Remuneration policy and outcomes for Code staff are determined by the committee. The design of the component parts of remuneration is as set out for the senior executives. For all Code staff, performance related pay is risk adjusted through the use of the underpins to the incentive plans, together with the application of deferrals, clawback and malus adjustments in accordance with the FSA Remuneration Code.

Share option plans

As a co-operative, the Bank does not operate a share or share-option plan.

Non-Executive directorships

The committee has determined that, subject to the committee's approval, senior executives may accept one Non-Executive directorship, or similar, with an external organisation. This represents an important opportunity to further develop individuals' skills and experience, which is beneficial to the Group. During the year, any fees received for such a role were paid to the Group, however at its meeting on 14 January 2013, the committee agreed that going forward any remuneration received as a result of taking up an external Non-Executive directorship could be retained by the individual.

Considerations elsewhere in the Banking Group

The committee takes account of the pay and conditions of other employees in the Bank when reviewing senior executive pay. The committee also considers senior executive pay within the wider context of the UK market in which the Bank competes for talent.

In 2012 the base salary increase of the Chief Executive increased by 2.5% which was generally comparable with that for employees in the Bank. Similar rises were also applied to the wider senior manager group.

Non-Executive Directors

All the Non-Executive Directors are appointed, and their directors' fees are determined and paid, by the Co-operative Group.

Non-Executive Directors who are also Co-operative Group directors waive their entitlement to a fee of £16,937. The basic fee for a Non-Executive Director elected to sit on the Co-operative Group Board who also served on the Boards of the Co-operative Banking Group, The Co-operative Bank, CIS General Insurance (until June 2012) and Co-operative Insurance Society during the year, was £16,937 per annum, and these same Non-Executive Directors receive additional fees for serving on the various Banking Group Board committees (which also have responsibility for Bank business). The Chair of the Bank is a Co-operative Group Board appointee and receives a fee of £117,432 per annum.

The Independent Professional Non-Executive Directors (IPNEDs) are party to agreements with the Co-operative Group governing the terms on which their services are made available to the Bank. These service agreements expire on 31 July 2014, with the exception of David Davies whose service agreement expires on 31 July 2013. The Co-operative Group Board may resolve to reappoint any of the IPNEDs at or before the date their service agreements expire for a further three year term. It is the normal policy of the Board not to allow an IPNED to serve for more than nine years in aggregate.

A benchmarking exercise by New Bridge Street in 2010 set the basic fees for the Banking Group IPNEDs which were approved by the Co-operative Group Board. The IPNEDs and the professional external Non-Executive Director who served on the Board during the year each received a fee of £59,966 per annum. From early 2012, the Group Board agreed that all renewal of terms of office and new service agreements for IPNEDs will provide for fees to increase at the discretion of the Co-operative Group Board and will be effective from the beginning of the financial year. In 2012, no such increase was agreed.

The fees for the Co-operative Group Board directors serving on the various Banking Group Boards and committees, were increased in line with RPI at 3.9% from the beginning of the 2012 financial year.

The IPNEDs who are members of committees do not receive additional fees for such posts. The Chairs of the various committees do receive additional fees, as do the Deputy Chairs to the Board, to reflect their additional responsibilities. However, where a Co-operative Banking Group Deputy Chair is a member of or chairs a committee there is no additional fee payable. Currently, Peter Harvey, who is one of the two Deputy Chairs, also chairs the Co-operative Banking Group Audit Committee.

The Non-Executive Directors' service agreements contain no specific provision for liquidated damages on early termination of an agreement.

None of the IPNEDs are directors of the Co-operative Group or members of any Co-operative Group pension scheme or incentive plan.

Details of the directors' year of appointment and fees are shown in table 3.

Implementation section

Total remuneration received by senior executives in respect of 2012 are set out in table 1 and 1a (on page 26).

Total emoluments include:
- zero annual bonus payments in respect of 2012;
- zero LTIP, plan cycle 2010–12, have vested due to aggregate PBT not being achieved;
- details of the termination payments made to senior executives leaving the Bank during 2012; and
- dates of appointment for senior executives.

2012 AIP Outturn

For the 2012 AIP, zero award is payable due to the threshold profit level not being met. Although balanced scorecard results were strong in areas of colleague engagement, customer advocacy and risk, the scheme profit underpin has not been achieved. Table 1 and 1a show that zero bonus is payable for 2012.

LTIP Outturn

The 2010–12 LTIP cycle was completed in December 2012. Performance was based on shareholder profit, cost management, customer satisfaction and colleague engagement. Zero award is payable due to the Bank not meeting the cumulative profit target. Tables 1 and 1a (column performance related pay medium/long term) show that zero payments are made.

To summarise, senior executives' LTIP grants for 2011–13 and 2012–14 remain outstanding. Payments, if any, would be made in 2014 and 2015 respectively, 50%, will be held in an alternative instrument for an additional six months, subject to additional performance conditions.

Pensions

The Chief Executive and the Managing Director-Retail Bank have restricted pension accrual and were paid a restricted pension allowance.

The Director-Mars Project, the Managing Director-Corporate & Business Banking and the HR Director opted for restricted pension accrual from 1 April 2012 and were paid a restricted pension allowance from that date.

The Managing Director-General Insurance and Director-Integration & Change opted out of future pension accrual from 1 April 2012 and were paid a pension allowance from that date.

The Chief Financial Officer was a member of the Britannia Scheme defined contribution section, under which the contractual employer contribution rate was 12%, until he joined Pace Complete and accrued full pension benefits from 1 April 2012.

The Chief Risk Officer was paid a pension allowance.

All other executives accrued full pension benefits in Pace Complete during the year.

Governance update

Members of the committee during 2012 were Rodney Baker-Bates (Deputy Chair-Co-operative Banking Group) as Chair, together with Len Wardle (Co-operative Group Chair), Peter Marks (Co-operative Group Chief Executive), Paul Flowers (Co-operative Banking Group Chair) and David Davies (Deputy Chair, Co-operative Banking Group). Changes to the committee during 2012 were the appointment of Anne Gunther (Chair) and the resignation of Rodney Baker-Bates. Len Wardle was the interim Chair between Rodney Baker-Bates and Anne Gunther. The Board believes that all members of the committee are independent for the purpose of reviewing remuneration matters.

The Bank's Chief Executive and the HR Director are also invited to attend meetings of the committee except when their own remuneration is being discussed. The Chief Risk Officer provides an annual report to the committee and advice on any specific risk adjustments in relation to remuneration issues as required by the FSA. The committee worked with The Co-operative Group Remuneration and Appointments Committee to ensure consistency, where appropriate, with arrangements across the wider Co-operative Group.

The committee met eight times in the year to 31 December 2012.

FSA Remuneration Code

Details of the aggregate remuneration information required by the FSA are shown in table 4 and are in respect of all the Banking Group's Code staff. The amounts shown in respect of senior executives and Non-Executive Directors do not represent additional remuneration.

By Order of the Board
Anne Gunther, Chair
Co-operative Banking Group Remuneration and Appointments Committee

20 March 2013

Remuneration report continued

Table 1 – Emoluments of senior executives (executive directors) for the year ending 31 December 2012

	Notes	Date of appointment (1)	Basic salary £000	Other supplements (2) £000	Performance related bonus – annual (3) £000	Benefits in kind (4) £000	Total related to 2012 £000	Performance related bonus – long term (5) £000	2012 Total emoluments £000	2011 Total emoluments £000
Barry Tootell		4 April 2008	513	70	–	1	584	–	584	766
Former Directors who served in the Bank in 2011	6								–	1,593
Compensation for loss of office	7								–	1,390
									584	3,749

The table above represents total emoluments for the Executive Directors in relation to services for the Co-operative Banking Group.

Note 1 Date of appointment may differ from date of service commenced with the Bank.

Note 2 Other supplements include full or partial pension allowance in lieu of pension provision and car allowance (ie non-P11D items).

Note 3 Performance related bonus – annual refers to bonus amounts in respect of the whole of 2012. Zero award is payable as the balanced scorecard operating profit level was not met.

Note 4 Benefits in kind include healthcare cover (ie P11D items). In addition to the above the executive director also receives life insurance.

Note 5 Performance related bonus – long term refers to bonus amounts in respect of the 2010–12 plan. Zero award is payable as the three year aggregate operating profit threshold target was not met.

Note 6 Former directors include Neville Richardson, Rod Bulmer, Tim Franklin and Phil Lee.

Note 7 Compensation for loss of office was in respect of Neville Richardson.

Table 1a – Emoluments of senior executives (members of the executive committee) for the year ending 31 December 2012

	Notes	Date of appointment (1)	Basic salary £000	Other supplements (2) £000	Performance related bonus – annual (3) £000	Benefits in kind (4) £000	Total related to 2012 £000	Performance related bonus – long term (5) £000	2012 Total emoluments £000	2011 Total emoluments £000
Rod Bulmer		1 June 2008	410	44	–	1	455	–	455	353
Keith Alderson		1 October 2010	332	28	–	1	361	–	361	392
Helen Taylor	6	1 October 2011	215	20	–	1	236	–	236	81
James Mack	6	1 August 2011	260	16	–	1	277	–	277	122
David Neave	7	1 March 2012	201	43	–	1	245	–	245	–
John Hughes	7	1 March 2012	206	23	–	–	229	–	229	–
Mark Summerfield	7	1 July 2012	120	8	–	1	129	–	129	–
Peter Shaw	7	1 July 2012	175	36	–	–	211	–	211	–
Phil Lee	8, 11	1 August 2009	136	8	–	3	147	–	147	330
Mike Fairbairn	9, 11	16 January 2006	144	10	–	–	154	–	154	352
Total			2,199	236	–	9	2,444	–	2,444	1,630
Former Executives who served in the Bank in 2011	10									613
Compensation for loss of office	11								1,378	1,159
									3,822	3,402

The table above represents total emoluments for the executive committee members in relation to services for the Co-operative Banking Group.

Note 1 Date of appointment may differ from date of service commenced with the Bank.

Note 2 Other supplements include full or partial pension allowance in lieu of pension provision, car allowance, phone and health supplements (ie non-P11D items).

Note 3 Performance related bonus – annual refers to bonus amounts in respect of the whole of 2012. Zero award is payable as the balanced scorecard operating profit level was not met.

Note 4 Benefits in kind include car and healthcare cover (ie P11D items). In addition to the above the executives also receive life insurance.

Note 5 Performance related bonus – long term refers to bonus amounts in respect of the 2010–12 plan. Zero award is payable as the three year aggregate operating profit threshold target was not met.

Note 6 2011 total emoluments for James Mack and Helen Taylor were for a part year only.

Note 7 David Neave and John Hughes were appointed to the Executive Committee on 1 March 2012. Mark Summerfield and Peter Shaw were also appointed to the Executive Committee on 1 July 2012. Total emoluments shown represent earnings from date of appointment.

Note 8 Phil Lee resigned on the 30 April 2012.

Note 9 Mike Fairbairn resigned on the 29 June 2012.

Note 10 Former directors include Karen Moir and Tim Franklin.

Note 11 Compensation for loss of office was in respect of Phil Lee £890,000 and Mike Fairbairn £488,000.

Table 2 – Pension details of senior executives (executive directors or members of the Executive Committee)

	Notes	Years of service	Total accrued pension at £000	Increase in accrued pension during the year £000	Increase in accrued pension during the year (net of inflation) £000	Transfer value of previous column at net of members' contributions £000	Transfer value of total accrued pension at 31 December 2011 £000	Transfer value of total accrued pension at £000	Increase in transfer values net of members' contributions £000
Barry Tootell	5	4	25	4	3	34	274	340	55
Keith Alderson	6	9	33	4	3	34	451	545	81
Rod Bulmer	7	5	25	5	4	27	210	257	32
Mike Fairbairn	8	36	75	5	4	87	1,664	1,820	149
John Hughes	9	8	28	4	3	31	339	410	59
Phil Lee	10	9	90	2	1	2	2,326	2,171	(161)
James Mack	11	2	3	3	3	20	–	33	20
David Neave	12	7	24	1	–	1	312	345	29
Peter Shaw	13	–	–	–	–	–	–	–	–
Mark Summerfield	14	8	30	6	5	58	346	450	89
Helen Taylor	15	6	19	4	3	27	172	219	35

General Notes

Note 1 The table above includes all senior executives who were either executive directors or members of the Executive Committee (or who switched status during the year) for the year ending 31 December 2012 and shows their pension details for the period during the year they were in the employment of the Banking Group.

Note 2 The total accrued pension is that which would be paid annually on retirement at normal retirement age based on service to 31 December 2012 and includes any transferred-in benefits as appropriate. Under the terms of their contracts, existing senior executives at 17 January 2007 may take these benefits from age 60 and new executives after 17 January 2007 may take these benefits from age 65. The transfer values in the table above have been calculated on this basis. Years of service include, where appropriate, pre-merger service with Britannia.

Note 3 All transfer values have been calculated in accordance with the current transfer value method and basis in force for the scheme applicable to the senior executive. This is set by the Trustee(s), after taking actuarial advice, to be consistent with the requirements of legislation and the rules of the scheme.

Note 4 Pension scheme members have the option of paying additional voluntary contributions to their respective pension scheme. Neither these contributions nor the benefits arising from them are shown in the above table.

Individual Notes

Note 5 Barry Tootell has restricted pension accrual and was paid a restricted pension allowance.

Note 6 Keith Alderson was a member of the Executive Committee during the year. He opted for restricted pension accrual from 1 April 2012 and was paid a restricted pension allowance.

Note 7 Rod Bulmer was a member of the Executive Committee during the year. He opted for restricted pension accrual from 1 April 2012 and was paid a restricted pension allowance.

Note 8 Mike Fairbairn opted out of Pace on 23 June 2012 and became entitled to a retirement pension. He left employment on 29 June 2012. His end of year figures are calculated at that date. The figures shown on the table at the start of the year and at the year end are after application of a pension sharing order.

Note 9 John Hughes was appointed to the Executive Committee on 1 March 2012. He has restricted pension accrual and was paid a restricted pension allowance.

Note 10 Phil Lee opted out of the Britannia Scheme from 1 April 2012 and became entitled to a deferred pension from the Britannia Scheme when he left the scheme. He was paid a pension allowance in lieu of pension provision. He left employment on 30 April 2012. His end of year figures are calculated at that date.

Note 11 James Mack was a member of the Executive Committee during the year. He was a member of the Britannia Scheme defined contribution section until he joined Pace Complete from 1 April 2012. His defined contribution pension details are shown on Table 2a.

Note 12 David Neave was appointed to the Executive Committee on 1 March 2012. He opted out of Pace from 1 April 2012 and became entitled to a deferred pension from Pace when he left the scheme. He was paid a pension allowance in lieu of pension provision.

Note 13 Peter Shaw was appointed to the Executive Committee on 1 July 2012. He was paid a pension allowance in lieu of pension provision.

Note 14 Mark Summerfield was appointed to the Executive Committee on 1 July 2012.

Note 15 Helen Taylor was a member of the Executive Committee during the year. She opted for restricted pension accrual from 1 April 2012 and was paid a restricted pension allowance.

Table 2a – Defined Contributions paid for senior executives

Name	Amount £
James Mack	7,108

Remuneration report continued

Table 3 – Non-Executive Directors' remuneration

	Notes	Date appointed	**2012 fees £000**	2011 fees £000
Non-Executive Directors				
Paul Flowers		2009	**125**	120
Duncan Bowdler	2, 8	2009	**22**	17
Peter Marks	1	2009	**–**	–
Ben Reid	2	2009	**20**	20
Len Wardle	8	2006	**20**	23
Martyn Wates	1	2007	**–**	–
Independent professional Non-Executive Directors (IPNEDS)				
David Davies	3, 7, 10	2003	**90**	85
Anne Gunther	6	2011	**60**	19
Peter Harvey	3, 4, 5	2009	**69**	68
Merlyn Lowther	5	2011	**71**	16
Bob Newton	9, 10, 11	2007	**97**	88
Former Directors who resigned during the year				
Rodney Baker-Bates (to 31 July 2012)	3	2009	**44**	75
Paul Hewitt (to 21 September 2012)	5	2003	**53**	68

All fees are pro rata if a position is held for part of the year.

Note 1 Peter Marks and Martyn Wates, who are employees of the Co-operative Group and are entitled to fees of £16,937 per annum have both agreed to waive these.

Note 2 Ben Reid and Duncan Bowdler, who are not IPNEDs and who are members of the Co-operative Banking Group Audit Committee, receive an additional fee of £3,387 per annum.

Note 3 The Deputy Chairs receive an additional fee of £15,720 per annum.

Note 4 The Chair of the Co-operative Banking Group Exposures Committee received an additional fee of £5,240 per annum.

Note 5 The Chair of the Board Risk Committee and the Chair of the Co-operative Banking Group Audit Committee each receive an additional fee of £11,004 per annum.

Note 6 The Chair of the Co-operative Banking Group Remuneration and Appointments Committee receives an additional fee of £9,000 per annum.

Note 7 David Davies receives an additional fee of £11,004 per annum as the Chair of Pace.

Note 8 The Non-Executive Directors who also serve on the Group Board receive an additional fee of £2,258 per annum for serving on the Co-operative Banking Group Remuneration and Appointments Committee and the same fee was payable for serving on the Co-operative Banking Group Exposures Committee until its discontinuation in September 2012.

Note 9 Bob Newton receives an additional fee of £25,000 per annum for serving on the Board of the Reclaim Fund Limited .

Note 10 David Davies and Bob Newton both sit on the Board of CIS General Insurance Limited and with effect from 17 July 2012 Bob Newton receives an additional fee of £11,004 per annum as Chair of the Board and David Davies receives an additional fee of £7,300 per annum as a member of the Board.

Note 11 The Chair of the Co-operative Banking Group Integration and Transformation Committee receives an additional fee of £7,336 per annum.

Table 4 – Aggregate information in respect of Code staff

Number of Code staff	Total remuneration (1) £000	Total fixed remuneration (2) £000	Total variable remuneration (3) £000	Annual incentive plan (4) £000	Long term incentive plan (5) £000	Sign on and severance payments £000	Severance payments made in year (7) £000
Senior Management 27 (6)	6,193	4,439	1,754	–	1,754	–	1378
Other Code staff 19	3,897	3,495	402	–	402	–	–

The table above represents the emoluments of Code staff in relation to their services for The Co-operative Bank.

Note 1 Total remuneration consists of base salary, allowances, employer pension contributions, together with future maximum earnings opportunity comprised in the 2013–15 long term incentive awards.

Note 2 Total fixed remuneration is base salary plus allowances and employer pension contributions.

Note 3 Total variable remuneration includes only the awards under the 2013–15 long term plan which are performance related and, to the extent achieved will be payable in 2016. All payments as and when due are made in cash.

Note 4 Zero awards are payable for the 2012 AIP, due to not meeting the threshold operating profit level.

Note 5 Awards made under the 2013–15 LTIP are all unvested and represent deferred remuneration in respect of the 2012 financial year, in accordance with the FSA Remuneration Code. Numbers quoted represent maximum earnings opportunities.

Note 6 Senior management consists of executive directors, members of the executive committee and Non-Executive Directors.

Note 7 Severance payments are in respect of redundancy for two senior managers. Severance terms include both redundancy payments and the buyout of notice.

Statutory disclosures information

Principal activities

The Bank and its subsidiary undertakings provide an extensive range of banking and financial services in the United Kingdom.

Results and dividends

Loss before taxation and significant items was £288.9m (2011 profit: £197.5m). Loss attributable to the ordinary shareholders amounted to £509.1m (2011 profit: £48.0m). No dividends were paid during 2012 and the directors recommend that no final dividend is paid in respect of 2012.

Post balance sheet events

On 24 January 2013, the Bank announced plans to merge branches in a number of locations where branches were operating in close proximity.

This will result in the closure of 37 branches.

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 the Bank will benefit from a reduction in its total risk weighted assets.

Supplier payment policy and practice

With the exception of the Britannia business area detailed below, the Group does not pay suppliers directly as all supplies and services are sourced through CFS Management Services Limited, a fellow subsidiary of the Banking Group. A management charge is payable to cover the cost of these services.

Suppliers are paid directly by the former Britannia business where the policy is to agree the terms of payment at the start of trading with the supplier, ensure that suppliers are aware of the terms of payment and pay in accordance with its contractual and other obligations. Creditor days at 31 December 2012 were 8 (2011: 27 days).

Significant contracts

The Bank maintains a number of significant contracts with IT providers, cash-handling entities and mailing-service companies as well as with the Banking Group company, CFS Management Services Limited which provides facilities and services for all Banking Group companies.

Outlets

At 31 December 2012 the Bank had 339 branches (2011: 342 branches).

Going concern

Introduction

These financial statements are prepared on a going concern basis as the directors are satisfied that the Group and parent company have the resources to continue in business for the foreseeable future.

The macro economic environment, which has contributed significantly to the result for the year, indicated the need for a refocusing of the Group's strategy. The economic environment shows little sign of improving in the short term. It is one of slow economic growth, low base rates and constrained demand for new lending and it is likely to continue for several more years. The new governor of the Bank of England has indicated that rates are likely to be low for longer with inflation being allowed to rise to improve growth. In response, a broad-ranging strategic review of the business is underway with the objective of improving the capitalisation and profitability of the Group.

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 discussed in the risk management section of these accounts. Analysis covered forecast information for the strategic planning period, 2013-2015 (the Plan), stress testing and reverse stress testing as well as the management actions under consideration as part of the strategic review discussed below.

Profit

The Group statutory loss for the year of £673.7m was driven by the following factors:

- credit impairment on non-core assets;
- intangible asset impairment; and
- Payment Protection Insurance provision.

The core business, reflecting the current strategy and risk appetite of the Bank, delivered an operating result of £96.8m profit (2011: £137.3m profit), which, while lower than 2011, provides a platform for future growth. The non-core business, those activities not congruent with the current strategy, which are managed for value and targeted for run down or exit, generated an operating result of £377.3m loss (2011: £3.8m profit). As a result, the combined operating result was £280.5m loss (2011: £141.1m profit). Looking forward, growth in profitability in the core business is expected to be muted in the short term due to continued margin compression and the costs of restructuring. However, this restructuring, simplification and cost reduction agenda will enhance the profitability of the core business in the medium term.

As the non-core business has been identified as inconsistent with the current strategy of the Group, the sale of a proportion of the assets is included in the Plan, with further sale or de-risking opportunities being pursued. The remainder of the non-core assets are being managed for value or targeted for run down. Following the significant levels of impairment charges in 2012, reflecting a deterioration in outlook and specific charges on a number of large cases, we expect further impairment charges to be more moderate, albeit the de-risking of the balance sheet may give rise to further adjustments to value which are expected to be capital neutral.

Statutory disclosures information continued

Capital

The Group's policy is to conserve a robust capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. However, the Group still recognises the need to maintain a balance between the potential higher returns that might be achieved with greater gearing, and the advantages and security afforded by a sound capital position.

Total capital resources are £2,578.2m (31 December 2011: £2,975.9m), with Core Tier 1 capital after regulatory deductions of £1,576.8m (31 December 2011: £1,947.4m).

The Group's capital position remains acceptable with a period end Core Tier 1 position of 8.8% (31 December 2011: 9.6%). Throughout 2012, the Bank and its individually regulated operations have complied with all externally imposed capital requirements. However, the Board recognises the need to build the capitalisation of the Group to provide increased resilience and capacity for future growth. Actions taken early in 2013 have already improved this position to 9.2%.

Current forecasts show that the Group's capital will remain above minimum regulatory requirements over the period of the Plan. However, in response to the impact of new Basel III regulations and the expectation of a prolonged economic downturn, we are reviewing our business with the intent of improving our profitability and capital position. Without management action, explained in the Opportunities section below, compliance with regulatory capital requirements would come under pressure.

Liquidity

Group liquidity has been reviewed by considering the latest liquidity forecast (part of the Plan), as well as the stress testing results from 31 December 2012 of the internal assessment of liquidity requirements, together with the Group's compliance with its regulatory required levels.

As at 31 December 2012, the Group held significant levels of surplus assets above regulatory required levels, and had a liquid asset ratio of 14.6% compared to 30 June 2012 of 12.7% and 31 December 2011 of 15.5%.

The Group is predominantly customer focused and there are no significant wholesale maturities due in 2013. Customer deposits have been very stable through the downgrades that the Bank has previously experienced. Stress testing forecasts, as at 31 December 2012, shows that sufficient liquidity levels can be maintained under the most severe scenarios. This is also documented in the Individual Liquidity Adequacy Assessment (ILAA). The Bank has available additional collateral equivalent to 20% of minimum regulatory requirements which can be used in any of the Bank of England schemes.

Risks

The idiosyncratic risks that could affect the future performance of the Group are:

- Further impairment of intangible assets, either due to finalisation of Project Verde (purchase of Lloyds Banking Group branches) or, if Verde were not to proceed, the decision to take a different strategic route in regard to banking technology platforms. The carrying value of the intangible asset, in the books of Co-operative Financial Services Management Services Limited, is £179m.
- Further significant loan impairment, for example on higher risk non-core corporate lending. The amount on the watchlist not covered by collateral is £275m. The collective impairment methodology takes into account the value and risk relating to all exposures that are not already in default. There is an additional risk of collateral value erosion, mitigated by non-core corporate disposals.
- Conduct risk issues requiring redress. The costs of redress associated with PPI are estimated at £244m. Another industry-wide issue of this type is a risk to the profitability of the Group. The Group has no material exposure to interest rate swap misselling.
- Potential rating agency downgrades. Although there is a risk of downgrade as evidenced by the negative outlook on ratings, forecasts indicate that the Group has sufficient liquidity surplus to accommodate a severe stress after taking account of the successful completion of management actions.
- Adverse customer reaction to the trading position of the Group.
- Failure to complete management actions to strengthen the Group's capital position.

Opportunities

The Co-operative Bank brand continues to show resilience in these tough market conditions and holds a strong market reputation. This is clearly evidenced by our strong customer advocacy scores and numbers of customers switching to us.

The Board sponsored strategic review seeks to build on this platform. This wide-ranging strategic review of our Banking Group businesses, considers the management actions at the Board's disposal which will be undertaken in order to improve profitability and capitalisation of the Group in line with market expectations and Basel III capital requirements. Initial action from this review was concluded in January 2013 when a securitisation transaction was completed to reduce the credit risk on the balance sheet. This improved the Core Tier 1 ratio by 0.4%. The signing of the Sale and Purchase Agreement and subsequent completion of the sale of our Life and Savings business, followed by the planned downstreaming of capital into the Group will also have positive implications for our capital position, subject to regulatory approval.

Amongst other actions, we intend to significantly deleverage or reduce risk in the balance sheet (facilitated to a large extent by the additional impairment charges taken in 2012) and build upon the strength of the core business through a simplification agenda and cost efficiency programme, as well as conservative credit risk appetite and long term growth strategy focused on our core relationship banking franchise. Some of the actions under consideration, for example, options around the sale of other Banking Group businesses (eg General Insurance and Life and Savings businesses), will require support from the immediate parent company, Co-operative Banking Group Limited, in order to downstream capital into the Group.

Although a subsidiary company of the Co-operative Group (the ultimate parent company), no reliance has been placed on that company for parental support as part of the going concern assessment.

The going concern assessment does not take into account the potential long term benefits of the purchase of the Lloyds Banking Group branches (Project Verde). This deal would provide opportunity to enhance the reach of the Bank, grow our customer base, and become a truly compelling alternative for the UK consumer. The deal will only be pursued if it is in the best interests of our customers and members.

Conclusion

The directors are satisfied that the Group is a going concern, has sufficient profit, capital and liquidity in place and forecast, and has plans in place to strengthen that position going forward.

Employees

The majority of the Banking Group's employees have contracts with CFS Management Services Limited and their services are allocated to subsidiaries, including the Bank. Including these people, the Bank and its subsidiary undertakings employed 7,754 persons at 31 December 2012 (2011: 8,528). The weekly average number of people was 8,107 (2011: 8,364) and their aggregate remuneration, before significant items, for the year was £188.0m (2011: £210.8m).

The Bank, as part of the Banking Group 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 Banking Group, in Bank-orientated activities, 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 and other unions, which continues to be fully involved where organisational change and other issues affect colleagues.

The Bank, as part of the Banking Group, is a member of the following diversity advisory bodies:

- Employers Forum on Disability;
- Employers Forum on Age;
- Race for Opportunity;
- Opportunity Now; and
- Stonewall.

Employees with disabilities

The Banking Group 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 Banking Group 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 Banking Group 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, as part of the Banking Group, recognises that health and wellbeing at work play a vital part in delivering its core values. 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 responsibility

The Bank's corporate responsibility activities are outlined on pages 13 and 14. In addition, the Co-operative Group Sustainability Report, which will be published in the first half of 2013, describes how the Co-operative Group Limited, the Banking Group, the Bank, Co-operative Insurance Society Limited and CIS General Insurance Limited manage their social, ethical and environmental impacts.

Political and charitable donations

During the year, CFS Management Services Limited made donations (which exclude affinity card payments) of £0.1m to charitable organisations on behalf of the Bank (2011: £0.3m). A number of securitisation vehicles were closed during the year and a dividend payment of £0.3m was made to their respective holding companies. Under the terms of the trust, this amount was subsequently paid out to charitable organisations. Additional costs associated with the Bank's community involvement are provided within the Co-operative Group Sustainability Report. It is the Bank's policy that no donations are made for political purposes.

Statement of directors' responsibilities in respect of the report of the Board of Directors and the annual report and financial statements

The directors are responsible for preparing the annual report and the Group and parent company financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare the financial statements for each financial year. Under that law they are required to prepare the financial statements in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU and applicable law and have elected to prepare the parent company financial statements on the same basis.

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 Group and parent company and of their profit or loss for that period. In preparing the financial statements, the directors are required to:

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

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Group's transactions and disclose with reasonable accuracy at any time the financial position of the Group 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 Group and to prevent and detect fraud and other irregularities.

The directors have decided to prepare voluntarily a directors' remuneration report in accordance with Schedule 8 to The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 made under the Companies Act 2006, as if those requirements were to apply to the Bank. The directors have also decided to prepare voluntarily a corporate governance statement as if the Bank were required to comply with the Listing Rules and the Disclosure and Transparency Rules of the Financial Services Authority in relation to those matters.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Bank's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Financial statements

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.

By Order of the Board
Moira Lees, Group Secretary

20 March 2013

Independent auditor's report to the members of The Co-operative Bank plc

We have audited the financial statements of The Co-operative Bank plc for the year ended 31 December 2012 set out on pages 33 to 78, 80 and 81 and pages 83 to 132. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU and, as regards the parent company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and in respect of reporting on corporate governance, on terms that have been agreed. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and in respect of reporting on corporate governance, those matters that we have agreed to state to them in our report, and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members, as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement set out on page 31, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

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.

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2012 and of the Group's loss for the year then ended;
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU;
- the parent 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 Group financial statements, Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

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 parent 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 the Listing Rules and the Disclosure Rules and Transparency Rules of the Financial Services Authority in relation to those matters. Under the terms of our engagement we are required to review:

- the directors' statement, set out on pages 29 and 30, in relation to going concern; and
- the part of the Corporate Governance Statement on pages 13 to 19 relating to the company's compliance with the nine provisions of the UK Corporate Governance Code specified for our review.

Andrew Walker, Senior Statutory Auditor
for and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
St James Square
Manchester
M2 6DS

20 March 2013

Consolidated income statement

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

	Notes	**Before significant items 2012**	**Significant items 2012**	**After significant items 2012**	Before significant items 2011	Significant items 2011	After significant items 2011
Interest receivable and similar income	4	**1,488.3**	**–**	**1,488.3**	1,583.7	–	1,583.7
Interest expense and similar charges	4	**(922.5)**	**–**	**(922.5)**	(948.7)	–	(948.7)
Net interest income		**565.8**	**–**	**565.8**	635.0	–	635.0
Fee and commission income	5	**251.2**	**(149.7)**	**101.5**	251.2	(90.0)	161.2
Fee and commission expense	5	**(74.0)**	**–**	**(74.0)**	(66.0)	–	(66.0)
Net fee and commission income		**177.2**	**(149.7)**	**27.5**	185.2	(90.0)	95.2
Net trading income	6	**14.1**	**–**	**14.1**	4.5	–	4.5
Other operating income	7	**33.9**	**–**	**33.9**	46.3	–	46.3
Operating income		**791.0**	**(149.7)**	**641.3**	871.0	(90.0)	781.0
Operating expenses	8	**(587.6)**	**(235.1)**	**(822.7)**	(528.7)	(53.3)	(582.0)
Financial Services Compensation Scheme levies	32	**(24.8)**	**–**	**(24.8)**	(14.5)	–	(14.5)
Operating profit before impairment losses		**178.6**	**(384.8)**	**(206.2)**	327.8	(143.3)	184.5
Impairment losses on loans and advances	15	**(474.1)**	**–**	**(474.1)**	(120.5)	–	(120.5)
Impairment gains on investments	16	**5.4**	**–**	**5.4**	5.6	–	5.6
Operating (loss)/profit		**(290.1)**	**(384.8)**	**(674.9)**	212.9	(143.3)	69.6
Share of post tax profits from joint ventures	36	**1.2**	**–**	**1.2**	0.2	–	0.2
(Loss)/profit before taxation and profit based payments		**(288.9)**	**(384.8)**	**(673.7)**	213.1	(143.3)	69.8
Profit based payments to members of							
The Co-operative Group		**–**	**–**	**–**	(15.6)	–	(15.6)
(Loss)/profit before taxation	2	**(288.9)**	**(384.8)**	**(673.7)**	197.5	(143.3)	54.2
Income tax	10	**88.6**	**77.0**	**165.6**	(42.4)	38.0	(4.4)
(Loss)/profit for the financial year		**(200.3)**	**(307.8)**	**(508.1)**	155.1	(105.3)	49.8
Attributable to:							
Equity shareholders	12	**(201.3)**	**(307.8)**	**(509.1)**	153.3	(105.3)	48.0
Minority interests		**1.0**	**–**	**1.0**	1.8	–	1.8
		(200.3)	**(307.8)**	**(508.1)**	155.1	(105.3)	49.8
Earnings per share (basic and diluted)	12	**(2.46)p**	**(3.75)p**	**(6.21)p**	1.87p	(1.28)p	0.59p

The significant items in 2012 relate to:

- £149.7m (2011: £90.0m) of provisions made for potential customer compensation claims relating to past sales of payment protection insurance (notes 5 and 32);
- £38.1m (2011: £nil) of costs incurred as a result of the bid for the Lloyds Bank branches (note 8);
- £47.0m (2011: £53.3m) of costs incurred on a programme of investment and integration (note 8); and
- £150.0m (2011: £nil) of recharged costs relating to intangible asset impairment regarding the development of new banking systems (note 8).

Consolidated statement of comprehensive income

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

	Group					
	Equity shareholders 2012	**Minority interests 2012**	**Total 2012**	Equity shareholders 2011	Minority interests 2011	Total 2011
(Loss)/profit for the financial year	**(509.1)**	**1.0**	**(508.1)**	48.0	1.8	49.8
Other comprehensive (expense)/income:						
Changes in cashflow hedges						
Net changes in fair value recognised directly in equity	**23.5**	**(0.8)**	**22.7**	88.9	0.3	89.2
Income tax	**(9.9)**	**0.2**	**(9.7)**	(19.8)	(0.1)	(19.9)
Transfers from equity to income or expense	**(30.9)**	**(0.1)**	**(31.0)**	(49.3)	(0.3)	(49.6)
Income tax	**13.4**	**–**	**13.4**	10.9	0.1	11.0
Changes in available for sale assets						
Net changes in fair value recognised directly in equity	**108.7**	**–**	**108.7**	101.6	–	101.6
Income tax	**(26.2)**	**–**	**(26.2)**	(26.9)	–	(26.9)
Transfers from equity to income or expense	**(95.5)**	**–**	**(95.5)**	(55.8)	–	(55.8)
Income tax	**23.5**	**–**	**23.5**	14.8	–	14.8
Revaluation of equity shares	**–**	**–**	**–**	(1.5)	–	(1.5)
Income tax	**–**	**–**	**–**	0.4	–	0.4
Defined benefit plan actuarial losses	**–**	**–**	**–**	–	–	–
Income tax	**(0.1)**	**–**	**(0.1)**	(0.1)	–	(0.1)
Other comprehensive (expense)/income for the financial year, net of income tax	**6.5**	**(0.7)**	**5.8**	63.2	–	63.2
Total comprehensive (expense)/income for the financial year	**(502.6)**	**0.3**	**(502.3)**	111.2	1.8	113.0

The accounting policies and notes on pages 40 to 132 form part of these financial statements.

Consolidated balance sheet

At 31 December 2012
All amounts are stated in £m unless otherwise indicated

	Notes	2012	2011
Assets			
Cash and balances at central banks	13	**5,433.0**	6,696.6
Loans and advances to banks	14	**1,904.1**	2,006.5
Loans and advances to customers	15	**33,339.5**	33,766.0
Fair value adjustments for hedged risk	15	**354.2**	366.3
Investment securities – loans and receivables	16	**295.0**	804.9
Investment securities – available for sale	16	**3,789.4**	3,423.0
Investment securities – fair value through income or expense	16	**1,845.2**	343.1
Investment securities – held for trading	16	**960.2**	–
Derivative financial instruments	17	**818.8**	975.8
Equity shares	18	**5.7**	5.7
Investments in joint ventures	36	**3.9**	2.7
Goodwill	19	**–**	0.6
Intangible fixed assets	20	**34.9**	40.7
Investment properties	21	**173.0**	172.7
Property, plant and equipment	22	**64.1**	80.1
Amounts owed by other Co-operative Group undertakings	37	**256.4**	179.2
Other assets	23	**70.3**	33.0
Prepayments and accrued income	24	**14.9**	18.7
Current tax assets		**172.6**	13.6
Deferred tax assets	33	**38.2**	26.4
Total assets		**49,573.4**	48,955.6
Liabilities			
Deposits by banks	25	**3,612.0**	3,302.7
Customer accounts	26	**35,884.4**	34,990.6
Customer accounts – capital bonds	27	**888.1**	1,429.8
Debt securities in issue	28	**4,713.7**	4,164.8
Derivative financial instruments	17	**967.6**	1,087.9
Other borrowed funds	29	**1,258.6**	1,258.8
Amounts owed to other Co-operative Group undertakings	37	**112.0**	132.3
Other liabilities	30	**104.0**	173.7
Accruals and deferred income	31	**20.1**	39.9
Provisions for liabilities and charges	32	**162.7**	102.0
Total liabilities		**47,723.2**	46,682.5
Capital and reserves attributable to the Bank's equity holders			
Ordinary share capital	38	**410.0**	410.0
Share premium account	38	**8.8**	8.8
Retained earnings		**1,304.3**	1,733.8
Available for sale reserve		**30.0**	19.5
Cashflow hedging reserve		**63.7**	67.6
		1,816.8	2,239.7
Minority interests		**33.4**	33.4
Total equity		**1,850.2**	2,273.1
Total liabilities and equity		**49,573.4**	48,955.6

Approved by the Board on 20 March 2013 and signed on its behalf by:

Paul Flowers, Chair
Barry Tootell, Chief Executive
Moira Lees, Secretary

The accounting policies and notes on pages 40 to 132 form part of these financial statements.

Bank balance sheet

At 31 December 2012

All amounts are stated in £m unless otherwise indicated

	Notes	2012	2011
Assets			
Cash and balances at central banks	13	**5,433.0**	6,696.6
Loans and advances to banks	14	**1,047.2**	1,300.1
Loans and advances to customers	15	**22,785.5**	22,735.0
Fair value adjustments for hedged risk	15	**354.1**	365.8
Investment securities – loans and receivables	16	**355.4**	866.1
Investment securities – available for sale	16	**3,563.9**	3,107.4
Investment securities – fair value through income or expense	16	**1,845.2**	343.1
Investment securities – held for trading	16	**960.2**	–
Derivative financial instruments	17	**590.9**	704.4
Equity shares	18	**5.7**	5.7
Investments in Group undertakings	36	**1,808.5**	1,573.4
Goodwill	19	**–**	0.6
Intangible fixed assets	20	**33.8**	39.3
Investment properties	21	**1.8**	–
Property, plant and equipment	22	**46.2**	61.5
Amounts owed by other Co-operative Group undertakings	37	**12,613.0**	12,961.2
Other assets	23	**67.3**	29.3
Prepayments and accrued income	24	**14.0**	17.7
Current tax assets		**154.0**	48.2
Deferred tax assets	33	**138.8**	110.3
Total assets		**51,818.5**	50,965.7
Liabilities			
Deposits by banks	25	**3,552.9**	3,239.8
Customer accounts	26	**33,750.3**	32,670.1
Customer accounts – capital bonds	27	**867.2**	1,397.3
Debt securities in issue	28	**1,752.2**	1,431.0
Derivative financial instruments	17	**922.6**	1,051.5
Other borrowed funds	29	**1,258.6**	1,258.8
Amounts owed to other Co-operative Group undertakings	37	**7,809.0**	7,461.2
Other liabilities	30	**99.5**	169.1
Accruals and deferred income	31	**15.5**	33.1
Provisions for liabilities and charges	32	**161.6**	93.4
Total liabilities		**50,189.4**	48,805.3
Capital and reserves attributable to the Bank's equity holders			
Ordinary share capital	38	**410.0**	410.0
Share premium account	38	**8.8**	8.8
Retained earnings		**1,116.9**	1,655.0
Available for sale reserve		**30.0**	19.5
Cashflow hedging reserve		**63.4**	67.1
Total equity		**1,629.1**	2,160.4
Total liabilities and equity		**51,818.5**	50,965.7

Approved by the Board on 20 March 2013 and signed on its behalf by:

Paul Flowers, Chair
Barry Tootell, Chief Executive
Moira Lees, Secretary

The accounting policies and notes on pages 40 to 132 form part of these financial statements.

Consolidated statement of cash flows

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

	2012	2011
Cash flows from operating activities		
(Loss)/profit before taxation	**(673.7)**	54.2
Adjustments for:		
Increase in prepayments and accrued income	**(8.2)**	(38.3)
Decrease in accruals and deferred income	**(20.0)**	(90.6)
Interest payable in respect of other borrowed funds	**81.4**	86.7
Effect of exchange rate movements	**10.4**	16.0
Effect of non-cash pension costs	**0.1**	–
Impairment losses on loans and advances	**480.2**	130.5
Movements on investment impairments	**(5.4)**	(39.9)
Depreciation and amortisation	**16.4**	21.4
Interest amortisation	**(6.3)**	(15.7)
Amortisation of investment securities	**(71.8)**	(340.8)
Impairment charge to write off goodwill	**0.6**	–
Loss on disposal of fixed assets	**0.9**	0.3
Unwind of fair value adjustments arising on transfer of engagements	**(15.2)**	(86.3)
Preference dividends	**5.6**	5.6
	(205.0)	(296.9)
Increase in deposits by banks	**309.3**	364.1
Increase in customer accounts and capital bonds	**352.6**	2,306.7
Increase/(decrease) in debt securities in issue	**480.3**	(141.0)
Increase in loans and advances to banks	**(68.2)**	(73.2)
Decrease in loans and advances to customers	**53.2**	1,034.2
Increase in amounts owed by other Co-operative Group undertakings	**(77.2)**	(178.6)
Decrease in amounts owed to other Co-operative Group undertakings	**(20.3)**	(56.2)
Net movement of other assets and other liabilities	**(15.3)**	532.3
Income tax paid	**(4.2)**	(21.2)
Net cash flows from operating activities	**805.2**	3,470.2
Cash flows from investing activities		
Purchase of tangible and intangible fixed assets	**(1.9)**	(14.8)
Proceeds from sale of fixed assets	**0.8**	–
Proceeds from sale of investment property	**0.9**	0.8
Purchase of investment securities	**(4,960.9)**	(3,667.6)
Proceeds from sale and maturity of investment securities	**2,616.4**	4,513.5
Net cash flows from investing activities	**(2,344.7)**	831.9
Cash flows from financing activities		
Interest paid on other borrowed funds	**(87.4)**	(69.6)
Repayment of other borrowed funds	**(256.5)**	(102.3)
Issuance of other borrowed funds	**235.4**	273.6
Dividends paid to securitisation holding companies	**(0.3)**	–
Dividends paid to minority interests	**(0.3)**	–
Preference share dividends paid	**(5.6)**	(5.6)
Capital contribution from parent	**80.0**	87.0
Net cash flows from financing activities	**(34.7)**	183.1
(Decrease)/increase in cash and cash equivalents	**(1,574.2)**	4,485.2
Cash and cash equivalents at the beginning of the financial year	**7,888.4**	3,403.2
Cash and cash equivalents at the end of the financial year	**6,314.2**	7,888.4
Cash and balances with central banks (note 13)	**5,393.6**	6,658.6
Loans and advances to banks (note 14)	**850.6**	1,019.8
Short term investments (note 16)	**70.0**	210.0
	6,314.2	7,888.4

The cash flows differ from the Group 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 accounting policies and notes on pages 40 to 132 form part of these financial statements.

Bank statement of cash flows

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

	2012	2011
Cash flows from operating activities		
Loss before taxation	**(735.2)**	(128.4)
Adjustments for:		
Increase in prepayments and accrued income	**(8.3)**	(39.0)
Decrease in accruals and deferred income	**(18.5)**	(82.9)
Interest payable in respect of other borrowed funds	**81.4**	86.7
Effect of exchange rate movements	**10.4**	16.0
Effect of non-cash pension costs	**0.1**	–
Impairment losses on loans and advances	**261.0**	103.4
Movements on investment securities impairments	**(5.4)**	(39.9)
Depreciation and amortisation	**19.1**	23.9
Interest amortisation	**(6.3)**	(15.7)
Amortisation of investment securities	**(60.7)**	(296.7)
Impairment charge to write off goodwill	**0.6**	–
Loss on disposal of fixed assets	**1.6**	0.2
Unwind of fair value adjustments arising on transfer of engagements	**(57.4)**	(154.0)
Preference dividends	**5.6**	5.6
	(512.0)	(520.8)
Increase in deposits by banks	**313.1**	369.0
Increase in customer accounts and capital bonds	**550.6**	2,412.4
Increase/(decrease) in debt securities in issue	**317.1**	(433.3)
Decrease/(increase) in loans and advances to banks	**79.0**	(31.6)
(Increase)/decrease in loans and advances to customers	**(247.1)**	935.9
Decrease in amounts owed by other Co-operative Group undertakings	**309.5**	1,272.5
Increase/(decrease) in amounts owed to other Co-operative Group undertakings	**347.8**	(879.7)
Net movement of other assets and other liabilities	**(293.9)**	359.6
Income tax received/(paid)	**22.4**	(8.2)
Net cash flows from operating activities	**886.5**	3,475.8
Cash flows from investing activities		
Purchase of tangible and intangible fixed assets	**(1.2)**	(2.4)
Purchase of investment securities	**(4,730.9)**	(3,237.6)
Proceeds from sale and maturity of investment securities	**2,442.2**	3,857.0
Net cash flows from investing activities	**(2,289.9)**	617.0
Cash flows from financing activities		
Interest paid on other borrowed funds	**(87.4)**	(69.6)
Repayment of other borrowed funds	**(256.5)**	(102.3)
Issuance of other borrowed funds	**235.4**	273.6
Preference share dividends paid	**(5.6)**	(5.6)
Capital contribution from parent	**80.0**	87.0
Net cash flows from financing activities	**(34.1)**	183.1
(Decrease)/increase in cash and cash equivalents	**(1,437.5)**	4,275.9
Cash and cash equivalents at the beginning of the financial year	**7,666.9**	3,391.0
Cash and cash equivalents at the end of the financial year	**6,229.4**	7,666.9
Cash and balances with central banks (note 13)	**5,393.6**	6,658.6
Loans and advances to banks (note 14)	**835.8**	1,008.3
Short term investments (note 16)	**–**	–
	6,229.4	7,666.9

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.

Consolidated and Bank statements of changes in equity

For the year ended 31 December 2012
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	Retained earnings	Total	Minority interest	Total equity
Group								
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 for the financial 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**
Group								
2011								
Balance at the beginning of the year	410.0	8.8	(13.1)	36.9	1,598.9	2,041.5	31.6	2,073.1
Total comprehensive income for the financial year	–	–	32.6	30.7	47.9	111.2	1.8	113.0
Transactions with owners recorded directly in equity:								
Capital contribution	–	–	–	–	87.0	87.0	–	87.0
Balance at the end of the year	410.0	8.8	19.5	67.6	1,733.8	2,239.7	33.4	2,273.1

During the year, a number of securitisation vehicles were closed and a dividend payment of £0.3m (2011: £nil) was made to their respective holding companies. This amount was subsequently paid out to charitable organisations.

	Attributable to equity holders of the Company					
	Share capital	Share premium	Available for sale reserve	Cashflow hedging reserve	Retained earnings	Total equity
Bank						
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 for the financial 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**
Bank						
2011						
Balance at the beginning of the year	410.0	8.8	(13.1)	36.4	1,661.4	2,103.5
Total comprehensive income for the financial year	–	–	32.6	30.7	(93.4)	(30.1)
Transactions with owners recorded directly in equity:						
Capital contribution	–	–	–	–	87.0	87.0
Balance at the end of the year	410.0	8.8	19.5	67.1	1,655.0	2,160.4

Basis of preparation and significant accounting policies

For the year ended 31 December 2012

The Co-operative Bank plc is registered in England and Wales under the Companies Act 2006.

Basis of preparation

Both the parent company financial statements and the Group 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 IFRS Interpretations Committee (IFRIC) guidance as adopted by the European Union (EU). On including the parent company financial statements here together with the Group 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. Information in respect of the Company alone is labelled throughout as 'Bank'.

The financial information has 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 Group 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 2012.

Standards and interpretations issued and effective

In preparing these consolidated financial statements, the Group has adopted the following pronouncements during the year that are new or revised:

- Amended IFRS 7 (Disclosures: Transfers of Financial Assets (2010))
  This amendment's objective is to promote the transparency of off balance sheet activities, particularly in relation to the securitisation of financial assets. Specifically, the transference of these assets and their associated risks are reported in a way that ensures that the user of the accounts is able to understand the financial position of such risks being transferred. The additional disclosure is set out in note 39.
- Amended IAS 12 (Income Taxes: Deferred Tax – Recovery of Underlying Assets (2010))
  This amendment's objective is to refine IAS 12's measurement of deferred tax which relates to the recovery of an entity's assets. Previously, the standard stated that an asset's recovery would occur only when it was either used or sold. However, and as a consequence of this amendment, investment properties measured at fair value are excluded from the standard's scope on recovery. The amendment to IAS 12 has no material impact on the financial statements of the Group.

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. Further phases of IFRS 9 are scheduled to cover impairment and hedge accounting.

  It becomes effective for accounting periods beginning on or after 1 January 2015. Early adoption is permitted, once endorsed by the EU. The impact of IFRS 9 is likely to be material to the Group, due to the value of financial instruments held on the Group's balance sheet. The standard is currently being drafted and so a detailed assessment of its impact is not currently possible.
- IFRS 10 (Consolidated Financial Statements (2011))
  This new standard establishes principles for the presentation and preparation of consolidated financial statements 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 becomes effective for accounting periods beginning on or after 1 January 2013. It has been adopted for use within the EU for accounting periods beginning on or after 1 January 2014. The impact to the Group of IFRS 10 is likely 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 becomes effective for accounting periods beginning on or after 1 January 2013. It has been adopted for use within the EU for accounting periods beginning on or after 1 January 2014. The impact to the Group 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 becomes effective for accounting periods beginning on or after 1 January 2013. It has been adopted for use within the EU for accounting periods beginning on or after 1 January 2014. The impact to the Group of the additional disclosure requirements is likely to be immaterial.
- IFRS 13 (Fair Value Measurement (2011))
  This new standard defines fair value and also acts as its single authority, dealing primarily with both its measurement and disclosure. It does not require fair value measurements in addition to those already required, or permitted by other IFRSs, and is not intended to establish valuation standards or affect valuation practices outside of financial reporting.

  The Group will adopt the standard for the accounting period beginning on 1 January 2013. With the exception of additional disclosure, the impact to the Group of IFRS 13 is likely to be immaterial.
- Amended IAS 1 (Presentation of Items of Other Comprehensive Income)
  This amendment proposes 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.

Basis of preparation continued

The Group will adopt the standard for the accounting period beginning on 1 January 2013. The impact of the amendment to IAS 1 is likely to be immaterial to the Group.

- Revised IAS 19 (Employee Benefits (2011))
  This revision covers the standard's recognition, measurement and presentation criteria with regard to a pension scheme's expense contained within IAS 19's 'defined benefit' scope. Actuarial gains or losses will now be fully recognised within income or expense, thus removing the previous partial recognition of 'corridor and spreading'.

  Furthermore, the revision eliminates the 'expected return on assets' from the measurement of a pension's expense and directs entities to instead charge a cost of finance against its net unfunded liability position.

  When determining a discount rate that calculates a pension obligation's present value, reference should be made to market yields. These yields should be matched to high quality corporate bonds, in terms of both the obligation's currency and maturity, ahead of any previously assumed government bond yield reference point.

  The Group will adopt the standard for the accounting period beginning on 1 January 2013. The impact of the revision to IAS 19 is likely to be material to the Group, due to the likely impact on the pension costs recharged to the Group.

- 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 statements' accounting bases. An entity shall therefore prepare its separate financial statements using one of two bases; either at cost or in accordance with IFRS 9.

  It becomes effective for accounting periods beginning on or after 1 January 2013. It has been adopted for use within the EU for accounting periods beginning on or after 1 January 2014. The impact of the amendment to IAS 27 is likely to be immaterial to the Group.

- 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 becomes effective for accounting periods beginning on or after 1 January 2013. It has been adopted for use within the EU for accounting periods beginning on or after 1 January 2014. The impact of the amendment to IAS 28 is likely to be immaterial to the Group.

- Amendments to IFRS 7 (Disclosures Offsetting Financial Assets and Liabilities)
  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 Group will adopt the standard for the accounting period beginning on 1 January 2013. The impact of the amendment to IFRS 7 is likely to be immaterial to the Group.

- 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 statement of financial position, as well as those recognised financial instruments that are subject to master netting or similar arrangements irrespective of whether they are offset.

  It becomes effective for accounting periods beginning on or after 1 January 2014. It has been adopted for use within the EU for accounting periods beginning on or after 1 January 2014. The impact of the amendment to IAS 32 is likely to be immaterial to the Group.

  Other standards and interpretations have been issued but these are not considered to be relevant to the Group's operations.

Going concern

The directors' judgment that it is appropriate to use the going concern basis in preparing the Group's accounts is set out in detail in the Directors' report on pages 29 and 30.

The Group's business activities, together with its financial position, and the factors likely to affect its future development and performance, are set out in the business and financial review on pages 6 to 9. In addition, the risk management section on pages 54 to 79 includes the Group's objectives, policies and processes for managing its risk and details of its exposure to risk. The capital management section on pages 80 to 82 provides information on the Group's capital policies and capital resources.

Consequently, after making enquiries, the directors are satisfied that the Group has 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.

Basis of preparation and significant accounting policies continued
For the year ended 31 December 2012

Basis of preparation continued

Use of estimates and judgments
The preparation of financial statements requires management to make judgments, 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 underlying 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.

Information about areas of estimation, uncertainty and critical judgments in applying accounting policies that have the most significant effect on the amounts recognised in the consolidated financial statements are described within the risk management section on pages 54 to 79 and the critical judgments section on pages 51 to 53.

Significant accounting policies
The accounting policies set out below have been applied consistently to all periods presented in these financial statements.

1) Business combinations
On 1 August 2009, The Co-operative Bank plc merged with Britannia Building Society, with Britannia transferring their engagements to the Group.

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 Group'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 Group. Control exists whenever the Group 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 statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases. The financial statements have been prepared using uniform accounting policies and are based on the same accounting period as the Group.

Intra-group balances and transactions, and any unrealised gains and losses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements.

b) Special purpose entities
Special purpose entities (SPEs) are entities that are created to accomplish a narrow and well defined objective; for the Group this includes:

- various securitisation transactions in which mortgages were sold to SPEs. The equity of these SPEs is not owned by the Group; and
- Covered Bond Limited Liability Partnerships created in order to act as a guarantor for the issue of covered bonds (refer to note 36 for further information).

An SPE is consolidated if, based on an evaluation of the substance of its relationship with the Group and the SPE's risks and rewards, the Group concludes that it controls the SPE.

The following circumstances may indicate a relationship in which, in substance, the Group controls and consequently consolidates an SPE:

- the activities of the SPE are being conducted on behalf of the Group according to its specific business needs so that the Group obtains benefits from the SPE's operation;
- the Group has the decision making powers to obtain the majority of the benefits of the activities of the SPE;
- the Group 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 Group 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 of the SPEs. Consequently the Group consolidates each SPE.

The assessment of whether the Group 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 Group and the SPE occur.

c) Interests in joint ventures
The Group's interests in joint ventures are accounted for using the equity method. The consolidated financial statements include the Group'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 Group.

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 Group 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.

Significant accounting policies continued

For assets acquired at a value significantly below the carrying value in the acquiree's financial statements 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.

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.

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.

4) Significant items

Items which are material by both size and nature (ie outside of the normal operating activities of the Group) are treated as significant items and disclosed separately on the face of the income statement.

The separate reporting of significant items helps to provide an indication of the Group's underlying business performance. Events which may give rise to the classification of items as significant include individually significant programmes of restructuring, investment, integration and provisions for material non-recurring items.

5) Financial instruments (excluding derivatives)

a) Recognition

The Group initially recognises loans and advances, deposits, debt securities issued and other borrowed funds 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 Group commits to purchase or sell the asset. All other financial assets and liabilities are initially recognised on the trade date at which the Group becomes a party to the contractual provisions of the instrument.

b) Derecognition

Financial assets are derecognised when they are qualifying transfers and:

- the rights to receive cash flows from the assets have ceased; or
- the Group has transferred substantially all the risks and rewards of ownership of the assets.

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.

c) Financial assets

i. Overview

The Group 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 Group 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 Group has elected to carry the loans and advances to customers at fair value through income or expense as described in accounting policy (5c. iv. below) and assets reclassified from available for sale (see below).

Basis of preparation and significant accounting policies continued

For the year ended 31 December 2012

Significant accounting policies continued

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 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 Group 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 Group 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.

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. 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 Group classifies capital instruments as financial liabilities or equity instruments in accordance with the substance of the contractual terms of the instruments. The Group's preference shares are classified as financial liabilities as they carry the right to a fixed non-cumulative preferential dividend (further information is provided in note 29) and are subsequently presented in other borrowed funds. The dividends on these preference shares are recognised in the income statement as interest expense on an amortised cost basis using the EIR method.

iii. Perpetual subordinated bonds

Perpetual subordinated bonds are carried at their nominal value plus any premium and a fair value adjustment for hedged risk where items are designated as part of a fair value hedge relationship.

Interest payable on perpetual subordinated bonds is recognised in the income statement using the EIR method.

Significant accounting policies continued

6) Impairment provisions

a) Assessment

i. Objective evidence

At the balance sheet date, the Group 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 Group to the borrower, for economic and legal reasons relating to the borrower's financial difficulty, a concession that the Group 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 Group considers evidence for impairment for loans and advances at both a specific asset and collective level.

ii. Forbearance

The Group operates a policy of forbearance which mitigates against borrower default. All such cases are included within its provisioning methodology.

- Residential secured mortgages
  If a loan is identified as being subject to forbearance, it is assessed for impairment. Once classified as impaired, mortgages subject to forbearance are treated in the same way as all other impaired mortgages in the impairment provisions calculations.
- Unsecured retail business
  Loans are treated as impaired where the Group has granted forbearance concessions. The amount of the impairment provision will vary with the type of concession granted.
- Corporate business
  Impairment provisions are made for accounts subject to forbearance which are in default or on a watchlist.

  Corporate customers are placed on a watchlist when they show signs of unsatisfactory performance and require close control, but are currently expected to continue trading and where no provision for bad debt is required. Forbearance is a strong indicator that a customer should be placed on the watchlist.

For further information on the Group's approach to forbearance, its management and execution, see the risk management section on pages 54 to 79.

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.

Loans and advances that do not meet the criteria for individual impairment are collectively assessed for impairment by grouping together loans and advances of similar risk characteristics.

ii. Collective accounts

a) Retail

When assessing collective impairment for secured retail loans, the Group estimates incurred losses on mortgages based on the borrower's external credit score or where the loan is identified as being subject to forbearance.

When assessing collective impairment for unsecured retail loans, the Group estimates losses on loans with delinquency greater than a pre-determined trigger point. In addition the Group makes provision on all loans arising from fraud and loans transferred to debt collection agencies. In respect of unsecured loans, the Group 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 judgment 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

Collective risk cover provides further balance sheet protection for total impairment losses. The amount of collective risk cover is adjusted monthly by the Group. The Group reviews all loans and considers the potential loss which might arise were the borrowers to fail (notwithstanding that continued trading remains the expectation). Trigger events may include a deteriorating balance sheet, material losses, trading difficulties (eg loss of material contracts or suppliers), breach of financial covenants, poor account conduct, arrears and material reduction in value of security. A collective impairment provision is raised against these loans based on the total estimated loss that may arise and the propensity for the borrower to fail.

Basis of preparation and significant accounting policies continued

For the year ended 31 December 2012

Significant accounting policies continued

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.

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.

7) 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.

8) 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.

9) 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 Group 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 on page 123. 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 Group 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 Group 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%.

Significant accounting policies continued

i. Cash flow 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 cashflow 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.

iii. Fair value hedge accounting for a portfolio hedge of interest rate risk
As part of its risk management process the Group identifies portfolios whose interest rate risk it wishes to hedge. The portfolios may comprise only assets, only liabilities or both assets and liabilities. The Group 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 Group 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 Group 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 Group 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 Group 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 posted to 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 is an integral part of the Group's trading activities.

10) Financial guarantee contracts
Other financial guarantees, in respect of intra-group funding and the pension deficit in respect of the Britannia Pension Scheme, between the Group and its subsidiaries 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.

Basis of preparation and significant accounting policies continued

For the year ended 31 December 2012

Significant accounting policies continued

11) Property, plant and equipment

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.

12) Intangible assets

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, such as core deposit intangibles, 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 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.

13) 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 Group's interest in the acquiree using a valuation technique. The technique involves assessing the future net profit 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.

Significant accounting policies continued

14) Leases

a) Overview

The Group 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 Group 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.

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.

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.

15) Investment property

Property held for long term rental yields that is not occupied by the Group, 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 discounted expected future cashflows and is representative of 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 Group 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 Group 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.

16) 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.

Bank overdrafts that are repayable on demand and form an integral part of the Company's cash management are included as a component of cash and cash equivalents for the purpose of the cashflow statement .

17) Income tax

a) Overview

Tax on the income statement 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.

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.

Basis of preparation and significant accounting policies continued
For the year ended 31 December 2012

Significant accounting policies continued

18) Pension costs
a) Defined contribution basis
With effect from 6 April 2006, the Group, along with other businesses within The Co-operative Group, has participated in the Co-operative Group Pension (average career earnings) Scheme (the Pace scheme), the assets of which are held in a separate fund administered by trustees. The Group's de facto participation level is on a defined contribution basis, as it pays fixed sums into the fund on a regular basis. This level of participation is required because the Pace defined benefit scheme exposes the participating businesses to actuarial risks associated with the current and former employees of other group companies, with the result that there is no consistent and reliable basis for allocating Pace's liabilities, assets and costs to individual companies participating in the scheme. Therefore pension costs in respect of the scheme are accounted for on a defined contribution basis and recognised as an expense in the income statement as incurred.

b) Former Britannia Building Society pension scheme
Following the transfer of engagements of Britannia Building Society, the Britannia defined benefit pension scheme transferred to the Co-operative Financial Services Management Services Limited (CFSMS), a fellow subsidiary undertaking of The Co-operative Banking Group. In accordance with policy 18.a, 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.

19) Foreign currency
The functional and presentational currency for the Group 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.

20) Investments in Group undertakings
Investments in subsidiaries are initially measured at fair value which equates to cost and subsequently valued at cost less impairment.

21) Provisions for liabilities and charges
A provision is recognised in the balance sheet if the Group 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.

22) Profit based payments to members of The Co-operative Group
Members of The Co-operative Group receive a dividend based on their transactions with The Co-operative Group and its subsidiaries including the Bank. Once these profit based payments are approved by The Co-operative Group Limited, the Bank is recharged an amount which reflects its eligible products' contribution to the overall Co-operative Group member dividend.

Critical judgments and estimates

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

1. Overview

The Group makes critical judgments and estimates which affect its reported assets, liabilities and profits. Estimates are calculated using various assumptions. Critical judgments, and the assumptions used in calculating estimates, are continually assessed and reviewed, and are based on historical experience and reasonable expectations of future events. Actual results may differ from these judgments and estimates.

2. Loans and advances

a. Overview

The loan portfolios are reviewed on a continual basis to assess impairment. In determining whether an impairment provision should be recorded, judgments 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.

Where loans are subject to forbearance, they may be treated as impaired. Further explanation of the treatment of forborne balances is included in the Group's risk management disclosures in sections 1.4.1.3, 1.4.1.4 and 1.4.1.5 on pages 60 to 70.

b. Collective provisions

i. Unsecured and secured residential

Personal advances 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, 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 band.

The majority of provisions are made against unsecured loans. A key estimate within this provisioning model is the percentage of accounts that will be charged off. A 1% change would change the collective provision by £0.9m.

ii. Corporate

The Group's corporate collective provision has increased to £22.4m (2011: £12.2m), reflecting the continuing difficulties and uncertainties currently being experienced in this sector. This is a consequence of increasing the pool of accounts which are identified as at risk.

Following a review of the loan loss provisioning for the 2012 year end, the collective unimpaired provision methodology has been refined for Corporate.

The methodology has been based on risk parameters defined by the Group. It is a risk based approach, covering accounts with exposures less than £0.5m, not individually reviewed and where a trigger event could have occurred but has not yet been observed.

The formula underpinning this methodology applied to the unimpaired portfolio is:

Exposure x Probability of Default x Loss Given Default x Loss emergence period of six months

A key estimate within the corporate collective model is the loss emergence period. A movement of 1 month in this estimate would change the provision by £6.2m.

c. Individual provisions

i. Secured residential

Mortgage accounts are identified as impaired and provided for on an individual basis by taking account of the age of the debt's delinquency on a case by case basis.

Due to continuing difficulties and uncertainties currently being experienced in this sector, the Group now classifies all accounts with arrears outstanding equivalent to 30 days or more as individually impaired. Previously, the trigger for recognition of individual impairment was 90 days or more.

A total of £5.3bn of impaired Britannia loans and advances to customers were acquired at a deep discount due to estimated future credit losses. This £121.1m discount (2011: £144.9m), is realised on the actual redemptions of the associated mortgages (mainly in Optimum). A key assumption in the judgment of estimated future credit losses is our estimate of future HPI movements. If future HPI movements were to differ from expectations by 5%, the impact on the estimate would be £4.4m.

Following a review of the parameters of the model, the Group maintains its view that no further write backs of the deep discount (2011: £20.0m) will be made due to the remaining uncertainties in the exact timing of economic recovery.

Critical judgments and estimates continued

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

2. Loans and advances continued

ii. Corporate

The Group's corporate individual provision has increased to £433.6m (2011: £105.1m). It reflects both the impact to the Group of having exhausted its associated fair value adjustment for credit risk within the year, and a deterioration of expected future recoveries against impaired loans.

Given the continuing and persistent weakness in economic recovery and the increasing 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 corporate loans identified as being individually impaired.

Each corporate account is assessed and allocated a 'risk grade' to enable the Group to monitor the overall quality of its lending assets. Those of lesser quality, where the lending is potentially at risk and provisions for loss may be required, are centrally monitored with 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.

A key estimate within the corporate individual model is collateral valuation. A 10% movement in this estimate would change the provision by £106.2m.

For further information on credit risk and impairment, see section 1 of risk management disclosures.

3. Effective interest rate

IAS 39 requires interest income to be recognised on an effective interest rate (EIR) basis, inclusive of directly attributable incremental transaction costs and fees, and discounts and premiums where appropriate.

The EIR basis spreads the interest income over the expected life of the instrument. The expected life of an instrument is the period from its inception up to its redemption or maturity date, ie for the mortgage portfolio it would be its redemption date, whilst for the non-mortgage portfolio it would be its maturity date.

On applying this approach to the mortgage portfolio, judgments are made in relation to estimating its average life. These judgments are made based on specific factors including product terms and historical repayment data. The estimates are updated in each reporting period to reflect actual performance. Key judgment areas, regularly reviewed for both current and expected levels of mortgage balance experience, are the average and total lives of the mortgage portfolio.

An increase or decrease in the average life by one year would increase or decrease gross interest income by 0.2% respectively.

During 2012, the Group's Optimum mortgage portfolio (which contains products sourced via intermediaries and purchases of mortgage portfolios up to the end of 2008) was remodelled to reflect both current experience of rising average lives (ie higher balances then expected), and projected trends of borrower behaviour predominantly contained within interest only products. In updating for this trend, the Group expects a higher level of mortgage balances over the majority of the contractual term and has therefore extended the end year of the total portfolio life from 2023 to 2035. Extending the average mortgage lives also impacts on redemption rates of the debt securities in issue. The impact of increasing the mortgage redemptions by 10% per annum relating to the fair value adjustments relating to debt securities in issue is to decrease profits by a total of £1.8m in the years up to 2013 and to increase profits by the same amount in the following years up to 2017.

4. Provisions for liabilities and charges

Provisions are carried in respect of certain known or forecast future expenditure, as described in note 32.

a. Financial Services Compensation Scheme levy

i. Background

The Financial Services Compensation Scheme (FSCS) provides compensation to customers of financial institutions in the event that an institution is unable to pay claims against it. As a result of a number of institutions' failures during 2008, the FSCS borrowed £19.7bn from HM Treasury (HMT) in order to meet its obligations to the depositors. These borrowings are anticipated to be repaid substantially from the realisation of the assets of the failed institutions. The FSCS raises annual levies from the banking industry in order to meet its management expenses and compensation cost.

The Group's provision is now made up of two components, an interest levy and a capital levy.

ii. Current expectations of performance

The Group has provided £38.6m (2011: £25.0m) for its share of levies that will be raised by the FSCS.

The interest levy element of the provision is £27.7m and relates to interest on the loan from HMT in respect of the levy years to 31 March 2014. This provision includes estimates for the interest that the FSCS will pay on the loan and of the Group's market participation in the relevant periods.

For every 50bps that 12 month LIBOR is increased, the Group's year end provision for the FSCS levy would increase by £2.9m.

The FSCS has announced that a capital levy totalling £802m will be charged from 2013/14. The Group has provided £10.9m for its share of this additional charge in 2012.

4. Provisions for liabilities and charges continued

b. Payment protection insurance (PPI) provision

i. Background

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 until January 2009, the Bank, along with many other financial services providers, sold PPI alongside credit products.

ii. Current position and expectations of PPI exposure

The Group has recognised a charge in 2012 of £149.7m (2011: £90.0m) for compensation relating to past sale of PPI policies. The provision represents management's best estimate of the anticipated costs of related customer contact and redress, including administration expenses. At 31 December 2012, after redress and operating costs paid during the year, the remaining provision was £116.0m.

The provision is based on the FSA's policy statement and industry claims experience. Its calculation requires significant judgment by management in determining appropriate assumptions, which include the level of complaints, uphold rates, proactive contact and response rates, and Financial Ombudsman Service referral and uphold rates. A 20% increase in the expected level of complaints would increase the provision by £40m.

The remaining provision is currently management's best estimate of total future settlements and the costs of handling them.

5. Transformation plan

The Banking Group has a strategic programme of investment around the replacement of the core banking system. This intangible asset is held on the balance sheet of CFSMS, a sister company of the Bank. It undergoes an annual impairment review, where the present values of projected future benefits are assessed against the carrying value of the asset plus estimated costs to complete.

After conducting the 2012 annual review, £150m of impairment has been recognised in the accounts of CFSMS, and recharged to the Bank. This impairment reflects a worse economic scenario than in the original business case and an increased understanding of the costs to complete.

This is a highly judgmental review, which uses estimated costs and benefits and relies of judgments around the strategic direction of the business, the future economic environment and the businesses' ability to exploit a new system.

There are inherent uncertainties in such estimates. Outside of the inherent uncertainties in estimating costs and benefits, there are two other material and sensitive judgments which must be made, being the discount rate and the date of implementation. A 1% change in the discount rate would increase/decrease the impairment by £26m in 2012. A six month delay in implementation would reduce the value in use by £35m.

The remaining £179m of spend, held on the balance sheet of CFSMS, would be written off if Project Verde were to be successfully concluded, given the intention to adopt the core banking platform used by the Verde business. Should Project Verde not be completed, this project would be reinvigorated and the directors are confident of a successful implementation.

6. Deferred tax

The Group has a net deferred tax asset balance of £37.2m that will result in future tax deductions.

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 tax credits can be utilised. The deferred tax asset representing tax losses carried forward can only be offset against future taxable profits in the Bank.

Other elements of the deferred tax asset will give rise to timing differences which can be used to offset against future taxable profits in the rest of The Co-operative Group.

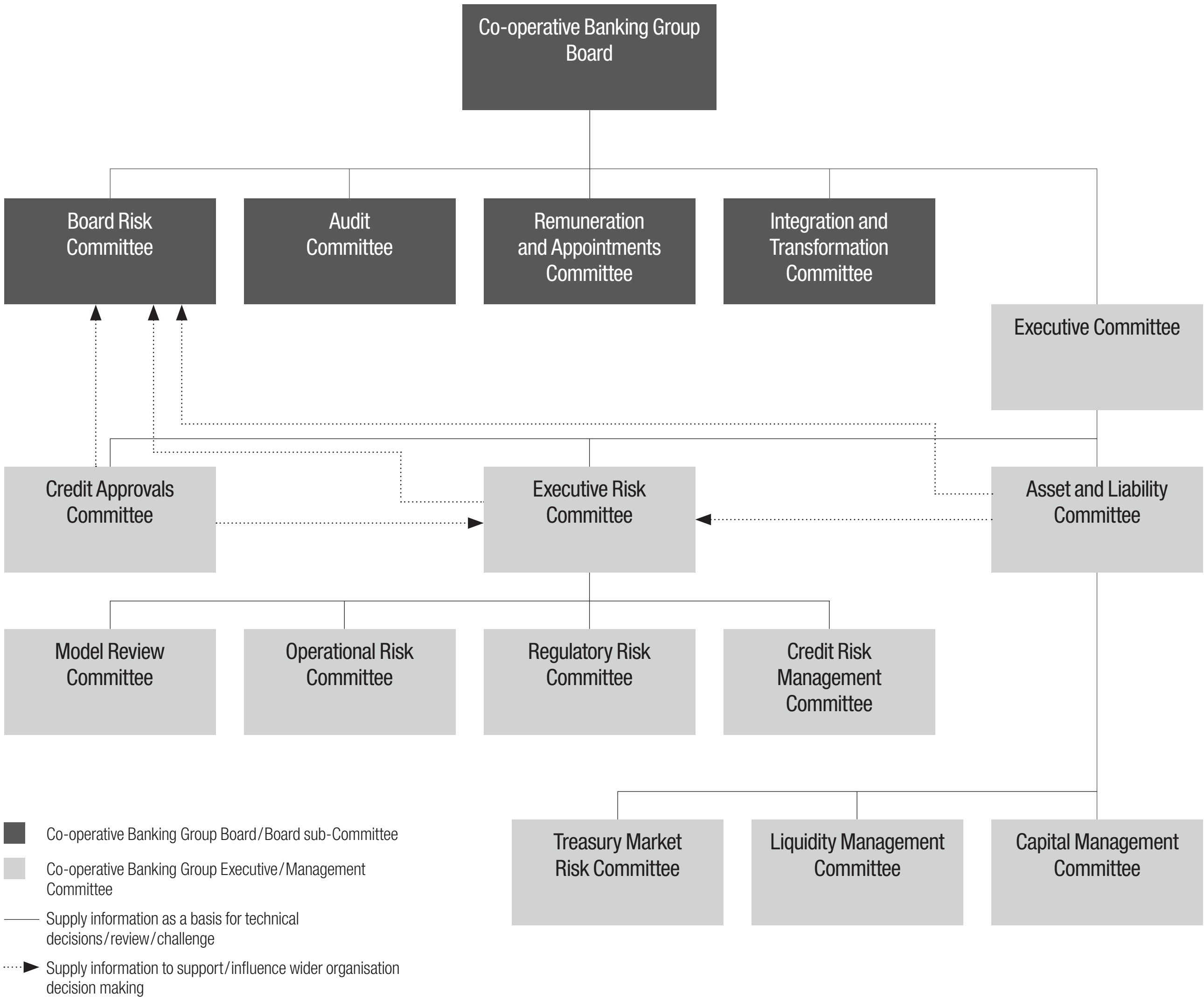
After preparing forecasts and projections of profits before tax for The Co-operative Banking Group, the directors are satisfied that there will be sufficient profits in the foreseeable future to absorb this level of unused tax losses.

Risk management

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

Risk management structure
The Co-operative Banking Group (the Banking Group) includes The Co-operative Insurance Society Limited, CIS General Insurance Limited and The Co-operative Bank plc.

The Banking Group has developed and implemented a common governance and organisation structure, which supports all of the Boards within the Banking Group. The following is that part of the governance structure applicable to The Co-operative Bank plc and its subsidiaries.



The Co-operative Banking Group Board
The Co-operative Banking Group Board (the Board) is responsible for approving the Banking Group strategy, its principal markets and the level of acceptable risks articulated through its statement of risk appetite. It is also responsible for overall corporate governance which includes ensuring that there is an adequate system of risk management and that the levels of capital and liquidity held are consistent with the risk profile of the business.

Board delegation
The Board has established Board sub-committees and senior management committees whose responsibilities include:

- overseeing the risk management process;
- identifying the key risks facing the business; and
- assessing the effectiveness of planned management actions.

Specific Board authority has been delegated to Board sub-committees and the Chief Executive Officer (CEO) who may, in turn, delegate authority to appropriate executive directors and their senior line managers.

This includes:

- setting limits for individual types of risk; and
- approving (at least annually) and monitoring compliance with risk policies and delegated levels of authority.

Board Risk Committee (BRC)
The BRC provides oversight and advice to the Board on current and potential risks and the overall risk framework. Its responsibilities include:

- reviewing and challenging the design, implementation, quality and effectiveness of the risk management framework including internal controls and principal risk coverage;
- monitoring the organisation's performance and compliance against high level risk appetite limits and tolerances;
- monitoring identified risk control failings and weaknesses and management actions taken to resolve them; and
- reporting on the effectiveness of the risk management framework and systems to the Board.

Audit Committee (AC)
The AC provides oversight on financial reporting, internal control, regulatory compliance and external and internal audit. Its responsibilities include:

- assisting the Board in carrying out its responsibilities relating to internal control, including control breaches and remediation; and
- exercising oversight of identified risk control framework failings and weaknesses as well as management actions taken to resolve them.

Remuneration and Appointments Committee
The terms of reference of the Remuneration and Appointments Committee are explained in the Directors' report on pages 20 to 25.

Integration and Transformation Committee
The role of the Integration and Transformation Committee is to provide oversight by in depth review of transformation activity within the organisation in order to give assurance on progress.

Executive Committee
The Executive Committee manages the business in line with the Board 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 Board agreed risk management framework;
- supporting the CEO in developing, reviewing and approving detailed risk appetite limits and tolerances as delegated by the Board; and
- ensuring the implementation of the risk strategy set by the Board so as to deliver an effective risk management environment for the Banking Group.

Credit Approvals Committee
The Credit Approvals Committee supports the CEO to carry out responsibilities, including but not limited to:

- sanctioning large counterparty transactions; and
- managing large exposure positions.

Executive Risk Committee (ERC)
The ERC is chaired by the Chief Risk Officer (CRO). Its purpose is to provide a mechanism to ensure all the Banking Group's risks are reviewed, challenged and approved (with escalation to BRC where required). Its responsibilities include:

- monitoring all significant and emerging risks against risk appetite;
- overseeing the development and implementation of stress testing and risk appetite across the Banking Group;
- driving the detailed implementation of the Banking Group's risk management framework approved by the Board;
- supporting the CEO in developing the risk strategy, risk management framework, and risk appetite statement with recommendations to BRC and the Board for approval where required; and
- monitoring the business' risk profile against the agreed limits and tolerances and reporting on these to the BRC.

Asset and Liability Committee (ALCO)
ALCO is chaired by the CEO. It is primarily responsible for overseeing the management of capital, market, liquidity and funding risks. Its responsibilities include:

- identifying, managing and controlling the Banking Group balance sheet risks in executing its chosen business strategy;
- ensuring that the capital and solvency position is managed in line with policy and that adequate capital is maintained at all times;
- overseeing and monitoring relevant risk control frameworks; and
- recommending to the CEO and ERC relevant principal risk policies and detailed risk appetite limits for approval.

To assist in carrying out these responsibilities, ALCO is supported by a Treasury Market Risk Committee, Liquidity Management Committee and Capital Management Committee.

Risk and capital management sub-committees
Model Review Committee (MRC)
The MRC provides oversight and challenge of model governance across the Banking Group in support of the Enterprise Risk Director.

Operational Risk Committee (ORC)
The ORC is chaired by the Operational Risk Director. It monitors significant operational risks and controls as well as the management actions taken to mitigate them to an acceptable level or transfer them.

Risk management continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

Regulatory Risk Committee (RRC)

The RRC supports the Regulatory Risk Director in oversight of:

- regulatory reporting requirements;
- ongoing regulatory engagement;
- conduct of business issues including fair treatment of customers; and
- the maintenance of the appropriate authorisations for the regulated entities within the Banking Group (including oversight of any variation to permission).

Credit Risk Management Committee (CRMC)

The CRMC advises and supports the Credit Risk Director. Its responsibilities include:

- designing the credit risk control implementation approach, the credit control framework and making recommendations to the ERC;
- reviewing and recommending to the ERC the Banking Group credit risk policy and credit measurement methodologies;
- defining and recommending the credit risk appetite and limits to the ERC; and
- reviewing and challenging the Banking Group's credit risk processes and procedures including the credit risk rating systems.

Treasury Market Risk Committee (TMRC)

The role of the TMRC is to review, challenge and monitor the market risk profile for the Banking Group, in line with policy and within risk appetite.

Liquidity Management Committee (LMC)

The role of the LMC is to enable more detailed discussion on all aspects of Banking Group 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 ensure the Banking Group's liquidity position remains in line with agreed levels.

Capital Management Committee (CMC)

The role of the CMC is to review, challenge and monitor the capital adequacy of the Banking Group, in line with capital policy and within risk appetite. The CMC is responsible for making recommendations to ALCO as appropriate.

Risk Management Forums

There is also a framework of sector specific management forums supporting risk and capital management, optimising performance and monitoring adherence policy.

Roles and Responsibilities

The Banking Group operates a three lines of defence governance model to ensure appropriate responsibility and accountability is allocated to the management, reporting and escalation of risks.

Business management act as the first line of defence. They are responsible for identifying where the business area 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 areas on a day to day basis, implementing effective monitoring and control processes to ensure that the business' risk profile is understood and maintained within the Board defined risk appetite.

The risk function act as the second line of defence. They oversee and challenge the implementation and monitoring of the risk framework and consider current and emerging risks across the Bank. They also provide review and challenge of the delegated authority framework and oversee appropriate escalation of breaches, mitigating actions and reporting to the ERC.

Internal Audit act 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 Audit Committee and senior management on the adequacy of both the first and second lines.

Recovery and Resolution Planning (RRP)

RRP is a Bank of England/FSA requirement, which has two distinct elements:

- the recovery plan is the Group's menu of options for addressing a range of financial stresses caused by idiosyncratic problems, market wide stresses, or both; and
- resolution planning is the provision of information and analysis to the authorities, in order to help them prepare a resolution plan for the Group.

There are six separate modules for RRP, all of which have gone through formal governance approval. The approval route is as follows:

- Executive team;
- ERC;
- BRC; and
- the Board.

In addition, as the recovery plan (module two) has been live since June 2012, a series of management information triggers and early warning signals are reported each month to the ERC, for the committee to determine whether to recommend the invocation of the recovery plan.

Significant risks
The following are considered to be the most significant risks facing the Group:

Risk type	Definition	Page
1. Credit risk	Credit risk is the current or prospective risk to earnings and capital arising from a borrower's failure to meet the terms of any contract with the Group or their failure to perform as agreed.	57
2. Liquidity and funding risk	Liquidity and funding risk is the risk that the Group'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 Group's assets and liabilities (including derivatives).	74
3. Market risk	Market risk is 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 Group's market risk arises from changes in interest rates.	76
4. Operational risk	Operational risk is 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.	79
5. Reputational risk	Reputational risk is the risk associated with an issue which could in some way be damaging to the brand of the Group either through its strategic decisions, business performance, an operational failure or external perception.	79
6. Strategic and business risk	Strategic and business risk arises from changes to the Group's business and the environment in which it operates, specifically the risk of not being able to carry out the Group's business plan and desired strategy.	79
7. Conduct risk	Conduct risk is the risk that the Group's behaviours, offerings or interactions will result in unfair outcomes for customers.	79
8. Pension risk	Pension risk is defined as the risk to Group capital and company funds from exposure to scheme liabilities and risks inherent in the valuation of scheme liabilities and assets.	79

The Board is aware that, as the potential acquisition of Verde progresses, the risk profile of the Group will continue to evolve. A considerable amount of work is underway to implement and embed the improvements to the risk management framework that were designed in 2012 and align it to the project work underway for Verde.

1. Credit risk
1.1 Overview
Credit risk is one of the principal risks identified in the risk management framework and is an integral part of our business activities. 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).

All authority to take credit risk derives from the Banking Group's Board. This authority is delegated to the CEO and then on to other 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.

1.2 Credit risk policy
The principal risk policy for credit risk is approved annually by the ERC and defines appropriate standards and principles for the effective management of credit risk throughout the Group.

The key principles of the policy are:

- credit risk management is fully embedded in Group operations and the business is managed in line with the risk strategy and risk appetite set by the Board;
- identified, emerging or current risks are actively managed in line with the Group's overall risk management approach of identification, measurement, management, monitoring and reporting;
- risk measurement is based on a set of metrics/ratios which are aligned with the risk appetite and support the limits framework;
- timely processes for assessing and reviewing credit risks throughout the credit life cycle are established and documented including completion of risk reports; and
- credit risk decisions are supported by fully evidenced rationale with all material credit risk exceptions reported promptly to the Credit Risk Director.

1.3 Credit exposure
1.3.1 Definitions
Impaired and not impaired in the tables below are defined in the following sections on retail and corporate credit risk and investment securities.

Fair value adjustments represent lifetime expected credit losses on assets acquired on the merger of the Bank and Britannia Building Society on 1 August 2009 and are reviewed on a regular basis to ensure appropriate allocation and utilisation.

Risk management continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

1.3.2 Analyses of 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 fair value adjustments and allowance for losses but including credit commitments); and
- the net credit exposure by class of asset (including fair value adjustments, 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.

	Loans and advances to banks	**Loans and advances to customers**	**Investment securities**	**Derivative financial instruments**	**Total**
2012					
Analysis of balance in note	14	15	16	17	
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**	**30,632.8**	**6,900.8**	**818.8**	**40,256.5**
Impaired	**–**	**3,686.7**	**39.0**	**–**	**3,725.7**
	1,904.1	**34,319.5**	**6,939.8**	**818.8**	**43,982.2**
Credit commitments	**54.1**	**4,885.0**	**–**	**–**	**4,939.1**
Gross credit risk exposure	**1,958.2**	**39,204.5**	**6,939.8**	**818.8**	**48,921.3**
Less:					
Fair value adjustments	**–**	**(337.0)**	**(11.0)**	**–**	**(348.0)**
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**

	Loans and advances to banks	Loans and advances to customers	Investment securities	Derivative financial instruments	Total
2011					
Analysis of balance in note	14	15	16	17	
Gross balance	2,006.5	34,058.0	4,616.2	975.8	41,656.5
Less: allowance for losses	–	(292.0)	(45.2)	–	(337.2)
	2,006.5	33,766.0	4,571.0	975.8	41,319.3
Analysis of credit risk exposure					
Not impaired	2,001.9	31,681.7	4,589.6	975.4	39,248.6
Impaired	21.0	2,772.7	46.4	0.4	2,840.5
	2,022.9	34,454.4	4,636.0	975.8	42,089.1
Credit commitments	40.6	4,858.7	–	–	4,899.3
Gross credit risk exposure	2,063.5	39,313.1	4,636.0	975.8	46,988.4
Less:					
Fair value adjustments	(16.4)	(396.4)	(19.8)	–	(432.6)
Allowance for losses	–	(292.0)	(45.2)	–	(337.2)
Net credit risk exposure	2,047.1	38,624.7	4,571.0	975.8	46,218.6

The comparative table has been updated to include the changes made to impairment criteria. An analysis of the credit risk exposure for the Bank is provided in note 40.

1.4 Analysis of impaired assets and associated collateral

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

- loans and advances to customers;
- investment securities; and
- loans and advances to banks.

1. Credit risk continued

1.4.1 Loans and advances to customers

1.4.1.1 How we oversee and control credit risk

The credit risk team is part of the risk directorate, independent from business management, and provides second line risk oversight. The credit risk team performs the following tasks and responsibilities related to its role:

- design and implementation of risk assessment and rating systems;
- monitoring of risk assessment and rating systems;
- maintenance of lending policy and procedures, and upkeep of various returns and reporting requirements;
- benchmarking against third party data and vendor model sources;
- reviewing the risk criteria to ensure they remain predictive of risk;
- oversight of independent validation;
- development and monitoring of risk appetites; and
- liaison with the FSA regarding proposed changes to rating systems and forecast regulatory capital levels.

On pages 60 to 70 the management of credit risk by portfolio is described covering:

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

1.4.1.2 Assessment for impairment

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 after recognition of an asset and by 31 December 2012.

Once a loan is defined as impaired the provision is calculated as the difference between the current carrying value of the asset (including fair value adjustments) 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 on page 45 and in the following credit risk sections.

The tables below analyse the gross balance by impairment classification for the Retail and Corporate and Business Banking (CABB) business segments. 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.

	Retail		CABB			Total
	Secured	Unsecured	Corporate		Optimum	
			Core	Non-core		
2012						
Analysis of balance in note 15						
Gross balance	**15,987.2**	**1,393.1**	**6,097.1**	**3,166.4**	**7,338.7**	**33,982.5**
Less: allowance for losses	**(3.2)**	**(172.8)**	**(137.3)**	**(318.7)**	**(11.0)**	**(643.0)**
	15,984.0	**1,220.3**	**5,959.8**	**2,847.7**	**7,327.7**	**33,339.5**
Analysis of credit risk exposure						
Not impaired	**15,836.3**	**1,179.4**	**5,827.8**	**1,617.5**	**6,171.8**	**30,632.8**
Impaired	**156.1**	**213.7**	**269.3**	**1,764.8**	**1,282.8**	**3,686.7**
	15,992.4	**1,393.1**	**6,097.1**	**3,382.3**	**7,454.6**	**34,319.5**
Credit commitments	**389.8**	**2,332.2**	**2,114.3**	**48.4**	**0.3**	**4,885.0**
Gross credit risk exposure	**16,382.2**	**3,725.3**	**8,211.4**	**3,430.7**	**7,454.9**	**39,204.5**
Less:						
Fair value adjustments	**(5.2)**	**–**	**–**	**(215.9)**	**(115.9)**	**(337.0)**
Allowance for losses	**(3.2)**	**(172.8)**	**(137.3)**	**(318.7)**	**(11.0)**	**(643.0)**
Net credit risk exposure	**16,373.8**	**3,552.5**	**8,074.1**	**2,896.1**	**7,328.0**	**38,224.5**
Reconciliation of accounting to customer balances						
Gross balance	**15,987.2**	**1,393.1**	**6,097.1**	**3,166.4**	**7,338.7**	**33,982.5**
Fair value adjustments	**5.2**	**–**	**–**	**215.9**	**115.9**	**337.0**
Other accounting adjustments	**(61.4)**	**95.4**	**32.5**	**(64.1)**	**37.6**	**40.0**
Gross customer balances	**15,931.0**	**1,488.5**	**6,129.6**	**3,318.2**	**7,492.2**	**34,359.5**

Risk management continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

	Retail		CABB			Total
	Secured	Unsecured	Corporate		Optimum	
			Core	Non-core		
2011						
Analysis of balance in note 15						
Gross balance	15,802.5	1,518.1	5,538.8	3,452.7	7,745.9	34,058.0
Less: allowance for losses	(3.1)	(163.3)	(82.9)	(34.4)	(8.3)	(292.0)
	15,799.4	1,354.8	5,455.9	3,418.3	7,737.6	33,766.0
Analysis of credit risk exposure						
Not impaired	15,665.3	1,298.5	5,354.1	2,928.2	6,435.6	31,681.7
Impaired	143.9	219.6	184.7	776.0	1,448.5	2,772.7
	15,809.2	1,518.1	5,538.8	3,704.2	7,884.1	34,454.4
Credit commitments	311.9	2,422.8	2,048.0	75.0	1.0	4,858.7
Gross credit risk exposure	16,121.1	3,940.9	7,586.8	3,779.2	7,885.1	39,313.1
Less:						
Fair value adjustments	(6.7)	–	–	(251.5)	(138.2)	(396.4)
Allowance for losses	(3.1)	(163.3)	(82.9)	(34.4)	(8.3)	(292.0)
Net credit risk exposure	16,111.3	3,777.6	7,503.9	3,493.3	7,738.6	38,624.7
Reconciliation of accounting to customer balances						
Gross balance	15,802.5	1,518.1	5,538.8	3,452.7	7,745.9	34,058.0
Fair value adjustments	6.7	–	–	251.5	138.2	396.4
Other accounting adjustments	(16.3)	17.5	(35.2)	(64.7)	50.1	(48.6)
Gross customer balances	15,792.9	1,535.6	5,503.6	3,639.5	7,934.2	34,405.8

The comparative table has been updated to include the changes made to impairment criteria and to include Platform within the Retail segment.

The disclosures in sections 1.4.1.3 Secured residential credit risk, 1.4.1.4 Unsecured retail credit risk and 1.4.1.5 Corporate credit risk are all based on the gross customer balances in the above tables.

1.4.1.3 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 2012 70% (2011: 55%) of mortgages were originated directly and 30% (2011: 45%) through intermediaries.

The Britannia and Co-operative Bank brands only originate prime residential mortgages, while Platform originates a combination of prime and 'almost prime' residential mortgages and buy to let loans. All new advances are on a repayment basis, with the exception of buy to lets.

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

	2012			2011		
	Amount advanced	**Average LTV %**	**Interest only %**	Amount advanced	Average LTV %	Interest only %
Retail prime	**1,854.7**	**60.3**	**7.8**	790.5	57.9	11.8
Platform prime	**248.1**	**62.0**	**17.5**	182.1	66.1	22.1
Total prime	**2,102.8**	**60.5**	**8.9**	972.6	59.3	13.0
Buy to let	**538.7**	**63.1**	**84.3**	446.3	62.6	83.0
Almost prime	**7.6**	**57.0**	**1.2**	10.3	52.9	13.4
Total completions	**2,649.1**	**61.0**	**24.6**	1,429.2	60.4	30.4

Mortgages originated by Platform prior to 2009 and those acquired by Britannia Treasury Services 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.

Loans may have been advanced on a capital and interest repayment 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.

1. Credit risk continued

The table below shows residential mortgages gross customer balances analysed by LTV banding:

	2012			2011		
	Retail secured	**Optimum**	**Total**	Retail secured	Optimum	Total
Less than 50%	**5,459.9**	**460.3**	**5,920.2**	5,706.7	484.0	6,190.7
50% to 60%	**2,233.1**	**358.6**	**2,591.7**	2,157.8	372.7	2,530.5
60% to 70%	**2,621.6**	**657.1**	**3,278.7**	2,418.0	673.0	3,091.0
70% to 80%	**2,698.0**	**1,013.8**	**3,711.8**	2,563.4	1,067.7	3,631.1
80% to 90%	**1,914.6**	**1,470.2**	**3,384.8**	1,874.5	1,604.9	3,479.4
90% to 100%	**621.0**	**1,537.9**	**2,158.9**	651.8	1,696.2	2,348.0
Greater than 100%	**382.8**	**1,994.3**	**2,377.1**	420.7	2,035.7	2,456.4
	15,931.0	**7,492.2**	**23,423.2**	15,792.9	7,934.2	23,727.1

The table below shows gross customer balances for residential mortgages analysed by asset class:

	2012			2011		
	Exposure	**Average LTV %**	**Interest only %**	Exposure	Average LTV %	Interest only %
Prime residential	**15,377.2**	**44.5**	**22.3**	15,745.9	43.5	25.1
Buy to let	**3,256.0**	**74.9**	**90.5**	2,881.3	76.1	90.5
Self-certified	**2,091.5**	**76.8**	**77.7**	2,228.7	76.6	77.3
Almost prime	**940.9**	**89.8**	**67.4**	997.1	89.5	67.1
Non-conforming	**1,757.6**	**77.6**	**66.7**	1,874.1	77.1	65.7
	23,423.2	**53.6**	**41.9**	23,727.1	52.7	42.9

Collateral

All mortgages are secured by a first charge over the property being purchased or remortgaged. Valuation of the property is normally assessed by a RICS certified valuer from the Group's approved panel of valuers. For low LTV remortgages, valuation may be assessed through the use of an automated valuation model (AVM). Performance of AVMs is monitored on a regular basis to ensure their ongoing accuracy.

It is not normal practice to reassess the valuation of collateral unless further lending is being considered, or the property has been repossessed, but on a quarterly basis the valuation is restated using a regional property price index.

The risk in the portfolio is revalued monthly using internally developed behavioural models, to assess the likelihood of loss and to reflect any changes in the value of collateral (see below). The revaluation will determine the amount of capital required to be held for individual loans.

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

	2012			2011		
	Exposure	**Collateral**	**Cover %**	Exposure	Collateral	Cover %
Impaired	**1,445.3**	**1,386.3**	**95.9**	1,603.5	1,541.4	96.1
Not impaired	**21,977.9**	**21,831.7**	**99.3**	22,123.6	21,990.3	99.4
	23,423.2	**23,218.0**	**99.1**	23,727.1	23,531.7	99.2

Impairment

A loan is considered to be individually impaired when:

- arrears outstanding are equivalent to 30 days or more; or
- the loan is more than 90 days past its due date for final repayment but has not been repaid; or
- the account is in litigation or the property is in possession; or
- the estimated forced sale value of the collateral on a roll up mortgage has reduced below the loan balance outstanding.

Loans meeting any of these criteria are considered impaired even if a loss is not expected in the event of repossession.

Loans are also assessed for impairment where any of the following criteria apply, although these factors alone are not deemed to be objective evidence of impairment and therefore a collective provision is held against potential losses:

- the loan is in arrears by less than 30 days; or
- there has been a material deterioration in the borrower's external credit score in the last 12 months; or
- the loan is identified as being subject to forbearance (refer to forbearance section).

On the Optimum portfolio only, any loans not meeting any of the preceding criteria are assessed for impairment based on the probability that they will move to 90 days in arrears within the next three months.

Risk management continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

For each loan assessed for impairment 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 current interest rate to reflect the anticipated time to sale, and taking into account anticipated fees and costs prior to sale. This shortfall is then reduced on a collective basis to reflect the probability of the loan being taken into possession.

The table below shows:

- impaired customer balances as a percentage of gross customer balances; and
- impairment coverage, ie impairment provisions and fair value adjustments as a percentage of impaired customer balances.

		2012			2011	
	Retail secured	**Optimum**	**Total**	Retail secured	Optimum	Total
Gross customer balances	**15,931.0**	**7,492.2**	**23,423.2**	15,792.9	7,934.2	23,727.1
Impaired customer balances	**156.0**	**1,289.3**	**1,445.3**	144.3	1,459.2	1,603.5
Impaired as a % of gross customer balances	**1.0%**	**17.2%**	**6.2%**	0.9%	18.4%	6.8%
Credit protection						
Impairment provisions	**3.2**	**11.0**	**14.2**	3.1	8.3	11.4
Fair value adjustments	**5.2**	**115.9**	**121.1**	6.7	138.2	144.9
	8.4	**126.9**	**135.3**	9.8	146.5	156.3
Credit protection as a % of impaired customer balances	**5.4%**	**9.8%**	**9.4%**	6.8%	10.0%	9.7%

The comparative figures have been updated to include additional balances subject to forbearance and Platform as it is now included within this segment.

The table below shows the credit quality of loans and advances that are not impaired:

		2012			2011	
	Retail secured	**Optimum**	**Total**	Retail secured	Optimum	Total
Low to medium risk	**14,931.6**	**5,901.0**	**20,832.6**	14,796.8	6,218.4	21,015.2
Medium to high risk	**843.4**	**301.9**	**1,145.3**	851.8	256.6	1,108.4
	15,775.0	**6,202.9**	**21,977.9**	15,648.6	6,475.0	22,123.6

Low to medium risk is defined as exposures with a probability of default (PD) in the next year of 1% or below using the internal ratings based (IRB) approach under Basel II. Medium to high risk is defined as exposures with a PD in the next year of greater than 1%.

Forbearance

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;
- payment holidays are allowed as part of a customer's flexible mortgage contract. Payment holidays are not knowingly allowed for customers experiencing financial hardship. However, in the absence of evidence to the contrary, loans that have had a payment holiday in the last two years are treated as being subject to forbearance;
- temporary conversion of a mortgage to interest only repayments. The capital repayments due in this period are spread over the remaining term on conversion back to capital repayment as part of an instalment recalculation exercise;
- a permanent switch from capital and interest repayments to interest only repayments, provided the borrower declares they have an alternative means of repaying the capital at the end of the term;
- an extension to the mortgage term to reduce the borrower's repayments. Loans that have had a term extension in the last two years (or since 2008 in the case of the Optimum portfolio) are considered to be subject to forbearance;
- capitalisation, where outstanding arrears are added to the capital value of the loan to be repaid over the remaining term. This is only considered where it is appropriate for the borrower's circumstances, and where the borrower has been performing for at least six months. During 2012, 20 (2011: 90) loans had arrears capitalised of £0.03m (2011: £0.3m). These loans are not treated as impaired unless the borrower meets another impairment trigger (eg misses a mortgage payment); and
- where applicable we will work with the customer as part of a government support scheme. 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.

1. Credit risk continued

The Group does not offer all forms of forbearance that are cited within the FSA's Finalised Guidance on Forbearance and Impairment. In particular, the following are not offered by the Group:

- change in payment date (other than a change to an alternative payment date within the same calendar month);
- deferral of payment (other than through an agreed concession as shown above);
- use of linked pre-approved reserve/credit/overdraft limits to meet an overdue mortgage payment;
- transfer to a lower interest rate, whether by variation to the agreed rate or through a concessionary product; and
- financial support to customers through assisted sales or partial debt write-off to reduce the amount owing.

The underlying basis for the calculation of residential mortgage impairment provisions remains unchanged. Mortgages subject to forbearance, once classified as impaired, are treated in the same way as all other impaired mortgages in the impairment provisions calculations.

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

	Neither past due nor impaired	**Impaired**	**Loans subject to forbearance**	**Impairment coverage**
2012				
Arrangements	**52.3**	**449.2**	**501.5**	**(22.2)**
Concessions	**1.0**	**4.4**	**5.4**	**(0.1)**
Payment holidays	**160.0**	**–**	**160.0**	**–**
Interest only switches	**582.2**	**0.1**	**582.3**	**(0.8)**
Term extensions	**313.5**	**–**	**313.5**	**–**
Capitalisations	**0.8**	**–**	**0.8**	**–**
	1,109.8	**453.7**	**1,563.5**	**(23.1)**

	Neither past due nor impaired	Impaired	Loans subject to forbearance	Impairment coverage
2011				
Arrangements	59.2	487.4	546.6	(26.0)
Concessions	1.9	5.3	7.2	(0.1)
Payment holidays	175.8	–	175.8	–
Interest only switches	564.2	0.6	564.8	(0.9)
Term extensions	146.5	–	146.5	(0.1)
Capitalisations	10.6	0.2	10.8	–
	958.2	493.5	1,451.7	(27.1)

1.4.1.4 Unsecured retail credit risk

Acquisition and account management

The Group offers unsecured lending through fixed repayment loans, credit cards and overdrafts. Borrowers are assessed using a combination of credit scoring and policy rules to ensure that expected delinquency levels are within the risk appetite of the business and deliver an appropriate level of return. Credit cards and overdrafts are subject to ongoing account management to increase or decrease credit limits and manage over limit authorisations.

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

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

	2012	2011
Loans	**734.3**	751.0
Credit cards	**2,703.6**	2,841.4
Overdrafts	**382.8**	377.0
	3,820.7	3,969.4

Impairment

Provisions are made on all debts with delinquency greater than a pre-determined trigger point, which the Group deems to be the point of impairment, and on all fraud and debt at agents' accounts.

Credit cards are identified as impaired immediately if the borrower fails to make the minimum payment by the due date.

Loans are identified as impaired if a monthly payment has not been made 15 days after it was due.

An overdraft is defined as impaired if the account has been overdrawn in excess of any agreed limit for 45 days, or if the agreed overdraft has expired but the account remains overdrawn.

Risk management continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

Accounts identified as impaired are segmented according to the number of days that the loan has been impaired. The provision for each segment is based on the loss expected. An account is charged off when all internal economical avenues to recover the debt have been exhausted, and written off when all external avenues have been exhausted.

The table below shows:

- gross customer balances (excluding undrawn commitments);
- impaired customer balances as a percentage of gross customer balances; and
- impairment coverage, ie impairment provisions including those charged off in relation to Debt Collection Agencies (DCA) as a percentage of impaired customer balances.

	2012	2011
Gross customer balances	**1,488.5**	1,535.6
Impaired customer balances	**301.1**	309.7
Impaired as a % of gross customer balances	**20.2%**	20.2%
Credit protection		
Impairment provisions	**172.8**	163.3
DCA balances charged off	**86.8**	90.0
	259.6	253.3
Credit protection as a % of impaired customer balances	**86.2%**	81.8%

The impaired customer balances and credit protection shown above include provisions charged off in relation to DCA cases.

Forbearance

A number of forbearance options are available to borrowers in financial difficulty. These include arrangements to repay arrears over a period of time or to accept payments of less than the contractual amount during a period of temporary financial hardship. In these circumstances, the loan continues to be reported as impaired until the arrears are cleared in full. Arrangements can be made directly with the customer or through a third party whom they have chosen to represent them.

Additional forbearance includes the following three treatments with an incremental provision of £3m raised in 2012:

- reducing overdrafts: this option is used to reduce the overdraft levels on current accounts in excess of the agreed formal overdraft or limit reduction applied by the Group. For this situation, the customer is given up to eight months to move the account back within the agreed limit;
- re-ages: there are a small number of credit card re-ages performed each month for customer service reasons; and
- debt consolidation loans: in certain circumstances, customers are offered a consolidation loan to pay off other internal debt.

1.4.1.5 Corporate credit risk

Acquisition and account management

The Group is managed through two distinct classifications. The Core business represents activity consistent with the strategy and risk appetite for the Group and within corporate comprises corporate banking, business banking and business services. Non-core business lines include activities not congruent with the current strategy of the Group, which are managed for value and targeted for run down or exit.

The Group operates to a new lending policy which is subject to meeting criteria as laid down in the corresponding sector strategy guidelines and strict policy with regards single name and sector concentrations. New lending is approved by experienced staff within the centrally based credit underwriting team, independent from income generation. Lending discretions are based on the risk profile of the customer and the amount of exposure. The lending discretions of the Credit Risk Director, the CEO and the Credit Approvals Committee are operated to sanction the largest credit applications.

The credit underwriting team uses the relevant 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, the financial stability of the counterparty and its ability to withstand such change.

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 management actions are taken to effect recovery.

The CRMC and ERC (and by exception BRC) receive regular reports on the performance of the portfolio.

1. Credit risk continued

The tables below show the distribution of the Corporate and Business Banking gross customer balances (including commitments, but excluding Unity Trust Bank) by sector and risk grade, where PD grades have been mapped to regulatory slotting categories for ease of interpretation in this report.

	Standardised	Strong	Good	Satisfactory	Weak	Default	Total
2012							
Core							
Accommodation, food and licensed services	**278.2**	**119.2**	**151.6**	**21.7**	**18.1**	**9.0**	**597.8**
Care	**249.3**	**35.8**	**73.1**	**31.5**	**0.5**	**2.1**	**392.3**
Education	**67.0**	**60.5**	**3.4**	**1.2**	**–**	**–**	**132.1**
Financial services	**83.6**	**79.3**	**30.5**	**3.6**	**–**	**4.8**	**201.8**
Football clubs	**–**	**33.2**	**–**	**0.4**	**0.1**	**0.9**	**34.6**
Housing associations	**8.3**	**256.3**	**0.9**	**–**	**–**	**–**	**265.5**
Manufacturing	**87.5**	**19.8**	**44.5**	**13.0**	**15.2**	**9.5**	**189.5**
Motor trade and garages	**24.9**	**57.3**	**26.2**	**10.3**	**0.8**	**3.7**	**123.2**
PFI	**–**	**1.1**	**1,250.3**	**34.7**	**–**	**10.7**	**1,296.8**
Professional services	**70.7**	**71.5**	**21.3**	**13.1**	**0.8**	**3.5**	**180.9**
Property and construction:							
Commercial investment	**49.8**	**92.3**	**1,157.5**	**178.2**	**25.0**	**87.4**	**1,590.2**
Residential investment	**13.4**	**5.9**	**115.9**	**15.1**	**7.3**	**7.8**	**165.4**
Commercial development	**2.7**	**10.1**	**154.9**	**75.4**	**15.2**	**35.6**	**293.9**
Residential development	**1.4**	**5.4**	**60.7**	**14.1**	**8.2**	**5.8**	**95.6**
Public sector entities	**180.0**	**1.3**	**–**	**–**	**–**	**–**	**181.3**
Renewable energy	**605.8**	**–**	**–**	**–**	**–**	**9.2**	**615.0**
Retail and wholesale trade	**108.3**	**396.8**	**55.6**	**12.4**	**5.4**	**19.3**	**597.8**
Services	**465.9**	**120.4**	**59.1**	**30.4**	**17.9**	**23.9**	**717.6**
Transport, storage and communication	**105.4**	**58.1**	**5.3**	**16.1**	**0.4**	**15.2**	**200.5**
Utilities	**94.4**	**1.6**	**2.0**	**0.5**	**–**	**0.6**	**99.1**
Business banking	**0.8**	**35.1**	**6.7**	**2.9**	**0.4**	**0.5**	**46.4**
Other	**7.3**	**1.9**	**1.5**	**5.3**	**–**	**2.1**	**18.1**
	2,504.7	**1,462.9**	**3,221.0**	**479.9**	**115.3**	**251.6**	**8,035.4**
Non-core							
Accommodation, food and licensed services	**38.3**	**–**	**0.6**	**–**	**–**	**269.1**	**308.0**
Football clubs	**–**	**–**	**–**	**–**	**–**	**18.3**	**18.3**
Housing associations	**–**	**834.3**	**45.0**	**–**	**–**	**–**	**879.3**
Property and construction:							
Commercial investment	**16.2**	**1.5**	**274.5**	**93.9**	**101.1**	**1,336.7**	**1,823.9**
Residential investment	**–**	**–**	**99.9**	**47.4**	**42.9**	**112.6**	**302.8**
Commercial development	**–**	**–**	**–**	**–**	**–**	**6.4**	**6.4**
Renewable energy	**27.9**	**–**	**–**	**–**	**–**	**–**	**27.9**
	82.4	**835.8**	**420.0**	**141.3**	**144.0**	**1,743.1**	**3,366.6**
Total exposure	**2,587.1**	**2,298.7**	**3,641.0**	**621.2**	**259.3**	**1,994.7**	**11,402.0**

Risk management continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

	Standardised	Strong	Good	Satisfactory	Weak	Default	Total
2011							
Core							
Accommodation, food and licensed services	256.1	60.9	52.7	31.4	1.5	10.8	413.4
Care	177.0	29.1	19.3	26.9	2.9	–	255.2
Education	68.6	46.1	11.6	0.8	–	–	127.1
Financial services	82.1	54.1	40.3	4.8	–	3.7	185.0
Football clubs	–	41.6	–	0.9	–	2.5	45.0
Housing associations	212.9	–	0.5	–	–	–	213.4
Manufacturing	92.4	15.9	40.5	20.9	24.4	1.6	195.7
Motor trade and garages	34.1	39.9	22.8	1.9	8.6	4.0	111.3
PFI	0.8	–	1,260.8	–	14.6	–	1,276.2
Professional services	61.6	26.6	27.4	7.9	3.3	4.2	131.0
Property and construction:							
Commercial investment	16.8	93.3	1,131.2	211.4	38.6	49.9	1,541.2
Residential investment	9.4	10.3	112.5	5.5	0.7	10.9	149.3
Commercial development	6.8	9.1	112.5	123.0	24.1	11.1	286.6
Residential development	1.7	1.8	65.3	35.1	13.4	3.9	121.2
Public sector entities	198.0	–	–	–	–	–	198.0
Renewable energy	407.2	–	–	–	–	10.3	417.5
Retail and wholesale trade	107.4	335.2	69.9	19.5	1.0	0.3	533.3
Services	460.3	103.3	50.5	60.8	8.4	21.6	704.9
Transport, storage and communication	168.5	53.5	11.0	7.4	15.0	23.9	279.3
Utilities	74.5	0.8	1.5	10.5	–	0.6	87.9
Business banking	0.8	32.6	7.5	3.3	0.9	0.5	45.6
Other	11.9	1.1	1.9	4.1	–	2.1	21.1
	2,448.9	955.2	3,039.7	576.1	157.4	161.9	7,339.2
Non-core							
Accommodation, food and licensed services	63.4	–	0.6	–	–	99.3	163.3
Football clubs	–	–	–	–	15.1	3.2	18.3
Housing associations	919.9	–	–	–	–	–	919.9
Professional services	–	–	–	–	–	0.3	0.3
Property and construction:							
Commercial investment	106.4	81.1	335.2	556.3	545.8	512.8	2,137.6
Residential investment	1.6	48.8	116.5	110.8	23.3	143.8	444.8
Renewable energy	30.3	–	–	–	–	–	30.3
	1,121.6	129.9	452.3	667.1	584.2	759.4	3,714.5
Total exposure	3,570.5	1,085.1	3,492.0	1,243.2	741.6	921.3	11,053.7

The Standardised category relates to customers who have not defaulted and, for the purposes of capital calculations, are not rated with a regulatory approved rating model. 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, newly established companies with an insufficient number of published financial accounts, project finance and charities. During 2012 the Group was granted regulatory approval to rate housing associations with a PD model; hence a significant amount of exposure has migrated from Standardised to the Strong category.

The movement of balances from Satisfactory and Weak to Default in the period is reflective of both the continued challenging commercial property environment and the Group's focus on the expected outlook for this sector and the consequential forbearance strategies and the completion of the Bank's review of its default and provisioning strategy.

1. Credit risk continued

Collateral

The Group uses guarantees and collateral to mitigate credit risk. Collateral is regularly revalued and guarantees are reviewed to ensure continuing effectiveness.

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 (supported by tangible security, where appropriate, including property, life policies and stocks and 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.

The table below analyses the fair value of the property collateral held against assets in the property and construction sectors (commonly referred to as commercial real estate):

	2012			2011		
Core	**Exposure**	**Collateral**	**Impairment provision**	Exposure	Collateral	Impairment provision
Non-default loans with <= 1 year & all defaulted exposures regardless of term						
Less than 50%	**69.3**	**69.3**	**–**	51.2	51.1	–
50% to 60%	**85.7**	**85.3**	**0.4**	53.0	53.0	–
60% to 70%	**106.6**	**106.6**	**–**	54.6	54.6	–
70% to 80%	**113.6**	**113.6**	**–**	88.5	88.5	–
80% to 90%	**26.7**	**26.2**	**0.5**	62.7	60.3	2.4
90% to 100%	**30.9**	**30.6**	**0.3**	18.8	18.0	0.8
Greater than 100%	**156.2**	**96.9**	**36.4**	145.8	87.5	12.4
Unsecured	**36.0**	**–**	**7.6**	33.2	–	6.1
	625.0	**528.5**	**45.2**	507.8	413.0	21.7
Non-default loans with > 1 year						
Less than 50%	**245.5**	**245.5**	**–**	221.1	221.1	–
50% to 60%	**292.5**	**292.5**	**–**	230.8	230.8	–
60% to 70%	**402.4**	**402.4**	**–**	276.8	276.8	–
70% to 80%	**309.1**	**309.1**	**–**	293.0	293.0	–
80% to 90%	**61.8**	**61.8**	**–**	132.1	132.1	–
90% to 100%	**33.5**	**33.5**	**–**	87.7	87.7	–
Greater than 100%	**105.2**	**78.3**	**–**	262.8	216.6	–
Unsecured	**70.1**	**–**	**–**	86.2	–	–
	1,520.1	**1,423.1**	**–**	1,590.5	1,458.1	–
	2,145.1	**1,951.6**	**45.2**	2,098.3	1,871.1	21.7

Risk management continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

	2012			2011		
Non-core	**Exposure**	**Collateral**	**Impairment provision**	Exposure	Collateral	Impairment provision
Non-default loans with <= 1 year & all defaulted exposures regardless of term						
Less than 50%	**0.6**	**0.5**	**0.1**	3.0	3.0	–
50% to 60%	**1.5**	**1.5**	**–**	6.5	–	6.5
60% to 70%	**36.8**	**34.2**	**2.6**	0.8	0.8	–
70% to 80%	**2.4**	**2.4**	**–**	117.0	116.3	0.7
80% to 90%	**45.8**	**44.5**	**1.3**	54.7	54.7	–
90% to 100%	**72.3**	**47.8**	**24.4**	53.4	49.8	3.6
Greater than 100%	**1,185.7**	**816.1**	**299.8**	781.1	489.0	182.7
Unsecured	**177.8**	**–**	**59.8**	31.8	–	2.4
	1,522.9	**947.0**	**388.0**	1,048.3	713.6	195.9
Non-default loans with > 1 year						
Less than 50%	**30.1**	**30.1**	**–**	59.4	59.4	–
50% to 60%	**63.7**	**63.7**	**–**	75.5	75.5	–
60% to 70%	**185.5**	**185.5**	**–**	146.5	146.5	–
70% to 80%	**30.5**	**30.5**	**–**	126.0	126.0	–
80% to 90%	**90.5**	**90.5**	**–**	210.7	210.6	0.1
90% to 100%	**67.9**	**67.9**	**–**	98.4	98.4	–
Greater than 100%	**124.2**	**93.1**	**–**	692.7	598.0	9.3
Unsecured	**17.8**	**–**	**–**	124.9	–	–
	610.2	**561.3**	**–**	1,534.1	1,314.4	9.4
	2,133.1	**1,508.3**	**388.0**	2,582.4	2,028.0	205.3

Of the above, £50m (2011: £48m) is not held as first charge.

Impairment

Corporate customers are placed on a watchlist when they show signs of unsatisfactory performance and require close control. 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; and
- application of forbearance strategies.

Dependent on the Group's satisfaction that the triggers leading to inclusion on the watchlist no longer apply, customers who stop exhibiting higher risk traits are removed from the watchlist.

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

The Group also reviews monthly 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).

Individual impairment provisions are raised at the point when business performance is assessed to have deteriorated to the extent that there is a real risk of loss of principal, interest or fees. Provisions will be required on some or all of the entire shortfall between the security held and the loan balance outstanding and represent a realistic assessment of the likely net loss after realisation of any security.

Objective evidence of impairment may 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 Group considers that at some point (normally taken within the next 12 months) actions such as an issue of formal demand will be required in order to achieve full repayment.

1. Credit risk continued

For provisioning purposes, an up to date 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 provision 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 cashflows discounted at the original interest rate are less than the current carrying amount.

Collective impairment provisions are based on the remaining portfolio where a trigger event could have occurred but has not yet been observed.

There has been a continued deterioration in the commercial property sector and with the relatively significant exposure to commercial property, the directors have reassessed the carrying value of the Group's loan portfolio.

The table below shows:

- impaired customer balances as a percentage of gross customer balances; and
- credit protection, ie impairment provisions and fair value adjustments as a percentage of impaired customer balances.

	2012		2011	
	Core	**Non-core**	Core	Non-core
Gross customer balances	**6,129.6**	**3,318.2**	5,503.6	3,639.5
Impaired customer balances	**242.9**	**1,739.1**	184.7	775.8
Impaired as a % of gross customer balances	**4.0%**	**52.4%**	3.4%	21.3%
Credit protection				
Impairment provisions	**137.3**	**318.7**	82.9	34.4
Fair value adjustments	**–**	**215.9**	–	251.5
	137.3	**534.6**	82.9	285.9
Credit protection as a % of impaired customer balances	**56.5%**	**30.7%**	44.9%	36.9%

Despite a substantial increase in provisions for corporate non-core loans, the impairment cover as a percentage of impaired customer balances has fallen from 36.9% last year to 30.7% in 2012. The newly impaired balances have a low credit protection rate reflecting the high average value of collateral held.

Core impaired balances have increased by £58.2m with an increase in the credit protection rate of 11.6%. This reflects the nature of the core portfolio which would generally have lower value security.

Forbearance

If the Group is convinced 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 the Group may grant 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.

Risk management continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

The table below analyses the exposures subject to forbearance:

	2012 Forborne	2012 Non-forborne	2012 Total	2011 Forborne	2011 Non-forborne	2011 Total
Core						
Default	**139.4**	**112.2**	**251.6**	60.2	101.7	162.9
On watchlist	**204.9**	**67.3**	**272.2**	198.3	78.8	277.1
Neither default nor on watchlist	**197.9**	**7,313.7**	**7,511.6**	332.3	6,567.9	6,900.2
	542.2	**7,493.2**	**8,035.4**	590.8	6,748.4	7,339.2
Non-core						
Default	**1,118.4**	**624.7**	**1,743.1**	309.0	450.4	759.4
On watchlist	**159.1**	**64.1**	**223.2**	840.2	330.0	1,170.2
Neither default nor on watchlist	**95.2**	**1,305.1**	**1,400.3**	113.2	1,671.7	1,784.9
	1,372.7	**1,993.9**	**3,366.6**	1,262.4	2,452.1	3,714.5
	1,914.9	**9,487.1**	**11,402.0**	1,853.2	9,200.5	11,053.7

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

For those customers that benefit from ongoing concessions (such as postponement of principal payments), the Group 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 Group removes the forbearance status 12 months after their occurrence.

1.4.2 Investment securities

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 predominantly made daily, save for several arrangements which permit calls on a weekly basis. Eligible financial collateral for Basel II reporting purposes includes gilts held under reverse repo agreements and cash held under both repo agreements and collaterised swap arrangements. The guarantees relied upon are either parental guarantees held against subsidiary exposures within bank groups or sovereign guarantees.

At the balance sheet date, the Group has a total investment securities portfolio of £6,928.8m (2011: £4,616.2m) of which £39.0m (2011: £46.4m) is considered impaired and against which £39.0m (2011: £45.2m) of provisions are held.

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

2012	Loans and receivables	Investment securities Available for sale	Investment securities Fair value through income or expense	Held for trading	Total
Analysis of balance per note 16					
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	**306.0**	**3,789.4**	**1,845.2**	**960.2**	**6,900.8**
Impaired	**–**	**39.0**	**–**	**–**	**39.0**
Gross credit risk exposure	**306.0**	**3,828.4**	**1,845.2**	**960.2**	**6,939.8**
Less:					
Fair value adjustments	**(11.0)**	**–**	**–**	**–**	**(11.0)**
Allowance for losses	**–**	**(39.0)**	**–**	**–**	**(39.0)**
Net credit risk exposure	**295.0**	**3,789.4**	**1,845.2**	**960.2**	**6,889.8**

1. Credit risk continued

2011	Loans and receivables	Investment securities Available for sale	Investment securities Fair value through income or expense	Held for trading	Total
Analysis of balance per note 16					
Gross balance	807.6	3,465.5	343.1	–	4,616.2
Less: allowance for losses	(2.7)	(42.5)	–	–	(45.2)
	804.9	3,423.0	343.1	–	4,571.0
Analysis of credit risk exposure					
Not impaired	823.5	3,423.0	343.1	–	4,589.6
Impaired	3.9	42.5	–	–	46.4
Gross credit risk exposure	827.4	3,465.5	343.1	–	4,636.0
Less:					
Fair value adjustments	(19.8)	–	–	–	(19.8)
Allowance for losses	(2.7)	(42.5)	–	–	(45.2)
Net credit risk exposure	804.9	3,423.0	343.1	–	4,571.0

An analysis of the credit risk exposure for the Bank is provided in note 40.

1.4.2.1 Impaired assets
Investment securities are considered past due where the contractual interest or principal payments are in arrears and it is determined that the Group 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 Group will be unable to collect all principal and interest outstanding, according to the contractual terms of the agreements.

At the balance sheet date, the Group assesses its investment securities for objective evidence that an impairment loss has occurred, for example this may be indicated by the disappearance of an active market. For available for sale securities particular consideration is given to evidence of any significant difficulty of the issuer or measurable decrease in the estimated cash flows from the investments.

1.4.2.2 Not impaired
The Group only invests in treasury assets which comply with the treasury credit risk policy. Within the treasury investment security portfolio 99% (2011: 89%) of exposures have an external credit rating equivalent to Fitch A or above.

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

1.5 Eurozone risk
The Group remains a UK focused retail and commercial operation. It has no sovereign exposure to 'peripheral' eurozone countries (Portugal, Ireland, Italy, Greece and Spain). As at 2012 the Group had a £306.7m (2011: £90.0m) gross exposure to the Government of Finland, £89.9m (2011: £nil) to the Swedish Export Credit Corporation and £12.3m (2011: £nil) to the Government of the Netherlands, repayable in over one year. It held no other non-UK sovereign debt.

Other than a £25k exposure to the London subsidiary of a Greek bank, the Group has no direct exposure to Greek financial institutions or any other counterparty types.

Risk management continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

1.5.1 Direct exposures

The analyses on the following pages set out the Group's exposures to financial institutions in European countries, both by asset maturity and by asset type.

The Group has exposures to financial institutions in the following European countries at 31 December 2012:

Country	Repayable within 30 days	Repayable within 1 year but more than 30 days	Repayable in over 1 year	Total gross exposure	Credit risk mitigation	Total net exposure
2012						
Austria	–	–	–	–	–	–
Belgium	–	–	–	–	–	–
Denmark	7.9	–	–	7.9	–	7.9
Finland	–	–	25.0	25.0	–	25.0
France	163.8	53.7	125.6	343.1	(34.0)	309.1
Germany	31.6	48.1	663.7	743.4	(689.5)	53.9
Ireland	–	–	–	–	–	–
Italy	0.1	–	–	0.1	–	0.1
Netherlands	0.1	59.7	412.6	472.4	–	472.4
Norway	–	–	72.3	72.3	(72.3)	–
Portugal	–	–	–	–	–	–
Spain	–	–	–	–	–	–
Sweden	0.4	–	64.0	64.4	–	64.4
Switzerland	59.1	608.0	56.9	724.0	(521.1)	202.9
	263.0	769.5	1,420.1	2,452.6	(1,316.9)	1,135.7

Country	Repayable within 30 days	Repayable within 1 year but more than 30 days	Repayable in over 1 year	Total gross exposure	Credit risk mitigation	Total net exposure
2011						
Austria	–	44.2	–	44.2	(4.1)	40.1
Belgium	–	20.0	34.0	54.0	(34.0)	20.0
Denmark	7.8	–	–	7.8	–	7.8
Finland	–	–	–	–	–	–
France	174.7	5.3	135.3	315.3	–	315.3
Germany	39.2	104.5	38.4	182.1	(15.7)	166.4
Ireland	5.0	25.0	–	30.0	–	30.0
Italy	–	–	–	–	–	–
Netherlands	0.1	40.2	210.6	250.9	–	250.9
Norway	–	–	–	–	–	–
Portugal	–	33.5	–	33.5	–	33.5
Spain	59.0	84.2	33.6	176.8	(31.5)	145.3
Sweden	10.2	10.0	7.3	27.5	–	27.5
Switzerland	73.1	10.0	413.8	496.9	(263.6)	233.3
	369.1	376.9	873.0	1,619.0	(348.9)	1,270.1

For the purposes of the above table, exposures to counterparties which comprise subsidiaries of larger banking groups within which Treasury maintains additional counterparty relationships are aggregated at the group level with the associated risk country being that of the ultimate parent entity. As at 31 December 2012 an exposure of £13.4m to an Irish subsidiary of a major American bank group was accordingly reported as exposure to the American based parent and is thus excluded from the analysis above. This exposure is fully guaranteed by the group holding company.

Credit risk mitigation takes the form of UK gilt collateral held in relation to reverse repo transactions, cash collateral held in relation to sold repo and derivative transactions, and sovereign/sub-sovereign guarantees in relation to specific debt security holdings.

1. Credit risk continued

The table below shows the Group's exposure to financial institutions in European countries by asset type.

Country	Bank and money market balances	Bonds	Derivatives	Other	Total net exposure
2012					
Austria	**–**	**–**	**–**	**–**	**–**
Belgium	**–**	**–**	**–**	**–**	**–**
Denmark	**0.1**	**–**	**–**	**7.8**	**7.9**
Finland	**–**	**25.0**	**–**	**–**	**25.0**
France	**0.1**	**100.3**	**16.9**	**191.8**	**309.1**
Germany	**0.3**	**–**	**22.3**	**31.3**	**53.9**
Ireland	**–**	**–**	**–**	**–**	**–**
Italy	**0.1**	**–**	**–**	**–**	**0.1**
Netherlands	**0.1**	**472.3**	**–**	**–**	**472.4**
Norway	**–**	**–**	**–**	**–**	**–**
Portugal	**–**	**–**	**–**	**–**	**–**
Spain	**–**	**–**	**–**	**–**	**–**
Sweden	**0.2**	**64.0**	**–**	**0.2**	**64.4**
Switzerland	**0.4**	**–**	**51.6**	**150.9**	**202.9**
	1.3	**661.6**	**90.8**	**382.0**	**1,135.7**

Country	Bank and money market balances	Bonds	Derivatives	Other	Total net exposure
2011					
Austria	–	40.1	–	–	40.1
Belgium	–	20.0	–	–	20.0
Denmark	1.0	–	–	6.8	7.8
Finland	–	–	–	–	–
France	–	63.2	24.4	227.7	315.3
Germany	0.2	103.3	23.9	39.0	166.4
Ireland	–	30.0	–	–	30.0
Italy	–	–	–	–	–
Netherlands	0.1	250.8	–	–	250.9
Norway	–	–	–	–	–
Portugal	–	33.5	–	–	33.5
Spain	–	126.3	19.0	–	145.3
Sweden	20.2	7.3	–	–	27.5
Switzerland	20.7	–	53.3	159.3	233.3
	42.2	674.5	120.6	432.8	1,270.1

In addition to the above exposures to financial institutions:

- in the overseas European Economic Area (EEA as defined by the European Banking Authority) and Switzerland, corporate customer exposures at 31 December 2012 totalled £170.8m (2011: £184.4m). There are no exposures to retail customers based outside of the UK and Channel Islands;
- gross exposure to European multilateral development banks (not included in the above table given the supranational status associated with these institutions) stood at £1,444.0m (2011: £529.0m) before credit risk mitigation (£997.8m post credit risk mitigation (2011: £457.5m)) of which £543.8m matures within a year (2011: £81.8m); and
- ABS/MBS exposures of £10.8m and £2.8m to Spanish and Belgian special purpose entities respectively were outstanding as at 31 December 2012.

The Group continues to monitor developments daily across all countries as they affect the Treasury portfolio. Proactive management actions have been taken to reduce risk within the Treasury portfolio with an underlying theme of reducing exposure in the south (peripheral eurozone) and increasing exposure in the north (eg Germany, the Netherlands, Finland and Sweden) where economies are more robust. Credit quality and liquidity within the portfolio have been enhanced by concentrating asset purchases in the shorter dated debt securities issued by AAA rated supranational financial institutions, government agencies and sovereign or state owned banks. Ongoing exposure to financial institutions within the peripheral eurozone is primarily restricted to selective short term money market lending and nostro account balances.

Risk management continued

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

Treasury operates a risk based approach which monitors counterparty limits and exposure via a credit risk register. The counterparties or the 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 entire portfolio and watchlists monthly for appropriate risk status bandings and any associated management actions.

As at 31 December 2012 there were no high risk watchlist exposures (2011: £277m). All high risk watchlist exposures, consisting entirely of debt security holdings, reached final maturity during the period to 31 December 2012 and were repaid in full.

1.5.2 Indirect exposures
Treasury risk management monitoring extends beyond the direct risk incurred through counterparty trading, to the underlying exposures (eg to peripheral eurozone countries) 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, often well ahead of any associated rating actions.

2. Liquidity risk

2.1 Capital and liquidity framework

The Group's capital and liquidity risk management framework comprises:

- a defined risk appetite, controls and governance in the Group's capital and liquidity management policies;
- articulation of how capital and liquidity risk is identified, measured, monitored and managed in the Internal Capital Adequacy Assessment Process (ICAAP), Individual Liquidity Adequacy Assessment (ILAA) and procedures and governance in place to mitigate the risk;
- capital and liquidity risk quantification and mitigation techniques and processes;
- management actions linked through to stress testing and capital 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 Group operates within its agreed risk appetite parameters in all planning models;
- ongoing development and enhancement of the Group's capital and liquidity risk appetite framework; and
- a process to attribute the cost, benefit and risks of liquidity to specific business lines via the Group's Funds Transfer Pricing mechanism.

2.2 Liquidity risk

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

- survival periods which measure the degree of sufficiency of liquid assets to support the Group'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 (from three months to one year) and a range of adverse liquidity events, both firm specific and market wide, which cover all aspects of the liquidity risk to which the Group is exposed. These stress tests include a number of downgrade scenarios, from one notch to multi-notch long term and short term downgrades.

The strategic measures approved by the Board include:

- customer loan/deposit ratio, 92% (2011: 94%) – the ratio of customer loans to customer deposits;
- encumbrance ratio, 27% (2011: 24%) – the ratio of encumbered assets divided by total assets;
- regulatory limits – Internal Liquidity Guidance and Net Stable Funding ratio; and
- internal liquidity stress tests – the survival period of the Group under a range of stressed scenarios.

2.3 Liquidity risk management overview

Liquidity risk arising from the structure of the balance sheet (structural liquidity) is managed in line with policies developed by LMC and ALCO. The Group's liquidity management policies are reviewed and approved annually by the BRC (on behalf of the Board) and compliance reviewed by LMC and monthly by ALCO. The Group's policy is to ensure that sufficient funds are 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 Group monitors its liquidity position on a daily basis and has a weekly LMC which operates to oversee the operational liquidity management. A range of indicators to detect early signs of liquidity risk either in the market or specific to the Group are also monitored. LMC 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 meetings ensure that the business plans are accurate and can be flexed as required.

The liquidity position is reported monthly to ALCO and the Board. It 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 Group's liquidity management framework is designed in line with FSA BIPRU regulations and industry guidelines.

2. Liquidity risk continued

2.3.1 Liquid asset portfolios

The Group holds a number of marketable asset pools that it uses for liquidity management through the Treasury operation. These include:

- liquid asset buffer (LAB); the highest quality debt and comprise of cash at the Bank of England, gilts, central government and multilateral development bank bonds. The liquid asset ratio was 14.6% at 31 December 2012 (2011: 15.5%). The table below shows the market value and composition of the liquid asset buffer:

Qualifying stock	2012	2011
Operational balance with central banks (note 13)	**5,121.0**	6,378.3
Gilts	**648.0**	1,085.5
Central government and multilateral development bank bonds	**1,455.1**	162.1
	7,240.9	7,625.9

- non-buffer assets, these assets are not as liquid as LAB assets, however they exist to diversify the liquid asset pool and enhance returns; and
- own retained asset pool, the Group has securitised part of its asset balance sheet and retained the issued notes. These assets form part of the Group's contingent funding plans.

The Group uses any combination of these asset pools to manage liquidity, with LAB and non-buffer assets used predominantly for short term cashflow movements, with the own retained asset pool creating longer term or contingent liquidity. Regular realisation through repo transactions and outright sales provide assurance that these asset pools remain sufficiently liquid.

2.3.2 Wholesale funding

The majority of the Group's funding comes from retail and commercial customer accounts. The Group's primary objective in respect of wholesale funding is 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 Group.

The Group also has access to a variety of long term wholesale funding sources including securitisations, covered bonds and Euro Medium Term Notes. In 2012 it raised £1,290.4m through these sources. The Group will continue to issue from the programmes as funding requirements and market conditions permit. The Group has a smaller presence in the shorter term wholesale liability markets, which it uses to manage short term cashflow requirements.

2.4 Liquidity gap

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 Group'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 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.

	Carrying value	Gross nominal outflow	Less than 1 month	1–3 months	3–12 months	1–5 years	Over 5 years
2012							
Contractual cash flows							
Non-derivative 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**
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	**112.0**	**112.0**	**112.0**	**–**	**–**	**–**	**–**
	46,468.8	**49,207.8**	**26,774.2**	**2,468.9**	**7,500.8**	**10,303.5**	**2,160.4**
Derivative liabilities							
Net outflow	**967.6**	**1,650.6**	**20.0**	**48.2**	**180.4**	**588.2**	**813.8**
	47,436.4	**50,858.4**	**26,794.2**	**2,517.1**	**7,681.2**	**10,891.7**	**2,974.2**
Other liabilities	**286.8**	**–**	**–**	**–**	**–**	**–**	**–**
Total recognised liabilities	**47,723.2**	**50,858.4**	**26,794.2**	**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	**52,493.5**	**55,628.7**	**31,545.4**	**2,536.2**	**7,681.2**	**10,891.7**	**2,974.2**
Behavioural adjustments							
Customer accounts	**–**	**–**	**(21,219.3)**	**570.8**	**2,410.2**	**18,238.3**	**–**
Total liabilities – behavioural	**52,493.5**	**55,628.7**	**10,326.1**	**3,107.0**	**10,091.4**	**29,130.0**	**2,974.2**

Risk management continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

2. Liquidity risk continued

	Carrying value	Gross nominal outflow	Less than 1 month	1–3 months	3–12 months	1–5 years	Over 5 years
2011							
Contractual cash flows							
Non-derivative liabilities							
Deposits by banks	3,302.7	3,397.1	1,591.2	583.9	323.1	898.9	–
Customer accounts	34,990.6	35,109.5	23,457.6	2,540.4	7,126.5	1,985.0	–
Customer accounts – capital bonds	1,429.8	1,420.3	–	97.9	425.3	892.4	4.7
Debt securities in issue	4,164.8	5,187.2	147.8	138.7	186.9	3,264.7	1,449.1
Other borrowed funds	1,258.8	2,305.8	7.2	4.6	77.1	878.6	1,338.3
Amounts owed to other Co-operative Group undertakings	132.3	132.3	132.3	–	–	–	–
	45,279.0	47,552.2	25,336.1	3,365.5	8,138.9	7,919.6	2,792.1
Derivative liabilities							
Net outflow	1,087.9	2,137.0	284.5	31.3	204.9	559.7	1,056.6
	46,366.9	49,689.2	25,620.6	3,396.8	8,343.8	8,479.3	3,848.7
Other liabilities	315.6	–	–	–	–	–	–
Total recognised liabilities	46,682.5	49,689.2	25,620.6	3,396.8	8,343.8	8,479.3	3,848.7
Unrecognised loan commitments	4,752.7	4,752.7	4,571.3	160.6	20.8	–	–
Total liabilities	51,435.2	54,441.9	30,191.9	3,557.4	8,364.6	8,479.3	3,848.7
Behavioural adjustments							
Customer accounts	–	–	(20,526.5)	464.1	1,230.3	18,832.1	–
Total liabilities – behavioural	51,435.2	54,441.9	9,665.4	4,021.5	9,594.9	27,311.4	3,848.7

The Bank's gross cash flow maturity analysis has not been disclosed as it is not materially different from the above Group disclosure.

2.5 Encumbrance

The Group ensures that sufficient eligible and unencumbered assets are available at all times to meet the needs of its secured funding programmes. Details of the Group's encumbered assets are shown in note 39d Fair value of transferred assets and associated liabilities.

3. Market risk

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 Group 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 create market risk through its various portfolio management and trading 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 Group's wholesale market activity, market risk limits and delegated authorities. The policy is managed by the TMRC and ALCO. Their prime task is to assess the interest rate risk inherent in the maturity and repricing characteristics of the Group's assets and liabilities. The Group seeks to minimise the volatility of future earnings from interest rate changes and all interest rate risk exposure is removed from the retail and CABB 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 Group. 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 TMRC and ALCO review the balance sheet risk positions and the utilisation of wholesale market risk limits.

3. Market risk continued

3.1.1 Non-treasury interest rate risk

The Group (excluding wholesale) uses a 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. Higher level analysis is performed for subsequent years.

TMRC monitors the non-trading interest rate risk which is split between certain wholesale portfolios, banking and investment books, and the rest of the Group's balance sheet. The following describes the Group 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 set 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) is 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) are 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 undertake 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 reprice with reference to different indices and at different times. This exposes the Group 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 2012 as customers continue to favour variable rate mortgages (where the introductory rate is linked to Bank of England base rate) and administered and fixed rate savings. Basis risk is monitored by TMRC 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 Group'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 repricing or maturity date and then summing by time band. The aim is to have assets evenly spread so that the Group is not exposed to sudden rate movements. The net position shows the amount that the Group is either over or under invested in the month. A £100m positive gap position would equate to the Group's income increasing by £1m per annum if rates increased by 1%. The maximum sensitivity for the period shown below equates to approximately a £10.9m decrease in income if rates increased by 1%.

	2012	2011
Net greater than 12 month gap position		
At the year end	**(928)**	(279)
Average for the year	**(612)**	(330)
Maximum sensitivity for the year	**(1,090)**	806
Minimum sensitivity for the year	**(248)**	(51)

3.1.2 Treasury interest rate risk

Treasury executes short term funding and hedging transactions with the wholesale markets on behalf of the Group and its customers. It also generates incremental income from proprietary trading within strict risk limits. There are two prime measures of risk supplemented by additional controls such as maturity and stop loss limits.

3.1.2.1 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 and was £0.4m at 31 December 2012 for the trading portfolios (2011: £0.4m). The VaR methodology has inherent limitations in that market volatility in the past may not be a reliable predictor of the future, and may not reflect the time required to hedge or dispose of the position, hence VaR is not used as the sole measure of risk.

3.1.2.2 PV100

This illustrates the change in valuation on a fixed income portfolio experienced given a 1% increase and decrease in interest rates, representing the treasury banking book and treasury trading book. PV100 is the effect on the net present value (NPV) of the wholesale portfolio to a parallel shift of 100 basis points upon the base yield curve. The effects of a 1% increase in interest rates are (£3.0m) (2011: £15.1m) and a 1% decrease £14.6m (2011: (£16.0m)).

3.2 Currency risk

The Group'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 2012
All amounts are stated in £m unless otherwise indicated

3. Market risk continued

The table below provides an analysis of the Group's assets and liabilities by currency:

	2012					2011				
	£	**$**	**€**	**Other**	**Total**	£	$	€	Other	Total
Assets										
Cash and balances at central banks	**5,433.0**	**–**	**–**	**–**	**5,433.0**	6,696.6	–	–	–	6,696.6
Loans and advances to banks	**1,738.4**	**38.4**	**124.5**	**2.8**	**1,904.1**	1,568.1	59.5	373.4	5.5	2,006.5
Loans and advances to customers	**33,121.3**	**40.2**	**153.4**	**24.6**	**33,339.5**	33,513.4	54.7	157.3	40.6	33,766.0
Fair value adjustments for hedged risk	**354.2**	**–**	**–**	**–**	**354.2**	366.3	–	–	–	366.3
Investment securities – loans and receivables	**237.7**	**12.8**	**44.5**	**–**	**295.0**	656.8	16.2	131.9	–	804.9
Investment securities – available for sale	**3,669.4**	**70.8**	**49.2**	**–**	**3,789.4**	3,127.8	124.7	170.5	–	3,423.0
Investment securities – fair value through income or expense	**1,821.9**	**12.3**	**11.0**	**–**	**1,845.2**	335.8	–	7.3	–	343.1
Investment securities – held for trading	**870.2**	**17.3**	**72.7**	**–**	**960.2**	–	–	–	–	–
Derivative financial instruments	**818.6**	**–**	**0.2**	**–**	**818.8**	975.3	0.2	0.3	–	975.8
Equity shares	**5.7**	**–**	**–**	**–**	**5.7**	5.7	–	–	–	5.7
Investments in joint ventures	**3.9**	**–**	**–**	**–**	**3.9**	2.7	–	–	–	2.7
Goodwill	**–**	**–**	**–**	**–**	**–**	0.6	–	–	–	0.6
Intangible fixed assets	**34.9**	**–**	**–**	**–**	**34.9**	40.7	–	–	–	40.7
Investment properties	**173.0**	**–**	**–**	**–**	**173.0**	172.7	–	–	–	172.7
Property, plant and equipment	**64.1**	**–**	**–**	**–**	**64.1**	80.1	–	–	–	80.1
Amounts owed by other Co-operative Group undertakings	**256.4**	**–**	**–**	**–**	**256.4**	179.2	–	–	–	179.2
Other assets	**69.7**	**0.2**	**0.4**	**–**	**70.3**	31.3	0.2	1.5	–	33.0
Prepayments and accrued income	**14.9**	**–**	**–**	**–**	**14.9**	18.7	–	–	–	18.7
Current tax assets	**172.6**	**–**	**–**	**–**	**172.6**	13.6	–	–	–	13.6
Deferred tax assets	**38.2**	**–**	**–**	**–**	**38.2**	26.4	–	–	–	26.4
Total assets	**48,898.1**	**192.0**	**455.9**	**27.4**	**49,573.4**	47,811.8	255.5	842.2	46.1	48,955.6
Liabilities										
Deposits by banks	**2,995.4**	**173.5**	**443.0**	**0.1**	**3,612.0**	2,567.3	260.6	474.7	0.1	3,302.7
Customer accounts	**35,784.6**	**47.5**	**49.7**	**2.6**	**35,884.4**	34,899.1	35.5	52.3	3.7	34,990.6
Customer accounts – capital bonds	**888.1**	**–**	**–**	**–**	**888.1**	1,429.8	–	–	–	1,429.8
Debt securities in issue	**4,705.5**	**–**	**8.2**	**–**	**4,713.7**	4,039.4	–	125.4	–	4,164.8
Derivative financial instruments	**967.4**	**–**	**0.2**	**–**	**967.6**	1,083.7	1.3	2.9	–	1,087.9
Other borrowed funds	**1,230.0**	**–**	**28.6**	**–**	**1,258.6**	1,229.5	–	29.3	–	1,258.8
Amounts owed to other Co-operative Group undertakings	**112.0**	**–**	**–**	**–**	**112.0**	132.3	–	–	–	132.3
Other liabilities	**103.6**	**0.2**	**0.2**	**–**	**104.0**	172.9	0.3	0.5	–	173.7
Accruals and deferred income	**20.1**	**–**	**–**	**–**	**20.1**	39.9	–	–	–	39.9
Provisions for liabilities and charges	**162.7**	**–**	**–**	**–**	**162.7**	102.0	–	–	–	102.0
Deferred tax liabilities	**–**	**–**	**–**	**–**	**–**	–	–	–	–	–
Total liabilities	**46,969.4**	**221.2**	**529.9**	**2.7**	**47,723.2**	45,695.9	297.7	685.1	3.8	46,682.5
Net on balance sheet position	**1,928.7**	**(29.2)**	**(74.0)**	**24.7**	**1,850.2**	2,115.9	(42.2)	157.1	42.3	2,273.1

The Bank's currency analysis has not been disclosed as it is not materially different from the above Group disclosure.

At 31 December 2012 the Group's open position was £2.7m (2011: £0.4m) representing a potential loss of £0.1m given a 3% depreciation in sterling (2011: £nil). The open position is monitored against limits in addition to limits in place on individual currencies. All figures are in £ sterling equivalent.

3. Market risk continued

The following risks (Operational to Pension) do not form part of the audited accounts and are not audited.

4. Operational risk

Operational risk is defined within the Banking Group as 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.

In order to meet the Banking Group's appetite for operational risk, appropriate controls are in place to minimise the chance of any significant disruption and to protect our reputation.

Operational risks are identified, managed and mitigated through ongoing risk management practices including risk assessments, formal control procedures and contingency planning. Operational risks and key controls are formally reviewed on a regular basis. Significant operational risks and the associated capital requirements are regularly reported to the ORC, the ERC and the BRC. These meet regularly to monitor the suitability of the risk management framework and management of significant risks within the Banking Group.

Business continuity arrangements are in place which set out to minimise the risk of disruption in the event of a sudden, unplanned occurrence that could seriously disrupt business operations. This includes developing and exercising crisis and incident management teams to maintain appropriate preparedness in the event of a major operational disruption.

The Banking Group also has a corporate insurance programme to transfer specific risks to insurers as part of its risk management approach.

5. Reputational risk

Reputational risk is defined as the risk associated with an issue which could in some way be damaging to the brand of The Co-operative Banking Group either through its strategic decisions, business performance, an operational failure or external perception.

As part of the assessment and control of this risk, 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 member, customer and market confidence.

6. Strategic and business risk

Strategic and business risk arises from changes to the Banking Group's business and the environment in which it operates, specifically the risk of not being able to carry out the Banking Group's business plan and desired strategy.

The Group's strategy is to grow our business in order to achieve the Banking Group's vision of becoming the compelling, co-operative alternative in the markets in which we compete.

The main risks to delivering the business plan and achieving the strategy are the challenging economic environment, the changing regulatory environment and the significant change programme being managed within the Group and the wider Co-operative Group.

The Board and Executive set and monitor the strategic plan in the light of this background having considered the stresses that extreme but plausible scenarios could have upon it.

7. Conduct risk

Conduct risk is the risk that the Banking Group's behaviours, offerings or interactions will result in unfair outcomes for customers. Accordingly, conduct risk may arise from any aspect of the way a business is conducted, the sole test being whether the outcome is an unfair one for customers.

The Banking Group mitigates and prevents emerging conduct risk through established systems and controls including ongoing oversight and monitoring from risk functions.

Significant conduct risks are reported through existing management structures and committees and challenged by the BRC.

8. Pension risk

Pension risk is defined as the risk of exposure to pension scheme liabilities and risks inherent in the valuation of scheme liabilities and assets resulting in a detriment to Banking Group capital. Risks are identified at The Co-operative Group level, with the impact of any potential changes to contribution assessed under the Banking Group's risk management framework.

The Banking Group is exposed to pension risk through two schemes:

- Pace – CFS Management Services Ltd (CFSMS) and the Bank are participating members of The Co-operative Pension Scheme (Pace) – defined benefit and contribution scheme; and
- Britannia Pension Scheme – CFSMS is the principal employer of the Britannia Pension Scheme – defined benefit and contribution sections (defined benefit section closed to new members in 2001, defined contribution section closed to new members in October 2012).

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 professional advice as appropriate.

The Britannia Pension Scheme Trustee, in consultation with CFSMS, is responsible for the risk management arrangements for the Britannia Pension Scheme, agreeing suitable contribution rates, investment strategy and for taking professional advice as appropriate.

The Group is therefore exposed to potential future increases in required contributions and capital set aside for pension risk.

Capital management

For the period ended 31 December 2012

All the amounts are stated in £m unless otherwise indicated

Capital resources (audited)

The Bank's policy is to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. However, the Bank still recognises the need to maintain a balance between the potential higher returns that might be achieved with greater gearing, and the advantages and security afforded by a sound capital position.

Our submissions to the FSA in the period have shown that the Bank and its individually regulated operations have complied with all externally imposed capital requirements.

The Bank's Core Tier 1 capital position at the year end was 8.8% (2011: 9.6%). However, the Board recognises the need to build the capitalisation of the Bank to provide increased resilience and capacity for future growth. To this end, a strategic review is underway targeting growth in the Core Tier 1 ratio. Part of this was concluded in January 2013 when a risk mitigation transaction completed which would increase the year end ratio to 9.2% on a proforma basis.

Adequate capitalisation can be maintained at all times even under the most severe stress scenarios, including the revised FSA 'anchor' stress scenario.

A capital buffer above Individual Capital Guidance (ICG) is being maintained, to provide the ability to absorb capital shocks and ensure sufficient surplus capital is available at all times to cover the Bank's regulatory minimum requirements.

The Bank's regulatory capital is analysed into two tiers:

Tier 1 capital

Tier 1 capital includes share capital, retained earnings, and non-cumulative irredeemable preference shares. Retained earnings exclude gains or losses on cashflow hedges and available for sale assets.

Tier 2 capital

Revaluation reserves relating to net gains on equity held in the available for sale financial assets category are included in Tier 2 capital.

The Tier 2 capital includes subordinated debt issues and perpetual subordinated bonds (PSBs). The rights of payment to the holders of this debt are subordinated to the claims of depositors and other creditors of the Bank. More information on these can be found in note 29.

	2012	2011
Reconciliation of equity per balance sheet to Core Tier 1 capital		
Total equity per balance sheet	**1,850.2**	2,273.1
Regulatory adjustments:		
Minority interests	**(0.4)**	(1.2)
Retained earnings	**–**	(49.8)
Available for sale reserve	**(30.0)**	(19.5)
Cashflow hedging reserve	**(63.7)**	(67.6)
Core Tier 1 capital before regulatory deductions	**1,756.1**	2,135.0

	2012	2011
Core Tier 1 capital before regulatory deductions:		
Permanent share capital	**410.0**	410.0
Retained earnings	**1,813.4**	1,686.0
Minority interests	**32.0**	30.2
Losses for the year	**(508.1)**	–
Share premium account	**8.8**	8.8
Total Core Tier 1 capital before regulatory deductions	**1,756.1**	2,135.0
Regulatory deductions from Core Tier 1 capital:		
Intangible assets	**(27.9)**	(71.1)
50% of excess of expected losses over impairment (net of tax)	**(159.7)**	(114.2)
50% of securitisation positions	**(0.7)**	(2.3)
Total Core Tier 1 capital after regulatory deductions	**1,567.8**	1,947.4
Other Tier 1 capital:		
Non-cumulative irredeemable preference shares	**60.0**	60.0
Regulatory deductions from other Tier 1 capital:		
50% of tax on excess of expected losses over impairment	**51.8**	41.1
50% of material holdings	**(2.0)**	(1.3)
Total Tier 1 capital after regulatory deductions	**1,677.6**	2,047.2
Tier 2 capital before regulatory deductions:		
Revaluation reserves	**2.0**	2.9
Collective provisions	**0.7**	0.7
Subordinated notes and perpetual subordinated bonds	**1,112.1**	1,084.0
Total Tier 2 capital before regulatory deductions	**1,114.8**	1,087.6
Regulatory deductions from Tier 2 capital:		
50% of excess of expected losses over impairment (gross of tax)	**(211.5)**	(155.3)
50% of securitisation positions	**(0.7)**	(2.3)
50% of material holdings	**(2.0)**	(1.3)
Total Tier 2 capital after regulatory deductions	**900.6**	928.7
Total capital resources	**2,578.2**	2,975.9

The capital ratios reported in the business and financial review are based on the Pillar I capital requirement.

Capital allocation

The allocation of capital among specific operations and activities is driven by optimisation of the return achieved on the capital allocated, and is based upon the regulatory capital. Capital allocation is undertaken independently of those responsible for capital management, and is reviewed by ALCO. Each new product must earn at least the Bank's minimum target return on equity.

Capital management continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

	2012	2011
Capital ratios (unaudited)		
Core Tier 1 ratio	**8.8%**	9.6%
Tier 1 ratio	**9.4%**	10.1%
Total capital ratio	**14.4%**	14.7%
Risk-weighted assets (unaudited)		
Credit risk	**15,974.8**	18,687.4
Market and counterparty risk	**492.6**	51.6
Operational risk	**1,441.3**	1,521.0
Total risk-weighted assets	**17,908.7**	20,260.0
Segmental analysis of credit risk risk-weighted assets (unaudited)		
Retail	**2,410.1**	2,333.9
Corporate	**7,760.3**	9,777.2
Other CABB	**4,361.2**	4,786.7
CABB total	**12,121.5**	14,563.9
Treasury	**1,149.1**	1,151.3
Other	**294.1**	638.3
Total credit risk risk-weighted assets	**15,974.8**	18,687.4

Core Tier 1 ratio has reduced by 0.8% to 8.8% as at 31 December 2012. This is due to a 19% (£379.6m) decrease in Core Tier 1 after deductions offset by a 12% (£2,351.3m) decrease in risk-weighted assets.

The reduction in Core Tier 1 is primarily due to the £673.7m before tax (£508.1m after tax) statutory loss. The result for the year was principally driven by a £468.7m credit impairment, £150.0m asset impairment and £149.7m PPI provision offset by a £96.8m operating profit in the core business. Core Tier 1 has benefited from a £80m capital injection from The Co-operative Banking Group.

The reduction in risk-weighted assets is primarily due to a 21% (£2,016.9m) reduction in corporate risk-weighted assets. The change is driven by the reassessment of the carrying value of corporate real estate exposures together with an ongoing review of regulatory capital requirements. Slotting models are used to analyse and monitor specialised lending exposures to property which are assigned to FSA 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). Downgrades are the primary reason for the reduction in corporate risk-weighted assets.

In addition, other CABB risk-weighted assets, mainly Optimum, have decreased by 9% (£425.5m) due to continuing run-off of the book. However, market and counterparty risk capital requirements have increased by £441.0m. This is primarily due to increased holdings of short dated gilts, UK covered and UK government guaranteed bond holdings which were purchased to invest the Bank's surplus liquidity.

Total excess of expected loss over impairment, a deduction from capital resources, has increased by £91.0m. Although credit impairments have increased significantly this has been more than offset by higher expected loss which has been driven by corporate downgrades.

Since the year end, the Bank has completed a securitisation transaction to reduce risk in the balance sheet which has improved the Core Tier 1 ratio by 0.4%. The signing of the Sale and Purchase Agreement relating to the Life and Savings business owned by The Co-operative Banking Group in 2013 is expected to further strengthen the capital position.

Basel III

Basel III rules in the EU (collectively known as CRD IV) have yet to be finalised and the implementation date is not known. The new rules will be implemented on a transitional basis from their effective date to full implementation in 2022 (at the earliest). During the transitional period to full implementation of Basel III the Bank will have the opportunity to generate additional capital from earnings and to implement management actions in order to mitigate the impact of Basel III and meet capital ratios. The Bank expects to be able to comply fully with the new requirements when they become applicable, including the proposed minimum leverage ratio of 3%.

The Bank continues to monitor its capital position under draft rules on both a transitional and full implementation basis. An analysis of capital resources and leverage ratio assuming draft Basel III rules were in place as at 31 December 2012 which can be found in the Bank Pillar 3 disclosure.

Notes to the financial statements

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

1. Segmental information

In 2011, the Bank reported its operating segments as Retail, Corporate and Business Banking (CABB) and Other, based on differences in products and services. In 2012, the Bank has further refined this to split its Corporate area into core and non-core and to move the Platform portfolio from CABB to the Retail business. The comparatives throughout the note have been restated as appropriate.

This level of information has been presented to the Board throughout the year. 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.

The Bank is comprised of the following main reportable segments:

- **Retail** – customer focused products and services for individuals, sole traders and small businesses. This includes mortgages, credit cards, consumer loans, current accounts and savings products;
- **CABB** – customer focused products and services for businesses, including large corporate and commercial entities. It includes loans, asset finance, current accounts and savings products. Core Corporate banking represents lines of business that are consistent with our strategy and risk appetite while non-core lines of business are targeted for run down or exit. CABB also includes the Optimum closed book of acquired mortgage portfolios and mortgages originated via intermediaries by Britannia, and the Illius portfolio of investment properties; and
- **Other** – includes Treasury, other central costs and Unity Trust Bank. Treasury comprises asset and liability management across the balance sheet, including trading activities. Unity Trust is a subsidiary bank operating in the corporate banking and social economy sectors on behalf of trade unions.

			Non-core						
	Retail	Corporate core	Corporate non-core	Other CABB	**Total CABB**	Treasury	Other	**Total Other**	**Total**
2012									
Net interest income	**399.9**	108.4	(22.6)	9.6	**95.4**	41.2	9.3	**50.5**	**545.8**
Non-interest income	**135.8**	55.2	2.7	15.4	**73.3**	14.8	1.5	**16.3**	**225.4**
Operating income	**535.7**	163.6	(19.9)	25.0	**168.7**	56.0	10.8	**66.8**	**771.2**
Operating expenses	**(444.2)**	(80.0)	(5.7)	(25.6)	**(111.3)**	(20.0)	(7.5)	**(27.5)**	**(583.0)**
Impairment losses on loans and advances	**(41.4)**	(79.9)	(346.6)	(4.5)	**(431.0)**	–	(1.7)	**(1.7)**	**(474.1)**
Impairment gains on investments	**–**	–	–	–	**–**	5.3	0.1	**5.4**	**5.4**
Operating profit/(loss)	**50.1**	3.7	(372.2)	(5.1)	**(373.6)**	41.3	1.7	**43.0**	**(280.5)**
Significant items									**(85.1)**
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)**

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 Group's activities are primarily in the UK.

Notes to the financial statements continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

1. Segmental information continued

	2012
Reconciliation to statutory income statement	
Net interest income	
Total interest margin for reportable segments	**545.8**
Interest fair value unwind	**20.0**
Net interest income	**565.8**
Non-interest income	
Total non-interest income for reportable segments	**225.4**
Interest fair value unwind	**(0.2)**
Non-interest income before significant items	**225.2**
Comprising:	
Net fee and commission income	**177.2**
Net trading income	**14.1**
Other operating income	**33.9**
Non-interest income before significant items	**225.2**
Operating expenses	
Total operating expenses for reportable segments	**(583.0)**
Interest fair value unwind	**(4.6)**
Operating expenses before significant items	**(587.6)**
Interest fair value unwind	
Total interest unwind for reportable segments	**15.2**
Interest margin unwind	**(20.0)**
Non-interest income unwind	**0.2**
Operating expenses unwind	**4.6**
Interest fair value unwind	**–**

			Non-core						
	Retail	Corporate core	Corporate non-core	Other CABB	Total CABB	Treasury	Other	Total Other	Total
2011									
Net interest income	400.5	101.7	(19.2)	65.4	147.9	59.2	11.2	70.4	618.8
Non-interest income	149.5	51.5	1.9	15.3	68.7	(20.6)	1.2	(19.4)	198.8
Operating income	550.0	153.2	(17.3)	80.7	216.6	38.6	12.4	51.0	817.6
Operating expenses	(423.5)	(79.2)	(6.8)	(29.7)	(115.7)	(15.3)	(7.1)	(22.4)	(561.6)
Impairment losses on loans and advances	(34.4)	(61.5)	(25.9)	2.8	(84.6)	–	(1.5)	(1.5)	(120.5)
Impairment gains on investments	–	–	–	–	–	5.6	–	5.6	5.6
Operating profit/(loss)	92.1	12.5	(50.0)	53.8	16.3	28.9	3.8	32.7	141.1
Significant items									(53.3)
PPI provision									(90.0)
Share of post tax profits from joint ventures									0.2
Financial Services Compensation Scheme levies									(14.5)
Fair value amortisation									86.3
Membership dividends									(15.6)
Profit before taxation									54.2
Income tax									(4.4)
Profit for the financial year									49.8

1. Segmental information continued

	2011
Reconciliation to statutory income statement	
Net interest income	
Total interest margin for reportable segments	618.8
Gains on sale of investment securities – loans and receivables	(37.2)
Interest fair value unwind	53.4
Net interest income	635.0
Non-interest income	
Total non-interest income for reportable segments	198.8
Gains on sale of investment securities – loans and receivables	37.2
Non-interest income before significant items	236.0
Comprising:	
Net fee and commission income	185.2
Net trading income	4.5
Other operating income	46.3
Non-interest income before significant items	236.0
Operating expenses	
Total operating expenses for reportable segments	(561.6)
Interest fair value unwind	32.9
Operating expenses before significant items	(528.7)
Interest fair value unwind	
Total interest unwind for reportable segments	86.3
Interest margin unwind	(53.4)
Operating expenses unwind	(32.9)
Interest fair value unwind	–

	Retail	Corporate core	Corporate non-core	Optimum	Treasury	Total
2012						
Segment assets	**17,662.7**	**5,412.5**	**2,837.5**	**7,645.2**	**13,170.9**	**46,728.8**
Unallocated assets						**1,858.5**
Total assets for reportable segments						**48,587.3**
Statutory reclassifications						**986.1**
Consolidated total assets						**49,573.4**

	Retail	Corporate core	Corporate non-core	Optimum	Treasury	Total
Segment liabilities	**28,141.5**	**7,582.8**	**–**	**–**	**9,884.7**	**45,609.0**
Unallocated liabilities						**863.9**
Total liabilities for reportable segments						**46,472.9**
Statutory reclassifications						**1,250.3**
Consolidated total liabilities						**47,723.2**

Notes to the financial statements continued

For the year ended 31 December 2012
All amounts are stated in £m unless otherwise indicated

1. Segmental information continued

	Retail	Corporate core	Corporate non-core	Optimum	Treasury	Total
2011						
Segment assets	17,657.8	5,237.5	3,274.3	8,035.9	12,342.0	46,547.5
Unallocated assets						1,813.2
Total assets for reportable segments						48,360.7
Statutory reclassifications						594.9
Consolidated total assets						48,955.6

	Retail	Corporate core	Corporate non-core	Optimum	Treasury	Total
Segment liabilities	27,859.2	7,657.9	–	–	9,004.9	44,522.0
Unallocated liabilities						1,426.5
Total liabilities for reportable segments						45,948.5
Statutory reclassifications						734.0
Consolidated total liabilities						46,682.5

2. Loss/profit before taxation

	2012 £'000	Restated 2011 £'000
Loss/profit before taxation is stated after:		
Audit of these financial statements	**367**	356
Amounts receivable by the Company's auditor and its associates in respect of:		
Audit of financial statements of subsidiaries of the Company	**325**	335
Audit related assurance services	**28**	11
Other tax advisory services	**–**	311
Other assurance services	**460**	149
Corporate finance services	**–**	90
All other services	**1,944**	365
	3,124	1,617

The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) (Amendment) Regulations 2011 is mandatory for periods starting on or after 1 October 2011. The comparatives in respect of the disclosures of Auditor Remuneration have been restated accordingly.

Amounts paid to the Bank's auditor and its associates in respect of services to the Bank, other than the audit of the Bank's financial statements, have not been disclosed as the information is required instead to be disclosed on a consolidated basis. Included within all other services are recharges of £1,038k (2011: £nil) in respect of assurance services relating to the bid for the Lloyds Bank branches.

3. Directors' emoluments

	2012 £'000	2011 £'000
Executive directors	**479**	1,645
Compensation for loss of office	**–**	926
	479	2,571

Directors' activities are undertaken across The Co-operative Banking Group. The figures above reflect the Group's share of these services.

Retirement benefits are accruing to one director (2011: one) under defined benefit schemes.

The aggregate of emoluments and amounts receivable under incentive schemes of the highest paid director was £479k (2011: £549k). Accrued pension under defined benefit pension schemes at the year end was £21k (2011: £15k).

All Non-Executive Directors are appointed and their directors' fees are determined and paid by The Co-operative Group and therefore no amounts are shown above (2011: £nil). Further details of directors' emoluments are included in the remuneration report on pages 20 to 28. The remuneration report is unaudited.

4. Net interest income

	2012	2011
Interest receivable and similar income		
On financial assets not at fair value through income or expense:		
On loans and advances to customers	**1,390.0**	1,482.4
On loans and advances to banks	**31.2**	14.3
On investment securities	**149.8**	210.6
	1,571.0	1,707.3
On financial assets at fair value through income or expense:		
Net interest expense on financial instruments hedging assets	**(133.4)**	(128.1)
Net interest income on financial instruments not in a hedging relationship	**50.7**	4.5
	1,488.3	1,583.7

Included within interest receivable is £17.8m (2011: £9.9m) relating to profit on sale of investment securities – available for sale.

Interest income accrued on impaired financial assets during the year was £48.5m (2011: £55.5m, restated to reflect revision of impairment criteria). Interest due to unwinding of discount on impairment provisions relating to impaired financial assets amounted to £7.1m (2011: £2.4m).

In 2011, the Optimum credit fair value adjustment was revalued resulting in additional income of £20.0m. There was no further revaluation in 2012.

	2012	2011
Interest expense and similar charges		
On financial liabilities not at fair value through income or expense:		
On customer accounts	**506.9**	524.4
On bank and other deposits	**227.9**	230.9
On subordinated liabilities	**77.0**	98.5
On perpetual secured debt	**43.2**	42.0
	855.0	895.8
On financial liabilities at fair value through income or expense:		
Net interest expense on financial instruments hedging liabilities	**33.7**	52.0
Net interest expense on financial instruments not in a hedging relationship	**33.8**	0.9
	922.5	948.7

5. Net fee and commission income

	Before significant items 2012	Significant items 2012	After significant items 2012	Before significant items 2011	Significant items 2011	After significant items 2011
Fee and commission income						
On items not at fair value through income or expense	**251.0**	**(149.7)**	**101.3**	250.1	(90.0)	160.1
On trust or fiduciary activities that result from holding or investing in assets on behalf of others	**0.2**	**–**	**0.2**	1.1	–	1.1
	251.2	**(149.7)**	**101.5**	251.2	(90.0)	161.2
Fee and commission expense						
On items not at fair value through income or expense	**66.0**	**–**	**66.0**	57.6	–	57.6
On items at fair value through income or expense	**8.0**	**–**	**8.0**	8.4	–	8.4
	74.0	**–**	**74.0**	66.0	–	66.0

The significant item in 2012 of £149.7m (2011: £90.0m) is a provision for customer compensation relating to past sales of PPI in response to the FSA's policy statement published on 10 August 2010. The Bank stopped selling non-mortgage PPI at the beginning of 2009 and stopped selling mortgage PPI in 2012.

The 2011 comparatives reflect a reclassification of £11.6m between fee and commission income – items not at fair value through income or expense and fee and commission expense – items not at fair value through income or expense.

Notes to the financial statements continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

6. Net trading income

	2012	2011
Foreign exchange	**5.3**	3.7
Other interest rate instruments	**8.8**	0.8
	14.1	4.5

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.

7. Other operating income

	2012	2011
Profit on sale of investment securities – loans and receivables	**15.7**	37.2
Profit on sale of loans and advances to banks	**9.3**	–
Rent receivable from investment properties (note 21)	**8.4**	7.9
Other rent receivable	**–**	1.3
Change in fair value of investment properties (note 21)	**0.2**	(0.1)
Other	**0.3**	–
	33.9	46.3

The profit on sale of investment securities arose from the restructuring of a portfolio of assets. Profit on smaller disposals in the normal course of business are included in net interest income.

8. Operating expenses

	Before significant items 2012	Significant items 2012	After significant items 2012	Before significant items 2011	Significant items 2011	After significant items 2011
Staff costs (note 9)	**266.5**	**27.9**	**294.4**	294.7	34.8	329.5
Administrative expenses	**267.7**	**207.2**	**474.9**	175.6	18.5	194.1
Depreciation of property, plant and equipment (note 22)	**14.8**	**–**	**14.8**	19.6	–	19.6
Amortisation of intangible fixed assets (note 20)	**6.2**	**–**	**6.2**	6.4	–	6.4
Loss on sale of property, plant and equipment	**0.9**	**–**	**0.9**	0.3	–	0.3
Operating lease rentals	**28.0**	**–**	**28.0**	28.4	–	28.4
Property provisions for liabilities and charges provided in the year (note 32)	**0.8**	**–**	**0.8**	0.4	–	0.4
Property provisions for liabilities and charges released during the year (note 32)	**(0.3)**	**–**	**(0.3)**	(0.3)	–	(0.3)
Other provisions for liabilities and charges provided in the year (note 32)	**0.5**	**–**	**0.5**	0.1	–	0.1
Other provisions for liabilities and charges released during the year (note 32)	**(0.6)**	**–**	**(0.6)**	(0.1)	–	(0.1)
Direct expenses from investment properties that generated rental income in the year	**3.0**	**–**	**3.0**	3.5	–	3.5
Direct expenses from investment properties that did not generate rental income in the year	**0.1**	**–**	**0.1**	0.1	–	0.1
	587.6	**235.1**	**822.7**	528.7	53.3	582.0

The significant items relate to £47.0m (2011: £53.3m) of costs incurred on a programme of investment and integration, £38.1m (2011: £nil) of costs incurred as a result of the bid for the Lloyds Bank branches and £150.0m (2011: £nil) of recharged costs relating to impairment of intangible fixed assets.

No expenditure has been incurred in respect of the Government's Bank Levy since the relevant aggregate liabilities of the Group are below the qualifying threshold.

9. Staff costs

	Before significant items 2012	Significant items 2012	After significant items 2012	Before significant items 2011	Significant items 2011	After significant items 2011
Wages and salaries	**188.0**	**9.8**	**197.8**	210.8	14.1	224.9
Social security costs	**15.8**	**1.0**	**16.8**	20.9	0.7	21.6
Pension costs:						
Defined benefit plans (note 34)	**0.2**	**–**	**0.2**	0.2	–	0.2
Defined contribution plans (note 34)	**32.6**	**1.1**	**33.7**	29.0	0.8	29.8
Other staff costs	**29.9**	**16.0**	**45.9**	33.8	19.2	53.0
	266.5	**27.9**	**294.4**	294.7	34.8	329.5

The Bank staff costs included above are £239.0m before significant items and £266.8m after significant items (2011: £262.5m before significant items, £297.4m after significant items).

Average number of employees
The average number of persons working for the Group and the Bank during the year is as follows:

	Group No. of employees 2012	No. of employees 2011	Bank No. of employees 2012	No. of employees 2011
Full time	**6,082**	6,260	**5,630**	5,751
Part time	**2,025**	2,104	**1,916**	1,988
	8,107	8,364	**7,546**	7,739

Employee activities are undertaken across The Co-operative Banking Group and the figures above reflect the Group and Bank's share of these services.

10. Income tax

	Before significant items 2012	Significant items 2012	After significant items 2012	Before significant items 2011	Significant items 2011	After significant items 2011
Current tax – current year	**(70.4)**	**(77.0)**	**(147.4)**	(3.4)	(38.0)	(41.4)
Current tax – prior year	**(2.5)**	**–**	**(2.5)**	(6.2)	–	(6.2)
Deferred tax – current year (note 33)	**(8.8)**	**–**	**(8.8)**	61.7	–	61.7
Deferred tax – prior year (note 33)	**(6.9)**	**–**	**(6.9)**	(9.7)	–	(9.7)
	(88.6)	**(77.0)**	**(165.6)**	42.4	(38.0)	4.4

Further information on deferred income tax is presented in note 33. The tax on the Group's (loss)/profit before taxation differs from the theoretical amount that would arise using the corporation tax rate in the UK as follows:

	2012	2011
(Loss)/profit before taxation	**(673.7)**	54.2
Tax calculated at a rate of 24.5% (2011: 26.49%)	**(165.0)**	14.4
Effects of:		
Preference share interest not deductible for tax purposes	**1.4**	1.5
Expenses not deductible for tax purposes	**5.1**	0.1
Depreciation of expenditure not qualifying for capital allowances	**1.2**	1.2
Profits taxed at lower rates	**(0.7)**	(1.2)
Non-taxable income	**(0.4)**	(0.1)
Adjustments to tax charge in respect of prior periods	**(9.4)**	(15.9)
Change in rate of deferred tax (note 33)	**4.5**	4.7
Other differences	**(2.3)**	(0.3)
	(165.6)	4.4

The 2012 adjustments to tax charge in respect of prior periods of £9.4m relates to accelerated capital allowances. In 2011, the adjustment included £13.0m relating to the taxation of a contingent consideration.

Notes to the financial statements continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

11. Group profit attributable to equity shareholders dealt with in the accounts of The Co-operative Bank plc

	Before significant items 2012	**Significant items 2012**	**After significant items 2012**	Before significant items 2011	Significant items 2011	After significant items 2011
Net (loss)/profit attributable to equity shareholders of the Bank	**(280.4)**	**(307.8)**	**(588.2)**	11.9	(105.2)	(93.3)

As permitted by Section 408 of the Companies Act 2006, the income statement of The Co-operative Bank plc has not been presented separately.

12. Earnings per share

Basic earnings per share is calculated by dividing the net profit attributable to equity shareholders of the Bank by the weighted average number of ordinary shares in issue during the year.

	Before significant items 2012	**Significant items 2012**	**After significant items 2012**	Before significant items 2011	Significant items 2011	After significant items 2011
Profit attributable to equity shareholders of the Bank	**(201.3)**	**(307.8)**	**(509.1)**	153.3	(105.3)	48.0
Ordinary shares in issue (millions)						
At the beginning and end of the year	**8,200.0**	**8,200.0**	**8,200.0**	8,200.0	8,200.0	8,200.0
Weighted average number of ordinary shares in issue (millions)	**8,200.0**	**8,200.0**	**8,200.0**	8,200.0	8,200.0	8,200.0
Basic earnings per share (expressed in pence per share)	**(2.46)**	**(3.75)**	**(6.21)**	1.87	(1.28)	0.59

13. Cash and balances at central banks

	Group		**Bank**	
	2012	2011	**2012**	2011
Cash in hand	**272.6**	280.3	**272.6**	280.3
Balances with the Bank of England other than mandatory reserve deposits	**5,121.0**	6,378.3	**5,121.0**	6,378.3
Included in cash and cash equivalents	**5,393.6**	6,658.6	**5,393.6**	6,658.6
Mandatory reserve deposits with the Bank of England	**39.4**	38.0	**39.4**	38.0
	5,433.0	6,696.6	**5,433.0**	6,696.6

Mandatory reserve deposits are not available for use in the Group and Bank's day to day operations, are non-interest bearing and are not included in cash and cash equivalents.

14. Loans and advances to banks

	Group		**Bank**	
	2012	2011	**2012**	2011
Items in course of collection from other banks	**103.9**	123.2	**103.9**	123.2
Placements with other banks	**746.7**	896.6	**731.9**	885.1
Included in cash and cash equivalents	**850.6**	1,019.8	**835.8**	1,008.3
Other loans and advances to banks	**1,053.5**	986.7	**211.4**	291.8
	1,904.1	2,006.5	**1,047.2**	1,300.1

15. Loans and advances to customers

	Group		**Bank**	
	2012	2011	**2012**	2011
Gross loans and advances	**33,982.5**	34,058.0	**23,203.7**	22,993.1
Less: allowance for losses	**(643.0)**	(292.0)	**(418.2)**	(258.1)
	33,339.5	33,766.0	**22,785.5**	22,735.0

Group and Bank loans and advances to customers include £153.6m (2011: £114.1m) 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, £48.7m (2011: £36.7m) are secured by real estate collateral.

15. Loans and advances to customers continued

Loans and advances to customers include £10,997.3m (2011: £9,099.8m) securitised under the Group's securitisation and covered bond programmes. The Group remains exposed to substantially all of the risks and rewards of ownership of these assets. Included within Group deposits by banks (note 25) are £58.4m (2011: £61.9m) of loans from external third parties and within Group debt securities in issue (note 28) are £4,144.5m (2011: £3,989.4m) of fixed and floating rate notes, all secured on these mortgage assets. Included within amounts owed by other Co-operative Group undertakings in the Bank are £6,297.3m (2011: £4,749.5m) of floating rate notes issued to the Bank and £1,014.7m (2011: £1,000.3m) of other loans, secured on these mortgage assets.

Concentration of exposure
The Group's exposure is virtually all within the UK. There is a detailed analysis of the concentration of exposure within the risk management disclosures, on pages 65 and 66.

Allowance for losses on loans and advances

Group	Individual retail	Individual corporate	Collective retail	Collective corporate	Total
2012					
At the beginning of the year	**9.0**	**105.1**	**165.7**	**12.2**	**292.0**
Charge against profits	**8.5**	**379.6**	**43.5**	**11.6**	**443.2**
Amounts written off	**(6.9)**	**(47.5)**	**(29.4)**	**(1.4)**	**(85.2)**
Unwind of discount allowance	**–**	**(3.7)**	**(3.4)**	**–**	**(7.1)**
Interest charged on impaired loans	**–**	**0.1**	**–**	**–**	**0.1**
At the end of the year	**10.6**	**433.6**	**176.4**	**22.4**	**643.0**
2011					
At the beginning of the year	8.6	55.8	157.8	0.4	222.6
Charge against profits	4.9	76.6	36.4	12.6	130.5
Amounts written off	(4.5)	(27.1)	(26.6)	(0.8)	(59.0)
Unwind of discount allowance	–	(0.5)	(1.9)	–	(2.4)
Interest charged on impaired loans	–	0.3	–	–	0.3
At the end of the year	9.0	105.1	165.7	12.2	292.0

Bank	Individual retail	Individual corporate	Collective retail	Collective corporate	Total
2012					
At the beginning of the year	**2.6**	**86.1**	**163.7**	**5.7**	**258.1**
Charge against profits	**1.0**	**171.4**	**42.3**	**9.3**	**224.0**
Amounts written off	**(1.1)**	**(25.9)**	**(29.3)**	**(1.4)**	**(57.7)**
Unwind of discount allowance	**–**	**(2.9)**	**(3.4)**	**–**	**(6.3)**
Interest charged on impaired loans	**–**	**0.1**	**–**	**–**	**0.1**
At the end of the year	**2.5**	**228.8**	**173.3**	**13.6**	**418.2**
2011					
At the beginning of the year	2.9	49.4	157.8	0.4	210.5
Charge against profits	0.5	62.4	34.4	6.1	103.4
Amounts written off	(0.8)	(25.6)	(26.6)	(0.8)	(53.8)
Unwind of discount allowance	–	(0.4)	(1.9)	–	(2.3)
Interest charged on impaired loans	–	0.3	–	–	0.3
At the end of the year	2.6	86.1	163.7	5.7	258.1

The net impairment charge in the Group income statement is £474.1m (2011: £120.5m). This includes amounts recovered by the Group of £6.1m (2011: £10.0m) 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.

The impairment charge also includes a provision of £37.0m (2011: £nil) made against fair value adjustments for hedged risk during the year (as shown in the fair value adjustments for hedged risk tables).

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All amounts are stated in £m unless otherwise indicated

15. Loans and advances to customers continued

Loans and advances to customers include finance lease receivables:

	Group		Bank	
	2012	2011	**2012**	2011
Gross investment in finance leases may be analysed as follows:				
No later than one year	**22.2**	26.1	**16.2**	20.2
Later than one year and no later than five years	**68.6**	62.8	**43.6**	41.9
Later than five years	**73.4**	82.2	**66.7**	65.6
	164.2	171.1	**126.5**	127.7
Unearned future finance income on finance leases	**(44.1)**	(47.7)	**(34.7)**	(35.4)
Net investment in finance leases	**120.1**	123.4	**91.8**	92.3
The net investment in finance leases may be analysed as follows:				
No later than one year	**15.5**	19.1	**11.7**	15.6
Later than one year and no later than five years	**47.9**	40.9	**29.0**	27.5
Later than five years	**56.7**	63.4	**51.1**	49.2
	120.1	123.4	**91.8**	92.3

There are no unguaranteed residual values for any of the finance leases.

The Group 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 £nil (2011: £0.1m).

Fair value adjustments for hedged risk

The Group 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.

	Group		Bank	
	2012	2011	**2012**	2011
Gross fair value adjustments for hedged risk	**391.2**	366.3	**391.1**	365.8
Less: impairment provision	**(37.0)**	–	**(37.0)**	–
	354.2	366.3	**354.1**	365.8

Movements on impairment provision on fair value adjustments for hedged risk are shown below:

	Group		Bank	
	2012	2011	**2012**	2011
At the beginning of the year	**–**	–	**–**	–
Charge against profits	**37.0**	–	**37.0**	–
At the end of the year	**37.0**	–	**37.0**	–

16. Investment securities

Loans and receivables

	Group		Bank	
	2012	2011	**2012**	2011
Loans and receivables				
Listed	**–**	113.5	**–**	113.5
Unlisted	**295.0**	694.1	**355.4**	755.3
	295.0	807.6	**355.4**	868.8
Less: allowance for losses	**–**	(2.7)	**–**	(2.7)
	295.0	804.9	**355.4**	866.1
Included in cash and cash equivalents	**–**	–	**–**	–

The movement in investment securities – loans and receivables excluding interest amounts is summarised as follows:

	Group		Bank	
	2012	2011	**2012**	2011
At the beginning of the year	**803.3**	1,914.7	**864.5**	1,984.2
Acquisitions	**–**	107.5	**–**	107.5
Disposals and maturities	**(582.0)**	(1,426.6)	**(587.9)**	(1,430.2)
Exchange adjustments	**(2.8)**	1.6	**(2.8)**	1.6
Fair value movements through income or expense	**–**	–	**–**	(0.3)
Amortisation	**73.5**	195.8	**78.6**	191.4
Release and utilisation of impairment provision	**2.7**	10.3	**2.7**	10.3
At the end of the year	**294.7**	803.3	**355.1**	864.5

Impairment analysis of investment securities – loans and receivables

	Group		Bank	
	2012	2011	**2012**	2011
At the beginning of the year	**2.7**	13.0	**2.7**	13.0
Released during the year	**(2.7)**	(5.6)	**(2.7)**	(5.6)
Utilised during the year	**–**	(4.7)	**–**	(4.7)
At the end of the year	**–**	2.7	**–**	2.7

Available for sale

	Group		Bank	
	2012	2011	**2012**	2011
Available for sale				
Listed	**3,552.3**	3,098.6	**3,552.3**	3,098.6
Unlisted	**276.1**	366.9	**50.6**	51.3
	3,828.4	3,465.5	**3,602.9**	3,149.9
Less: allowance for losses	**(39.0)**	(42.5)	**(39.0)**	(42.5)
	3,789.4	3,423.0	**3,563.9**	3,107.4
Included in cash and cash equivalents	**70.0**	210.0	**–**	–

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16. Investment securities continued

The movement in investment securities – available for sale excluding interest amounts is summarised as follows:

	Group		Bank	
	2012	2011	**2012**	2011
At the beginning of the year	**3,405.5**	2,948.1	**3,090.5**	2,613.0
Acquisitions	**3,962.8**	8,328.8	**2,617.8**	6,888.9
Disposals and maturities	**(3,608.2)**	(8,122.7)	**(2,173.1)**	(6,662.7)
Exchange adjustments	**(8.1)**	(12.7)	**(8.1)**	(12.7)
Fair value movements through equity	**108.7**	101.6	**108.7**	101.6
Fair value movements through income or expense	**(68.2)**	124.9	**(68.2)**	124.9
Amortisation	**(19.7)**	7.9	**(19.7)**	7.9
Release and utilisation of impairment provision	**2.7**	29.6	**2.7**	29.6
At the end of the year	**3,775.5**	3,405.5	**3,550.6**	3,090.5

The 2011 movement in investment securities – available for sale, for the Group and Bank, have been updated to reflect a reclassification of amortisation.

Impairment analysis of investment securities – available for sale

	Group		Bank	
	2012	2011	**2012**	2011
At the beginning of the year	**42.5**	72.3	**42.5**	72.3
Released during the year	**(2.7)**	–	**(2.7)**	–
Utilised during the year	**–**	(29.6)	**–**	(29.6)
Exchange adjustments	**(0.8)**	(0.2)	**(0.8)**	(0.2)
At the end of the year	**39.0**	42.5	**39.0**	42.5

Fair value through income or expense

	Group		Bank	
	2012	2011	**2012**	2011
Fair value through income or expense				
Listed	**1,845.2**	343.1	**1,845.2**	343.1
	1,845.2	343.1	**1,845.2**	343.1
Less: allowance for losses	**–**	–	**–**	–
	1,845.2	343.1	**1,845.2**	343.1
Included in cash and cash equivalents	**–**	–	**–**	–

The movement in investment securities – fair value through income or expense excluding interest amounts is summarised as follows:

	Group		Bank	
	2012	2011	**2012**	2011
At the beginning of the year	**339.5**	26.5	**339.5**	26.5
Acquisitions	**1,895.5**	339.0	**1,895.5**	339.0
Disposals and maturities	**(410.8)**	(25.0)	**(410.8)**	(25.0)
Exchange adjustments	**(0.1)**	–	**(0.1)**	–
Fair value movements through income or expense	**6.5**	(1.0)	**6.5**	(1.0)
At the end of the year	**1,830.6**	339.5	**1,830.6**	339.5

The 2011 movement in investment securities – fair value through income or expense, for the Group and Bank, have been updated to reflect a reclassification of amortisation.

16. Investment securities continued

Held for trading

	Group 2012	Group 2011	Bank 2012	Bank 2011
Held for trading				
Listed	**960.2**	–	**960.2**	–
	960.2	–	**960.2**	–
Less: allowance for losses	**–**	–	**–**	–
	960.2	–	**960.2**	–
Included in cash and cash equivalents	**–**	–	**–**	–

The movement in investment securities – held for trading excluding interest amounts may be summarised as follows:

	Group 2012	Group 2011	Bank 2012	Bank 2011
At the beginning of the year	**–**	–	**–**	–
Acquisitions	**1,268.8**	280.0	**1,268.8**	280.0
Disposals and maturities	**(321.6)**	(280.0)	**(321.6)**	(280.0)
Fair value movements through income or expense	**7.1**	–	**7.1**	–
At the end of the year	**954.3**	–	**954.3**	–

Analysis of investment securities by issuer

	Group 2012	Group 2011	Bank 2012	Bank 2011
Investment securities issued by public bodies:				
Government securities	**2,184.9**	1,834.5	**2,184.9**	1,834.5
Other public sector securities	**2,208.5**	563.6	**2,208.5**	563.6
	4,393.4	2,398.1	**4,393.4**	2,398.1
Investment securities issued by other issuers:				
Bank and building society certificates of deposits	**225.5**	315.7	**–**	–
Other debt securities:				
Other floating rate notes	**1,975.9**	1,165.9	**1,975.9**	1,165.9
Mortgage backed securities	**295.0**	691.3	**355.4**	752.6
	2,270.9	1,857.2	**2,331.3**	1,918.5
	6,889.8	4,571.0	**6,724.7**	4,316.6

Other floating rate notes (FRNs) relate to sterling, euro and US dollar denominated FRNs with maturities ranging from one month to 12 years from the balance sheet date.

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17. Derivative financial instruments

The Bank, as principal, has entered 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 Group does not have a legal right of offset.

Derivatives held for trading purposes

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.

Non-trading derivatives

Non-trading transactions comprise derivatives held for hedging purposes to manage the asset and liability positions of the Group. 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.

	Group Fair value		Bank Fair value	
	Assets	**Liabilities**	**Assets**	**Liabilities**
2012				
Derivatives held for trading purposes				
Interest rate derivatives:				
Interest rate swaps	**195.9**	**(167.2)**	**197.4**	**(168.6)**
Over The Counter (OTC) interest rate options	**1.4**	**(1.1)**	**1.4**	**(1.1)**
Total derivative assets/(liabilities) held for trading purposes	**197.3**	**(168.3)**	**198.8**	**(169.7)**
Derivatives held for non-trading purposes				
Derivatives designated as cashflow hedges:				
Interest rate swaps	**120.1**	**(52.3)**	**120.1**	**(52.2)**
Derivatives designated as fair value hedges:				
Interest rate swaps	**110.7**	**(587.0)**	**110.7**	**(586.0)**
Cross currency interest rate swaps	**–**	**(42.6)**	**–**	**(42.6)**
Derivatives held for non-trading purposes for which hedge accounting has not been applied:				
Interest rate swaps	**44.8**	**(62.9)**	**10.0**	**(54.2)**
Embedded derivatives – options	**60.6**	**(0.1)**	**60.6**	**(0.1)**
Forward currency transactions	**222.3**	**(51.4)**	**28.7**	**(14.8)**
OTC interest rate options	**–**	**(2.8)**	**–**	**(2.8)**
Equity swaps	**63.0**	**(0.2)**	**62.0**	**(0.2)**
Total derivative assets/(liabilities) held for non-trading purposes	**621.5**	**(799.3)**	**392.1**	**(752.9)**
Total recognised derivative assets/(liabilities)	**818.8**	**(967.6)**	**590.9**	**(922.6)**

17. Derivative financial instruments continued

	Group Fair value Assets	Group Fair value Liabilities	Bank Fair value Assets	Bank Fair value Liabilities
2011				
Derivatives held for trading purposes				
Interest rate derivatives:				
Interest rate swaps	162.0	(141.8)	164.7	(144.3)
Over The Counter (OTC) interest rate options	1.7	(1.7)	1.7	(1.7)
Total derivative assets/(liabilities) held for trading purposes	163.7	(143.5)	166.4	(146.0)
Derivatives held for non-trading purposes				
Derivatives designated as cashflow hedges:				
Interest rate swaps	218.5	(106.2)	218.4	(106.3)
Derivatives designated as fair value hedges:				
Interest rate swaps	137.3	(670.5)	120.1	(666.3)
Cross currency interest rate swaps	0.1	(60.7)	0.1	(60.7)
Derivatives held for non-trading purposes for which hedge accounting has not been applied:				
Interest rate swaps	13.7	(50.6)	12.1	(51.0)
Embedded derivatives – options	28.6	(0.4)	28.6	(0.4)
Forward currency transactions	300.9	(52.1)	46.9	(16.9)
OTC interest rate options	–	(3.5)	–	(3.5)
Equity swaps	113.0	(0.4)	111.8	(0.4)
Total derivative assets/(liabilities) held for non-trading purposes	812.1	(944.4)	538.0	(905.5)
Total recognised derivative assets/(liabilities)	975.8	(1,087.9)	704.4	(1,051.5)

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.

The number of non-margin exchange traded contracts held by the Bank as at 31 December 2012 was nil (2011: nil).

In line with industry standards, credit valuation adjustments (CVAs) are applied to non-collateralised swaps representing the fair value measurement of counterparty risk. This is a conservative approach to valuation and reduces the fair value of derivative assets. The credit adjustment across the portfolio was £2.8m as at the end of 2012. We do not apply CVA for derivatives that are fully cash collateralised.

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18. Equity shares

	Group and Bank 2012	Group and Bank 2011
Investment securities – unlisted	**5.7**	5.7
Included above are the following trade investments:		
Vocalink Limited – 4,416,165 ordinary shares of £1 each (2011: 4,416,165)	**5.6**	5.6

Equity shares are classified as available for sale.

19. Goodwill

	Group and Bank 2012	Group and Bank 2011
Net book amount		
At the beginning of the year	**0.6**	0.6
Impairment charge	**(0.6)**	–
At the end of the year	**–**	0.6

The Bank's goodwill was recognised in 2009 and related to the transfer of engagements of Britannia Building Society.

Each year the Group tests the asset for impairment by comparing its recoverable amount, determined in accordance with IAS 36, with its carrying amount. The directors have concluded that the carrying value should be written down to nil. The amount has been charged to operating expenses.

20. Intangible fixed assets

	Group 2012			Group 2011		
	Internally generated intangible assets	**Other intangible assets**	**Total**	Internally generated intangible assets	Other intangible assets	Total
Cost						
At the beginning of the year	**13.5**	**46.0**	**59.5**	13.9	46.0	59.9
Additions	**0.4**	**–**	**0.4**	2.0	–	2.0
Disposals	**(2.3)**	**–**	**(2.3)**	(2.4)	–	(2.4)
At the end of the year	**11.6**	**46.0**	**57.6**	13.5	46.0	59.5
Accumulated amortisation						
At the beginning of the year	**8.0**	**10.8**	**18.8**	8.5	6.3	14.8
Charge for the year	**1.5**	**4.7**	**6.2**	1.9	4.5	6.4
Disposals	**(2.3)**	**–**	**(2.3)**	(2.4)	–	(2.4)
At the end of the year	**7.2**	**15.5**	**22.7**	8.0	10.8	18.8
Net book value						
At the end of the year	**4.4**	**30.5**	**34.9**	5.5	35.2	40.7
At the beginning of the year	5.5	35.2	40.7	5.4	39.7	45.1

20. Intangible fixed assets continued

	Internally generated intangible assets	Other intangible assets	Total	Internally generated intangible assets	Other intangible assets	Total
	Bank 2012			Bank 2011		
Cost						
At the beginning of the year	**12.1**	**46.0**	**58.1**	13.1	46.0	59.1
Additions	**0.2**	**–**	**0.2**	1.4	–	1.4
Disposals	**(2.3)**	**–**	**(2.3)**	(2.4)	–	(2.4)
At the end of the year	**10.0**	**46.0**	**56.0**	12.1	46.0	58.1
Accumulated amortisation						
At the beginning of the year	**8.0**	**10.8**	**18.8**	9.0	6.3	15.3
Charge for the year	**1.0**	**4.7**	**5.7**	1.4	4.5	5.9
Disposals	**(2.3)**	**–**	**(2.3)**	(2.4)	–	(2.4)
At the end of the year	**6.7**	**15.5**	**22.2**	8.0	10.8	18.8
Net book value						
At the end of the year	**3.3**	**30.5**	**33.8**	4.1	35.2	39.3
At the beginning of the year	4.1	35.2	39.3	4.1	39.7	43.8

Internally generated intangible assets consist of software development costs.

Other intangible assets consist of a core deposit intangible of £44.0m and a brand intangible of £2.0m. The brand intangible has an indefinite useful life and is not amortised but is subject to an annual impairment review. On the basis of this review the brand is considered to be unimpaired.

21. Investment properties

	Group 2012	Group 2011	Bank 2012	Bank 2011
Fair value				
At the beginning of the year	**172.7**	162.3	**–**	–
Additions – acquisitions	**–**	9.2	**–**	–
Additions – other expenditure	**1.0**	2.1	**0.9**	–
Disposals	**(0.9)**	(0.8)	**–**	–
Changes in fair value (note 7)	**0.2**	(0.1)	**0.9**	–
At the end of the year	**173.0**	172.7	**1.8**	–

During the year £0.9m of properties, previously carried at historical cost, were transferred to investment properties from other assets. The carrying value of these properties has been assessed for fair value resulting in a £0.9m gain in the year.

All investment properties are held to generate rental income until such time that the Group considers it appropriate to realise its investment. Investment properties are carried at fair value.

The range of yields applied to the net annual rental income to determine the fair value of property is 3% to 8%.

The Group 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 (2011: £3.0m). The Group has not recognised any contingent rent in the year (2011: £nil). None of the lease agreements are individually significant.

Included in Group other operating income for the year is £8.4m (2011: £7.9m) of rental income relating to investment properties (note 7).

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22. Property, plant and equipment

2012 Group	Land and buildings	Leasehold improvements	Computers and other equipment	Total
Cost				
At the beginning of the year	**55.7**	**25.0**	**115.3**	**196.0**
Additions	**–**	**–**	**0.5**	**0.5**
Disposals	**(0.3)**	**(0.1)**	**(12.9)**	**(13.3)**
At the end of the year	**55.4**	**24.9**	**102.9**	**183.2**
Accumulated depreciation				
At the beginning of the year	**6.6**	**13.4**	**95.9**	**115.9**
Charge for the year	**1.2**	**5.0**	**8.6**	**14.8**
Disposals	**–**	**(0.1)**	**(11.5)**	**(11.6)**
At the end of the year	**7.8**	**18.3**	**93.0**	**119.1**
Net book value				
At the end of the year	**47.6**	**6.6**	**9.9**	**64.1**
At the beginning of the year	49.1	11.6	19.4	80.1

2011 Group	Land and buildings	Leasehold improvements	Computers and other equipment	Total
Cost				
At the beginning of the year	55.7	24.9	125.1	205.7
Additions	–	0.1	1.4	1.5
Disposals	–	–	(11.2)	(11.2)
At the end of the year	55.7	25.0	115.3	196.0
Accumulated depreciation				
At the beginning of the year	5.4	8.0	93.8	107.2
Charge for the year	1.2	5.4	13.0	19.6
Disposals	–	–	(10.9)	(10.9)
At the end of the year	6.6	13.4	95.9	115.9
Net book value				
At the end of the year	49.1	11.6	19.4	80.1
At the beginning of the year	50.3	16.9	31.3	98.5

22. Property, plant and equipment continued

2012 Bank	Land and buildings	Leasehold improvements	Computers and other equipment	Total
Cost				
At the beginning of the year	**34.8**	**24.9**	**111.1**	**170.8**
Additions	**–**	**–**	**0.1**	**0.1**
Disposals	**(0.3)**	**(0.1)**	**(12.8)**	**(13.2)**
At the end of the year	**34.5**	**24.8**	**98.4**	**157.7**
Accumulated depreciation				
At the beginning of the year	**3.0**	**13.3**	**93.0**	**109.3**
Charge for the year	**0.8**	**5.0**	**8.0**	**13.8**
Disposals	**–**	**(0.1)**	**(11.5)**	**(11.6)**
At the end of the year	**3.8**	**18.2**	**89.5**	**111.5**
Net book value				
At the end of the year	**30.7**	**6.6**	**8.9**	**46.2**
At the beginning of the year	31.8	11.6	18.1	61.5

2011 Bank	Land and buildings	Leasehold improvements	Computers and other equipment	Total
Cost				
At the beginning of the year	34.8	24.8	121.0	180.6
Additions	–	0.1	0.9	1.0
Disposals	–	–	(10.8)	(10.8)
At the end of the year	34.8	24.9	111.1	170.8
Accumulated depreciation				
At the beginning of the year	2.2	7.9	91.4	101.5
Charge for the year	0.8	5.4	12.2	18.4
Disposals	–	–	(10.6)	(10.6)
At the end of the year	3.0	13.3	93.0	109.3
Net book value				
At the end of the year	31.8	11.6	18.1	61.5
At the beginning of the year	32.6	16.9	29.6	79.1

	Group		Bank	
	2012	2011	**2012**	2011
The net book value of land and buildings comprises:				
Freehold	**47.1**	48.6	**30.2**	31.3
Leasehold	**0.5**	0.5	**0.5**	0.5
	47.6	49.1	**30.7**	31.8

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23. Other assets

	Group		Bank	
	2012	2011	**2012**	2011
Amounts recoverable within one year:				
Trade debtors	**59.9**	23.2	**59.9**	23.2
Other assets	**10.4**	9.8	**7.4**	6.1
	70.3	33.0	**67.3**	29.3

24. Prepayments and accrued income

	Group		Bank	
	2012	2011	**2012**	2011
Amounts recoverable within one year:				
Other	**14.9**	18.7	**14.0**	17.7

25. Deposits by banks

	Group		Bank	
	2012	2011	**2012**	2011
Items in course of collection	**49.1**	48.7	**49.1**	48.7
Deposits from other banks	**3,562.9**	3,254.0	**3,503.8**	3,191.1
	3,612.0	3,302.7	**3,552.9**	3,239.8

Included within deposits from other banks are liabilities of £1,880.6m (2011: £1,703.2m) secured on investment securities with a carrying value of £1,983.6m (2011: £2,114.4m) which have been sold under sale and repurchase agreements (note 39).

26. Customer accounts

	Group		Bank	
	2012	2011	**2012**	2011
Customer accounts	**35,884.4**	34,990.6	**33,750.3**	32,670.1

The Group has entered into interest rate swaps that protect it from changes in interest rates on the floating rate assets that are funded by its fixed rate customer accounts. Changes in the fair values of these swaps are offset by changes in the fair values of the fixed rate customer accounts. Included within customer accounts are 'fair value hedged' fixed rate accounts with a total nominal value of £nil (2011: £3.0m) against which there are fair value adjustments for hedged risk of £nil (2011: £(0.4)m), giving a total carrying value of £nil (2011: £2.6m).

27. Customer accounts – capital bonds

	Group		Bank	
	2012	2011	**2012**	2011
Customer accounts – capital bonds	**888.1**	1,429.8	**867.2**	1,397.3

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.

The maximum amount the Group would contractually be required to pay at maturity for all the capital bonds is £888.7m (2011: £1,429.6m).

The Group 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 £33.0m (2011: £24.8m). 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 £0.1m (2011: £0.6m).

28. Debt securities in issue

	Group		Bank	
	2012	2011	**2012**	2011
Certificates of deposit	**157.8**	252.1	**157.8**	252.1
Commercial paper	**8.2**	–	**8.2**	–
Fixed and floating rate notes	**4,547.7**	3,912.7	**1,586.2**	1,178.9
	4,713.7	4,164.8	**1,752.2**	1,431.0

The Group 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. 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. There is no requirement for the Group to make good any shortfall out of general funds. The maturity date of the notes matches the maturity date of the underlying assets.

29. Other borrowed funds

	Group and Bank	
	2012	2011
Step up callable subordinated notes 2019	**37.8**	150.0
60,000,000 9.25% non-cumulative irredeemable preference shares of £1 each	**60.0**	60.0
Floating rate subordinated notes 2016	**21.7**	20.6
5.625% fixed rate subordinated notes 2021	**8.7**	150.0
9.25% fixed rate subordinated notes 2021	**275.0**	275.0
7.875% fixed rate subordinated notes 2022	**235.4**	–
Fixed rate subordinated notes 2024	**173.7**	167.1
Fixed rate subordinated notes 2033	**125.4**	122.2
Perpetual subordinated bonds	**292.1**	282.9
Issue costs, discounts and accrued interest	**28.8**	31.0
	1,258.6	1,258.8

Step up callable subordinated notes 2019

The notes were issued on 1 April 2004 at a discount of 0.946%.

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 interest rate of 5.875% per annum to (but excluding) 2 April 2014, and thereafter the interest rate will be determined by reference to the gross redemption yield on the five year benchmark gilt, and a margin of 2.25%. Interest is payable annually in arrears on 2 April.

The Bank may redeem all, but not less than all, of the notes at their principal amount on 2 April 2014.

On 19 December 2012 the Bank invited investors to exchange their holdings in the above instrument for a new subordinated note, which resulted in the redemption of £112.2m of the notes (representing 74.8% of the amount outstanding), leaving £37.8m outstanding.

60,000,000 9.25% non-cumulative irredeemable preference shares of £1 each

The preference shares carry the right to a fixed non-cumulative preferential dividend on the capital for the time being paid up, at the rate of 9.25% per annum exclusive of any associated tax credit. The dividends are payable on 31 May and 30 November each year and take priority over dividends to any other class of share in the capital of the Bank.

On a return of capital on winding up, the assets of the Bank shall be applied in repaying the preference share capital in priority to any payments to the holders of any other class of shares in the capital of the Bank. The amount receivable by the holders of the preference shares shall be the greater of the capital paid up or the average quoted price during the three months immediately preceding the date of the notice convening the meeting to consider the resolution to wind up.

The holders of the preference shares shall have the right to vote at a general meeting of the Bank only if and when, at the date of the notice convening the meeting, the dividend due to them has been in arrears for six months or more or if a resolution is to be proposed at the meeting abrogating or varying their rights or privileges or for the winding up of the Bank or other return of capital and then only on that resolution.

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29. Other borrowed funds continued

Floating rate subordinated notes 2016

The notes were issued on 18 May 2006 at a discount of 0.14%.

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 are denominated in euros and interest is calculated at three months EURIBOR plus a margin of 0.28%. From 18 May 2011 interest has been calculated at three months EURIBOR plus a margin of 0.78%. The first interest coupon was paid in August 2006.

The notes were hedged with a cross currency swap converting the exposure into sterling which paid a floating rate of three months LIBOR with a margin on interest coupon of 0.34125% and received a floating rate of three months EURIBOR plus a margin on interest coupon of 0.28%. The cross currency swap matured on 18 May 2011.

On 28 April 2011 the Bank redeemed €149.2m of the notes (representing 81% of the amount outstanding) leaving €34.9m outstanding. The Bank had the option to call the outstanding notes in whole but not in part on the interest payment date falling on or nearest to May 2011, and now at any interest payment date thereafter subject to prior consent of the Financial Services Authority.

5.625% fixed rate subordinated notes 2021

The notes were issued on 16 November 2006 at a discount of 0.189%.

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 5.625% up to and including the interest payment date on 16 November 2016, when the interest basis changes to floating rate. During the fixed rate period, interest is payable semi-annually in arrears on 16 May and 16 November.

From 17 November 2016, the notes carry a floating interest rate of three months LIBOR plus a margin of 1.75%. Interest is payable quarterly in arrears on 16 February, 16 May, 16 August and 16 November, commencing on the interest payment date falling in February 2017 up to and including the maturity date.

The Bank may redeem all, but not less than all, of the notes at the principal amount on 16 November 2016, and on any quarterly interest payment date thereafter.

On 19 December 2012 the Bank invited investors to exchange their holdings in the above instrument for a new subordinated note, which resulted in the redemption of £141.3m of the notes (representing 94.2% of the amount outstanding) leaving £8.7m outstanding.

9.25% fixed rate subordinated notes 2021

On 28 April 2011 the Bank issued £275.0m fixed rate subordinated notes due 2021, issued at par.

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 9.25% up to (but excluding) 28 April 2021. Interest is payable annually in April.

There is no option to redeem the notes early.

7.875% fixed rate subordinated notes 2022

On 19 December 2012 the Bank issued £235.4m fixed rate subordinated notes due 2022, issued at par.

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 7.875% up to 18 December 2022. Interest is payable annually in arrears in December.

There is no option to redeem the notes early.

29. Other borrowed funds continued

Fixed rate subordinated notes 2024

The notes were issued on 17 March 2004 at a discount of 1.148%.

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 5.75% to 2 December 2019 (reset date). During this period the notes are hedged with interest rate swaps that convert the interest rate payable into floating rates at six months LIBOR plus a margin of 0.72%. The fixed receipt leg of the swap is received annually to match the payment to the noteholders. The floating payment leg of the swap is payable semi-annually in June and December. The interest rate swaps mature on 2 December 2019.

From the reset date the interest rate will be calculated based on the Five Year Benchmark Gilt rate plus a margin of 1.94%. The Five Year Benchmark Gilt rate being the Gross Redemption Yield determined by the UK government security having a maturity date falling on or nearest the fifth anniversary of the determination date (the determination date being two days prior to the reset date), converted to an annualised yield. The Gross Redemption Yield being calculated on the basis set out by the UK Debt Management Office in the publication 'Formulae for Calculating Gilt Prices from Yields'. From the reset date the interest will be paid annually in arrears until maturity or redemption.

The notes are callable in whole but not in part, at the principal amount, on 2 December 2019, subject to the prior consent of the Financial Services Authority.

Fixed rate subordinated notes 2033

The notes were issued on 28 March 2002 at a discount of 0.93%.

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 5.875% to maturity. Interest is payable semi-annually in March and September.

Of the notes, £100m are hedged with interest rate swaps that have a floating payment leg at six months LIBOR payable in March and September. The fixed interest rate receivable legs on the swaps are £25m at 5.405% and £75m at 5.225%. The semi-annual interest receivable leg on the swap is matched to the dates on the notes.

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%.

Both the £110m and £200m PSBs are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of the bondholders will be subordinated in right of payment of all creditors (including subordinated creditors) of the Bank.

The PSBs with a par value of £110m carry an annual interest rate of 13%. Interest is payable semi-annually in January and July.

The PSBs with a par value of £200m carry an annual interest rate of 5.5555% up until the reset date. This coupon is payable semi-annually in June and December. From the reset date of 14 December 2015 the interest rate will be amended to the rate for three month deposits in sterling plus a margin of 2.05% per annum. The interest payments will then be made quarterly in arrears in March, June, September and December, with the interest resetting at each interest payment date.

During the period up until the reset date the PSBs are hedged with an interest rate swap that converts the interest rate payable into floating rates at six months LIBOR plus a margin of 1.175%. The semi-annual interest receivable and payable on the swap is aligned to the interest payment dates of the notes. The interest rate swap matures on 14 December 2015.

Given prior relevant supervisory consent, the Bank may elect to repay all, but not less than all, of these PSBs on 14 December 2015 or on any interest payment date thereafter at their principal amount.

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30. Other liabilities

	Group		Bank	
	2012	2011	**2012**	2011
Amounts falling due within one year:				
ATM creditor	**61.5**	122.4	**61.5**	122.4
Other creditors	**37.7**	46.5	**33.5**	42.2
Amounts falling due after one year:				
Other creditors	**4.8**	4.8	**4.5**	4.5
	104.0	173.7	**99.5**	169.1

Other creditors of the Group and Bank include finance lease obligations as follows:

	Present value of lease payments		Future minimum lease payments	
	2012	2011	**2012**	2011
Due within one year	**–**	–	**–**	–
Due between one year and five years	**0.1**	0.1	**0.1**	0.1
Due after five years	**1.2**	1.0	**1.6**	1.7
	1.3	1.1	**1.7**	1.8

The future minimum lease payments have been discounted at LIBOR over the term of the lease to give the present value of these payments.

31. Accruals and deferred income

	Group		Bank	
	2012	2011	**2012**	2011
Amounts falling due within one year:				
Other	**19.5**	34.6	**15.0**	27.9
Amounts falling due after one year:				
Other	**0.6**	5.3	**0.5**	5.2
	20.1	39.9	**15.5**	33.1

32. Provisions for liabilities and charges

2012 Group	Property	FSCS levies	PPI	Other	Total
At the beginning of the year	**6.9**	**25.0**	**61.7**	**8.4**	**102.0**
Income statement movements:					
Provided in the year – operating expense	**0.8**	**24.8**	**–**	**0.5**	**26.1**
Provided in the year – net fee and commission income	**–**	**–**	**149.7**	**–**	**149.7**
Released in the year – operating expense	**(0.3)**	**–**	**–**	**(0.6)**	**(0.9)**
Released in the year – net fee and commission income	**–**	**–**	**–**	**–**	**–**
Utilised during the year	**(0.1)**	**(11.2)**	**(95.4)**	**(7.5)**	**(114.2)**
At the end of the year	**7.3**	**38.6**	**116.0**	**0.8**	**162.7**
Provisions were analysed as follows:					
Amounts falling due within one year	**3.2**	**24.9**	**77.2**	**0.8**	**106.1**
Amounts falling due after one year	**4.1**	**13.7**	**38.8**	**–**	**56.6**
	7.3	**38.6**	**116.0**	**0.8**	**162.7**

2011 Group	Property	FSCS levies	PPI	Other	Total
At the beginning of the year	8.8	20.9	4.3	21.8	55.8
Income statement movements:					
Provided in the year – operating expense	0.4	14.5	–	0.1	15.0
Provided in the year – net fee and commission income	–	–	90.0	1.0	91.0
Released in the year – operating expense	(0.3)	–	–	(0.1)	(0.4)
Released in the year – net fee and commission income	–	–	–	(0.9)	(0.9)
Utilised during the year	(2.0)	(10.4)	(32.6)	(13.5)	(58.5)
At the end of the year	6.9	25.0	61.7	8.4	102.0
Provisions were analysed as follows:					
Amounts falling due within one year	3.0	10.9	51.3	8.4	73.6
Amounts falling due after one year	3.9	14.1	10.4	–	28.4
	6.9	25.0	61.7	8.4	102.0

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32. Provisions for liabilities and charges continued

2012 Bank	**Property**	**FSCS levies**	**PPI**	**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**

2011 Bank	Property	FSCS levies	PPI	Other	Total
At the beginning of the year	7.4	20.3	4.3	7.3	39.3
Income statement movements:					
Provided in the year – operating expense	0.4	14.5	–	–	14.9
Provided in the year – net fee and commission income	–	–	90.0	–	90.0
Released in the year – operating expense	(0.2)	–	–	–	(0.2)
Released in the year – net fee and commission income	–	–	–	(0.1)	(0.1)
Utilised during the year	(0.8)	(9.9)	(32.6)	(7.2)	(50.5)
At the end of the year	6.8	24.9	61.7	–	93.4
Provisions were analysed as follows:					
Amounts falling due within one year	2.9	10.8	51.3	–	65.0
Amounts falling due after one year	3.9	14.1	10.4	–	28.4
	6.8	24.9	61.7	–	93.4

Property

The Group 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 11%.

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 Group will be liable to pay a proportion of the outstanding borrowings that the FSCS has borrowed from HM Treasury. Additionally the Group is obliged to pay its share of management expenses and compensation based upon the Group'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 Group has provided £38.6m (2011: £25.0m) 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 2014. The provision includes £27.7m in respect of the interest levy (2011: £25.0m). The Group's interest levy provision calculation includes estimates of the total FSCS levy in each levy year and estimates of the Group's market participation in each levy year. During 2012, the FSCS indicated that it expected to raise a capital levy to cover an estimated shortfall in excess of £800m in the amounts recovered from the failed banks to repay HM Treasury loans made to the FSCS. The Group's share of such a levy is estimated at £24.0m and the Group has provided £10.9m in the current year in respect of this.

32. Provisions for liabilities and charges continued

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 complete a proactive review of all past business to identify mis-sold policies where no complaint has been made. An additional provision of £149.7m (2011: £90.0m) has been recognised in the year (note 5), in respect of the total expected cost to the Bank of carrying out this work and paying compensation, making total provisions raised of £244.0m (2011: £94.3m).

33. Deferred tax

Deferred taxes are calculated on all temporary differences under the liability method using an effective tax rate of 23% (2011: 25%).

The movements on the deferred tax accounts are as follows:

	Group		Bank	
	2012	2011	**2012**	2011
Net deferred tax at the beginning of the year	**26.4**	87.0	**110.3**	154.0
Income statement credit/(charge)	**8.8**	(61.7)	**14.1**	(44.5)
Prior year adjustments	**6.9**	9.7	**9.4**	9.4
Charged to equity:				
Fair value unwinds	**–**	–	**8.9**	–
Unrealised appreciation on investments	**–**	0.4	**–**	0.4
Pensions and other post-retirement benefits	**–**	(0.1)	**–**	(0.1)
Cashflow hedges	**3.5**	(8.9)	**3.5**	(8.9)
Available for sale	**(7.4)**	–	**(7.4)**	–
Net deferred tax at the end of the year	**38.2**	26.4	**138.8**	110.3
Components of net deferred tax:				
Deferred tax asset	**165.9**	137.5	**138.8**	110.3
Deferred tax liability	**(127.7)**	(111.1)	**–**	–
	38.2	26.4	**138.8**	110.3
Net deferred tax comprises:				
Cashflow hedges	**(18.9)**	(22.4)	**(18.9)**	(22.4)
Unrealised appreciation on investments	**(0.7)**	(0.7)	**(0.7)**	(0.7)
Capital allowances on fixed assets	**33.4**	28.5	**37.0**	29.4
Capital allowances on assets leased to customers	**1.3**	(2.7)	**1.3**	0.6
Pensions and other post-retirement benefits	**0.9**	0.9	**0.9**	0.9
Fair value adjustments	**(55.8)**	(3.4)	**65.6**	98.9
Other temporary differences	**26.1**	26.2	**1.7**	3.6
Tax losses carried forward	**51.9**	–	**51.9**	–
	38.2	26.4	**138.8**	110.3

Other temporary differences for the Group of £26.1m (2011: £26.2m) 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.

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33. Deferred tax continued

The deferred tax (credit)/charge in the income statement comprises the following temporary differences:

	Group		Bank	
	2012	2011	**2012**	2011
Capital allowances on fixed assets	**(8.1)**	4.0	**(7.6)**	4.1
Capital allowances on assets leased to customers	**(0.7)**	(0.7)	**(0.7)**	(0.2)
Fair value adjustments	**42.0**	35.7	**33.3**	27.8
Other temporary differences	**1.5**	13.0	**1.9**	3.4
Tax losses carried forward	**(50.4)**	–	**(50.4)**	–
	(15.7)	52.0	**(23.5)**	35.1

Deferred tax assets expected to be recoverable after one year are £38.2m (2011: £26.4m). The deferred tax asset is considered to be recoverable as, after preparing forecasts and projections for the Banking Group, the directors are satisfied that the Group will be profitable in the foreseeable future.

The 2012 Autumn Statement on 5 December 2012 announced that the UK corporation tax rate will reduce to 21% by 2014. A reduction in the rate from 26% to 25% (effective from 1 April 2012) was substantively enacted on 5 July 2011, and further reductions to 24% (effective from 1 April 2012) and 23% (effective from 1 April 2013) were substantively enacted on 26 March 2012 and 3 July 2012 respectively. This will reduce the Group's future current tax charge accordingly. The deferred tax asset at 31 December 2012 has been calculated based on the rate of 23% substantively enacted at the balance sheet date. It has not yet been possible to quantify the full anticipated effect of the announced further 2% rate reduction, although this will further reduce the Group's future current tax charge and reduce the Group's deferred tax asset accordingly.

34. Pensions

Defined contribution basis

The Group participates in The Co-operative Group Pension (average career earnings) Scheme (Pace). Pace is a defined benefit scheme, the assets of which are held in a separate fund administered by trustees. As a group wide pension scheme, Pace exposes the participating businesses to actuarial risks associated with the current and former employees of other Group companies, with the result that there is no consistent and reliable basis for allocating liabilities, assets and costs to individual companies participating in the scheme. Therefore, pension costs in respect of the scheme are accounted for on a defined contribution basis and recognised as an expense in the income statement as incurred, based on a fixed percentage as agreed with the trustees.

Key assumptions of the Group pension scheme

The key aspects of The Co-operative Group's Pace scheme are as follows:

	2012	2011
The principal assumptions used to determine the liabilities of the Pace scheme are:		
Discount rate	**4.60%**	4.60%
Rate of increase in salaries	**4.80%**	4.80%
Future pension increases where capped at 5.0% per annum	**3.30%**	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%**	5.20%
Expected long term return on scheme assets	**5.10%**	6.20%
Rate of increase in salaries	**4.80%**	5.20%

The average life expectancy (in years) for mortality tables used to determine scheme liabilities for the Pace scheme at the 2012 year end is:

	Male	**Female**
Life expectancy:		
Member currently aged 65 (current life expectancy)	**22.4**	**24.0**
Member currently aged 40 (life expectancy at age 65)	**24.2**	**25.9**

The amounts recognised in the balance sheet of The Co-operative Group are as follows:

	2012	2011
Fair value of plan assets	**6,919.4**	6,610.5
Present value of funded obligations	**(6,532.1)**	(6,242.6)
	387.3	367.9
Present value of unfunded obligations	**(4.5)**	(4.4)
	382.8	363.5

34. Pensions continued

The weighted average asset allocations at the year end were as follows:

	2012	2011
Equities	**31%**	29%
Liability driven investments	**49%**	51%
Alternative growth	**14%**	14%
Property	**4%**	5%
Cash	**2%**	1%

To develop the expected long term rate of return on assets assumption, The Co-operative Group considered the current level of expected returns on risk free investments (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. The expected return for each asset class was then weighted based on the target asset allocation to develop the expected long term rate of return on assets assumption for the portfolio. This resulted in the selection of the 5.1% assumption for the year ended 31 December 2012 (2011: 6.2%).

Former Britannia Building Society pension scheme

Following the transfer of engagements of Britannia Building Society, the Britannia pension scheme transferred to the Co-operative Financial Services Management Services Limited (CFSMS). The pension cost shown in these accounts in respect of the Britannia defined benefit scheme for the period after 31 July 2009 is the actual contribution paid by the Bank. The scheme closed on 6 October 2012 with active members at the date of closure being transferred to the Co-operative Pension Scheme (Pace).

The key aspects of the Britannia defined benefit scheme are as follows:

	2012	2011
The principal assumptions used to determine the liabilities of the Britannia defined benefit scheme are:		
Discount rate	**4.60%**	4.60%
Rate of increase in salaries	**4.80%**	4.80%
Future pension increases where capped at 5.0% per annum	**3.30%**	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%**	5.20%
Expected long term return on scheme assets	**5.00%**	6.00%
Rate of increase in salaries	**4.80%**	5.20%

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 2012 year end is:

	Male	**Female**
Life expectancy:		
Member currently aged 65 (current life expectancy)	22.4	24.6
Member currently aged 40 (life expectancy at age 60)	24.2	26.5

The amounts recognised in the balance sheet of The Co-operative Group are as follows:

	2012	2011
Fair value of plan assets	**602.7**	569.9
Present value of funded obligations	**(586.8)**	(608.4)
	15.9	(38.5)
Pension surplus not recognised under IAS 19	**(15.9)**	–
Present value of unfunded obligations	**(2.9)**	(2.9)
	(2.9)	(41.4)

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34. Pensions continued

The weighted average asset allocations at the year end were as follows:

	2012	2011
Equities	**25%**	25%
Diversified growth	**14%**	15%
Liability driven investments	**48%**	57%
Property	**13%**	3%

To develop the expected long term rate of return on assets assumption, The Co-operative Group considered the current level of expected returns on risk free investments (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. The expected return for each asset class was then weighted based on the target asset allocation to develop the expected long term rate of return on assets assumption for the portfolio. This resulted in the selection of the 5.0% assumption for the year ended 31 December 2012 (2011: 6.0%).

Bank (unfunded) pension scheme

The Bank also operates a small unfunded pension scheme.

	2012	2011	2010	2009	2008
Expected return on scheme assets	**n/a**	n/a	n/a	n/a	n/a
Rate of increase of pensions in payment	**3.3%**	3.3%	3.7%	3.8%	3.3%
Rate of increase in salaries	**4.8%**	4.8%	5.2%	5.3%	4.8%
Discount rate	**4.6%**	4.6%	5.2%	5.6%	5.7%

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:

	Group and Bank	
	2012	2011
Present value of unfunded obligations	**(4.0)**	(3.9)
Deficit in scheme	**(4.0)**	(3.9)
Related deferred tax asset	**0.9**	0.9
Net pension liability	**(3.1)**	(3.0)
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:

	Group and Bank	
	2012	2011
Opening defined benefit liabilities	**3.9**	3.8
Current service cost	**–**	–
Interest on liabilities	**0.2**	0.2
Actuarial losses	**–**	–
Benefits paid	**(0.1)**	(0.1)
Closing defined benefit liabilities	**4.0**	3.9

Amounts recognised in the statement of comprehensive income:

	Group and Bank	
	2012	2011
Actuarial losses on scheme liabilities during the year	**–**	–
Actuarial gains on scheme assets during the year	**–**	–
Total scheme losses during the year	**–**	–

34. Pensions continued

The amounts for the current year are as follows:

	Group and Bank 2012	2011
Defined benefit obligation	**(4.0)**	(3.9)
Scheme assets	**–**	–
Deficit in scheme	**(4.0)**	(3.9)
Experience adjustment on scheme liabilities	**–**	–
Experience adjustment on scheme assets	**–**	–

35. Contingent liabilities and commitments

The tables below give, for the Group and the Bank, 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 FSA rules.

The contingent liabilities of the Group and the Bank as detailed below arise in the normal course of banking business and it is not practical to quantify their future financial effect.

	Contract amount 2012	Risk weighted amount 2012	Contract amount 2011	Risk weighted amount 2011
Group				
Contingent liabilities:				
Guarantees and irrevocable letters of credit	**168.8**	**120.6**	167.6	131.8
Bank				
Contingent liabilities:				
Guarantees and irrevocable letters of credit	**168.2**	**120.3**	166.6	131.3
Group				
Other commitments:				
Documentary credits and short term trade related transactions	**3.7**	**0.7**	7.7	1.5
Forward asset purchases and forward deposits placed	**53.2**	**0.1**	44.9	0.9
Undrawn formal standby facilities, credit lines and other commitments to lend (includes revocable and irrevocable commitments) (i)	**4,713.4**	**1,065.0**	4,700.1	1,148.1
	4,770.3	**1,065.8**	4,752.7	1,150.5
Bank				
Other commitments:				
Documentary credits and short term trade related transactions	**3.7**	**0.7**	7.7	1.5
Forward asset purchases and forward deposits placed	**53.2**	**0.1**	44.9	0.9
Undrawn formal standby facilities, credit lines and other commitments to lend (includes revocable and irrevocable commitments) (i)	**4,565.5**	**1,061.0**	4,504.2	1,138.7
	4,622.4	**1,061.8**	4,556.8	1,141.1

Notes

(i) Undrawn loan commitments include revocable commitments which are unused credit card limits of £2,048.1m (2011: £2,181.6m).

Assets pledged

Assets are pledged as collateral under repurchase agreements with other banks. These deposits are not available to finance the Group's day to day operations. Mandatory reserve deposits are also held with the Bank of England in accordance with statutory requirements.

See note 39.d for further details of assets pledged.

Notes to the financial statements continued

For the year ended 31 December 2012

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35. Contingent liabilities and commitments continued

Commitments under operating leases

The Group 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 Group and the Bank will be required to make over the remaining lives of the leases.

	Land and buildings 2012	**Equipment 2012**	Land and buildings 2011	Equipment 2011
Group				
Falling due:				
Within one year	**21.9**	**0.3**	26.1	0.3
Between one and five years	**63.9**	**0.5**	76.5	0.4
In five years or more	**79.6**	**–**	87.3	0.1
	165.4	**0.8**	189.9	0.8
Bank				
Falling due:				
Within one year	**22.6**	**0.3**	25.4	0.3
Between one and five years	**65.3**	**0.5**	78.7	0.4
In five years or more	**66.0**	**–**	73.7	0.1
	153.9	**0.8**	177.8	0.8

The Group 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 Group and for the Bank was £9.1m (2011: £12.8m).

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 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.

Intra-group guarantee

The Bank has an indemnification agreement, accounted for as an intra-group 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.

Interest rate hedging products

The Bank has sold circa 100 interest rate hedging products to small businesses. It has participated in the FSA pilot review of such sales, though the full review has not yet been completed. The Bank expects any redress payments would not be material and no provision has been made in the annual results.

36. Investments in Group undertakings

Investments in equity shares and loans of subsidiary undertakings are financial assets.

	2012			2011		
	Ordinary shares	**Capital contributions**	**Total**	Ordinary shares	Capital contributions	Total
At the beginning of the year	**569.7**	**1,003.7**	**1,573.4**	569.0	889.9	1,458.9
Additions	**–**	**1,185.0**	**1,185.0**	1.0	1,057.8	1,058.8
Repayments	**(0.2)**	**(949.7)**	**(949.9)**	(0.3)	(944.0)	(944.3)
At the end of the year	**569.5**	**1,239.0**	**1,808.5**	569.7	1,003.7	1,573.4

Subsidiary undertakings
The Bank 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 consolidated Group results.

Principal subsidiary undertakings which are registered in England and operating in the UK:

		Group interest 2012	Group interest 2011
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%

See note 39.d for further details of the covered bond transactions.

The accounting policy for Special Purpose Entities (SPEs) is disclosed on page 42.

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.

Investments in equity shares and loans with subsidiary undertakings are shown net of impairments.

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.

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36. Investments in Group undertakings continued

Registered in the Isle of Man and operating overseas:

Britannia International Limited	Deposit taking

Registered in Scotland and operating in the UK:

Britannia Life Direct Limited	Direct sales of financial services

Securitisation vehicles

The results of the following principal securitisation vehicles are consolidated into the results of the Group under SIC 12 (Consolidation: Special Purpose Entities):

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
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

All securitisation vehicles are registered in England and operate in the UK.

All of the above companies are related parties to the Group. See note 37 for the related party disclosures.

See note 39.d for further details of securitisation vehicles.

Joint ventures

The Group's investment in joint ventures is £3.9m (2011: £2.7m).

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 Group's interest in Britannia Personal Lending Limited is as follows:

	2012	2011
Current assets	**6.5**	17.5
Long term assets	**11.8**	13.0
	18.3	30.5
Current liabilities	**10.7**	20.2
Long term liabilities	**7.6**	10.3
	18.3	30.5
Income	**1.5**	1.3
Expenses	**0.1**	(1.1)
Profit before tax	**1.6**	0.2
Taxation	**(0.4)**	–
Profit after tax	**1.2**	0.2

Joint ventures are accounted for using the equity method.

37. Related party transactions

Parent, subsidiary and ultimate controlling party

The Co-operative Banking Group Limited owns 100% of the issued ordinary share capital of the Bank and is the Bank's immediate holding company. The Co-operative Banking Group Limited is incorporated in England and is registered under the Industrial and Provident Societies Acts. The ultimate holding organisation is The Co-operative Group Limited, which is incorporated in England and registered under the Industrial and Provident Societies Acts. The financial statements of the immediate and ultimate holding organisations are available from 1 Angel Square, Manchester M60 0AG.

Further details of subsidiary undertakings and joint ventures are disclosed in note 36.

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. Key management, as defined by IAS 24 (Related Party Disclosures), are considered to be Board and executive members of the Group, and Board and executive members of the Group's immediate and ultimate holding organisations. The volume of related party transactions, outstanding balances at the year end, and related income and expense for the year are as follows:

Directors, key management personnel and close family

	Group and Bank	
	2012	2011
Loans outstanding at the beginning of the year	**2.2**	2.3
Net movement	**0.4**	(0.1)
Loans outstanding at the end of the year	**2.6**	2.2
Deposits and investments at the beginning of the year	**1.9**	2.0
Net movement	**0.5**	(0.1)
Deposits and investments at the end of the year	**2.4**	1.9

Directors' loans

	Mortgages 2012	**Personal loans 2012**	**Credit cards 2012**	Mortgages 2011	Personal loans 2011	Credit cards 2011
Number of directors with loan type	**5**	**2**	**4**	6	1	9
Total value of directors' loans	**1.0**	**–**	**–**	1.8	–	–

The Bank undertook the following transactions with Group companies during the year:

	Interest paid to Bank	**Interest received from Bank**	**Staff recharges paid to Bank**	**Rent received from Bank**	**Administration recharge paid to Bank**
2012					
Transactions with subsidiary undertakings	**84.3**	**66.6**	**14.5**	**0.6**	**8.3**
2011					
Transactions with subsidiary undertakings	93.8	94.3	9.4	0.6	–

Interest accrues on outstanding balances at a transfer price rate agreed between the Bank and its subsidiaries.

	Interest and fees received from other Co-operative Group undertakings 2012	**Interest and fees paid to other Co-operative Group undertakings 2012**	Interest and fees received from other Co-operative Group undertakings 2011	Interest and fees paid to other Co-operative Group undertakings 2011
Parent undertakings	**4.3**	**0.2**	4.6	1.0
Fellow subsidiary undertakings	**1.0**	**–**	1.1	–
	5.3	**0.2**	5.7	1.0

At the year end the following unsecured balances were outstanding:

	Loans owed to Bank 2012	**Loans owed by Bank 2012**	Loans owed to Bank 2011	Loans owed by Bank 2011
Amounts outstanding with subsidiary undertakings	**4,638.6**	**3,854.0**	6,558.0	3,674.3

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37. Related party transactions continued

	Loans owed by other Co-operative Group undertakings 2012	**Loans owed to other Co-operative Group undertakings 2012**	Loans owed by other Co-operative Group undertakings 2011	Loans owed to other Co-operative Group undertakings 2011
Group				
Parent undertakings	**56.4**	**29.4**	1.6	74.0
Fellow subsidiary undertakings	**200.0**	**82.6**	177.6	58.3
	256.4	**112.0**	179.2	132.3

	Loans owed by other Co-operative Group undertakings 2012	**Loans owed to other Co-operative Group undertakings 2012**	Loans owed by other Co-operative Group undertakings 2011	Loans owed to other Co-operative Group undertakings 2011
Bank				
Parent undertakings	**56.4**	**29.4**	1.6	74.0
Fellow subsidiary undertakings	**199.6**	**82.6**	180.5	58.3
	256.0	**112.0**	182.1	132.3

There are no formal repayment terms with subsidiary companies.

Recharges from CFSMS

During the year, operating costs of £779.7m (2011: £488.6m) incurred on its behalf were charged at cost to the Bank by CFSMS, a fellow subsidiary of the Co-operative Banking Group Limited. £150.0m (2011: £nil) of these recharges related to the impairment of intangible assets relating to the development of new banking systems. At 31 December 2012, the Bank was owed £199.6m (2011: £180.5m) by CFSMS.

Transactions with SPEs

The Bank undertook the following transactions with SPEs during the year:

	Interest paid to Bank 2012	**Interest received from Bank 2012**	Interest paid to Bank 2011	Interest received from Bank 2011
Transactions with SPEs	**108.4**	**118.0**	103.1	121.0

	Fees paid to Bank 2012	**Fees received from Bank 2012**	Fees paid to Bank 2011	Fees received from Bank 2011
Transactions with SPEs	**2.9**	**–**	2.4	–

The 2011 figure for interest received from Bank has been amended to include deemed loan interest paid to SPEs.

At the year end the following balances were outstanding with SPEs:

	Loans owed to Bank 2012	**Loans owed by Bank 2012**	Loans owed to Bank 2011	Loans owed by Bank 2011
Amounts outstanding with SPEs	**7,718.4**	**3,843.0**	6,221.1	3,654.6

In addition to the above, the Bank holds floating rate notes in Leek Finance Number Seventeen plc of £14.3m (2011: £18.5m), in Leek Finance Number Eighteen plc of £19.8m (2011: £23.3m) and in Leek Finance Number Nineteen plc of £25.2m (2011: £28.7m) included within investment securities – available for sale.

The loans owed to the SPEs comprise cash balances deposited with the Bank.

Key management compensation

	Group and Bank	
	2012	2011
Salaries and short term benefits	**3.0**	4.6
Termination benefits	**1.4**	2.5
	4.4	7.1

Directors' remuneration

A list of the members of the Board of directors is shown on page 12. The total remuneration of directors was £0.6m (2011: £3.7m).

Further details of directors' remuneration are provided in the remuneration report on pages 20 to 28.

38. Share capital

	Group and Bank			
	No. of shares (millions) 2012	**Share capital 2012**	No. of shares (millions) 2011	Share capital 2011
Authorised capital (ordinary shares of 5p each)				
At the beginning and end of the year	**8,200**	**410.0**	8,200	410.0
Allotted, called up and fully paid (ordinary shares of 5p each)				
At the beginning and end of the year	**8,200**	**410.0**	8,200	410.0
Share premium account at the beginning and the end of the year		**8.8**		8.8

The shareholders have one vote for every share held.

39. Fair values of financial assets and liabilities

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	Cashflow hedges	Total
2012							
Group							
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	**197.3**	**501.2**	–	–	–	**120.3**	**818.8**
Equity shares	–	–	–	**5.7**	–	–	**5.7**
Amounts owed by other Co-operative Group undertakings	–	–	**256.4**	–	–	–	**256.4**
Total financial assets	**1,157.5**	**2,500.0**	**41,428.6**	**3,795.1**	–	**120.3**	**49,001.5**
Non-financial assets							**571.9**
Total assets							**49,573.4**
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	**168.3**	**747.0**	–	–	–	**52.3**	**967.6**
Other borrowed funds	–	–	–	–	**1,258.6**	–	**1,258.6**
Amounts owed to other Co-operative Group undertakings	–	–	–	–	**112.0**	–	**112.0**
Total financial liabilities	**168.3**	**1,635.1**	–	–	**45,580.7**	**52.3**	**47,436.4**
Non-financial liabilities							**286.8**
Total liabilities							**47,723.2**
Capital and reserves							**1,850.2**
Total liabilities and equity							**49,573.4**

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39. 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	Cashflow hedges	Total
2011							
Group							
Assets							
Cash and balances at central banks	–	–	6,696.6	–	–	–	6,696.6
Loans and advances to banks	–	–	2,006.5	–	–	–	2,006.5
Loans and advances to customers	–	114.1	33,651.9	–	–	–	33,766.0
Fair value adjustments for hedged risk	–	–	366.3	–	–	–	366.3
Investment securities	–	343.1	804.9	3,423.0	–	–	4,571.0
Derivative financial instruments	163.7	593.6	–	–	–	218.5	975.8
Equity shares	–	–	–	5.7	–	–	5.7
Amounts owed by other Co-operative Group undertakings	–	–	179.2	–	–	–	179.2
Total financial assets	163.7	1,050.8	43,705.4	3,428.7	–	218.5	48,567.1
Non-financial assets							388.5
Total assets							48,955.6
Liabilities							
Deposits by banks	–	–	–	–	3,302.7	–	3,302.7
Customer accounts	–	–	–	–	34,990.6	–	34,990.6
Customer accounts – capital bonds	–	1,429.8	–	–	–	–	1,429.8
Debt securities in issue	–	–	–	–	4,164.8	–	4,164.8
Derivative financial instruments	143.5	838.2	–	–	–	106.2	1,087.9
Other borrowed funds	–	–	–	–	1,258.8	–	1,258.8
Amounts owed to other Co-operative Group undertakings	–	–	–	–	132.3	–	132.3
Total financial liabilities	143.5	2,268.0	–	–	43,849.2	106.2	46,366.9
Non-financial liabilities							315.6
Total liabilities							46,682.5
Capital and reserves							2,273.1
Total liabilities and equity							48,955.6

39. 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	Cashflow hedges	Total
2012							
Bank							
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	198.8	271.8	–	–	–	120.3	590.9
Equity shares	–	–	–	5.7	–	–	5.7
Amounts owed by other Co-operative Group undertakings	–	–	12,613.0	–	–	–	12,613.0
Total financial assets	1,159.0	2,270.6	42,434.6	3,569.6	–	120.3	49,554.1
Non-financial assets							2,264.4
Total assets							51,818.5
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	169.7	700.7	–	–	–	52.2	922.6
Other borrowed funds	–	–	–	–	1,258.6	–	1,258.6
Amounts owed to other Co-operative Group undertakings	–	1,764.4	–	–	6,044.6	–	7,809.0
Total financial liabilities	169.7	3,332.3	–	–	46,358.6	52.2	49,912.8
Non-financial liabilities							276.6
Total liabilities							50,189.4
Capital and reserves							1,629.1
Total liabilities and equity							51,818.5

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39. 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	Cashflow hedges	Total
2011							
Bank							
Assets							
Cash and balances at central banks	–	–	6,696.6	–	–	–	6,696.6
Loans and advances to banks	–	–	1,300.1	–	–	–	1,300.1
Loans and advances to customers	–	114.1	22,620.9	–	–	–	22,735.0
Fair value adjustments for hedged risk	–	–	365.8	–	–	–	365.8
Investment securities	–	343.1	866.1	3,107.4	–	–	4,316.6
Derivative financial instruments	166.4	319.5	–	–	–	218.5	704.4
Equity shares	–	–	–	5.7	–	–	5.7
Amounts owed by other Co-operative Group undertakings	–	–	12,961.2	–	–	–	12,961.2
Total financial assets	166.4	776.7	44,810.7	3,113.1	–	218.5	49,085.4
Non-financial assets							1,880.3
Total assets							50,965.7
Liabilities							
Deposits by banks	–	–	–	–	3,239.8	–	3,239.8
Customer accounts	–	–	–	–	32,670.1	–	32,670.1
Customer accounts – capital bonds	–	1,397.3	–	–	–	–	1,397.3
Debt securities in issue	–	–	–	–	1,431.0	–	1,431.0
Derivative financial instruments	146.0	799.3	–	–	–	106.2	1,051.5
Other borrowed funds	–	–	–	–	1,258.8	–	1,258.8
Amounts owed to other Co-operative Group undertakings	–	2,130.6	–	–	5,330.6	–	7,461.2
Total financial liabilities	146.0	4,327.2	–	–	43,930.3	106.2	48,509.7
Non-financial liabilities							295.6
Total liabilities							48,805.3
Capital and reserves							2,160.4
Total liabilities and equity							50,965.7

The 2011 Bank amounts owed to other Co-operative Group undertakings have been amended to include intercompany balances designated at fair value.

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 Group, 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. The Bank has detailed policies and procedures to manage risks. Retail mortgage lending and much of the lending to corporate and business banking customers is secured.

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.

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 capital funds. In addition to ordinary share capital and retained earnings, when appropriate, the Bank issues preference shares and perpetual and fixed term subordinated notes.

39. Fair values of financial assets and liabilities continued

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, forward rate agreements, 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 approved by the Board.

b. Valuation of financial instruments 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:			
	Level 1	Level 2	Level 3	Total
2012				
Group				
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	–	–	5.7	5.7
Derivative financial instruments	–	783.4	35.4	818.8
Total assets carried at fair value	4,990.3	2,530.3	52.3	7,572.9
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

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39. Fair values of financial assets and liabilities continued

	Fair value at end of the reporting period using:			
	Level 1	Level 2	Level 3	Total
2011				
Group				
Non-derivative financial assets				
Held for trading:				
Investment securities	–	–	–	–
Designated at fair value:				
Loans and advances to customers	–	101.7	12.4	114.1
Investment securities	343.1	–	–	343.1
Available for sale financial assets:				
Investment securities	1,836.9	1,586.1	–	3,423.0
Equity shares	–	–	5.7	5.7
Derivative financial instruments	–	950.4	25.4	975.8
Total assets carried at fair value	2,180.0	2,638.2	43.5	4,861.7
Non-derivative financial liabilities				
Designated at fair value:				
Customer accounts – capital bonds	–	1,429.8	–	1,429.8
Derivative financial instruments	–	1,074.6	13.3	1,087.9
Total liabilities carried at fair value	–	2,504.4	13.3	2,517.7

	Fair value at end of the reporting period using:			
	Level 1	**Level 2**	**Level 3**	**Total**
2012				
Bank				
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	**–**	**–**	**5.7**	**5.7**
Derivative financial instruments	**–**	**580.0**	**10.9**	**590.9**
Total assets carried at fair value	**4,990.3**	**2,101.4**	**27.8**	**7,119.5**
Non-derivative financial liabilities				
Designated at fair value:				
Customer accounts – capital bonds	**–**	**867.2**	**–**	**867.2**
Amounts owed to other Co-operative Group 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**

39. Fair values of financial assets and liabilities continued

	Fair value at end of the reporting period using:			
	Level 1	Level 2	Level 3	Total
2011				
Bank				
Non-derivative financial assets				
Held for trading:				
Investment securities	–	–	–	–
Designated at fair value:				
Loans and advances to customers	–	101.7	12.4	114.1
Investment securities	343.1	–	–	343.1
Available for sale financial assets:				
Investment securities	1,836.9	1,270.5	–	3,107.4
Equity shares	–	–	5.7	5.7
Derivative financial instruments	–	694.9	9.5	704.4
Total assets carried at fair value	2,180.0	2,067.1	27.6	4,274.7
Non-derivative financial liabilities				
Designated at fair value:				
Customer accounts – capital bonds	–	1,397.3	–	1,397.3
Amounts owed to other Co-operative Group undertakings	–	–	2,130.6	2,130.6
Derivative financial instruments	–	1,041.6	9.9	1,051.5
Total liabilities carried at fair value	–	2,438.9	2,140.5	4,579.4

The 2011 Bank amounts owed to other Co-operative Group undertakings (level 3) have been amended to include intercompany balances designated at fair value.

The carrying values of financial instruments measured at fair value are determined in compliance with the accounting policies on pages 40 to 50 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 £142.4m (2011: £101.7m) 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
OTC (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.

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.

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39. Fair values of financial assets and liabilities continued

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 £11.2m (2011: £12.4m) 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 £0.5m in 2012 (2011: £0.5m decrease). A reasonable change in the assumptions would not result in any material change in the valuation.

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 Group's percentage shareholding and the net asset value of the company according to its most recently published financial statements.

Amounts owed to other Co-operative Group undertakings
Amounts owed to other Co-operative Group 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 as discussed above.

Revaluation of the £1,764.4m (2011: £2,130.6m) 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.

During 2012, the Bank's amounts owed to other Co-operative Group undertakings decreased due to reanalysis of intercompany balances.

The amortisation profile is as per the swap's valuation methodology, assuming some annual prepayment, but is extended beyond any bond maturity, until all the mortgages themselves mature, which is circa 25 years. Similarly, the revenue receipts are calculated as per the swap valuation methodology, but extended until all the mortgages mature. 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 LIBOR 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 covered bond pool were originated pre 31 December 2007.

The fair value of the swap is based on a valuation model that reflects the mortgage cash flows over a three year period using a discount rate based on LIBOR spreads. This derivative eliminates on consolidation.

Derivative financial instruments
Derivative financial instruments including internal interest rate swaps have been entered into between the Bank and Silk Rd 1.

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 Silk Rd 1 pays 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 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.

The fair value of the swaps is based on a valuation model that reflects the mortgage cash flows over a three year period using a discount rate based on LIBOR spreads. These derivatives eliminate on consolidation.

39. 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
Group					
2012					
Loans and advances to customers	**12.4**	**–**	**–**	**(1.2)**	**11.2**
Derivative assets	**25.4**	**–**	**–**	**10.0**	**35.4**
Equity shares	**5.7**	**–**	**–**	**–**	**5.7**
Derivative liabilities	**(13.3)**	**–**	**–**	**0.9**	**(12.4)**
	30.2	**–**	**–**	**9.7**	**39.9**
2011					
Loans and advances to customers	11.8	–	–	0.6	12.4
Derivative assets	17.5	–	–	7.9	25.4
Equity shares	7.2	–	–	(1.5)	5.7
Derivative liabilities	(27.2)	–	–	13.9	(13.3)
	9.3	–	–	20.9	30.2

	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
Bank					
2012					
Loans and advances to customers	**12.4**	**–**	**–**	**(1.2)**	**11.2**
Derivative assets	**9.5**	**–**	**–**	**1.4**	**10.9**
Equity shares	**5.7**	**–**	**–**	**–**	**5.7**
Derivative liabilities	**(9.9)**	**–**	**–**	**(3.0)**	**(12.9)**
Amounts owed to other Co-operative Group undertakings	**(2,130.6)**	**–**	**361.8**	**4.4**	**(1,764.4)**
	(2,112.9)	**–**	**361.8**	**1.6**	**(1,749.5)**
2011					
Loans and advances to customers	11.8	–	–	0.6	12.4
Derivative assets	20.1	–	–	(10.6)	9.5
Equity shares	7.2	–	–	(1.5)	5.7
Derivative liabilities	(17.5)	–	–	7.6	(9.9)
Amounts owed to other Co-operative Group undertakings	(2,585.8)	–	448.2	7.0	(2,130.6)
	(2,564.2)	–	448.2	3.1	(2,112.9)

The 2011 Bank amounts owed to other Co-operative Group undertakings (level 3) have been amended to include intercompany balances designated at fair value.

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39. Fair values of financial assets and liabilities continued

c. Fair values of financial instruments not carried at fair value

The carrying values of financial instruments measured at amortised cost are determined in compliance with the accounting policies on pages 40 to 50.

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.

	Group		Bank	
	Carrying value	Fair value	Carrying value	Fair value
2012				
Financial assets				
Loans and receivables				
Loans and advances to banks	**1,904.1**	**1,902.9**	**1,047.2**	**1,046.0**
Loans and advances to customers	**33,185.9**	**33,222.7**	**22,631.9**	**22,487.6**
Fair value adjustments for hedged risk	**354.2**	**354.2**	**354.1**	**354.1**
Investment securities	**295.0**	**302.3**	**355.4**	**380.2**
Amounts owed by other Co-operative Group undertakings	**256.4**	**256.4**	**12,613.0**	**12,575.0**
Financial liabilities				
Financial liabilities at amortised cost				
Deposits by banks	**3,612.0**	**3,626.8**	**3,552.9**	**3,567.7**
Customer accounts	**35,884.4**	**36,108.4**	**33,750.3**	**33,969.4**
Debt securities in issue	**4,713.7**	**4,939.7**	**1,752.2**	**1,799.8**
Other borrowed funds	**1,258.6**	**1,161.3**	**1,258.6**	**1,161.3**
Amounts owed to other Co-operative Group undertakings	**112.0**	**112.0**	**6,044.6**	**6,115.6**

	Group		Bank	
	Carrying value	Fair value	Carrying value	Fair value
2011				
Financial assets				
Loans and receivables				
Loans and advances to banks	2,006.5	2,004.2	1,300.1	1,297.8
Loans and advances to customers	33,651.9	33,870.1	22,620.9	22,622.6
Fair value adjustments for hedged risk	366.3	366.3	365.8	365.8
Investment securities	804.9	798.5	866.1	859.7
Amounts owed by other Co-operative Group undertakings	179.2	179.2	12,961.2	12,373.3
Financial liabilities				
Financial liabilities at amortised cost				
Deposits by banks	3,302.7	3,305.1	3,239.8	3,242.2
Customer accounts	34,990.6	35,138.9	32,670.1	32,812.2
Debt securities in issue	4,164.8	4,008.1	1,431.0	1,434.5
Other borrowed funds	1,258.8	1,092.6	1,258.8	1,092.6
Amounts owed to other Co-operative Group undertakings	132.3	132.3	5,330.6	5,425.1

39. 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 fair value of floating rate placements and overnight deposits is their carrying amount. 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. A credit loss adjustment has been applied based on expected loss amounts derived from the Bank's regulatory capital calculations.

Loans and advances to customers
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 variable rate assets. A credit loss adjustment has been applied based on expected loss amounts derived from the Bank's regulatory capital calculations. The fair value of Group assets are higher than carrying value primarily because the current levels of interest rates are lower in comparison to the fixed levels of interest originated, and are reduced by the increased expectation of losses as the economy is expected to remain fragile for longer. In the Bank the expectation of losses outweighs the impact of interest rates and fair value is lower than carrying value. However in the Group, the fair value is higher because included within the carrying value are assets acquired through the merger with Britannia Building Society that were at a significant discount to their exposure amount.

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 discounted cash flows using interest rates for new debts with similar remaining maturity.

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, a discounted cash flow model is used based on a current yield curve appropriate for the remaining term to maturity.

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 maturity dates of the notes match the maturity dates of the underlying assets.

The Group retains substantially all of the risks and rewards of ownership. The Group benefits to the extent to which surplus income generated by the transferred mortgage portfolios exceeds the administration costs of those mortgages. The Group continues to bear the credit risk of these mortgage assets.

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39. Fair values of financial assets and liabilities continued

The results of the following principal securitisation vehicles are consolidated into the results of the Group. The table below shows the carrying values and fair values of the assets transferred to principal securitisation vehicles and their associated liabilities:

	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					
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)**

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.

In 2012, the market value of many of the fixed and floating rate notes has increased, with many of the AAA notes now trading above par, therefore uplifting the fair value. However, the repayment of the notes will be at par.

The securitisation vehicles receive cash daily in relation to the transferred loans and advances and semi-annually for the transferred gilts. These amounts will be 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.

	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
2011					
Leek Finance Number Seventeen plc	638.4	699.2	632.0	576.7	55.3
Leek Finance Number Eighteen plc	758.6	855.5	751.4	677.8	73.6
Leek Finance Number Nineteen plc	740.8	854.4	732.5	661.3	71.2
Leek Finance Number Twenty plc	1,581.7	1,556.8	1,555.6	1,450.5	105.1
Leek Finance Number Twenty One plc	998.0	1,011.3	983.3	915.1	68.2
Leek Finance Number Twenty Two plc	418.5	431.9	413.6	393.3	20.3
Meerbrook Finance Number Six Limited	82.4	61.9	81.4	61.9	19.5
Silk Road Finance Number One plc	2,130.6	2,151.5	2,130.6	2,124.7	5.9
Silk Road Finance Number Two plc	823.6	804.1	827.3	799.2	28.1
	8,172.6	8,426.6	8,107.7	7,660.5	447.2

Covered Bond Limited Liability Partnership

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 (2011: £0.6bn) and a capital contribution of £1.2bn (2011: £1.0bn) with Moorland Covered Bonds LLP.

The loans issued by the Bank are included within amounts owed by other Co-operative Group undertakings. The associated capital contribution invested by the Bank is included within investments in Group undertakings. The notes issued by the Bank in November 2011 are included within debt securities in issue.

39. Fair values of financial assets and liabilities continued

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 Group 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
2012					
Moorland Covered Bonds LLP	**1,808.4**	**600.0**	**1,835.8**	**693.8**	**1,142.0**

	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
2011					
Moorland Covered Bonds LLP	1,559.5	600.0	1,602.4	602.8	999.6

39. Fair values of financial assets and liabilities continued

Assets pledged

Assets are pledged as collateral under repurchase agreements with other banks. These deposits are not available to finance the Group'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
2012					
Group					
Investment securities sold under repurchase agreements	**1,907.4**	**1,830.9**	**1,907.7**	**1,827.5**	**80.2**
Bank					
Investment securities sold under repurchase agreements	**1,907.4**	**1,830.9**	**1,907.7**	**1,827.5**	**80.2**
Amounts owed by other Co-operative Group undertakings sold under repurchase agreements	**1,324.6**	**896.7**	**1,301.6**	**911.7**	**389.9**

	Carrying amount of assets not derecognised	Carrying amount of associated liabilities	Fair value of assets not derecognised	Fair value of associated liabilities	Net position
2011					
Group					
Investment securities sold under repurchase agreements	2,114.4	1,703.2	2,114.9	1,869.1	245.8
Bank					
Investment securities sold under repurchase agreements	2,114.4	1,703.2	2,114.9	1,869.1	245.8
Amounts owed by other Co-operative Group undertakings sold under repurchase agreements	777.1	613.9	767.4	614.3	153.1

Associated liabilities are included within deposits by banks.

The Group and Bank have loans and advances to banks of £250.0m (2011: £255.7m) under reverse sale and repurchase agreements and against gilts are held with a fair value of £250.4m (2011: £267.8m). These transactions are conducted under terms that are usual and customary to standard stock lending, securities borrowing and reverse purchase agreements. The Group is permitted to sell or repledge the assets received as collateral in the absence of their default. The Group is obliged to return equivalent securities. At 31 December 2012 the fair value of collateral repledged amounted to £250.4m (2011: £267.8m). The Group and Bank do not adjust for the fair value of securities received under reverse sale and repurchase agreements.

Notes to the financial statements continued

For the year ended 31 December 2012

All amounts are stated in £m unless otherwise indicated

40. Bank only analysis of credit risk exposure

2012	**Loans and advances to banks**	**Loans and advances to customers**	**Investment securities**				**Derivative financial instruments**	**Total**
			Loans and receivables	**Available for sale**	**Fair value through income or expense**	**Held for trading**		
Analysis of balance in note	14	15	16	16	16	16	17	
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**	**366.4**	**3,563.9**	**1,845.2**	**960.2**	**590.9**	**30,305.8**
Impaired	**–**	**1,311.6**	**–**	**39.0**	**–**	**–**	**–**	**1,350.6**
	1,047.2	**23,243.6**	**366.4**	**3,602.9**	**1,845.2**	**960.2**	**590.9**	**31,656.4**
Credit commitments	**54.1**	**4,736.5**	**–**	**–**	**–**	**–**	**–**	**4,790.6**
Gross credit risk exposure	**1,101.3**	**27,980.1**	**366.4**	**3,602.9**	**1,845.2**	**960.2**	**590.9**	**36,447.0**
Less:								
Fair value adjustments	**–**	**(39.9)**	**(11.0)**	**–**	**–**	**–**	**–**	**(50.9)**
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**

2011	Loans and advances to banks	Loans and advances to customers	Investment securities				Derivative financial instruments	Total
			Loans and receivables	Available for sale	Fair value through income or expense	Held for trading		
Analysis of balance in note	14	15	16	16	16	16	17	
Gross balance	1,300.1	22,993.1	868.8	3,149.9	343.1	–	704.4	29,359.4
Less: allowance for losses	–	(258.1)	(2.7)	(42.5)	–	–	–	(303.3)
	1,300.1	22,735.0	866.1	3,107.4	343.1	–	704.4	29,056.1
Analysis of credit risk exposure								
Not impaired	1,295.5	22,240.0	884.7	3,107.4	343.1	–	704.0	28,574.7
Impaired	21.0	795.9	3.9	42.5	–	–	0.4	863.7
	1,316.5	23,035.9	888.6	3,149.9	343.1	–	704.4	29,438.4
Credit commitments	40.6	4,661.8	–	–	–	–	–	4,702.4
Gross credit risk exposure	1,357.1	27,697.7	888.6	3,149.9	343.1	–	704.4	34,140.8
Less:								
Fair value adjustments	(16.4)	(42.8)	(19.8)	–	–	–	–	(79.0)
Allowance for losses	–	(258.1)	(2.7)	(42.5)	–	–	–	(303.3)
Net credit risk exposure	1,340.7	27,396.8	866.1	3,107.4	343.1	–	704.4	33,758.5

The comparative figures for loans and advances to customers have been updated to include the changes made to impairment definitions.

Responsibility statement

for the year ended 31 December 2012

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 profit or loss 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
Barry Tootell, Chief Executive

20 March 2013

Notice of Annual General Meeting 2013

NOTICE IS HEREBY GIVEN that the Annual General Meeting of The Co-operative Bank plc will be held on the 9th Floor, 1 Angel Square, Manchester M60 0AG at 9am on Wednesday 15 May 2013 for the following purposes:

Ordinary Business

1. To receive the notice convening the meeting.

2. To receive the annual reports and adopt the financial statements for the year ended 31 December 2012, together with the auditors' report.

3. To approve the remuneration report for the year ended 31 December 2012.

4. To accept the following recommendations of the Board in respect of the non-cumulative irredeemable preference shares:

i) that the payment of the dividend of 4.625p per £1 share on 30 November 2012 be confirmed.

ii) that a dividend of 4.625p per £1 share be declared and paid on 31 May 2013 to the registered holders as at 3 May 2013 providing a dividend rate of 9.25 per cent per annum and making a total distribution of £5,550,000.

5. To re-elect the following directors who retire by rotation, in accordance with the provisions of Article 105:

i) Duncan Bowdler, Non-Executive Director

ii) Peter Harvey, Non-Executive Director

iii) Bob Newton, Non-Executive Director

6. To re-appoint the following directors who were appointed to the Board since the last Annual General Meeting of the Company:

i) Richard Coates, Non-Executive Director

7. To re-appoint KPMG Audit Plc as auditor of the Company, to hold office from the conclusion of this meeting until the conclusion of the next General Meeting at which accounts are laid before the Company, at a remuneration to be fixed by the Directors:

Registered Office:
1 Balloon Street
Manchester M60 4EP
Reg. No. 990937 (England)
Tel: 0161 832 3456
Fax: 0161 829 4475
Tel: 0870 702 0003

Registrar:
Computershare Investor Services PLC
P.O. Box 82
The Pavilions
Bridgwater Road
Bristol BS99 7NH

By Order of the Board
Moira Lees, Secretary

20 March 2013

A member entitled to attend and vote at the meeting is entitled to appoint a proxy to attend and vote on his/her behalf. A proxy need not also be a member. Further information on preference shareholders' voting rights is given below.

Members should note that to attend the meeting their shareholding must be registered on the register of the Company not later than 9am on 13 May 2013. This applies to shares held in uncertified forms in CREST and to shares held in certified form.

Notes:

1. Director information

The biographies of the directors up for re-election and re-appointment at the Annual General Meeting can be found on page 12 of the financial statements.

2. Preference shareholders – Extract from Articles of Association 4 (B)(c)

Voting and General Meetings

i) The holders of the preference shares shall be entitled to receive notice of and attend (either in person or by proxy) all General Meetings of the Company. The holders of the preference shares shall have a right to speak and vote at a General Meeting of the Company only if and when, at the date of the notice convening such meeting, the fixed preferential dividend payable to them respectively has been in arrears for six months or more after any date fixed for payment thereof, or if a resolution is to be proposed at such meeting abrogating or varying any of the respective rights or privileges attaching to their shareholding or for the winding-up of the Company or other return of capital and then on such resolution only.

ii) Whenever the holders of the preference shares are entitled to vote at a General Meeting of the Company upon any resolution proposed at such meeting, on a show of hands every holder who (being an individual) is present in person or (being a corporation) is present by a representative or by proxy shall have one vote and, on a poll, shall have one vote in respect of each preference share registered in the name of such holder.

Glossary

For the year ended 31 December 2012

The following glossary defines terminology used within the Group'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.
Asset & Liability Committee (ALCO)	This committee is chaired by the Chief Executive Officer and is primarily responsible for overseeing the management of market, liquidity and funding risks. Its responsibilities include ensuring that the capital and solvency position is managed in line with policy and that adequate capital is maintained at all times overseeing and monitoring relevant risk control frameworks and recommending to CEO and ERC relevant risk policies and detailed risk appetite limits for approval.
Asset-backed securities (ABS)	Securities that represent an interest in an underlying pool of referenced assets. The referenced pool can comprise any assets which attract a set of associated cash flows but are commonly pools of residential or commercial mortgages but could also include leases, credit card receivables, motor vehicles, student loans.
Audit Committee (AC)	The committee which provides oversight in relation to financial reporting, internal control, regulatory compliance, external and internal audit across the Banking Group.
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.
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 was implemented in the UK by the FSA.
Basel III	A strengthening of the requirements laid out in Basel II, to be phased into the Bank gradually between 2013 and 2019 ahead of full implementation by 2023. This phased implementation is now expected to commence in the UK in 2014.
Basis points (bps)	One hundredth of a per cent (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 FSA's capital requirements.
Board Risk Committee (BRC)	This committee provides oversight and advice to the Banking Group Board on current and potential risks and the overall risk framework, including risk appetite, risk tolerance and management strategies.
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 Management Committee (CMC)	This committee reviews, challenges and monitors the capital adequacy of the Banking Group, in line with capital policy and within risk appetite.
Capital ratio	Total of Tier 1 capital plus Tier 2 capital, all divided by risk weighted assets.
Capital resources	Capital held, allowable under regulatory rules, less certain regulatory adjustments and deductions that are required to be made. Capital includes the general reserve, revaluation reserve, collectively assessed impairment allowances for products measured on a standardised basis and subordinated debt.
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 fellow 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.

Glossary continued
For the year ended 31 December 2012

Terminology	Definition
Commercial real estate	Commercial real estate includes office buildings, industrial property, malls, retail stores, shopping centres, multifamily housing buildings, warehouses, and industrial properties.
Conduct risk	The risk that the Banking Group'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.
Core business	Lines of business that are consistent with the Bank's strategy and risk appetite.
Corporate and Business Banking (CABB)	The Group's operating segment which includes Corporate, Optimum and Illius. This includes lending to large corporate and commercial entities, acquired mortgage books and a specialist mortgage team dealing with intermediary lending.
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 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 Approvals Committee	The Credit Approvals Committee supports the Chief Executive Officer carrying out his responsibilities including, but not limited to, sanctioning large counterparty transactions and managing large exposure positions.
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.
Credit Risk Management Committee (CRMC)	This committee advises and supports the Credit Risk Director. It designs the credit risk control implementation approach and risk control framework. It reviews the CBG credit risk policy and credit measurement methodologies, defines and recommends the credit risk appetite and limits and reviews and challenges the CBG credit risk processes and procedures.
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 advocacy	An external survey, measuring the level of the Bank's customers who would personally recommend the Bank to other potential new customers as their primary financial services provider.
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 for equity swaps	The act whereby a creditor exchanges a loan asset for a stake in its relevant debtor company's equity share capital.
Debt securities in issue	Transferable certificates of indebtedness of the Group to the bearer of the certificates. These are liabilities of the Group 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.
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.

Terminology	Definition
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.
Eurozone	The geographical area containing countries whose economies function using the European single currency.
Executive Risk Committee (ERC)	The committee is chaired by the Chief Risk Officer (CRO). Its purpose is to provide a mechanism to ensure that the Banking Group's risk management is reviewed, challenged and approved (with escalation to Board Risk Committee where required) and embedded within the Banking Group.
Executive Committee	This committee manages the business in line with the Board risk appetite statement. It also maintains oversight of risk management processes and management information.
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 parameter used in internal ratings based approaches to estimate the amount outstanding at the time of default.
External audit	The independent review by an external firm of the Company's financial statements.
External credit rating	A financial indicator of risk, assigned by credit rating agencies, to potential investors in the Group.
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 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 regulates the financial services industry in the best interests of its stakeholders. It is a company limited by guarantee and financed by the financial services industry.
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 FSA 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 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').
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.

Glossary continued
For the year ended 31 December 2012

Terminology	Definition
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 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 FSA (see 'Liquidity risk').
Individual Liquidity Guidance (ILG)	A FSA 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.
Integration and Transformation Committee	This committee provides oversight by in depth review of transformation activity within the Group in order to give assurance on progress.
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 FSA permission.
Investment grade	A debt security, treasury bill or similar instrument with a credit rating measured by external agencies of AAA to BBB.
Legacy insurance products	Insurance products which are no longer sold to customers by the Group.
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.
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).
Liquidity Management Committee (LMC)	This committee enables more 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 ensure the Bank's liquidity position remains in line with agreed levels.
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 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 and Appointments 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 Group'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.

Terminology	Definition
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’).
Member	A person who holds and retains one share in The Co-operative Group. The share is paid for by a £1 deduction from the member’s first profits payment. The member, by a result of the deduction, becomes a shareholder of the Co-operative Group Limited.
Merger	Any combination of two or more business enterprises into a single enterprise. In the Group, this specifically refers to the merger of the Bank with Britannia Building Society on 1 August 2009 (see ‘Transfer of engagements’).
Mobile banking service	A service allowing customers to access their account information and locate branches and ATMs via iPhone, BlackBerry and Android handsets.
Model Review Committee (MRC)	This committee provides oversight and challenge of model governance across the Banking Group in support of the Enterprise Risk Director.
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.
Operational Risk Committee (ORC)	This committee reports into the Executive Risk Committee and is chaired by the Operational Risk Director. It monitors significant operational risks and controls as well as the management actions taken to mitigate them to an acceptable level and/or transfer them.
Optimum	A sub-segment within Corporate and Business Banking 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 Banking Group 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 are fixed interest shares and are non-cumulative and irredeemable. On a return of capital on winding up, the assets of the Bank shall be applied in repaying the preference share capital in priority to any payments to the holders of any other class of shares in the capital of the Bank.
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.
Project Verde	The bid to purchase the Verde business from the Lloyds Banking Group. Also referred to as project Mars.

Glossary continued
For the year ended 31 December 2012

Terminology	Definition
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.
Regulatory Risk Committee (RRC)	This committee supports the Regulatory Risk Director. It ensures maintenance of appropriate authorisations for the regulated entities within CBG, adherence to regulatory reporting requirements and any ongoing regulatory engagement.
Remuneration and Appointments Committee	This committee determines the policy on remuneration and other terms and conditions of employment of senior executives. It makes recommendations on senior executive appointments and the related terms and conditions. It reviews and agrees remuneration policy for staff under the FSA remuneration code (see 'Remuneration Code'). In addition, it reviews and approves incentive schemes and decides on issues surrounding the retirement benefit schemes.
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 Co-operative Banking Group either through its strategic decisions, business performance, an operational failure or external perception.
Retail segment	The segment that comprises 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 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 Group is willing to accept (or not accept) in order to safeguard the interests of the members whilst achieving its business objectives.
Risk Management Forums	A framework of sector specific management forums supporting risk and capital management, optimising performance and monitoring adherence to policy.
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.
Roll up mortgage	A mortgage, whose accrued interest is added to its principal amount and settled at the end of its repayment term.
Sale and purchase agreement (SPA)	A legal contract which obliges the buyer to buy and seller to sell products or services.
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 Group 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.
Significant items	Items which are material by both size and nature (ie outside of the normal operating activities of the Group) are treated as significant items and disclosed separately on the face of the income statement.

Terminology	Definition
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').
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 and business risk	Risk arising from changes to the Banking Group'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.
Subordinated debt/liabilities	Liabilities which, in the event of insolvency or liquidation of the Group, are subordinated to the claims of depositors and other creditors of the Group.
Sub-sovereign	Any level of government below the national or central government. This includes regions, provinces, states, municipalities.
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.
Tenor	The length of time until a loan is due. For example, a loan is taken out with a two year tenor. After one year passes, the tenor of the loan is one year.
Term deposit	A deposit balance that cannot be withdrawn before a date specified at the time of deposit.
the Bank	The Co-operative Bank as a standalone entity.
the Banking Group	See 'The Co-operative Banking Group'.
the Board	The Board of Directors. They manage the Banking Group's business performance in line with its purpose, givens, vision and values.
The Co-operative Banking Group	An internal brand, which is a consolidation of the following entities: CFS Management Services Ltd, CFS Services Ltd, CIS General Insurance Ltd, Co-operative Insurance Society Ltd, Co-operative Asset Management Ltd and Co-operative Bank plc.
The Co-operative Group	The ultimate holding company.
the Group	The Co-operative Bank consolidated with its subsidiaries.
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 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.

Glossary continued

For the year ended 31 December 2012

Terminology	Definition
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 (see 'Upper Tier 2' and 'Lower Tier 2').
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 Market Risk Committee (TMRC)	This committee reviews, challenges and monitors the market risk profile for the Banking Group, in line with policy and within the risk appetite.
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 Group's external auditor.
Unfunded pension scheme	Pension scheme which has liabilities and no assets. The Group will pay the liabilities of the scheme as they fall due.
Unsecured lending	Lending for which there is no collateral for the loan.
Upper Tier 2	Upper Tier 2 capital comprises the Group's preference shares, perpetual subordinated bonds and revaluation reserves.
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').

Notes

Notes

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