The Co-operative Bank plc

Building the compelling co-operative alternative

Interim financial report 2012

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

The **co-operative**
good with money

Contents

Highlights

As a key part of The Co-operative Banking Group, the Co-operative Bank plc measures its success against a range of areas.

These are our highlights for the first half of 2012.

Lloyds Banking Group

- Agreed Head of Terms with Lloyds Banking Group over sale of Verde Business, potentially giving the Co-operative Bank a 7% share of UK current accounts

Financial

- Income of £385.1m, down 11.4% on previous year reflecting the difficult economic environment
- Core operating result of £84.3m for the first half of the year (down 20.5%)
- PBT of £(58.6)m, of which non-core is £(73.0)m (2011: PBT £(9.8)m)
- No sovereign exposure to Portugal, Ireland, Italy, Greece and Spain, and material reduction of 76% in exposure to financial institutions in these jurisdictions, from £208.8m to £50.2m

Customer and colleagues

- 3.3% increase in number of customers who hold their primary current accounts with us
- 5% more customers switched to us from their previous bank compared with same time last year
- Three month ‘interest freeze’ on overdrafts in first quarter of the year
- Launch of mobile banking app for iPhone and Blackberry
- Colleague engagement levels stable and slightly ahead of last year

Ethical

- £1bn commitment to invest in green energy
- Celebrating 20 years of our Ethical Policy

Awards

- Awarded Europe’s most sustainable bank for third year running
- Multiple award winner in the Money Wise Customer Service Awards
- Best Financial Services provider in the 2012 ‘Which?’ awards
- Won ‘Best Card Cross Selling Programme of the Year’ at UK Card and payments awards

Purpose, vision, givens and values

Our strategy is made up of our **purpose, vision, givens, values** and our business plans. Together they help define us as a business, set the direction and inform the decisions we make and how we behave.

Our **purpose**

Our **purpose** is to be a pioneering business delivering sustainable financial services for members and society.

Our **vision**

To be the UK's most admired financial services business.

Our **givens**

- we champion **co-operative values, principles and ethics**;
- we are **financially prudent and strong**;
- we **share profits** with members; and
- we only do business **consistent with our values and principles**.

Our **values**

Our **values** describe what is important to our organisation and guide our behaviours by determining how we interact with each other and our customers. By living our values, we will deliver a consistent and positive customer experience every time.

As a co-operative business:

- we put our **members and customers first** in all we do;
- we take **personal and social responsibility**;
- together we will create **a great place to work, grow and develop**;
- we strive relentlessly to be **faster, better, more successful**; and
- we are open and fair and are committed to **excellent communication**.

Business and financial review

Overview

The UK market in 2012 is proving to be challenging, with the first double dip recession seen in the UK since the 1970s. The continued uncertainty in the eurozone together with the prolonged low base rate environment and consequent margin compression have continued to place significant pressure on the industry. Higher levels of unemployment and falling living standards continue to inhibit customer confidence.

Our financial performance reflects the impact of these difficult conditions. The disappointing operating result of £11.3m for 2012 (2011: £108.6m) testifies to the continuing strain within the corporate sector reflected in an increase in impairments, alongside the reduction in income due to the continued low base rate environment and increasingly higher cost of funding. The income statement also benefited from gains on the sale of Treasury assets of £10.7m (2011: £24.2m). In addition to these sales, we have also sold our remaining claim against Lehman resulting in an additional £9.7m profit. The loss before taxation of £58.6m (2011: loss of £9.8m) reflects the reduction in operating profits noted above, a provision for additional PPI mis-selling of £40.0m (2011: £90.0m), and higher significant items, partly as the result of our bid for the 632 Lloyds Bank branches ('Project Verde').

We have continued to focus on our balance sheet strength and solid financial foundations for the business. Our core tier one ratio remains steady, at 9.6% (December 2011: 9.6%). Levels of liquidity have been carefully managed, reducing somewhat since the elevated levels at the end of 2011, to balance margin, capital and liquidity requirements, yet still remaining at acceptable levels. The loan-deposit ratio was 101% at the end of June (December 2011: 94%). This reflects our policy of keeping the ratio broadly in balance.

Maintaining the trend reported at the end of 2011, residential mortgage asset quality continues to improve, with our levels of late residential mortgage arrears (>2.5% of balance) now standing at 1.03% (December 2011: 1.18%).

Balanced scorecard

Financial results are only one component of our performance. We continue to run our business on a balanced basis via the scorecard, incorporating effective risk and process management, and our impact on colleagues and customers. We remain committed to building long term relationships with our customers and our ambition to offer a compelling co-operative alternative within the financial services industry is as strong as ever. Our aim is to continue to deliver service improvements to our customers, for example through the use of mobile banking (launched in June 2012) and contactless payments technology which we launched in July 2012. Our customer advocacy levels testify to the high degree of trust placed in us by our customers, and our great customer service. As at June 2012, advocacy for The Co-operative Banking Group was 9.3% above the average of our top five competitors.

Similarly, the number of customers who consider us their main bank, key to our continued overall growth, has increased further, with the number of primary current accounts increasing by 3.3% during the first half of 2012. In the first six months of the year, 5.0% more customers have switched to us from their previous bank compared with the same point last year.

In April 2012, a sample of Banking Group colleagues took part in our Group wide interim colleague survey. The results suggest that despite the current levels of change and uncertainty in the business, engagement levels are stable and slightly ahead of last year.

Our commitment to sustainability has again been recognised, as The Co-operative Banking Group was awarded the accolade of Europe's most sustainable bank for the third year running by the Financial Times. Our success recognises that we are trusted to deliver on our commitment to leadership and innovation in social and environmental banking better than any other financial institution in Europe and demonstrates the resilience of the co-operative model during difficult financial times. Amongst other factors, the award acknowledged our Ethical Policy (launched over two decades ago), our £1bn commitment to investment in green energy (as seen in the financing of the UK's largest community wind farm) and our support for the financially excluded (for example our commitment to scrapping interest charges on agreed overdrafts).

Financial summary

	2012 £m	2011 £m	Change £m	Change %
Income	**385.1**	434.6	(49.5)	(11.4)
Operating costs – steady state	**(272.7)**	(268.6)	(4.1)	(1.5)
Operating costs – strategic initiatives	**(9.2)**	(11.3)	2.1	18.6
Impairment losses	**(91.9)**	(46.1)	(45.8)	(99.3)
Operating result	**11.3**	108.6	(97.3)	(89.6)
Of which:				
Core	**84.3**	106.1	(21.8)	(20.5)
Non-core	**(73.0)**	2.5	(75.5)	(3,020.0)
Operating result	**11.3**	108.6	(97.3)	(89.6)
Significant items	**(19.3)**	(27.7)	8.4	30.3
Transformation costs relating to Project Verde	**(20.0)**	–	(20.0)	n/a
Recharges paid to The Co-operative Group	**(10.1)**	–	(10.1)	n/a
Payment protection insurance (PPI) provision	**(40.0)**	(90.0)	50.0	55.6
Share of post tax profits from joint ventures	**0.6**	0.3	0.3	100.0
Financial Services Compensation Scheme (FSCS) levies	**(0.8)**	(5.9)	5.1	86.4
Fair value amortisation	**19.7**	16.7	3.0	18.0
Membership dividend	**–**	(11.8)	11.8	100.0
Loss before taxation	**(58.6)**	(9.8)	(48.8)	(498.0)

The operating result for the six months to June 2012 was £11.3m (2011: £108.6m). While the underlying performance was satisfactory, the disappointing overall result and the reduction of £97.3m against 2011 was predominantly a reflection of the current adverse economic conditions.

Income levels for the Bank were down £49.5m against 2011. This reflects the pressures from the higher cost of funding across all areas of the business, as well as the impact of additional funding raised over the past year. The reduced level of income was the main driver in the reduction in the operating result for the core business.

Operating costs (excluding strategic investment costs) have increased by 1.5% from £268.6m in 2011 to £272.7m in 2012. Removing the impact of inflation (including higher pension costs), underlying costs improved by £6.4m or 2.4%, reflecting a policy of tight cost control, ongoing procurement initiatives and the impact of Project Unity, The Co-operative Group programme seeking to maximise the customer and commercial benefits of belonging to the world's largest consumer co-operative. Operating costs were also higher compared to 2011 due to the additional depreciation charge arising from the investment programme undertaken in recent years. However, work is ongoing in cost management

Business and financial review continued

and we remain committed to further improving the cost position over the medium term.

As seen particularly in the second half of 2011, impairment losses continue to reflect the strains in the Corporate sector. The impairment charge rose to £91.9m from £46.1m, due principally to charges on the non-core Corporate loan portfolio. Together with the reduced levels of income, this was the main cause of the operating loss of £73.0m (2011: profit of £2.5m) for the non-core business. The residential mortgage book (both Retail and Optimum) continued to perform well and arrears reduced further during 2012, with late mortgage arrears (>2.5% of balance) down from 1.18% at December 2011 to 1.03% at June 2012.

The loss before tax was after a charge of £40.0m for PPI mis-selling (2011: £90.0m). In line with many of our competitors, we have seen an acceleration in the rate of claims during 2012, driven largely by the activity of claims management companies, and the additional charge in 2012 reflects this. We remain committed to doing the right thing for our customers, especially if we get things wrong and will deal with their complaints in a fair, personal, easy and responsible manner.

Significant items of £19.3m (2011: £27.7m) were incurred during the year, primarily associated with the investment in our transformation and integration programme. In addition a further £20.0m of transaction costs were incurred in relation to Project Verde.

As part of Unity, we have consolidated a number of enterprise services and these, and the value of central group functions, are paid as a group recharge.

No membership dividend is to be paid for the first half of 2012.

Comprehensive income, which includes movements directly through reserves as well as the income statement, was £15.3m (2011: £6.1m) principally reflecting increases in value of investment securities available for sale.

During these difficult times, we have maintained our focus on supporting our customers. £1.0bn has been lent to Retail Bank mortgage customers in the first half of 2012 (2011: £0.5bn) and a further £0.5bn (2011: £0.3bn) via Platform, our intermediary mortgage business. The balance sheet has been actively managed so as to ensure a balance between margin, capital and liquidity. Despite the resulting reduction in levels of liquidity, the position remains robust with the loan-deposit ratio broadly in balance at 101% (December 2011: 94%). Early in the third quarter of 2012, £650m was raised via our third 'Silk Road' prime mortgage securitisation since the merger.

Capital continues to be carefully managed, with the Bank core tier one capital ratio at 9.6% (December 2011: 9.6%). The total capital ratio was 14.8% (2011: 14.7%), with a tier one ratio of 9.9% (2011: 9.9%).

Our businesses

Operating result	**2012 £m**	2011 £m	Change £m	Change %
Core				
Retail Banking	**32.0**	57.8	(25.8)	(44.6)
CABB – core	**30.1**	20.3	9.8	48.3
Treasury/other	**22.2**	28.0	(5.8)	(20.7)
Core operating result	**84.3**	106.1	(21.8)	(20.5)
Non-core				
CABB – non-core	**(73.0)**	2.5	(75.5)	(3,020.0)
Operating result	**11.3**	108.6	(97.3)	(89.6)

The Bank consists of two primary operating segments – Retail Banking, and Corporate and Business Banking (CABB).

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).

Corporate banking is now being managed through two business units. The 'Core' business unit represents lines of business that are consistent with our strategy and risk appetite. 'Non-Core' lines of business, which include sectors not congruent with our current strategy, are managed for value and are targeted for run down or exit, and contain the majority of the impairment risk. 'CABB – non-core' also includes Optimum (the closed book of intermediary and acquired loan book assets) and Illius (the residential property company).

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

Retail Banking

Retail Banking operating result	**2012 £m**	2011 £m	Change £m	Change %
Net interest income	**196.6**	204.6	(8.0)	(3.9)
Non-interest income	**68.4**	81.1	(12.7)	(15.7)
Net income	**265.0**	285.7	(20.7)	(7.2)
Operating costs – steady state	**(208.1)**	(201.1)	(7.0)	(3.5)
Operating costs – strategic initiatives	**(6.7)**	(8.7)	2.0	23.0
Impairment losses	**(18.2)**	(18.1)	(0.1)	(0.6)
Operating result	**32.0**	57.8	(25.8)	(44.6)

The Retail Banking operating result for the six months to June 2012 was £32.0m (2011: £57.8m). This comprised £27.6m (2011: £59.1m) for Retail Bank and £4.4m (2011: loss of £1.3m) for Platform.

Retail Bank

Interest income for Retail Bank was down £13.8m at the half year, mainly reflecting the higher cost of attracting and retaining retail deposits against a backdrop of the general economic contraction and low interest rates. The costs of acquisition associated with our current account customer campaign have also resulted in lower year on year interest income. This has however been partly offset by the continuing improvement in the profitability of the mortgage book as a result of higher margins on both new and existing business.

Non-interest income was lower than last year due to a combination of factors, including lower investment income from the sale of third party products, reflecting the contraction of the wider investment advice market.

Impairment losses were flat year on year reflecting the high quality of new lending, and continuing improvements in the collection of arrears, against the backdrop of the deteriorating economic environment. Mortgage quality has been maintained with continued low rates of impairment, and late arrears (>2.5% of balance) on only 0.29% of accounts (December 2011: 0.30%).

In line with our strategic plan, both lending and deposit balances have contracted slightly in order to optimise income opportunities and to protect our strong customer funding position.

The strength of the Retail customer proposition continues to be recognised by a range of awards. In 2012 The Co-operative Bank was successful in multiple categories at the Moneywise Customer Service Awards and The Card & Payments Awards, recognising consumer banking propositions across both the Bank and the wider Co-operative Group. The Co-operative Bank's credibility amongst customers and commentators alike was underscored by a third successive year of being shortlisted for 'Best Financial Services Provider' at the 2012 'Which?' awards.

Platform

The Platform intermediary mortgage business, focusing on the prime mortgage and buy to let markets, has continued to grow modestly in the marketplace in the first half of 2012. The focus for Platform continues to be on good quality prudent lending and advances of £0.5bn have been extended during the first six months to June 2012 (2011: £0.3bn) with strong margins achieved and late arrears (>2.5% of balance) on only 0.29% of accounts (December 2011: 0.30%).

Corporate and Business Banking – core

CABB core operating result	2012 £m	2011 £m	Change £m	Change %
Net interest income	**54.0**	51.4	2.6	5.1
Non-interest income	**32.2**	26.2	6.0	22.9
Net income	**86.2**	77.6	8.6	11.1
Operating costs – steady state	**(37.2)**	(37.9)	0.7	1.8
Operating costs – strategic initiatives	**(1.4)**	(1.3)	(0.1)	(7.7)
Impairment losses	**(17.5)**	(18.1)	0.6	3.3
Operating result	**30.1**	20.3	9.8	48.3

Core Corporate and Business banking has delivered an operating result of £30.1m during the first half of 2012 (2011: £20.3m) through improved margins and lower costs. There has been limited measured growth of Corporate Banking assets through selected high quality new business, leading to improved margins.

The potential mis-selling of derivatives to corporate and business banking customers has been much publicised in recent weeks. The Bank has agreed to join the FSA review of these sales. The Bank has sold only small numbers of simple products to our customers to help them manage interest rate risk. We have examined these sales and do not believe there to be customer detriment or inappropriate sales.

Treasury/other businesses

The main component for the 'Treasury/other' business segment is our Treasury operation, which focuses on ensuring that the Bank has a stable liquidity base, access to a diverse range of funding sources and that market risk is managed within a defined risk appetite. Treasury profit reduced by £5.0m from 2011 to 2012, mainly due to the impact of the higher funding costs and additional levels of funding raised in the past 12 months. During the first six months of 2012 Treasury profits benefited from some asset sales and reinvestment in current market yielding assets. This generated a profit of £10.7m. In addition to these sales, we have also sold our remaining claim against Lehman resulting in an additional £9.7m profit. The business introduced credit valuation adjustments to non-collateralised swaps, resulting in a fair value reduction to the swap assets and a £4m adverse impact on profit.

The Bank remains a UK focused operation. It has no sovereign exposure to 'peripheral' eurozone countries (Portugal, Ireland, Italy, Greece and Spain), and has materially reduced its exposure to financial institutions in these jurisdictions, from £208.8m to £50.2m. As at 30 June 2012 the Bank had a £304.9m (31 December 2011: £90m) exposure to the Government of Finland, repayable in over one year. It held no other non-UK European sovereign debt. The Bank has no direct exposure to financial institutions in Greece, Portugal or Italy.

Corporate and Business Banking – non-core

CABB non-core operating result	2012 £m	2011 £m	Change £m	Change %
Net interest income	**(8.5)**	22.4	(30.9)	(137.9)
Non-interest income	**9.4**	8.0	1.4	17.5
Net income	**0.9**	30.4	(29.5)	(97.0)
Operating costs – steady state	**(15.2)**	(18.3)	3.1	16.9
Operating costs – strategic initiatives	**(0.3)**	(1.1)	0.8	72.7
Impairment losses	**(58.4)**	(8.5)	(49.9)	(587.1)
Operating result	**(73.0)**	2.5	(75.5)	(3,020.0)

The non-core operating result for the six months to June 2012 was a loss of £73.0m (2011: profit of £2.5m). This comprised a loss of £70.0m (£19.9m) for the non-core Corporate portfolio, a £2.2m loss (profit of £23.9m) for Optimum and a £0.8m loss (£1.5m) for Illius.

Non-core Corporate

The non-core Corporate business delivered an operating loss of £70.0m (2011: £19.9m) in the first half of 2012. The fall in net interest income was due to an increase in the cost of funding, partly associated with the tenor of much of this lending. Impairment losses rose from £8.3m to £56.9m, reflecting the current difficult times for the industry and continuing the trend seen in the second half of 2011.

Strategic options are being reviewed to improve the profitability and capital consumption of this book. However, any viable solutions are likely to be medium term in nature and, in the short term, very active and close management of the impairment and profitability position is being undertaken.

Optimum

In 2012 the Optimum portfolio, a closed book of intermediary and acquired mortgage book assets, reduced in size, as planned, by 2% to £7.5bn. The loss of £2.2m for Optimum (2011: profit of £23.9m) partly reflected the impact of lower income derived from a declining book and the additional cost of funding borne by the business, mitigated by margin widening in the period.

Throughout the year, the business has continued to deliver improvements in its management of arrears, with a focus both on existing and pre-arrears cases. As a result, arrears in Optimum have continued to improve steadily, with late arrears (>2.5% of balance) on 3.12% of accounts (December 2011: 3.59%).

Integration and transformation

The successful merger with Britannia Building Society increased our customer base and extended our geographical reach. The rebranding of the 245 Britannia branches dramatically augmented the branch network from the original 90 Co-operative branches, which now stands at over 340 sites. As we reported last year, since the merger we have introduced the capability for customers to service current accounts in Britannia branded branches.

The IT transformation programme was initiated to deliver a platform for growth through the replacement of legacy banking systems. From the start of 2012, we have delivered the requirements of the new EU payment services regulations, via our project to ensure 'Faster Payments' can be delivered to customers. The regulations require all payments to reach their destination no later than the following business day. During 2012 we have further advanced efficiency and cost savings by streamlining our project delivery function to create a single operating model that is geared towards delivering major change.

Our mobile banking application was launched in June 2012. Initially aimed at the iPhone, this will allow customers easy access to balance and transaction information, and is being rolled out to other mobile phone platforms.

The Co-operative Banking Group continues to play a pivotal role in The Co-operative Group's Project Unity. Although cost reduction is a vital part of Unity, the potential for revenue generation is the primary purpose behind this programme. As part of this, we have launched a pilot that will see legal services and funeral planning products available within our Bank branch network.

In March 2012 The Co-operative Bank was awarded the 'Best Card Cross Selling Programme of the Year' at the UK Cards and Payment awards. This resulted from proposals developed within Project Unity on Customer Propositions, which incentivised Bank customers to shop in Food outlets using vouchers.

The Co-operative Group have also been enhancing our customer insight to better understand our customers and how they relate to the Co-operative as a whole. A 'Single Customer View', based on two years of trading data, will allow the Group to target services and prioritise key demographics more effectively than ever before.

Business and financial review continued

The Business to Business Workstream is a further example of where the Co-operative family of businesses are really benefiting from each other. By leveraging established individual business relationships, significant increased revenue will be generated across The Co-operative Group.

In addition to this we are developing a new membership proposition which will be more compelling and rewarding for our customers, while differentiating The Co-operative Group through our unique heritage.

Going forward there will be increasing momentum across Project Unity focusing on colleagues and on putting the customer at the heart of everything we do.

Outlook

On 19 July the Bank announced that agreement had been reached with Lloyds Banking Group (LBG) to proceed on the basis of non-binding Heads of Terms in relation to acquisition of 632 LBG branches (the ‘Verde’ business). The move would create a real challenger bank on the high street with almost 1,000 branches. The Bank and its parent, The Co-operative Group, are now working with LBG towards agreeing definitive, binding documentation, subject to the satisfactory completion of further due diligence and Board approvals. Completion of the transaction is expected before the end of November 2013 and will be conditional upon, among other things, regulatory approvals from the FSA, HMT and the European Commission.

While the transaction remains subject to final regulatory approval before signing the sale and purchase agreement (SPA), the business is therefore continuing to progress its transformation plan. However, while we have been pursuing Project Verde, progress has been managed down and spend reduced in those areas where Project Verde could impact our plans, to minimise the risk of redundant investment. This carefully managed slowdown will continue as we await conclusion of the SPA process. In the event of proceeding to SPA we will revisit the value ascribed to the investments made in the transformation plan to date. Should the deal with Lloyds fail to conclude successfully, then the existing Transformation Project will be reinvigorated, and the work undertaken to date will be completed and used to drive the business forwards.

If the sale proceeds, this would represent a step change in the Bank’s growth. The Verde business has approximately five million customers and, when combined with the Co-operative business, circa 7% of UK current accounts. However, we have been consistently clear about the fact that this is a complex transaction and that we would only proceed if we could reach an agreement that was in the interests of our members and other stakeholders. With or without the acquisition of the Lloyds branches, our strategy of growth remains unchanged.

The outlook for our industry looks unlikely to improve in the short to medium term and the risks remain considerable. Any economic recovery is likely to be slow at best, offering little prospect of near term recovery in funding margins, while the impact of increased financial regulation will continue to add cost pressures. Impairment pressures are unlikely to significantly abate in the short term. However, the exciting prospects from the acquisition of the 632 Lloyds branches should be of considerable benefit for both the financial strength of the Bank and the quality of service and product range offered to our customers. The focus of the business is to continue our transformation journey and become the compelling co-operative alternative, while delivering an acceptable level of financial performance in this very challenging economic environment.

Risk management

For the period ended 30 June 2012 (unaudited)

All amounts are stated in £m unless otherwise indicated

The Disclosure and Transparency Rules (DTR 4.2.7) require that a description of the principal risks and uncertainties are given in the interim financial report in respect of the remaining six months of the financial year. These risks are consistent with those described in the Bank's risk management section of the 2011 financial statements on pages 46 to 70.

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 the Boards within the Banking Group.

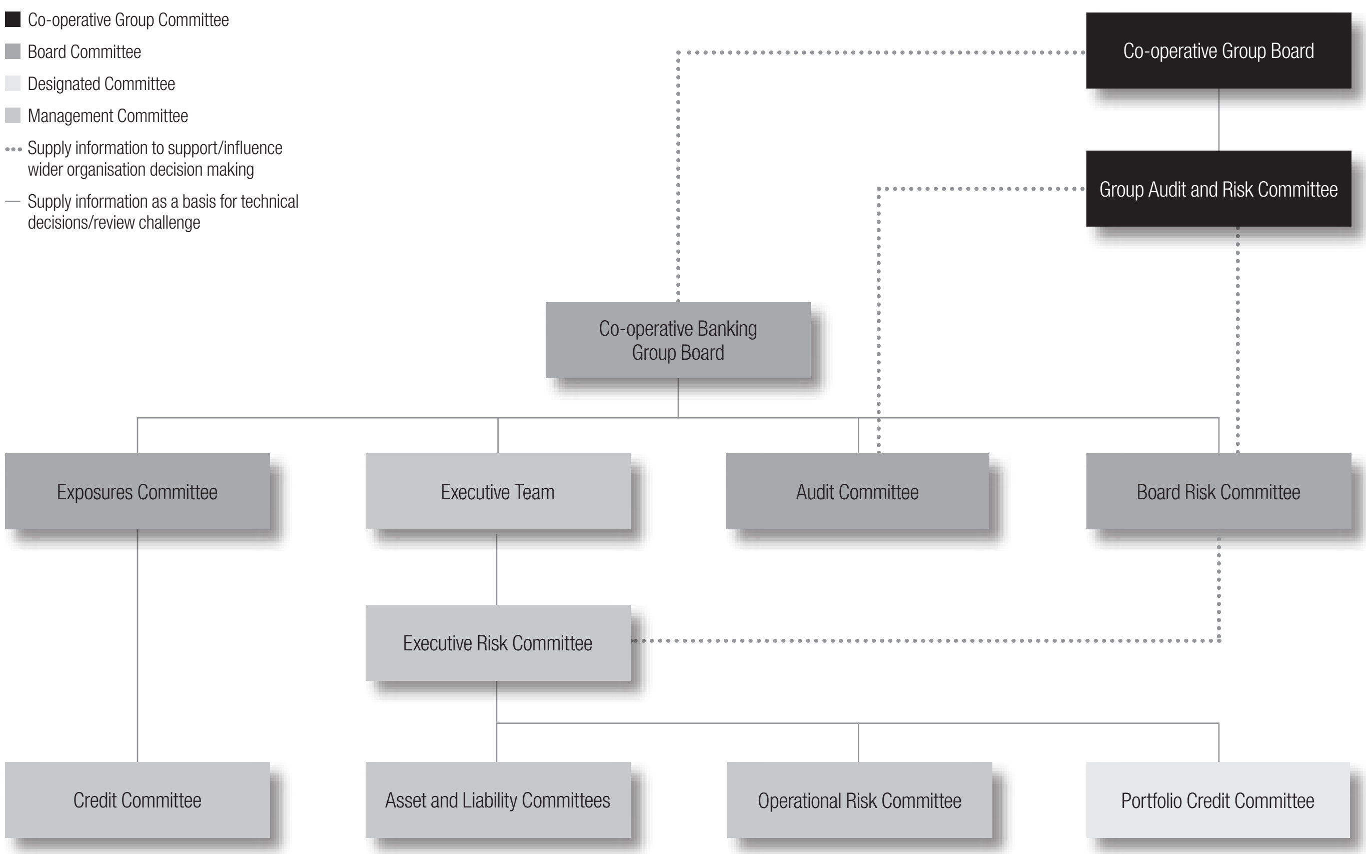
The Banking Group Board is responsible for approving the Banking Group strategy, its principal markets and the level of acceptable risks articulated through its statement of risk appetite. It is also responsible for overall corporate governance which includes ensuring that there is an adequate system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

The Board has established Board committees and senior management committees to:

- oversee the risk management process;
- identify the key risks facing the business; and
- assess the effectiveness of planned management actions.

Specific Board authority has been delegated to Board committees and the Chief Executive who may, in turn, delegate elements of his discretions to appropriate executive directors and their senior line managers.

Risk management structure



Risk management continued

For the period ended 30 June 2012 (unaudited)

All amounts are stated in £m unless otherwise indicated

Risk management structure continued

Risk management committees

The Banking Group's Board delegates authority to the Banking Group's Board Risk Committee for monitoring compliance with the Board approved risk appetite statements. 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): this committee is responsible for the oversight of the adequacy of capital for all risks across the Banking Group. This includes:

- operation of mandates and limits and any breaches thereof;
- risk management framework policy approval;
- risk management information reporting and integrity of relevant data;
- identification and measurement of risk;
- risk and portfolio exposure management strategy;
- adequacy of the risk mitigation process;
- review and discussion of risk issues identified as a result of internal audit work; and
- review and challenge of the impact assessment of the strategic plan on the risk and capital profile.

Audit Committee (AC): this committee provides oversight on financial reporting, internal control, regulatory compliance, external and internal audit.

Exposures Committee: this committee ensures that non-executive directors are actively involved in major credit decisions (including sanctioning large counterparty transactions), monitors large exposures and problem loans as well as reviewing the adequacy of individual credit provisions.

Executive Team: the Executive Team manages the business in line with the Board risk appetite statement. It also maintains oversight of risk management processes and management information.

Executive Risk Committee (ERC): this committee is chaired by the Chief Risk Officer. Its purpose is to provide a mechanism to ensure that the Banking Group's risk management is reviewed, challenged, approved (with escalation to the Executive Team and/or BRC where required) and embedded within the Banking Group. The committee also monitors all significant and emerging risks, and oversees the development and implementation of stress testing and risk appetite across the Banking Group.

Risk and capital management sub-committees

Portfolio Credit Committee (PCC): this committee reports to ERC and is chaired by the Banking Risk Officer. It is responsible for defining the Banking Group's credit risk appetite; providing oversight and timely action in relation to credit risk management; monitoring, challenging and approving changes to Basel rating systems; and reviewing lending and arrears policies.

Asset and Liability Committees (ALCO): these committees are management committees of the Board which are chaired by the Chief Financial Officer. They are primarily responsible for overseeing the management of market, liquidity and funding risks. They also advise on capital utilisation and the composition and sourcing of adequate capital.

Credit Committee: this committee is chaired by the Banking Risk Officer. The chair has delegated authority for approving credit facilities within approved strategies and delegated authorities.

Operational Risk Committee (ORC): this committee reports into ERC and is chaired by the Director of Specialist Risk Services. It monitors significant operational risks and controls as well as the management actions taken to mitigate them to an acceptable level or transfer them. This includes business continuity arrangements and insurance cover to protect the Banking Group's business. Capital requirements in relation to operational risk are monitored by the ERC.

There is also a framework of sector specific management committees carrying out the following roles:

- supporting risk and capital management;
- implementing changes in business strategy;
- optimising performance;
- monitoring adherence to and setting of policy; and
- developing management information and training.

Bank significant risks

The Bank's significant risks are, and are expected to continue to be:

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 Bank or their failure to perform as agreed.	9
2. Liquidity risk	Liquidity risk is the risk that the Bank's resources will prove inadequate to meet its liabilities as they contractually fall due or as a result of any contingent or discretionary cash outflows that may occur in a stress. It arises from the mismatch of timings of cash flows generated from the Banking Group's assets and liabilities (including derivatives).	25
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 Bank's market risk arises from changes in interest rates.	28

Operational and other risks as disclosed in the 2011 financial statements on pages 69 and 70 are unchanged since the year end. The Board are aware that, should Verde proceed, this will alter the Bank's operational, execution and regulatory reporting risk profiles. The Bank has contingency plans in place to address this.

1. Credit risk

1.1 Overview

Credit risk is an integral part of our business activities and 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 Chief Executive 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 policies

The credit risk policies are approved annually by the ERC. The policies determine the criteria for the management of:

- credit risk associated with retail, corporate and wholesale segments (including securitisation, market exposures and credit management standards);
- country, sector and counterparty limits;
- risk appetites; and
- delegated authorities.

1.2.1 Retail credit risk

The Bank's policy on retail secured and unsecured credit is to establish credit criteria that determine the balance between volume growth (generating higher income) and higher arrears and losses, so as to ensure the return is commensurate with the Bank's risk appetite and strategic objectives. Retail credit risk related decisions are based on a combination of defined lending policies and the use of bespoke scorecards derived from historic data. Regular updates are provided to the PCC and ERC on the performance of the portfolios.

1.2.2 Corporate credit risk

The Bank's corporate sector policy is to maintain a broad spread of exposures across sectors which reflect the Bank's areas of expertise. Credit exposures to corporate and business banking customers are assessed individually. The quality of the overall portfolio is monitored using a credit grading system calibrated to expected loss. The PCC and ERC receive regular reports on the performance of the portfolio. The Exposures Committee receives regular reports on lending facilities, bad debt provisions and the management of problem loans.

1.2.3 Wholesale credit risk

The Bank's credit risk framework for wholesale markets has, at its centre, a credit risk policy which governs the types of exposure the business can take and sets concentration parameters. To complement this, individual authority is delegated, dependent on Internal Rating Grade and associated Probability of Default (PD), to approve limits to individual counterparties within the parameters established by the credit risk policy. The ERC receives regular reports on the performance of the portfolio. The Exposures Committee receives regular reports on changes in exposure limits, watchlist and problem counterparty information.

1.3 Credit exposure

1.3.1 Definitions

Impaired and past due but not impaired in the tables on the following pages are further defined in the following sections on retail and corporate credit risk and investment secturities.

Within neither past due nor impaired, low risk has been defined as exposures where the PD is 1% or below over a one year time horizon for exposures on an internal ratings based (IRB) approach under Basel II, and strong/good/satisfactory categories for corporate exposures under the slotting approach. Medium to high risk has been defined as a PD of greater than 1% over a one year time horizon for exposure on IRB approach under Basel II and weak category for corporate exposures under the slotting approach.

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 period ended 30 June 2012 (unaudited)
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 allowance for losses and including credit commitments);
- the net credit exposure by class of asset (including both allowance for losses and credit commitments);
- an analysis of the net credit exposures by level of impairment or risk; and
- fair value adjustments.

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 – loans and receivables	Investment securities – available for sale	Investment securities – fair value through income or expense	Investment securities – held for trading	Derivative financial instruments	Total
30 June 2012								
Analysis of balance per note		5	6	6	6	6		
Gross balance	**2,359.7**	**34,349.5**	**483.0**	**3,259.9**	**817.4**	**439.0**	**910.8**	**42,619.3**
Less: allowance for losses	**–**	**(341.1)**	**–**	**(42.3)**	**–**	**–**	**–**	**(383.4)**
	2,359.7	**34,008.4**	**483.0**	**3,217.6**	**817.4**	**439.0**	**910.8**	**42,235.9**
Analysis of credit risk exposure								
Gross balance	**2,359.7**	**34,349.5**	**483.0**	**3,259.9**	**817.4**	**439.0**	**910.8**	**42,619.3**
Credit commitments	**93.0**	**5,345.1**	**–**	**–**	**–**	**–**	**–**	**5,438.1**
Gross credit risk exposure	**2,452.7**	**39,694.6**	**483.0**	**3,259.9**	**817.4**	**439.0**	**910.8**	**48,057.4**
Less: allowance for losses	**–**	**(341.1)**	**–**	**(42.3)**	**–**	**–**	**–**	**(383.4)**
Net credit risk exposure	**2,452.7**	**39,353.5**	**483.0**	**3,217.6**	**817.4**	**439.0**	**910.8**	**47,674.0**
Analysis of net credit risk exposure by level of impairment or risk								
Individually impaired								
90 days past due or evidence of impairment	**–**	**1,821.6**	**–**	**42.3**	**–**	**–**	**2.6**	**1,866.5**
Impairment recognised	**–**	**(156.1)**	**–**	**(42.3)**	**–**	**–**	**–**	**(198.4)**
	–	**1,665.5**	**–**	**–**	**–**	**–**	**2.6**	**1,668.1**
Collectively impaired								
Less than 90 days past due	**–**	**1,281.7**	**–**	**–**	**–**	**–**	**–**	**1,281.7**
90–179 days past due	**–**	**26.0**	**–**	**–**	**–**	**–**	**–**	**26.0**
180 days plus past due	**–**	**165.6**	**–**	**–**	**–**	**–**	**–**	**165.6**
Impairment recognised	**–**	**(185.0)**	**–**	**–**	**–**	**–**	**–**	**(185.0)**
	–	**1,288.3**	**–**	**–**	**–**	**–**	**–**	**1,288.3**
Past due but not impaired								
0–29 days past due	**–**	**274.8**	**–**	**–**	**–**	**–**	**–**	**274.8**
30–59 days past due	**–**	**83.8**	**–**	**–**	**–**	**–**	**–**	**83.8**
60–89 days past due	**–**	**51.7**	**–**	**–**	**–**	**–**	**–**	**51.7**
	–	**410.3**	**–**	**–**	**–**	**–**	**–**	**410.3**
Neither past due nor impaired								
Low risk	**2,452.6**	**32,082.4**	**502.8**	**3,217.6**	**817.4**	**439.0**	**898.9**	**40,410.7**
Medium to high risk	**0.1**	**4,284.8**	**–**	**–**	**–**	**–**	**9.3**	**4,294.2**
	2,452.7	**36,367.2**	**502.8**	**3,217.6**	**817.4**	**439.0**	**908.2**	**44,704.9**
Fair value adjustments	**–**	**(377.8)**	**(19.8)**	**–**	**–**	**–**	**–**	**(397.6)**
	2,452.7	**39,353.5**	**483.0**	**3,217.6**	**817.4**	**439.0**	**910.8**	**47,674.0**

1. Credit risk continued

	Loans and advances to banks	Loans and advances to customers	Investment securities – loans and receivables	Investment securities – available for sale	Investment securities – fair value through income or expense	Investment securities – held for trading	Derivative financial instruments	Total
31 December 2011								
Analysis of balance per note		5	6	6	6	6		
Gross balance	2,006.5	34,058.0	807.6	3,465.5	343.1	–	975.8	41,656.5
Less: allowance for losses	–	(292.0)	(2.7)	(42.5)	–	–	–	(337.2)
	2,006.5	33,766.0	804.9	3,423.0	343.1	–	975.8	41,319.3
Analysis of credit risk exposure								
Gross balance	2,006.5	34,058.0	807.6	3,465.5	343.1	–	975.8	41,656.5
Credit commitments	40.6	4,858.7	–	–	–	–	–	4,899.3
Gross credit risk exposure	2,047.1	38,916.7	807.6	3,465.5	343.1	–	975.8	46,555.8
Less: allowance for losses	–	(292.0)	(2.7)	(42.5)	–	–	–	(337.2)
Net credit risk exposure	2,047.1	38,624.7	804.9	3,423.0	343.1	–	975.8	46,218.6
Analysis of net credit risk exposure by level of impairment or risk								
Individually impaired								
90 days past due or evidence of impairment	–	1,657.7	3.9	42.5	–	–	0.4	1,704.5
Impairment recognised	–	(114.1)	(2.7)	(42.5)	–	–	–	(159.3)
	–	1,543.6	1.2	–	–	–	0.4	1,545.2
Collectively impaired								
Less than 90 days past due	–	1,301.0	–	–	–	–	–	1,301.0
90–179 days past due	–	15.5	–	–	–	–	–	15.5
180 days plus past due	21.0	152.6	–	–	–	–	–	173.6
Impairment recognised	–	(177.9)	–	–	–	–	–	(177.9)
	21.0	1,291.2	–	–	–	–	–	1,312.2
Past due but not impaired								
0–29 days past due	–	271.1	–	–	–	–	–	271.1
30–59 days past due	–	87.3	–	–	–	–	–	87.3
60–89 days past due	–	50.7	–	–	–	–	–	50.7
	–	409.1	–	–	–	–	–	409.1
Neither past due nor impaired								
Low risk	2,000.8	31,519.7	768.4	3,334.4	343.1	–	970.6	38,937.0
Medium to high risk	41.7	4,257.5	55.1	88.6	–	–	4.8	4,447.7
	2,042.5	35,777.2	823.5	3,423.0	343.1	–	975.4	43,384.7
Fair value adjustments	(16.4)	(396.4)	(19.8)	–	–	–	–	(432.6)
	2,047.1	38,624.7	804.9	3,423.0	343.1	–	975.8	46,218.6

The analysis of net credit exposure for loans and advances to customers has been updated to include additional balances subject to forbearance within collectively impaired.

Risk management continued
For the period ended 30 June 2012 (unaudited)
All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

1.4 Analysis of impaired assets and associated collateral
The following sections provide further analysis and disclosure of the Bank's credit risk associated with:

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

1.4.1 Loans and advances to customers
1.4.1.1 How we oversee and control credit risk
The Credit Risk Control Unit (CRCU) provides an independent view of credit risk in order to support the business' decision making. CRCU does not directly benefit from decisions to extend credit. The CRCU provides risk oversight by virtue of its independence from the business management functions. The CRCU function is in house and is not outsourced.

CRCU is responsible for procedures across both retail and corporate, and performs the following tasks and responsibilities related to its role:

- design and implementation of risk assessment and rating systems;
- testing, validating, documenting and monitoring of risk assessment and rating systems;
- production and analysis of summary reports of risk assessment and rating systems;
- maintenance of lending policy and procedures, and upkeep of various returns and reporting requirements;
- monitoring system decision overrides and exceptions;
- 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 15 to 22 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, usually once a month, to assess impairment. A loan will be deemed to be impaired where there is objective evidence that a loss event has occurred after recognition of an asset and by 30 June 2012. Further detail is provided in the following credit risk sections.

Once a loan is defined as impaired the provision will be 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 41 of the 2011 financial statements and in the following credit risk sections.)

1. Credit risk continued

The following tables analyse the gross balance by impairment classification for the Retail (secured and unsecured) and CABB (Corporate and Optimum) business segments. It includes 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		
	Secured	Unsecured	Corporate	Optimum	Total
30 June 2012					
Analysis of balance in note 5					
Gross balance	16,226.8	1,531.8	9,015.0	7,575.9	34,349.5
Less: allowance for losses	(3.4)	(164.9)	(164.8)	(8.0)	(341.1)
	16,223.4	1,366.9	8,850.2	7,567.9	34,008.4
Analysis of credit risk exposure					
Gross balance	16,226.8	1,531.8	9,015.0	7,575.9	34,349.5
Credit commitments	556.5	2,340.1	2,448.4	0.1	5,345.1
Gross credit risk exposure	16,783.3	3,871.9	11,463.4	7,576.0	39,694.6
Less: allowance for losses	(3.4)	(164.9)	(164.8)	(8.0)	(341.1)
Net credit risk exposure	16,779.9	3,707.0	11,298.6	7,568.0	39,353.5
Analysis of net credit risk exposure by level of impairment or risk					
Individually impaired					
90 days past due or evidence of impairment	77.3	–	865.8	878.5	1,821.6
Impairment recognised	(3.0)	–	(147.1)	(6.0)	(156.1)
	74.3	–	718.7	872.5	1,665.5
Collectively impaired					
Less than 90 days past due	287.3	31.4	275.3	687.7	1,281.7
90–179 days past due	–	26.0	–	–	26.0
180 days plus past due	–	164.8	0.8	–	165.6
Impairment recognised	(0.4)	(164.9)	(17.7)	(2.0)	(185.0)
	286.9	57.3	258.4	685.7	1,288.3
Past due but not impaired					
0–29 days past due	54.1	6.8	0.3	213.6	274.8
30–59 days past due	28.7	–	–	55.1	83.8
60–89 days past due	12.8	–	15.1	23.8	51.7
	95.6	6.8	15.4	292.5	410.3
Neither past due nor impaired					
Low risk	15,995.8	2,560.2	9,173.2	4,353.2	32,082.4
Medium to high risk	333.3	1,082.7	1,383.1	1,485.7	4,284.8
	16,329.1	3,642.9	10,556.3	5,838.9	36,367.2
Fair value adjustments	(6.0)	–	(250.2)	(121.6)	(377.8)
	16,779.9	3,707.0	11,298.6	7,568.0	39,353.5
Reconciliation of accounting to customer balances					
Gross balance	16,226.8	1,531.8	9,015.0	7,575.9	34,349.5
Fair value adjustments	6.0	–	250.2	121.6	377.8
Other accounting adjustments	(10.3)	(24.9)	67.7	25.5	58.0
Gross customer balances	16,222.5	1,506.9	9,332.9	7,723.0	34,785.3

Risk management continued
For the period ended 30 June 2012 (unaudited)
All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

	Retail		CABB		
	Secured	Unsecured	Corporate	Optimum	Total
31 December 2011					
Analysis of balance in note 5					
Gross balance	15,802.5	1,518.1	8,991.5	7,745.9	34,058.0
Less: allowance for losses	(3.1)	(163.3)	(117.3)	(8.3)	(292.0)
	15,799.4	1,354.8	8,874.2	7,737.6	33,766.0
Analysis of credit risk exposure					
Gross balance	15,802.5	1,518.1	8,991.5	7,745.9	34,058.0
Credit commitments	311.9	2,422.8	2,123.0	1.0	4,858.7
Gross credit risk exposure	16,114.4	3,940.9	11,114.5	7,746.9	38,916.7
Less: allowance for losses	(3.1)	(163.3)	(117.3)	(8.3)	(292.0)
Net credit risk exposure	16,111.3	3,777.6	10,997.2	7,738.6	38,624.7
Analysis of net credit risk exposure by level of impairment or risk					
Individually impaired					
90 days past due or evidence of impairment	73.7	–	710.0	874.0	1,657.7
Impairment recognised	(2.7)	–	(105.1)	(6.3)	(114.1)
	71.0	–	604.9	867.7	1,543.6
Collectively impaired					
Less than 90 days past due	267.8	52.6	290.4	690.2	1,301.0
90–179 days past due	–	15.5	–	–	15.5
180 days plus past due	–	151.5	1.1	–	152.6
Impairment recognised	(0.4)	(163.3)	(12.2)	(2.0)	(177.9)
	267.4	56.3	279.3	688.2	1,291.2
Past due but not impaired					
0–29 days past due	43.2	6.5	0.4	221.0	271.1
30–59 days past due	31.1	–	–	56.2	87.3
60–89 days past due	11.3	–	11.4	28.0	50.7
	85.6	6.5	11.8	305.2	409.1
Neither past due nor impaired					
Low risk	15,380.0	2,585.2	9,285.7	4,268.8	31,519.7
Medium to high risk	314.0	1,129.6	1,067.0	1,746.9	4,257.5
	15,694.0	3,714.8	10,352.7	6,015.7	35,777.2
Fair value adjustments	(6.7)	–	(251.5)	(138.2)	(396.4)
	16,111.3	3,777.6	10,997.2	7,738.6	38,624.7
Reconciliation of accounting to customer balances					
Gross balance	15,802.5	1,518.1	8,991.5	7,745.9	34,058.0
Fair value adjustments	6.7	–	251.5	138.2	396.4
Other accounting adjustments	(16.3)	17.5	(99.9)	50.1	(48.6)
Gross customer balances	15,792.9	1,535.6	9,143.1	7,934.2	34,405.8

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

1. Credit risk continued

1.4.1.3 Secured residential credit risk

Acquisition and account management

Mortgages are loans to non-corporate borrowers secured by a first charge over a residential property. Mortgages are originated directly to customers via branches, telephone and the internet in the Retail business under the Britannia and Co-operative Bank brands, and via intermediaries in the Platform brand. In the period to 30 June 2012 66% (31 December 2011: 55%) of mortgages were originated through the Retail business and 34% (31 December 2011: 45%) through Platform.

The Retail brands only originate prime residential mortgages, while Platform originates a combination of prime and 'almost prime' residential mortgages and buy to let loans.

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 be 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 normally repaid at the end of the term.

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

	Period to 30 June 2012			Period to 30 June 2011		
	Amount advanced	**Average LTV %**	**Interest only %**	Amount advanced	Average LTV %	Interest only %
Retail prime	**972.9**	**57.8**	**10.6**	427.2	60.0	12.5
Platform prime	**180.3**	**58.6**	**25.0**	103.6	71.7	19.4
Total prime	**1,153.2**	**57.9**	**12.2**	530.8	62.0	13.3
Buy to let	**306.6**	**62.8**	**84.5**	140.3	61.2	81.7
Almost prime	**3.4**	**56.1**	**2.8**	5.4	51.3	17.9
Total completions	**1,463.2**	**59.0**	**25.6**	676.5	61.7	24.8

The risk in the portfolio is re-evaluated monthly using internally developed behavioural scorecards, to assess the probability of a borrower defaulting in the following 12 months and to reflect any changes in the value of collateral. The revaluation will determine the amount of capital required to be held for individual loans.

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

	30 June 2012			31 December 2011		
	Retail secured	**Optimum**	**Total**	Retail secured	Optimum	Total
Less than 50%	**5,654.8**	**459.4**	**6,114.2**	5,706.7	484.0	6,190.7
50% to 60%	**2,217.0**	**355.5**	**2,572.5**	2,157.8	372.7	2,530.5
60% to 70%	**2,613.6**	**641.9**	**3,255.5**	2,418.0	673.0	3,091.0
70% to 80%	**2,792.7**	**1,010.5**	**3,803.2**	2,563.4	1,067.7	3,631.1
80% to 90%	**1,876.5**	**1,523.7**	**3,400.2**	1,874.5	1,604.9	3,479.4
90% to 100%	**630.5**	**1,600.3**	**2,230.8**	651.8	1,696.2	2,348.0
Greater than 100%	**437.4**	**2,131.7**	**2,569.1**	420.7	2,035.7	2,456.4
	16,222.5	**7,723.0**	**23,945.5**	15,792.9	7,934.2	23,727.1

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

	30 June 2012			31 December 2011		
	Exposure	**Average LTV %**	**Interest only %**	Exposure	Average LTV %	Interest only %
Prime residential	**15,875.7**	**44.3**	**24.1**	15,745.9	43.5	25.1
Buy to let	**3,119.1**	**75.8**	**90.5**	2,881.3	76.1	90.5
Self-certified	**2,164.0**	**77.3**	**77.5**	2,228.7	76.6	77.3
Almost prime	**969.0**	**91.2**	**67.4**	997.1	89.5	67.1
Non-conforming	**1,817.7**	**78.2**	**66.2**	1,874.1	77.1	65.7
	23,945.5	**53.5**	**42.6**	23,727.1	52.7	42.9

Risk management continued
For the period ended 30 June 2012 (unaudited)
All amounts are stated in £m unless otherwise indicated

1. Credit risk continued
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 Bank'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 will be restated using a regional property price index.

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

	30 June 2012			31 December 2011		
	Exposure	**Collateral**	**Cover %**	Exposure	Collateral	Cover %
Impaired	**1,938.7**	**1,859.5**	**95.9**	1,853.6	1,785.8	96.3
Non-impaired	**22,006.8**	**21,866.3**	**99.4**	21,873.5	21,751.2	99.4
	23,945.5	**23,725.8**	**99.1**	23,727.1	23,537.0	99.2

Impairment

Loans and advances to customers are considered impaired where there is objective evidence of a loss event having occurred after the original advance. This indicates that the Bank may be unable to collect all principal and interest outstanding according to the contractual terms of the agreements.

A loan is considered to be individually impaired when:

- arrears outstanding are equivalent to 90 days or more; or
- the loan is more than three months past its due date for repayment but has not been repaid; or
- the value of the collateral on a roll up mortgage has reduced below the loan balance outstanding.

A loan is also assessed for impairment when:

- the loan is in arrears by less than 90 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).

Loans meeting the latter criteria are only deemed to be impaired when a loss is expected in the event of repossession.

Loans that have arrears of less than 90 days, but when a loss is not expected, are defined as past due but not impaired.

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.

	30 June 2012			31 December 2011		
	Retail secured	**Optimum**	**Total**	Retail secured	Optimum	Total
Gross customer balances	**16,222.5**	**7,723.0**	**23,945.5**	15,792.9	7,934.2	23,727.1
Impaired customer balances	**365.0**	**1,573.7**	**1,938.7**	342.3	1,575.8	1,918.1
Impaired as a % of gross customer balances	**2.2%**	**20.4%**	**8.1%**	2.2%	19.9%	8.1%
Credit protection						
Impairment provisions	**3.4**	**8.0**	**11.4**	3.1	8.3	11.4
Fair value adjustments	**6.0**	**121.6**	**127.6**	6.7	138.2	144.9
	9.4	**129.6**	**139.0**	9.8	146.5	156.3
Credit protection as a % of impaired customer balances	**2.6%**	**8.2%**	**7.2%**	2.9%	9.3%	8.1%

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

1. Credit risk continued

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 will depend 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 will be deemed impaired, and arrears will continue to be reported, 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 will be deemed to be impaired. Note that this treatment is distinct from a 'payment holiday', which is allowed as part of a customer's flexible mortgage contract. Payment holidays would not knowingly be 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 have been treated as impaired within the accounts;
- temporary conversion of a mortgage to interest only repayments. This treatment has sometimes been used as an alternative to a concession for mortgage borrowers experiencing short term financial hardship. The capital repayments due in this period are added to the capital balance outstanding on the mortgage;
- 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. As the borrower is not required to prove they have an alternative repayment vehicle in place, there is a risk that borrowers have switched purely to reduce their repayments and may not in reality have a repayment vehicle. Consequently all loans that have switched to interest only after the origination of the loan are considered to be subject to forbearance;
- an extension to the term of the mortgage to reduce the borrower's repayments. Term extensions may be offered proactively to a borrower experiencing financial hardship, or in response to a borrower's request. Loans that have had a term extension in the last two years are considered to be subject to forbearance; and
- 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 the period to 30 June 2012, 8 (31 December 2011: 90) loans had arrears capitalised of £0.01m (31 December 2011: £0.3m). These loans are not treated as impaired unless the borrower meets another impairment trigger (eg misses a mortgage payment).

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. Many of the forbearance options are temporary in nature and, with the exception of arrangements, it is expected that customers will generally return to performing status. This is reflected in the low levels of impairment required on these exposures.

The table below analyses secured residential mortgage balances by type of forbearance and the associated gross impairment provision:

	30 June 2012		31 December 2011	
	Exposure	**Impairment**	Exposure	Impairment
Arrangements	**551.4**	**25.6**	546.6	26.0
Concessions	**5.2**	**0.1**	7.2	0.1
Payment holidays	**175.8**	**–**	175.8	–
Interest only switches	**616.6**	**1.4**	584.6	1.1
Term extensions	**240.2**	**0.1**	147.3	0.1
Capitalisations	**3.6**	**–**	9.8	–
	1,592.8	**27.2**	1,471.3	27.3

1.4.1.4 Unsecured retail credit risk

Acquisition and account management

The Bank 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 re-evaluated 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 commitments) by product type:

	30 June 2012	31 December 2011
Loans	**750.6**	751.0
Credit cards	**2,724.6**	2,830.4
Overdrafts	**371.8**	377.0
	3,847.0	3,958.4

Risk management continued

For the period ended 30 June 2012 (unaudited)

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

Impairment

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 15 days, or if the agreed overdraft has expired but the account remains overdrawn.

Accounts identified as impaired will be segmented according to the number of days that the loan has been impaired. The provision for each segment is based on the probability of charge off. An account is charged off when all economical avenues to recover the debt have been exhausted.

The table below shows:

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

	30 June 2012	31 December 2011
Gross customer balances	**1,506.9**	1,535.6
Impaired customer balances	**297.8**	309.7
Impaired as a % of gross customer balances	**19.8%**	20.2%
Credit protection		
Impairment provisions	**164.9**	163.3
DCA balances written off	**83.4**	90.0
	248.3	253.3
Credit protection as a % of impaired customer balances	**83.4%**	81.8%

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

Forbearance

Where a borrower is unable to clear their arrears in full, the Bank will endeavour to agree an arrangement with the borrower to repay the outstanding arrears over a period of time, or may agree to accept payments of less than the contractual amount during a period of temporary financial hardship. In these instances 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 who they have chosen to represent them. Proven payers are categorised as 'regular payers' while unproven are categorised as 'standard collections'.

A negative disposable income account is where the customer's current financial situation means they are unable to make any monthly payments to their unsecured creditors. In such circumstances the Bank may refrain from further action during a period of financial hardship. The customer's circumstances will be reviewed on a regular basis, with a view to resolving the situation once those circumstances improve. These loans continue to be reported as impaired, and will have a higher dedicated provision rate than the standard provisioning rates.

Regular payers are defined as accounts that are greater than 90 days in arrears and where regular payments are being made (irrespective of whether they are on a formal arrangement or not). These accounts continue to be reported as impaired, but the provision rate will reflect the level of recoveries on this segment.

The table below shows current exposure and provision by treatment type:

	30 June 2012		31 December 2011	
	Current exposure	**Impairment provision**	Current exposure	Impairment provision
Regular payers	**93.4**	**70.4**	93.5	70.2
Standard collections	**35.1**	**22.9**	41.5	23.1
Negative disposable income	**19.1**	**17.7**	16.9	15.7
Fraud	**4.5**	**4.3**	5.3	4.8
Individual voluntary arrangements	**55.5**	**49.6**	55.5	49.5
	207.6	**164.9**	212.7	163.3

When all internal activities to rehabilitate the borrower have been exhausted, accounts are charged off and referred to DCAs to seek full recovery of the debt. This has a specific provision rate, as an element of recovery is expected.

	30 June 2012			31 December 2011		
	Original balance	**Charged off**	**Current exposure**	Original balance	Charged off	Current exposure
DCAs	**90.2**	**83.4**	**6.8**	97.0	90.0	7.0

1. Credit risk continued

1.4.1.5 Corporate credit risk

Acquisition and account management

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 Banking Risk Officer, the Chief Executive and the Exposure 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.

The Bank's corporate sector policy is to maintain a broad sectoral spread of exposures which reflect the Bank's areas of expertise. Credit exposures to corporate and business banking customers are assessed individually. The quality of the overall portfolio is monitored using a credit grading system calibrated to expected loss.

The PCC and the ERC receive regular reports on the performance of the portfolio. The Exposures Committee receives regular reports on new facilities and changes in facilities, sector exposures, bad debt provisions and the management of problem loans.

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.

30 June 2012	Unrated*	Strong	Good	Satisfactory	Weak	Default	Total
Accommodation, food and licensed services	**355.9**	**114.0**	**156.0**	**24.7**	**53.1**	**164.9**	**868.6**
Care	**180.0**	**34.1**	**65.3**	**30.9**	**2.8**	**–**	**313.1**
Education	**71.8**	**46.6**	**9.1**	**1.4**	**–**	**–**	**128.9**
Financial services	**88.9**	**67.0**	**24.6**	**3.8**	**–**	**2.3**	**186.6**
Football clubs	**–**	**41.5**	**–**	**15.5**	**0.1**	**4.3**	**61.4**
Housing associations	**1,189.6**	**–**	**0.5**	**–**	**–**	**–**	**1,190.1**
Manufacturing	**70.5**	**20.8**	**43.4**	**17.9**	**21.2**	**1.2**	**175.0**
Motor trade and garages	**29.4**	**39.5**	**23.0**	**10.0**	**0.8**	**3.7**	**106.4**
Private Finance Initiatives (PFI)	**0.1**	**4.0**	**1,297.5**	**–**	**–**	**14.9**	**1,316.5**
Professional services	**68.6**	**71.0**	**17.9**	**9.8**	**2.5**	**3.9**	**173.7**
Property and construction:							
Commercial investment	**19.6**	**159.9**	**1,373.0**	**471.4**	**1,045.0**	**525.0**	**3,593.9**
Residential investment	**10.5**	**45.8**	**252.7**	**37.6**	**52.5**	**82.8**	**481.9**
Commercial development	**24.4**	**13.0**	**140.7**	**81.4**	**39.3**	**11.7**	**310.5**
Residential development	**1.5**	**2.6**	**79.1**	**12.7**	**11.9**	**4.9**	**112.7**
Public sector entities	**197.2**	**–**	**–**	**–**	**–**	**–**	**197.2**
Renewable energy	**596.6**	**–**	**–**	**–**	**–**	**9.4**	**606.0**
Retail and wholesale trade	**107.5**	**374.5**	**31.0**	**22.1**	**–**	**5.2**	**540.3**
Services	**458.2**	**110.2**	**62.0**	**39.2**	**20.7**	**18.5**	**708.8**
Transport, storage and communication	**143.2**	**53.0**	**10.2**	**8.3**	**14.1**	**5.7**	**234.5**
Utilities	**86.1**	**1.5**	**0.3**	**11.5**	**–**	**0.6**	**100.0**
Business banking	**0.7**	**33.5**	**7.9**	**4.5**	**0.7**	**0.3**	**47.6**
Other	**8.9**	**1.7**	**1.4**	**4.2**	**–**	**2.1**	**18.3**
	3,709.2	**1,234.2**	**3,595.6**	**806.9**	**1,264.7**	**861.4**	**11,472.0**

Risk management continued
For the period ended 30 June 2012 (unaudited)
All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

31 December 2011	Unrated*	Strong	Good	Satisfactory	Weak	Default	Total
Accommodation, food and licensed services	319.5	60.9	53.3	31.4	1.5	110.1	576.7
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	15.1	5.7	63.3
Housing associations	1,132.8	–	0.5	–	–	–	1,133.3
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
Private Finance Initiatives (PFI)	0.8	–	1,260.8	–	14.6	–	1,276.2
Professional services	61.6	26.6	27.4	7.9	3.3	4.5	131.3
Property and construction:							
Commercial investment	123.2	174.4	1,466.4	767.7	584.4	562.7	3,678.8
Residential investment	11.0	59.1	229.0	116.3	24.1	154.7	594.2
Commercial development	6.8	9.1	112.5	123.0	24.0	11.1	286.5
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	437.5	–	–	–	–	10.3	447.8
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
	3,570.5	1,085.1	3,492.0	1,243.2	741.6	921.3	11,053.7

*The Unrated 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 housing associations, 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.

The movement of balances from the Satisfactory category to Weak in the period is reflective of the continued challenging commercial property environment and the Bank's focus on the expected outlook for this sector and the consequential forbearance strategies.

Collateral
The Bank 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 Company, 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:

	30 June 2012		31 December 2011	
	Exposure	**Collateral**	Exposure	Collateral
Default	**624.4**	**314.8**	732.4	386.3
On watchlist	**1,409.0**	**1,162.0**	1,252.6	1,068.6
Neither individually impaired nor on watchlist	**2,465.6**	**2,235.0**	2,695.7	2,444.3
	4,499.0	**3,711.8**	4,680.7	3,899.2

Of the above, at 30 June 2012 £40m (31 December 2011: £48m) is not held as first charge.

1. Credit risk continued

Impairment

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.

Customers who stop exhibiting higher risk traits are removed from the watchlist. This is dependent upon the Bank's satisfaction that the triggers leading to inclusion on the watchlist no longer apply, such as:

- balance sheet improvements (eg cash injection, agreement with creditors or funders on revised terms);
- return to an acceptable level of profitability and cash flow;
- improved account conduct;
- the loan to security value is restored, or additional security taken; or
- covenant breach cured or revised covenants agreed.

Removal from the watchlist usually requires the customer's management information to show that trading is achieving the revised plan with a reasonable expectation for this to continue. The internal guideline is for at least six months' satisfactory trading to have been evidenced.

The Bank 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). Events which may trigger higher risk status 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. In such circumstances, the Bank works with the customers to resolve their business problems and agree a clear strategy, often with the support of external, independent professional advisors.

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:

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

The definition of impairment is as used by management to categorise corporate customer balances as in default.

For provisioning purposes, an up to date property valuation or selling agent's recommendation will be 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 will be 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.

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.

	30 June 2012	31 December 2011
Gross customer balances	**9,332.9**	9,143.1
Impaired customer balances	**1,097.0**	960.5
Impaired as a % of gross customer balances	**11.8%**	10.5%
Credit protection		
Impairment provisions	**164.8**	117.3
Fair value adjustments	**250.2**	251.5
	415.0	368.8
Credit protection as a % of impaired customer balances	**37.8%**	38.4%

Forbearance

If the Bank 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.

Risk management continued
For the period ended 30 June 2012 (unaudited)
All amounts are stated in £m unless otherwise indicated

1. Credit risk continued
In addition to the above, other forbearance concessions the Bank 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.

The table below analyses the exposures subject to forbearance:

	30 June 2012			31 December 2011		
	Forborne	**Non-forborne**	**Total**	Forborne	Non-forborne	Total
Default	**393.2**	**468.2**	**861.4**	369.2	552.1	921.3
On watchlist	**1,227.6**	**414.6**	**1,642.2**	1,038.5	408.8	1,447.3
Neither default nor on watchlist	**284.3**	**8,684.1**	**8,968.4**	445.5	8,239.6	8,685.1
	1,905.1	**9,566.9**	**11,472.0**	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 Bank retains the forbearance status for as long as the concession remains in place. In the event of one off concessions (such as capitalisation of interest payments), the Bank removes the forbearance status 12 months after their occurrence.

1.4.2 Investment securities
Policies are in place within Treasury with regard to the management and valuation of collateral, with daily monitoring undertaken. Repos and secured lending positions are revalued daily with margin calls on collateralised swaps 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 Bank has a total investment securities' portfolio of £4,999.3m (31 December 2011: £4,616.2m) of which £42.3m (31 December 2011: £46.4m) is considered impaired and against which £42.3m (31 December 2011: £45.2m) of provisions are held.

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

At the balance sheet date, the Bank assesses its investment securities for objective evidence that an impairment loss has occurred, 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 Past due but not impaired
Investment securities are considered past due where the contractual interest or principal payments are in arrears and it is determined that the Bank will be able to collect all principal and interest outstanding according to the contractual terms of the agreements.

1.4.2.3 Neither past due nor impaired
The Bank only invests in treasury assets which comply with the treasury credit risk policy. Within the treasury investment security portfolio 97% (31 December 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 Bank's exposures to loans and advances to banks are impaired. The Bank considers that its exposures to loans and advances to banks are all of low to medium risk.

1.5 Eurozone risk
The Bank 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 30 June 2012 the Bank had a £304.9m (31 December 2011: £90.0m) exposure to the Government of Finland (eligible for prudential liquidity), repayable in over one year. It held no other non-UK European sovereign debt.

The Bank has no direct exposure to Greek or Italian financial institutions or any other counterparties.

1. Credit risk continued

1.5.1 Direct exposures

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

The Bank has exposures to financial institutions in the following European countries at 30 June 2012:

Country	**Repayable within 30 days**	**Repayable within 1 year but more than 30 days**	**Repayable in over 1 year**	**Credit risk mitigation**	**Total exposure**
30 June 2012					
Austria	**–**	**4.2**	**–**	**(4.2)**	**–**
Belgium	**–**	**22.8**	**11.2**	**(34.0)**	**–**
Denmark	**57.2**	**–**	**–**	**–**	**57.2**
France	**151.4**	**70.2**	**158.2**	**(59.3)**	**320.5**
Germany	**161.0**	**32.2**	**187.5**	**(174.0)**	**206.7**
Ireland	**0.1**	**–**	**–**	**–**	**0.1**
Netherlands	**0.1**	**54.4**	**264.7**	**–**	**319.2**
Norway	**–**	**–**	**70.6**	**–**	**70.6**
Portugal	**–**	**–**	**–**	**–**	**–**
Spain	**–**	**1.8**	**71.3**	**(23.0)**	**50.1**
Sweden	**10.7**	**10.0**	**114.9**	**–**	**135.6**
Switzerland	**93.5**	**3.1**	**660.1**	**(373.6)**	**383.1**
	474.0	**198.7**	**1,538.5**	**(668.1)**	**1,543.1**

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

For the purposes of the above table, exposures to counterparties which comprise subsidiaries of larger banking groups have been aggregated at the group level with the associated risk country being that of the ultimate parent entity.

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.

As at 30 June 2012, exposure to European multilateral development banks (not included in the above table given the supranational status associated with these institutions) stood at £1,333.5m (31 December 2011: £529.0m) before credit risk mitigation (£793.3m post credit risk mitigation (31 December 2011: £457.5m)) of which £576.0m matures within a year (31 December 2011: £81.8m).

Risk management continued
For the period ended 30 June 2012 (unaudited)
All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

Ongoing exposure to 'peripheral' eurozone counterparties is primarily restricted to short dated money market lending. Where investment assets are held for peripheral eurozone counterparties these are deemed to be in run-off, with associated counterparty and country limits reducing upon maturity or sale.

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

Country	Bank and money market balances	Bonds	Derivatives	Other	Total exposure
30 June 2012					
Austria	**–**	**–**	**–**	**–**	**–**
Belgium	**–**	**–**	**–**	**–**	**–**
Denmark	**49.4**	**–**	**–**	**7.8**	**57.2**
France	**0.1**	**100.4**	**19.7**	**200.3**	**320.5**
Germany	**128.0**	**25.0**	**20.8**	**32.9**	**206.7**
Ireland	**0.1**	**–**	**–**	**–**	**0.1**
Netherlands	**0.1**	**319.1**	**–**	**–**	**319.2**
Norway	**–**	**70.6**	**–**	**–**	**70.6**
Portugal	**–**	**–**	**–**	**–**	**–**
Spain	**–**	**50.1**	**–**	**–**	**50.1**
Sweden	**20.2**	**114.9**	**0.5**	**–**	**135.6**
Switzerland	**20.6**	**–**	**40.8**	**321.7**	**383.1**
	218.5	**680.1**	**81.8**	**562.7**	**1,543.1**

Country	Bank and money market balances	Bonds	Derivatives	Other	Total exposure
31 December 2011					
Austria	–	40.1	–	–	40.1
Belgium	–	20.0	–	–	20.0
Denmark	1.0	–	–	6.8	7.8
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
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 30 June 2012 totalled £172.3m (31 December 2011: £184.4m). There are no exposures to retail customers based outside of the UK and Channel Islands.

The Bank continues to monitor developments daily across all countries as they affect the Treasury portfolio. A number of proactive management actions have been taken to reduce the risk including, as part of the rebalancing of exposure in the eurozone, a theme of reducing exposure in the south (peripheral eurozone) and increasing exposure in the north (eg Sweden and the Netherlands) where economies are more robust. There has also been portfolio diversification with increased exposure to well rated supranational financial institutions.

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 30 June 2012 high risk watchlist exposures totalled £25m (31 December 2011: £277m), this consisted of a single holding in an FRN issued by a German financial institution with a final maturity date of 25 August 2012. High risk watchlist exposures totalling £252m and consisting entirely of debt security holdings reached final maturity during the period 31 December 2011 to 30 June 2012 and have been repaid in full.

1. Credit risk continued

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 if it suffered 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 Bank's capital and liquidity management framework comprises:

- an asset and liability management control programme;
- risk, capital and liquidity 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 severe but plausible economic stress;
- defined processes to invoke necessary management actions detailed in the Internal Capital Adequacy Assessment Process (ICAAP) submission document;
- articulation of how liquidity risk is identified, measured, monitored and managed in the Individual Liquidity Adequacy Assessment (ILAA) and procedures and governance in place to mitigate the risk;
- a defined risk appetite, controls and governance in the Bank's capital and liquidity management policies; and
- detailed and documented ongoing development and embedding plans for capital adequacy, capital allocation and risk appetite development.

Impacts on capital and liquidity of a severe economic downturn are stress tested to ensure sufficient and proactive management actions, triggers, systems and controls are in place.

The risk appetite reflects the amount and type of risk that the Bank is prepared to seek, accept or tolerate as defined in the following four capital objectives:

- maintain capital quantity and quality adequate to cover existing and projected risks in the business;
- maintain capital adequate to be confident of weathering extreme but plausible market scenarios;
- maintain operations such that we are confident that our customer service and our reputation are sustained in extreme but plausible scenarios; and
- generate good, stable returns for members.

The Bank is progressing towards implementation of Basel III and other UK and EU risk and capital legislative requirements. These include the Capital Requirements Directive IV and considerations resulting from the reports issued by the Independent Commission on Banking.

2.2 Liquidity risk

2.2.1 Overview

Liquidity risk arising from the structure of the balance sheet (structural liquidity) is managed in line with policies developed by ALCO. The Bank's liquidity management policies are reviewed and approved annually by the BRC (on behalf of the Board) and compliance reviewed monthly by ALCO. The Bank'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's risk appetite is met.

The Bank operates within a liquidity risk framework of stress testing combined with a number of strategic and tactical measures which feed into an overall liquidity status score. This is supported with detailed contingency funding plans which are tested and reviewed on a regular basis. The Bank's liquidity management framework is designed in line with FSA BIPRU regulations and industry guidelines, including Institute of International Finance and Bank for International Settlements recommendations.

The Board's risk appetite for liquidity risk is defined as survival in a number of stress scenarios, adherence to specific ratios and compliance with all regulatory limits. The stress tests encompass survival across various timescales and a range of adverse liquidity events, both firm specific and market wide, which cover all aspects of the liquidity risk to which the Bank is exposed.

The Bank monitors its liquidity position on a daily basis against the Board approved liquidity risk appetite and stress scenario. It also monitors the adequacy of its controls to provide assurance that liquidity risk is being appropriately managed, and regularly assesses its funding position.

The Bank manages liquidity risk by applying:

- a systematic control process embedded in the Bank's operations; and
- controlled end to end liquidity management with:
  - net outflows monitored to ensure they are within FSA limits;
  - maintenance of a diversified funding base;
  - management of liquid assets: high quality primary liquidity including cash and gilts, along with secondary liquidity including certificates of deposit;
  - target strategic ratios; and
  - stress testing.

The strategic measures approved by the Board and monitored monthly are:

- wholesale borrowing ratio, 20.6% (31 December 2011: 17.8%) – the amount of wholesale borrowing compared to total liabilities;
- liquid asset ratio, 12.7% (31 December 2011: 15.5%) – amount of total assets that are unencumbered high quality liquid assets as defined under BIPRU; and
- customer loan/deposit ratio, 101.0% (31 December 2011: 93.9%) – the ratio of customer loans to customer deposits.

Day to day cash flow (tactical liquidity) is managed within guidelines laid down by ALCO and in accordance with the standards established for all banks by the FSA.

Risk management continued
For the period ended 30 June 2012 (unaudited)
All amounts are stated in £m unless otherwise indicated

2. Liquidity risk continued
The Bank has a high proportion of retail assets funded by retail deposits demonstrated by the loan/deposit ratio which averaged 99.9% during the first half of 2012 (99.3% in the year to 31 December 2011), ensuring there is no over reliance on wholesale funding. There are customer funding and wholesale funding target ratios as described above which are set in line with the Board approved strategic plan. The Bank's structural liquidity risk management is therefore retail based and is dependent on behavioural analysis of both customer demand and deposit and loan drawdown profiles by product category, based on experience over the last ten years. The behaviour of retail products is reviewed by ALCO and, in addition, the Bank has maturity mismatch limits to control the exposure to longer term mismatches.

The Bank continually reviews its structural funding position and is confident that current funding plans will ensure that it will meet the requirements of the net stable funding ratio proposed by Basel III.

Marketable assets are maintained as a liquidity pool against potential retail outflows. The liquidity pool is the highest quality debt and consists of government issued debt and cash at the Bank of England. The liquid asset ratio was 12.7% at the end of June 2012 (31 December 2011: 15.5%) and the average ratio during the first half of 2012 was 12.3% compared with 10.6% over the same period in 2011. The ratio peaked in December 2011 with larger than usual cash balances invested in short term deposits with the Bank of England. Throughout 2012 the ratio has been in line with the Bank's liquidity risk appetite.

The table below shows the market value and composition of the liquid asset buffer:

	30 June 2012	31 December 2011
Qualifying stock		
Operational balances with central banks	**4,050.9**	6,378.3
Gilts	**967.4**	1,085.5
Multilateral development banks	**880.2**	162.1
	5,898.5	7,625.9

The Bank has access to a variety of medium term wholesale funding sources: securitisation, regulated covered bond and euro medium term notes. The Bank will issue from the programmes as funding requirements and market conditions permit.

ALCO discusses 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 Bank's primary objective in respect of secured funding is to raise longer term funds (over one year in duration) and to diversify the source of funds from wholesale means to support the business plan of the Bank. The Bank ensures that sufficient eligible and unencumbered assets are available at all times to meet the needs of its secured funding programmes.

2.2.2 Liquidity gap
The Bank's liquidity position is monitored on a daily basis and reported to ALCO. Treasury holds a pool of liquid assets on behalf of the Bank, and management actions are in place to provide additional liquidity when required. These sources of liquidity are held in order to be available to meet unexpected liquidity requirements.

The Bank manages liquidity on a behavioural rather than contractual basis, reflecting where actual behaviour differs from contractual maturity:

- retail and corporate deposit bases are very stable, with deposits being attracted to the Bank by good customer service and its ethical policy. As a result, the deposit base remains stable although the contractual maturity is immediate for instant access deposits; and
- personal loan and visa balances are repaid earlier than their contractual maturity date.

2.2.3 Gross cashflow maturity analysis
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.

2. Liquidity risk continued

30 June 2012 Contractual cash flows	**Carrying value**	**Gross nominal outflow**	**Less than 1 month**	**1–3 months**	**3–12 months**	**1–5 years**	**Over 5 years**
Non-derivative liabilities							
Deposits by banks	**4,416.0**	**4,614.6**	**1,732.1**	**476.7**	**1,566.7**	**839.1**	**–**
Customer accounts	**33,054.7**	**33,210.1**	**23,083.8**	**2,784.1**	**5,421.7**	**1,920.5**	**–**
Customer accounts – capital bonds	**1,141.7**	**1,121.5**	**39.3**	**66.0**	**302.8**	**709.1**	**4.3**
Debt securities in issue	**4,146.8**	**5,315.4**	**83.0**	**317.3**	**223.3**	**3,437.1**	**1,254.7**
Other borrowed funds	**1,257.1**	**1,965.1**	**7.2**	**4.4**	**82.8**	**933.9**	**936.8**
Amounts owed to other Co-operative Group undertakings	**97.7**	**97.7**	**97.7**	**–**	**–**	**–**	**–**
	44,114.0	**46,324.4**	**25,043.1**	**3,648.5**	**7,597.3**	**7,839.7**	**2,195.8**
Derivative liabilities							
Net outflow	**983.1**	**391.3**	**319.9**	**23.1**	**42.7**	**38.7**	**(33.1)**
	45,097.1	**46,715.7**	**25,363.0**	**3,671.6**	**7,640.0**	**7,878.4**	**2,162.7**
Other liabilities	**223.0**	**–**	**–**	**–**	**–**	**–**	**–**
Total recognised liabilities	**45,320.1**	**46,715.7**	**25,363.0**	**3,671.6**	**7,640.0**	**7,878.4**	**2,162.7**
Unrecognised loan commitments	**5,265.5**	**5,265.5**	**4,909.8**	**317.4**	**38.3**	**–**	**–**
Total liabilities	**50,585.6**	**51,981.2**	**30,272.8**	**3,989.0**	**7,678.3**	**7,878.4**	**2,162.7**
Behavioural adjustments							
Customer accounts	**–**	**–**	**(19,900.2)**	**(23.2)**	**1,720.0**	**18,203.4**	**–**
Total liabilities – behavioural	**50,585.6**	**51,981.2**	**10,372.6**	**3,965.8**	**9,398.3**	**26,081.8**	**2,162.7**

31 December 2011 Contractual cash flows	Carrying value	Gross nominal outflow	Less than 1 month	1–3 months	3–12 months	1–5 years	Over 5 years
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

Risk management continued
For the period ended 30 June 2012 (unaudited)
All amounts are stated in £m unless otherwise indicated

3. Market risk
The Bank's market risk includes interest rate risk, interest basis risk and currency risk. The majority of the Bank's market risk arises from changes in interest rates.

3.1 Interest rate risk
Interest rate risk policy statements, approved by the ERC on behalf of the Board, specify the scope of the Bank's wholesale market activity, market risk limits and delegated authorities. ALCO is the senior management forum for the consideration of market risk exposures and trends. Its prime task is to assess the interest rate risk inherent in the maturity and repricing characteristics of the Bank's assets and liabilities. The Bank seeks to minimise the volatility of future earnings from interest rate changes and all interest rate risk exposure is removed from the 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 Bank. The principal analytical techniques involve assessing the impact of different interest rate scenarios and changes in balances over various time periods.

The Board receives reports on the management of balance sheet risk and ALCO reviews the balance sheet risk position and the utilisation of wholesale market risk limits.

3.1.1 Non-treasury interest rate risk
The Bank (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.

ALCO monitors the non-trading interest rate risk which is split between certain wholesale portfolios, banking and investment books, and the rest of the Bank's balance sheet. The following describes the Bank non-trading portfolios excluding these certain wholesale portfolios. These positions are managed by Treasury. All interest rate risk is centralised into Treasury using appropriate transfer pricing rates.

Gap reports are based on defined time periods. ALCO 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.

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. Drawdown risk, in particular for fixed rate mortgages, is managed through weekly balance sheet meetings. The balance sheet 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 Bank to income volatility if indices do not move in a ratio of one to one. This risk is managed by performing a future simulation of the balance sheet to establish what the Bank's income volatility would be if the rates do not move in a one for one ratio. Cash placements are then undertaken with the Treasury markets team to reduce the income volatility. The Treasury markets team execute external trades as required.

The table below illustrates the sensitivity analysis relating to the Bank, a primary measure in the approach to managing interest rate risk.

The table illustrates the greater than 12 month net gap position at the end of the period on the Bank's balances, excluding wholesale treasury and customer currency balances which are managed within the treasury risk framework. The gap is driven by product pricing and product mix. The gap is calculated by placing all assets and liabilities at the earliest of their repricing or maturity date and then summing by time band. The aim is to have assets evenly spread so that the Bank is not exposed to sudden rate movements. The net position shows the amount that the Bank is either over or under invested in the month. A £100m positive gap position would equate to the Bank's income increasing by £1m per annum if rates increased by 1%. The maximum sensitivity for the period shown below equates to approximately a £5m decrease in income if rates increased by 1%.

Net greater than 12 month gap position	**30 June 2012**	31 December 2011
At the period end	**(300)**	(279)
Average for the period	**(207)**	(330)
Maximum sensitivity for the period	**(533)**	806
Minimum sensitivity for the period	**(111)**	(51)

3.1.2 Treasury interest rate risk
Treasury executes short term funding and hedging transactions with the wholesale markets on behalf of the Bank 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 used is historical simulation using a time series of one year to latest day and was £0.18m at 30 June 2012 (31 December 2011: £0.35m) for the Treasury traded portfolios. 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 for Treasury, representing Treasury banking book and trading book combined. PV100 is the effect on the net present value (NPV) of the Treasury portfolio to a parallel shift of 100 basis points upon the base yield curve. The effect of a 1% increase in interest rates is a gain of £9.2m (31 December 2011: £15.1m) and a 1% decrease is a loss of £7.6m (31 December 2011: £16.0m).

3. Market risk continued

3.2 Currency risk

The Bank's treasury foreign exchange activities primarily:

- provide a service in meeting the foreign exchange requirements of customers;
- maintain liquidity in euros and US dollars by raising funds and investing these to generate a return; and
- perform limited intraday trading and overnight positioning in major currencies to generate incremental income.

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

	30 June 2012					31 December 2011				
	£	**$**	**€**	**Other**	**Total**	£	$	€	Other	Total
Assets										
Cash and balances at central banks	**4,316.6**	**–**	**–**	**–**	**4,316.6**	6,696.6	–	–	–	6,696.6
Loans and advances to banks	**1,896.2**	**61.3**	**400.3**	**1.9**	**2,359.7**	1,568.1	59.5	373.4	5.5	2,006.5
Loans and advances to customers	**33,798.6**	**43.4**	**146.0**	**20.4**	**34,008.4**	33,513.4	54.7	157.3	40.6	33,766.0
Fair value adjustments for hedged risk	**368.2**	**–**	**–**	**–**	**368.2**	366.3	–	–	–	366.3
Investment securities – loans and receivables	**388.9**	**22.2**	**71.9**	**–**	**483.0**	656.8	16.2	131.9	–	804.9
Investment securities – available for sale	**3,108.5**	**36.2**	**72.9**	**–**	**3,217.6**	3,127.8	124.7	170.5	–	3,423.0
Investment securities – at FV through income or expense	**782.2**	**28.7**	**6.5**	**–**	**817.4**	335.8	–	7.3	–	343.1
Investment securities – held for trading	**411.3**	**–**	**27.7**	**–**	**439.0**	–	–	–	–	–
Derivative financial instruments	**910.1**	**0.1**	**0.6**	**–**	**910.8**	975.3	0.2	0.3	–	975.8
Equity shares	**5.7**	**–**	**–**	**–**	**5.7**	5.7	–	–	–	5.7
Investments in joint ventures	**3.4**	**–**	**–**	**–**	**3.4**	2.7	–	–	–	2.7
Goodwill	**0.6**	**–**	**–**	**–**	**0.6**	0.6	–	–	–	0.6
Intangible fixed assets	**37.9**	**–**	**–**	**–**	**37.9**	40.7	–	–	–	40.7
Investment properties	**172.2**	**–**	**–**	**–**	**172.2**	172.7	–	–	–	172.7
Property, plant and equipment	**72.2**	**–**	**–**	**–**	**72.2**	80.1	–	–	–	80.1
Amounts owed by other Co-operative Group undertakings	**288.9**	**–**	**–**	**–**	**288.9**	179.2	–	–	–	179.2
Other assets	**51.1**	**0.2**	**0.4**	**–**	**51.7**	31.3	0.2	1.5	–	33.0
Prepayments and accrued income	**17.6**	**–**	**–**	**–**	**17.6**	18.7	–	–	–	18.7
Current tax assets	**37.3**	**–**	**–**	**–**	**37.3**	13.6	–	–	–	13.6
Deferred tax assets	**–**	**–**	**–**	**–**	**–**	26.4	–	–	–	26.4
Total assets	**46,667.5**	**192.1**	**726.3**	**22.3**	**47,608.2**	47,811.8	255.5	842.2	46.1	48,955.6
Liabilities										
Deposits by banks	**3,375.4**	**155.9**	**884.6**	**0.1**	**4,416.0**	2,567.3	260.6	474.7	0.1	3,302.7
Customer accounts	**32,968.0**	**46.1**	**38.2**	**2.4**	**33,054.7**	34,899.1	35.5	52.3	3.7	34,990.6
Customer accounts – capital bonds	**1,141.7**	**–**	**–**	**–**	**1,141.7**	1,429.8	–	–	–	1,429.8
Debt securities in issue	**4,102.3**	**6.4**	**38.1**	**–**	**4,146.8**	4,039.4	–	125.4	–	4,164.8
Derivative financial instruments	**983.0**	**0.1**	**–**	**–**	**983.1**	1,083.7	1.3	2.9	–	1,087.9
Other borrowed funds	**1,228.8**	**–**	**28.3**	**–**	**1,257.1**	1,229.5	–	29.3	–	1,258.8
Amounts owed to other Co-operative Group undertakings	**97.7**	**–**	**–**	**–**	**97.7**	132.3	–	–	–	132.3
Other liabilities	**89.9**	**0.2**	**0.5**	**–**	**90.6**	172.9	0.3	0.5	–	173.7
Accruals and deferred income	**26.4**	**–**	**–**	**–**	**26.4**	39.9	–	–	–	39.9
Provisions for liabilities and charges	**104.4**	**–**	**–**	**–**	**104.4**	102.0	–	–	–	102.0
Deferred tax liabilities	**1.6**	**–**	**–**	**–**	**1.6**	–	–	–	–	–
Total liabilities	**44,119.2**	**208.7**	**989.7**	**2.5**	**45,320.1**	45,695.9	297.7	685.1	3.8	46,682.5
Net on balance sheet position	**2,548.3**	**(16.6)**	**(263.4)**	**19.8**	**2,288.1**	2,115.9	(42.2)	157.1	42.3	2,273.1

At 30 June 2012 the Bank's open position was £6.9m (31 December 2011: £0.4m) representing a potential loss of £0.2m given a 3% depreciation in sterling (31 December 2011: £nil). The open position is monitored against limits in addition to limits in place on individual currencies. All figures are in £ sterling equivalent.

Capital management

For the period ended 30 June 2012 (unaudited)
All amounts are stated in £m unless otherwise indicated

Capital resources

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 capital position remains resilient with a period end core tier one position of 9.6% (31 December 2011: 9.6%).

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, demonstrating that there is currently more than sufficient surplus capital to cover the Bank's PPI risk. The Bank has provided an additional £40.0m for PPI in the first half of 2012 (2011: £90.0m).

The Bank's regulatory capital is analysed into two tiers:

Tier one capital

Tier one 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 two capital

Revaluation reserves relating to net gains on equity held in the available for sale financial assets category are included in tier two capital.

The tier two capital includes six subordinated debt issues and two tranches of 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 the 2011 financial statements.

	30 June 2012	31 December 2011
Reconciliation of equity per balance sheet to core tier one capital		
Total equity per balance sheet	**2,288.1**	2,273.1
Regulatory adjustments:		
Minority interests	**(0.9)**	(1.2)
Retained earnings	**–**	(49.8)
Available for sale reserve	**(72.5)**	(19.5)
Cashflow hedging reserve	**(75.5)**	(67.6)
Core tier one capital before regulatory deductions	**2,139.2**	2,135.0

Capital resources continued

	30 June 2012	31 December 2011
Core tier one capital		
Permanent share capital	**410.0**	410.0
Retained earnings	**1,733.7**	1,686.0
Minority interests	**32.0**	30.2
Interim losses	**(45.3)**	–
Share premium account	**8.8**	8.8
	2,139.2	2,135.0
Other tier one capital		
Non-cumulative irredeemable preference shares	**60.0**	60.0
Total tier one capital before regulatory deductions	**2,199.2**	2,195.0
Intangible assets	**(30.6)**	(71.1)
Expected loss shortfall	**(111.7)**	(114.2)
Securitisation positions	**(0.7)**	(2.3)
Material holdings	**(1.7)**	(1.3)
Total tier one capital after regulatory deductions	**2,054.5**	2,006.1
Tier two capital		
Revaluation reserves	**1.8**	2.9
Collective provisions	**0.7**	0.7
Subordinated notes and perpetual subordinated bonds	**1,126.1**	1,084.0
Total tier two capital before regulatory deductions	**1,128.6**	1,087.6
Expected loss shortfall	**(111.7)**	(114.2)
Securitisation positions	**(0.7)**	(2.3)
Material holdings	**(1.7)**	(1.3)
Total tier two capital after regulatory deductions	**1,014.5**	969.8
Total capital resources	**3,069.0**	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.

Basel III
The Bank is working towards compliance with the latest banking accord, Basel III. It expects to be able to comply fully with the new requirements when they become applicable, including the minimum leverage ratio of 3%.

Independent review report to The Co-operative Bank plc

Introduction
We have been engaged by the Company to review the condensed set of financial statements in the interim financial report for the six months ended 30 June 2012 which comprises the consolidated income statement, consolidated statement of comprehensive income, consolidated balance sheet, consolidated statement of cash flows, consolidated statement of changes in equity and the related explanatory notes. We have read the other information contained in the interim financial report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed set of financial statements.

This report is made solely to the Company in accordance with the terms of our engagement to assist the Company in meeting the requirements of the Disclosure and Transparency Rules ('the DTR') of the UK's Financial Services Authority ('the UK FSA'). Our review has been undertaken so that we might state to the Company those matters we are required to state to it in this 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 for our review work, for this report, or for the conclusions we have reached.

Directors' responsibilities
The interim financial report is the responsibility of, and has been approved by, the directors. The directors are responsible for preparing the interim financial report in accordance with the DTR of the UK FSA.

As disclosed in the basis of preparation, the annual financial statements of the Company are prepared in accordance with IFRSs as adopted by the EU. The condensed set of financial statements included in this half-yearly financial report has been prepared in accordance with IAS 34 *Interim Financial Reporting* as adopted by the EU.

Our responsibility
Our responsibility is to express to the Company a conclusion on the condensed set of financial statements in the interim financial report based on our review.

Scope of review
We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity* issued by the Auditing Practices Board for use in the UK. A review of interim financial information consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK and Ireland) and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion
Based on our review, nothing has come to our attention that causes us to believe that the condensed set of financial statements in the interim financial report for the six months ended 30 June 2012 is not prepared, in all material respects, in accordance with IAS 34 as adopted by the EU and the DTR of the UK FSA.

Andrew Walker
for and on behalf of KPMG Audit Plc
Chartered Accountants
St James' Square
Manchester
M2 6DS

22 August 2012

Consolidated income statement

For the period ended 30 June 2012 (unaudited)

All amounts are stated in £m unless otherwise indicated

	Notes	Period to 30 June 2012			Period to 30 June 2011		
		Before significant items	**Significant items**	**After significant items**	Before significant items	Significant items	After significant items
Interest receivable and similar income		**724.3**	**–**	**724.3**	803.5	–	803.5
Interest expense and similar charges		**(453.1)**	**–**	**(453.1)**	(473.9)	–	(473.9)
Net interest income	2	**271.2**	**–**	**271.2**	329.6	–	329.6
Fee and commission income		**128.0**	**(40.0)**	**88.0**	123.5	(90.0)	33.5
Fee and commission expense		**(41.2)**	**–**	**(41.2)**	(25.1)	–	(25.1)
Net fee and commission income	3	**86.8**	**(40.0)**	**46.8**	98.4	(90.0)	8.4
Net trading income/(expense)		**9.3**	**–**	**9.3**	(3.0)	–	(3.0)
Other operating income		**39.8**	**–**	**39.8**	28.6	–	28.6
Operating income		**407.1**	**(40.0)**	**367.1**	453.6	(90.0)	363.6
Operating expenses	4	**(294.3)**	**(39.3)**	**(333.6)**	(282.2)	(27.7)	(309.9)
Financial Services Compensation Scheme levies	9	**(0.8)**	**–**	**(0.8)**	(5.9)	–	(5.9)
Impairment losses on loans and advances	5	**(94.6)**	**–**	**(94.6)**	(44.8)	–	(44.8)
Impairment gains/(losses) on investments	6	**2.7**	**–**	**2.7**	(1.3)	–	(1.3)
Operating profit/(loss)		**20.1**	**(79.3)**	**(59.2)**	119.4	(117.7)	1.7
Share of post tax profits from joint ventures		**0.6**	**–**	**0.6**	0.3	–	0.3
Profit/(loss) before taxation and profit based payments		**20.7**	**(79.3)**	**(58.6)**	119.7	(117.7)	2.0
Profit based payments to members of The Co-operative Group		**–**	**–**	**–**	(11.8)	–	(11.8)
Profit/(loss) before taxation		**20.7**	**(79.3)**	**(58.6)**	107.9	(117.7)	(9.8)
Income tax		**(6.1)**	**19.4**	**13.3**	(31.0)	31.2	0.2
Profit/(loss) for the period		**14.6**	**(59.9)**	**(45.3)**	76.9	(86.5)	(9.6)
Attributable to:							
Equity shareholders		**13.8**	**(59.9)**	**(46.1)**	75.4	(86.5)	(11.1)
Minority interests		**0.8**	**–**	**0.8**	1.5	–	1.5
		14.6	**(59.9)**	**(45.3)**	76.9	(86.5)	(9.6)
Earnings per share		**0.17p**	**(0.73)p**	**(0.56)p**	0.92p	(1.06)p	(0.14)p

The significant items in 2012 relate to:

- £40.0m (2011: £90.0m) of provisions made for potential customer compensation claims relating to past sales of payment protection insurance (notes 3 and 9);
- £20.0m (2011: £nil) of costs incurred as a result of the bid for the Lloyds Bank branches (note 4); and
- £19.3m (2011: £27.7m) of costs incurred on a programme of investment and integration (note 4).

Consolidated statement of comprehensive income

For the period ended 30 June 2012 (unaudited)

All amounts are stated in £m unless otherwise indicated

	Period to 30 June 2012			Period to 30 June 2011		
	Equity shareholders	**Minority interests**	**Total**	Equity shareholders	Minority interests	Total
(Loss)/profit for the period	**(46.1)**	**0.8**	**(45.3)**	(11.1)	1.5	(9.6)
Other comprehensive income/(expense):						
Changes in cashflow hedges						
Net changes in fair value recognised directly in equity	**32.4**	**(0.3)**	**32.1**	15.7	(0.1)	15.6
Income tax	**(3.9)**	**0.1**	**(3.8)**	(3.6)	–	(3.6)
Net (gains)/losses transferred from equity to income or expense	**(23.1)**	**(0.1)**	**(23.2)**	0.1	–	0.1
Income tax	**2.5**	**–**	**2.5**	–	–	–
Changes in available for sale assets						
Net changes in fair value recognised directly in equity	**159.3**	**–**	**159.3**	7.4	(0.1)	7.3
Income tax	**(40.7)**	**–**	**(40.7)**	(2.5)	–	(2.5)
Transfers from equity to income or expense	**(89.3)**	**–**	**(89.3)**	(1.6)	–	(1.6)
Income tax	**23.7**	**–**	**23.7**	0.4	–	0.4
Other comprehensive income/(expense) for the period, net of income tax	**60.9**	**(0.3)**	**60.6**	15.9	(0.2)	15.7
Total comprehensive income for the period	**14.8**	**0.5**	**15.3**	4.8	1.3	6.1

The accounting policies and notes on pages 38 to 51 form part of these financial statements.

Consolidated balance sheet

At 30 June 2012 (unaudited)

All amounts are stated in £m unless otherwise indicated

	Notes	30 June 2012	31 December 2011
Assets			
Cash and balances at central banks		**4,316.6**	6,696.6
Loans and advances to banks		**2,359.7**	2,006.5
Loans and advances to customers	5	**34,008.4**	33,766.0
Fair value adjustments for hedged risk	5	**368.2**	366.3
Investment securities – loans and receivables	6	**483.0**	804.9
Investment securities – available for sale	6	**3,217.6**	3,423.0
Investment securities – fair value through income or expense	6	**817.4**	343.1
Investment securities – held for trading	6	**439.0**	–
Derivative financial instruments		**910.8**	975.8
Equity shares		**5.7**	5.7
Investments in joint ventures		**3.4**	2.7
Goodwill		**0.6**	0.6
Intangible fixed assets		**37.9**	40.7
Investment properties		**172.2**	172.7
Property, plant and equipment		**72.2**	80.1
Amounts owed by other Co-operative Group undertakings		**288.9**	179.2
Other assets		**51.7**	33.0
Prepayments and accrued income		**17.6**	18.7
Current tax assets		**37.3**	13.6
Deferred tax assets		**–**	26.4
Total assets		**47,608.2**	48,955.6
Liabilities			
Deposits by banks		**4,416.0**	3,302.7
Customer accounts	7	**33,054.7**	34,990.6
Customer accounts – capital bonds	8	**1,141.7**	1,429.8
Debt securities in issue		**4,146.8**	4,164.8
Derivative financial instruments		**983.1**	1,087.9
Other borrowed funds		**1,257.1**	1,258.8
Amounts owed to other Co-operative Group undertakings		**97.7**	132.3
Other liabilities		**90.6**	173.7
Accruals and deferred income		**26.4**	39.9
Provisions for liabilities and charges	9	**104.4**	102.0
Deferred tax liabilities		**1.6**	–
Total liabilities		**45,320.1**	46,682.5
Capital and reserves attributable to the Bank's equity holders			
Ordinary share capital		**410.0**	410.0
Share premium account		**8.8**	8.8
Retained earnings		**1,687.7**	1,733.8
Available for sale reserve		**72.5**	19.5
Cashflow hedging reserve		**75.5**	67.6
		2,254.5	2,239.7
Minority interests		**33.6**	33.4
Total equity		**2,288.1**	2,273.1
Total liabilities and equity		**47,608.2**	48,955.6

The accounting policies and notes on pages 38 to 51 form part of these financial statements.

Consolidated statement of cash flows

For the period ended 30 June 2012 (unaudited)
All amounts are stated in £m unless otherwise indicated

	Period to 30 June 2012	Period to 30 June 2011
Cash flows from operating activities		
Loss before taxation	**(58.6)**	(9.8)
Adjustments for:		
Increase in prepayments and accrued income	**(0.2)**	(50.4)
Decrease in accruals and deferred income	**(19.0)**	(128.1)
Interest payable in respect of other borrowed funds	**36.3**	13.1
Effect of exchange rate movements	**8.6**	(58.1)
Impairment losses on loans and advances	**95.8**	47.5
Movements on investment impairments	**(2.7)**	1.3
Depreciation and amortisation	**8.4**	11.8
Interest amortisation	**(4.7)**	(7.6)
Amortisation of investments	**(55.6)**	19.7
Profit on disposal of fixed assets	**(0.4)**	(0.5)
Unwind of fair value adjustments arising on transfer of engagements	**(19.7)**	(16.7)
Preference dividend	**2.8**	2.8
	(9.0)	(175.0)
Increase/(decrease) in deposits by banks	**1,113.3**	(227.2)
(Decrease)/increase in customer accounts	**(2,223.7)**	1,634.7
Decrease in debt securities in issue	**(59.7)**	(890.0)
Decrease in loans and advances to banks	**29.7**	909.3
(Increase)/decrease in loans and advances to customers	**(278.5)**	654.5
Increase in amounts owed by other Co-operative Group undertakings	**(109.7)**	(77.4)
(Decrease)/increase in amounts owed to other Co-operative Group undertakings	**(34.6)**	67.4
Net movement of other assets and other liabilities	**(128.8)**	78.9
Income tax paid	**(0.7)**	(16.0)
Net cash flows from operating activities	**(1,701.7)**	1,959.2
Cash flows from investing activities		
Purchase of property, plant, equipment and software	**(0.5)**	(11.2)
Proceeds from sale of property, plant, equipment and software	**0.8**	–
Proceeds from sale of investment property	**0.7**	0.5
Purchase of investment securities	**(2,176.7)**	(2,240.1)
Proceeds from sale and maturity of investment securities	**1,981.5**	2,696.8
Net cash flows from investing activities	**(194.2)**	446.0
Cash flows from financing activities		
Interest paid on other borrowed funds	**(48.1)**	(21.5)
Repayment of other borrowed funds	**–**	(82.2)
Issuance of other borrowed funds	**–**	275.0
Preference share dividends paid	**(2.8)**	(2.8)
Capital contribution from parent	**–**	87.0
Dividends paid to minority shareholders in subsidiary undertaking	**(0.3)**	–
Net cash flows from financing activities	**(51.2)**	255.5
(Decrease)/increase in cash and cash equivalents	**(1,947.1)**	2,660.7
Cash and cash equivalents at beginning of the period	**7,888.4**	3,403.2
Cash and cash equivalents at end of the period	**5,941.3**	6,063.9
Cash and balances with central banks	**4,278.3**	3,453.7
Loans and advances to banks	**1,403.0**	2,290.2
Short term investments (note 6)	**260.0**	320.0
	5,941.3	6,063.9

The cash flows cannot be directly reconciled to the Bank balance sheet movements as these movements include the non-cash unwinds of the fair value adjustments arising on the transfer of engagements of Britannia Building Society.

The accounting policies and notes on pages 38 to 51 form part of these financial statements.

Consolidated statement of changes in equity

For the period ended 30 June 2012 (unaudited)

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
Period from 1 January 2012 to 30 June 2012								
At the beginning of the period	**410.0**	**8.8**	**19.5**	**67.6**	**1,733.8**	**2,239.7**	**33.4**	**2,273.1**
Total comprehensive income for the period	**–**	**–**	**53.0**	**7.9**	**(46.1)**	**14.8**	**0.5**	**15.3**
Transactions with owners recorded directly in equity:								
Dividend	**–**	**–**	**–**	**–**	**–**	**–**	**(0.3)**	**(0.3)**
At the end of the period	**410.0**	**8.8**	**72.5**	**75.5**	**1,687.7**	**2,254.5**	**33.6**	**2,288.1**
Period from 1 July 2011 to 31 December 2011								
At the beginning of the period	410.0	8.8	(9.4)	49.1	1,674.8	2,133.3	32.9	2,166.2
Total comprehensive income for the period	–	–	28.9	18.5	59.0	106.4	0.5	106.9
At the end of the period	410.0	8.8	19.5	67.6	1,733.8	2,239.7	33.4	2,273.1
Period from 1 January 2011 to 30 June 2011								
At the beginning of the period	410.0	8.8	(13.1)	36.9	1,598.9	2,041.5	31.6	2,073.1
Total comprehensive income for the period	–	–	3.7	12.2	(11.1)	4.8	1.3	6.1
Transactions with owners recorded directly in equity:								
Capital contribution	–	–	–	–	87.0	87.0	–	87.0
At the end of the period	410.0	8.8	(9.4)	49.1	1,674.8	2,133.3	32.9	2,166.2

The accounting policies and notes on pages 38 to 51 form part of these financial statements.

Basis of preparation and accounting policies

For the period ended 30 June 2012 (unaudited)

Basis of preparation

EU law (IAS Regulation EC1606/2002) requires that the annual consolidated financial statements for the year ended 31 December 2012 are prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and International Financial Reporting Interpretations Committee guidance as issued by the European Union.

The information in this interim financial report 2012 is unaudited and does not constitute statutory accounts within the meaning of Section 434 of the Companies Act 2006. The comparative figures for the financial year ended 31 December 2011 are not the Company's statutory accounts for that financial year. Those accounts have been reported on by the Company's auditors and delivered to the registrar of companies. The report of the auditors was unqualified, did not include a reference to any matters to which the auditors drew attention by way of emphasis without qualifying their report, and did not contain a statement under Section 498(2) or (3) of the Companies Act 2006.

The interim financial report 2012 was approved by the Board of Directors on 22 August 2012.

This condensed consolidated interim financial report for the half year ended 30 June 2012 has been prepared in accordance with the Disclosure and Transparency Rules of the Financial Services Authority and with IAS 34, 'Interim Financial Reporting' as adopted by the European Union. The interim financial report should be read in conjunction with the 2011 financial statements, which have been prepared in accordance with IFRS as adopted by the European Union.

Accounting policies

The accounting policies, methods of computation and presentation adopted by the Bank in the preparation of its interim financial report 2012 are those which the Bank currently expects to adopt in its 2012 financial statements and are consistent with those disclosed in the 2011 financial statements.

Going concern

The Bank'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. Further risk information is provided in the risk management section. In addition, the risk management section of the 2012 interim financial report includes the Bank's objectives, policies and processes for managing its risk and details of its exposure to risk. The capital management section provides information on the Bank's capital policies.

In common with many financial institutions, the Bank meets its day to day liquidity requirements through managing both its retail and wholesale funding sources, and is required to maintain a sufficient buffer over regulatory capital requirements in order to continue to be authorised to carry on its business. The Bank's forecasts and objectives, taking into account a number of potential changes in trading performance and funding retention, show that the Bank should be able to operate at adequate levels of both liquidity and capital for the foreseeable future. The Bank has also considered a number of stress tests on capital and liquidity and these provide assurance that the Bank is sufficiently capitalised and is comfortably in excess of liquidity stress tests.

Consequently, after making enquiries, the directors are satisfied that the Bank has sufficient resources to continue in business for the foreseeable future and have therefore continued to adopt the going concern basis in preparing the interim financial report. This is in accordance with the Financial Reporting Council's 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009' report.

Use of estimates and judgments

The preparation of financial information 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 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.

Payment protection insurance (PPI) provision

The Bank has recognised a provision of £40.0m (2011: £90.0m) in respect of PPI policies as a result of discussions with the FSA and a judgment handed down by the UK High Court (note 9). The provision represents management's best estimate of the anticipated costs of related customer contact and redress, including administration expenses. However, there are still a number of uncertainties as to the eventual costs from any such contact and redress given the inherent difficulties of assessing the impact of detailed implementation of the FSA policy, uncertainties around the ultimate emergence period for complaints and the activities of claims management companies, all of which will significantly affect complaints volumes, uphold rates and redress costs.

The provision requires significant judgment by management in determining appropriate assumptions, which include the level of complaints, uphold rates, proactive contact and response rates, Financial Ombudsman Service referral and uphold rates as well as redress costs used to determine the best estimate of the anticipated costs of redress.

Notes to the interim financial report

For the period ended 30 June 2012 (unaudited)

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 the period under review, 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 period. 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.

Period to 30 June 2012	**Retail**	Corporate core	Corporate non-core	Other CABB	**Total CABB**	Treasury	Other	**Total Other**	**Total**
Interest margin	**196.6**	54.0	(11.5)	3.0	**45.5**	2.7	4.4	**7.1**	**249.2**
Non-interest income	**68.4**	32.2	1.2	8.1	**41.5**	24.9	1.1	**26.0**	**135.9**
Operating income	**265.0**	86.2	(10.3)	11.1	**87.0**	27.6	5.5	**33.1**	**385.1**
Operating expenses	**(214.8)**	(38.6)	(2.8)	(12.6)	**(54.0)**	(9.6)	(3.5)	**(13.1)**	**(281.9)**
Impairment losses on loans and advances	**(18.2)**	(17.5)	(56.9)	(1.5)	**(75.9)**	–	(0.5)	**(0.5)**	**(94.6)**
Impairment gains on investments	**–**	–	–	–	**–**	2.7	–	**2.7**	**2.7**
Operating profit	**32.0**	30.1	(70.0)	(3.0)	**(42.9)**	20.7	1.5	**22.2**	**11.3**
Significant items – costs incurred as a result of the bid for the Lloyds Bank branches									**(20.0)**
Significant items – costs incurred on a programme of investment and integration									**(19.3)**
Payment protection insurance provision									**(40.0)**
Share of post tax profits from joint ventures									**0.6**
Financial Services Compensation Scheme levies									**(0.8)**
Fair value amortisation									**19.7**
Profit based payments to members of The Co-operative Group									**–**
Recharges paid to The Co-operative Group									**(10.1)**
Loss before taxation									**(58.6)**
Income tax									**13.3**
Loss for the period									**(45.3)**

The Board relies primarily on net interest revenue to assess the performance of each segment. As a result interest margin is reported on a net basis to the Board. The Bank's activities are primarily in the UK.

Notes to the interim financial report continued

For the period ended 30 June 2012 (unaudited)

All amounts are stated in £m unless otherwise indicated

1. Segmental information continued

Reconciliation to statutory income statement	**Period to 30 June 2012**
Interest margin	
Total interest margin for reportable segments	**249.2**
Fair value amortisation	**22.0**
Net interest income	**271.2**
Operating expenses	
Total operating expenses for reportable segments	**(281.9)**
Recharges paid to The Co-operative Group	**(10.1)**
Fair value amortisation	**(2.3)**
Operating expenses	**(294.3)**
Fair value amortisation	
Total interest unwind for reportable segments	**19.7**
Interest margin unwind	**(22.0)**
Operating expenses unwind	**2.3**
Fair value amortisation	**–**

Period to 30 June 2011	Retail	Corporate core	Corporate non-core	Other CABB	Total CABB	Treasury	Other	Total Other	Total
Interest margin	204.6	51.4	(8.8)	31.2	73.8	27.0	5.2	32.2	310.6
Non-interest income	81.1	26.2	0.5	7.3	34.0	7.9	1.0	8.9	124.0
Operating income	285.7	77.6	(8.3)	38.5	107.8	34.9	6.2	41.1	434.6
Operating expenses	(209.8)	(39.2)	(3.3)	(15.9)	(58.4)	(7.9)	(3.8)	(11.7)	(279.9)
Impairment losses on loans and advances	(18.1)	(18.1)	(8.3)	(0.2)	(26.6)	–	(0.1)	(0.1)	(44.8)
Impairment losses on investments	–	–	–	–	–	(1.3)	–	(1.3)	(1.3)
Operating profit	57.8	20.3	(19.9)	22.4	22.8	25.7	2.3	28.0	108.6
Significant items – costs incurred on a programme of investment and integration									(27.7)
Payment protection insurance provision									(90.0)
Share of post tax profits from joint ventures									0.3
Financial Services Compensation Scheme levies									(5.9)
Fair value amortisation									16.7
Profit based payments to members of The Co-operative Group									(11.8)
Recharges paid to The Co-operative Group									–
Loss before taxation									(9.8)
Income tax									0.2
Loss for the period									(9.6)

1. Segmental information continued

Reconciliation to statutory income statement	Period to 30 June 2011
Interest margin	
Total interest margin for reportable segments	310.6
Fair value amortisation	19.0
Net interest income	329.6
Operating expenses	
Total operating expenses for reportable segments	(279.9)
Fair value amortisation	(2.3)
Operating expenses	(282.2)
Fair value amortisation	
Total interest unwind for reportable segments	16.7
Interest margin unwind	(19.0)
Operating expenses unwind	2.3
Fair value amortisation	–

30 June 2012	**Retail**	**CABB excluding Optimum**	**Optimum**	**Treasury**	**Total**
Segment assets	**18,033.2**	**8,829.9**	**7,511.3**	**10,926.7**	**45,301.1**
Unallocated assets					**1,230.5**
Total assets for reportable segments					**46,531.6**
Statutory reclassifications					**1,076.6**
Consolidated total assets					**47,608.2**

	Retail	**CABB excluding Optimum**	**Optimum**	**Treasury**	**Total**
Segment liabilities	**26,453.8**	**6,683.0**	**–**	**10,168.6**	**43,305.4**
Unallocated liabilities					**930.9**
Total liabilities for reportable segments					**44,236.3**
Statutory reclassifications					**1,083.8**
Consolidated total liabilities					**45,320.1**

31 December 2011	Retail	CABB excluding Optimum	Optimum	Treasury	Total
Segment assets	17,657.8	8,684.7	7,662.4	12,715.5	46,720.4
Unallocated assets					1,640.3
Total assets for reportable segments					48,360.7
Statutory reclassifications					594.9
Consolidated total assets					48,955.6

	Retail	CABB excluding Optimum	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

Notes to the interim financial report continued
For the period ended 30 June 2012 (unaudited)
All amounts are stated in £m unless otherwise indicated

2. Net interest income

	Period to 30 June 2012	Period to 30 June 2011
Interest receivable and similar income		
On financial assets not at fair value through income or expense:		
On loans and advances to customers	**786.2**	755.8
On loans and advances to banks	**13.4**	13.3
On investment securities	**63.8**	103.7
	863.4	872.8
On financial assets at fair value through income or expense:		
Net expense on financial instruments hedging assets	**(126.9)**	(69.5)
Net interest (expense)/income on financial instruments not in a hedging relationship	**(12.2)**	0.2
	724.3	803.5
Interest expense and similar charges		
On financial liabilities not at fair value through income or expense:		
On customer accounts	**268.2**	248.4
On bank and other deposits	**111.0**	130.3
On subordinated liabilities	**41.7**	66.2
On perpetual secured debt	**23.0**	10.2
	443.9	455.1
On financial liabilities at fair value through income or expense:		
Net expense on financial instruments hedging liabilities	**9.2**	18.8
	453.1	473.9

3. Net fee and commission income

	Period to 30 June 2012			Period to 30 June 2011		
	Before significant items	**Significant items**	**After significant items**	Before significant items	Significant items	After significant items
Fee and commission income						
On items not at fair value through income or expense	**127.9**	**(40.0)**	**87.9**	122.9	(90.0)	32.9
On trust or fiduciary activities that result from holding or investing in assets on behalf of others	**0.1**	**–**	**0.1**	0.6	–	0.6
	128.0	**(40.0)**	**88.0**	123.5	(90.0)	33.5
Fee and commission expense						
On items not at fair value through income or expense	**35.0**	**–**	**35.0**	22.6	–	22.6
On items at fair value through income or expense	**6.2**	**–**	**6.2**	2.5	–	2.5
	41.2	**–**	**41.2**	25.1	–	25.1

The significant item of £40.0m (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.

4. Operating expenses

	Period to 30 June 2012			Period to 30 June 2011		
	Before significant items	**Significant items**	**After significant items**	Before significant items	Significant items	After significant items
Staff costs:						
Wages and salaries	**97.3**	**7.3**	**104.6**	110.9	7.4	118.3
Social security costs	**7.5**	**0.6**	**8.1**	10.6	0.4	11.0
Pension costs – defined benefit plans	**0.1**	**–**	**0.1**	0.1	–	0.1
Pension costs – defined contribution plans	**18.5**	**0.7**	**19.2**	15.1	0.4	15.5
Other staff costs	**14.7**	**8.3**	**23.0**	13.5	11.3	24.8
	138.1	**16.9**	**155.0**	150.2	19.5	169.7
Administrative expenses	**128.9**	**22.4**	**151.3**	102.8	8.2	111.0
Depreciation of property, plant and equipment	**7.7**	**–**	**7.7**	11.1	–	11.1
Amortisation of intangible fixed assets	**3.1**	**–**	**3.1**	3.0	–	3.0
Profit on sale of property, plant and equipment	**(0.4)**	**–**	**(0.4)**	(0.5)	–	(0.5)
Operating lease rentals	**14.7**	**–**	**14.7**	14.0	–	14.0
Property provisions for liabilities and charges provided in the period (note 9)	**1.0**	**–**	**1.0**	–	–	–
Property provisions for liabilities and charges released during the period (note 9)	**(0.3)**	**–**	**(0.3)**	–	–	–
Other provisions for liabilities and charges provided in the period (note 9)	**0.1**	**–**	**0.1**	–	–	–
Direct expenses from investment properties that generated rental income in the period	**1.4**	**–**	**1.4**	1.5	–	1.5
Direct expenses from investment properties that did not generate rental income in the period	**–**	**–**	**–**	0.1	–	0.1
	294.3	**39.3**	**333.6**	282.2	27.7	309.9

The significant items relate to a programme of investment and integration, and costs incurred as a result of the bid for the Lloyds Bank branches.

Notes to the interim financial report continued

For the period ended 30 June 2012 (unaudited)

All amounts are stated in £m unless otherwise indicated

5. Loans and advances to customers

	30 June 2012	31 December 2011
Gross loans and advances	**34,349.5**	34,058.0
Less: allowance for losses	**(341.1)**	(292.0)
	34,008.4	33,766.0

Loans and advances to customers include £148.0m (31 December 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 £56.4m (31 December 2011: £36.7m) are secured by real estate collateral.

Loans and advances to customers include £9,316.9m (31 December 2011: £9,099.8m) securitised under the Bank's securitisation and covered bond programmes. The Bank remains exposed to substantially all of the risks and rewards of ownership of these assets.

Concentration of exposure

The Bank's exposure is virtually all within the UK. The following industry concentrations of gross advances are considered significant:

	30 June 2012	31 December 2011
Property and construction	**4,085.8**	4,247.1
Retail distribution	**415.4**	391.6
Business and other services	**4,532.4**	4,445.1
Personal – unsecured	**1,531.8**	1,518.1
Personal – secured	**23,784.1**	23,456.1
	34,349.5	34,058.0

Allowance for losses on loans and advances

	Individual retail	Individual corporate	Collective retail	Collective corporate	Total
Period to 30 June 2012					
At the beginning of the period	**9.0**	**105.1**	**165.7**	**12.2**	**292.0**
Charge against profits	**2.8**	**68.7**	**18.1**	**6.2**	**95.8**
Amounts written off	**(2.8)**	**(24.8)**	**(14.8)**	**(0.7)**	**(43.1)**
Unwind of discount allowance	**–**	**(1.9)**	**(1.7)**	**–**	**(3.6)**
Interest charged on impaired loans	**–**	**–**	**–**	**–**	**–**
At the end of the period	**9.0**	**147.1**	**167.3**	**17.7**	**341.1**
Period to 31 December 2011					
At the beginning of the year	8.6	55.8	157.8	0.4	222.6
Charge against profits for the period to 30 June 2011	1.5	17.2	28.3	0.5	47.5
Charge against profits for the period to 31 December 2011	3.4	59.4	8.1	12.1	83.0
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

The net impairment charge in the Bank income statement is £94.6m (30 June 2011: £44.8m). This includes amounts recovered by the Bank of £1.2m (30 June 2011: £2.7m) against amounts previously written off. The recoveries have been made from the mortgagors and from other parties involved in the origination or acquisition of the mortgages.

Fair value adjustments for hedged risk

The Bank has entered into interest rate swaps that protect it from changes in interest rates on the floating rate liabilities that fund its portfolio of fixed rate mortgages. Changes in the fair values of these swaps are offset by changes in the fair values of the fixed rate mortgages. The changes in fair value of fixed rate mortgages are disclosed on the balance sheet as fair value adjustments for hedged risk immediately below the loans and advances to customers.

Fair value adjustments to loans and advances to customers attributable to portfolio hedged risk are £368.2m (31 December 2011: £366.3m).

6. Investment securities

	30 June 2012	31 December 2011
Loans and receivables		
Listed	**–**	113.5
Unlisted	**483.0**	694.1
	483.0	807.6
Less: allowance for losses	**–**	(2.7)
	483.0	804.9
Included in cash and cash equivalents	**–**	–

Impairment analysis of investment securities – loans and receivables

	30 June 2012	31 December 2011
At the beginning of the period	**2.7**	13.0
(Release)/charge for the period to 30 June 2012 (30 June 2011)	**(2.7)**	1.3
Release for the period to 31 December 2011	**–**	(6.9)
Release for the period	**(2.7)**	(5.6)
Utilised during the period	**–**	(4.7)
At the end of the period	**–**	2.7

	30 June 2012	31 December 2011
Available for sale		
Listed	**2,866.6**	3,098.6
Unlisted	**393.3**	366.9
	3,259.9	3,465.5
Less: allowance for losses	**(42.3)**	(42.5)
	3,217.6	3,423.0
Included in cash and cash equivalents	**260.0**	210.0

Impairment analysis of investment securities – available for sale

	30 June 2012	31 December 2011
At the beginning of the period	**42.5**	72.3
Charge for the period to 30 June 2012 (30 June 2011)	**–**	–
Charge for the period to 31 December 2011	**–**	–
Charge for the period	**–**	–
Utilised during the period	**–**	(29.6)
Exchange adjustments	**(0.2)**	(0.2)
At the end of the period	**42.3**	42.5

	30 June 2012	31 December 2011
Fair value through income or expense		
Listed	**817.4**	343.1
	817.4	343.1
Less: allowance for losses	**–**	–
	817.4	343.1
Included in cash and cash equivalents	**–**	–

Notes to the interim financial report continued

For the period ended 30 June 2012 (unaudited)

All amounts are stated in £m unless otherwise indicated

6. Investment securities continued

	30 June 2012	31 December 2011
Held for trading		
Listed	**439.0**	–
	439.0	–
Less: allowance for losses	**–**	–
	439.0	–
Included in cash and cash equivalents	**–**	–

Analysis of investment securities by issuer

	30 June 2012	31 December 2011
Investment securities issued by public bodies:		
Government securities	**1,263.9**	1,834.5
Other public sector securities	**–**	563.6
	1,263.9	2,398.1
Investment securities issued by other issuers:		
Bank and building society certificates of deposits	**340.6**	315.7
Other debt securities:		
Other floating rate notes	**2,869.5**	1,165.9
Mortgage backed securities	**483.0**	691.3
	3,352.5	1,857.2
	4,957.0	4,571.0

Other floating rate notes (FRNs) relate to sterling, euro, US dollar, Canadian dollar and Australian dollar denominated FRNs with maturities ranging from one month to nine years from the balance sheet date.

7. Customer accounts

	30 June 2012	31 December 2011
Customer accounts	**33,054.7**	34,990.6

The Bank 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 £3.0m (31 December 2011: £3.0m) against which there are fair value adjustments for hedged risk of £(0.5)m (31 December 2011: £(0.4)m), giving a total carrying value of £2.5m (31 December 2011: £2.6m).

8. Customer accounts – capital bonds

	30 June 2012	31 December 2011
Retail	**1,141.7**	1,429.8

The capital bonds are fixed term customer accounts with returns based on the movement in an index (eg FTSE 100) over the term of the bond.

The capital bonds have been designated on initial recognition at fair value through income or expense and are carried at their fair value.

The fair values for the capital bonds are obtained on a monthly basis from the third parties that issue these products. These external valuations are reviewed independently using valuation software to ensure the fair values are priced on a consistent basis.

None of the change in the fair value of the capital bonds is attributable to changes in the liability's credit risk.

The maximum amount the Bank would contractually be required to pay at maturity for all the capital bonds is £1,147.1m (31 December 2011: £1,429.6m).

The Bank uses swaps to create economic hedges against all of its capital bonds. The loss on capital bonds in the income statement for the period is £11.0m (30 June 2011: loss of £6.8m). However, taking into account changes in fair value of the associated swaps, the net impact to the income statement for the period is a gain of £0.2m (30 June 2011: gain of £0.1m).

9. Provisions for liabilities and charges

Period to 30 June 2012	Property	FSCS levies	PPI	Other	Total
At the beginning of the period	**6.9**	**25.0**	**61.7**	**8.4**	**102.0**
Income statement movements:					
Provided in the period – operating expense	**1.0**	**0.8**	**–**	**0.1**	**1.9**
Provided in the period – net fee and commission income	**–**	**–**	**40.0**	**–**	**40.0**
Released in the period – operating expense	**(0.3)**	**–**	**–**	**–**	**(0.3)**
Utilised during the period	**(0.5)**	**–**	**(32.3)**	**(6.4)**	**(39.2)**
At the end of the period	**7.1**	**25.8**	**69.4**	**2.1**	**104.4**
Provisions were analysed as follows:					
Amounts falling due within one year	**3.1**	**10.9**	**69.4**	**2.1**	**85.5**
Amounts falling due after one year	**4.0**	**14.9**	**–**	**–**	**18.9**
	7.1	**25.8**	**69.4**	**2.1**	**104.4**

Period to 31 December 2011	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 period to 30 June 2011 – operating expense	–	5.9	–	–	5.9
Provided in the period to 31 December 2011 – operating expense	0.4	8.6	–	0.1	9.1
Provided in the period to 30 June 2011 – fee and commission income	–	–	90.0	–	90.0
Provided in the period to 31 December 2011 – fee and commission income	–	–	–	1.0	1.0
Released in the period to 31 December 2011 – operating expense	(0.3)	–	–	(0.1)	(0.4)
Released in the period to 31 December 2011 – 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

Property

The Bank has a number of leasehold properties available for rent. Provisions are made when either the sub-lease income does not cover the rental expense or the property is vacant. The provision is based on the expected outflows during the remaining periods of the leases using the 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 Bank could be liable to pay a proportion of the outstanding borrowings that the FSCS has borrowed from HM Treasury. Additionally the Bank is obliged to pay its share of management expenses and compensation based upon the Bank's proportion of the total market protected deposits at 31 December of each year.

The Bank has provided £25.8m as at 30 June 2012 (31 December 2011: £25.0m) for its share of the levies that will be raised by the FSCS including the interest on the loan from HM Treasury in respect of the 2011/12 and 2012/13 levy years. The Bank's provision calculation includes estimates of the total FSCS levy in each levy year and estimates of the Bank's market participation in each levy year.

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 FSCS has indicated that it expects 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 Bank's share of such a levy is estimated at £22m.

In May 2012 the International Accounting Standards Board published a draft IFRIC interpretation on 'Levies Charged by Public Authorities on Entities that Operate in a Specific Market'. The interpretation states that if a levy is triggered by the entity operating in a specific market at the end of the accounting period then the provision for the levy should only be recognised at the end of the accounting period. The Bank has applied this guidance in respect of the FSCS levy for the levy period from 1 April 2013 to 31 March 2014, which is based on the value of deposits at 31 December 2012, and has not made a provision for this levy in the interim financial report 2012. This guidance only impacts the Bank making a levy provision in this interim financial report and will not impact the levy provision made in the 2012 financial statements.

Notes to the interim financial report continued

For the period ended 30 June 2012 (unaudited)

All amounts are stated in £m unless otherwise indicated

9. Provisions for liabilities and charges continued

PPI

Provisions have been made in respect of various 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 non-mortgage credit products.

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 new rules were challenged by the BBA which launched a judicial review heard in January 2011. The results of the review were announced on 20 April 2011 and the High Court dismissed the BBA arguments. Consequently 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 £40.0m (30 June 2011: £90.0m) has been recognised in the period (note 3), in respect of the expected cost to the Bank of carrying out this work and paying compensation.

Interest rate hedging products

The Bank has agreed to join the FSA review of sales of interest rate hedging products. The Bank has only sold circa 100 of these products. No provision has been made in the interim results, the redress has yet to be quantified but is expected to be immaterial.

10. Related party transactions

Related party transactions and transactions with key management personnel in the half year to 30 June 2012 are similar in nature to those for the year ended 31 December 2011. Details of the Bank's related party transactions and transactions with key management personnel for the year ended 31 December 2011 can be found in the 2011 financial statements.

A number of banking transactions are entered into with related parties in the normal course of business on normal commercial terms.

11. Risk analysis

The Bank's principal risks relating to financial instruments are considered to be consistent with those reported in the 2011 financial statements. Further analysis is provided in the risk management section of this report.

12. 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
30 June 2012							
Assets							
Cash and balances at central banks	–	–	4,316.6	–	–	–	4,316.6
Loans and advances to banks	–	–	2,359.7	–	–	–	2,359.7
Loans and advances to customers	–	148.0	34,228.6	–	–	–	34,376.6
Investment securities	439.0	817.4	483.0	3,217.6	–	–	4,957.0
Derivative financial instruments	180.7	547.0	–	–	–	183.1	910.8
Equity shares	–	–	–	5.7	–	–	5.7
Amounts owed by other Co-operative Group undertakings	–	–	288.9	–	–	–	288.9
Total financial assets	619.7	1,512.4	41,676.8	3,223.3	–	183.1	47,215.3
Non-financial assets							392.9
Total assets							47,608.2
Liabilities							
Deposits by banks	–	–	–	–	4,416.0	–	4,416.0
Customer accounts	–	–	–	–	33,054.7	–	33,054.7
Customer accounts – capital bonds	–	1,141.7	–	–	–	–	1,141.7
Debt securities in issue	–	–	–	–	4,146.8	–	4,146.8
Derivative financial instruments	164.3	778.8	–	–	–	40.0	983.1
Other borrowed funds	–	–	–	–	1,257.1	–	1,257.1
Amounts owed to other Co-operative Group undertakings	–	–	–	–	97.7	–	97.7
Total financial liabilities	164.3	1,920.5	–	–	42,972.3	40.0	45,097.1
Non-financial liabilities							223.0
Total liabilities							45,320.1
Total equity							2,288.1
Total liabilities and equity							47,608.2

Notes to the interim financial report continued
For the period ended 30 June 2012 (unaudited)
All amounts are stated in £m unless otherwise indicated

12. 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
31 December 2011							
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	34,018.2	–	–	–	34,132.3
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
Total equity							2,273.1
Total liabilities and equity							48,955.6

a. Use of financial instruments
The use of financial instruments is essential to the Bank's business activities and financial instruments constitute a significant proportion of the Bank's assets and liabilities. The main financial instruments used by the Bank, and the purposes for which they are held, are outlined below.

Loans and advances to customers and customer accounts
The provision of banking facilities to customers is the prime activity of the Bank and loans and advances to customers and customer accounts are major constituents of the balance sheet. Loans and advances to customers include retail mortgages, corporate loans, credit cards, unsecured retail lending and overdrafts. Customer accounts include retail and corporate current and saving 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.

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 wholesale market loans are invested in marketable, investment grade debt securities, short term wholesale market placements and used to fund customer loans.

Other borrowed funds
The Bank has a policy of maintaining prudent capital ratios and 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.

12. 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. 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 disclosed in the 2011 financial statements.

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.

	30 June 2012		31 December 2011	
	Carrying value	**Fair value**	Carrying value	Fair value
Financial assets				
Loans and receivables				
Loans and advances to banks	**2,359.7**	**2,358.6**	2,006.5	2,004.2
Loans and advances to customers	**34,228.6**	**34,489.5**	34,018.2	34,236.4
Investment securities	**483.0**	**480.2**	804.9	798.5
Financial liabilities				
Financial liabilities at amortised cost				
Deposits by banks	**4,416.0**	**4,429.7**	3,302.7	3,305.1
Customer accounts	**33,054.7**	**33,257.3**	34,990.6	35,138.9
Debt securities in issue	**4,146.8**	**4,028.9**	4,164.8	4,008.1
Other borrowed funds	**1,257.1**	**993.9**	1,258.8	1,092.6

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 the zero coupon rate. Forecast principal repayments are based on redemption at the earlier of maturity or repricing date with some overlay for historic 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.

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 price 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 cashflow model is used based on a current yield curve appropriate for the remaining term to maturity.

Responsibility statement

We confirm that to the best of our knowledge:

- the condensed set of financial statements has been prepared in accordance with IAS 34 *Interim Financial Reporting* as adopted by the EU; and
- the interim management report includes a fair review of the information required by:
  - DTR 4.2.7R of the Disclosure and Transparency Rules, being an indication of important events that have occurred during the first half of the financial year and their impact on the condensed set of financial statements; and a description of the principal risks and uncertainties for the remaining half of the year; and
  - DTR 4.2.8R of the Disclosure and Transparency Rules, being related party transactions that have taken place in the first half of the current financial year and that have materially affected the financial position or performance of the entity during that period; and any changes in the related party transactions described in the last annual report that could do so.

By Order of the Board

Barry Tootell, Acting Chief Executive

22 August 2012

The Co-operative Bank plc Board of Directors:

Executive directors:

Barry Tootell	Acting Chief Executive

Non-executive directors:

Paul Flowers	Chair
Rodney Baker-Bates	(retired 31 July 2012)
Duncan Bowdler	
David Davies	
Anne Gunther	
Peter Harvey	
Paul Hewitt	
Merlyn Lowther	
Peter Marks	
Bob Newton	
Ben Reid	
Len Wardle	
Martyn Wates	

Notice to shareholders

The half yearly dividend to Preference Shareholders of 4.625p per £1 preference share, amounting to £2,775,000 will be paid on 30 November 2012 to holders on the register at 2 November 2012.

Registered Office:
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Reg. No. 990937 (England)
Tel: 0870 702 0003

22 August 2012

Registrar:
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