The Co-operative Bank plc
Interim financial report 2013

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

Contents

1	Chairman's statement
2	Chief Executive's overview
3	Business and financial review
7	Risk management
29	Capital management
32	Independent review report
33	Condensed financial statements
33	Consolidated income statement
34	Consolidated statement of comprehensive income
35	Consolidated balance sheet
36	Consolidated statement of cash flows
37	Consolidated statement of changes in equity
38	Basis of preparation and accounting policies
42	Notes to the interim financial report
60	Responsibility statement
61	Notice to shareholders

Reference is made to the Bank, the consolidated Co-operative Banking Group and the wider Co-operative Group throughout these financial statements. Information in relation to the Bank and its subsidiary undertakings is referred to as 'the Bank', information relating to the consolidated Co-operative Banking Group is referred to as 'the Banking Group' and information relating to the wider Co-operative Group is referred to as 'the Group'.

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

Chairman's statement

These are the first results I have had to introduce since I became Chairman of The Co-operative Bank on 5 June 2013 and there is no hiding that they are disappointing. Niall Booker, our new Chief Executive, joined the Bank on 10 June 2013. Together, and with the wider board and management teams, we are required to address the issues the Bank is facing, which were reported in the 2012 year end results and continued to impact the financial performance for the first half of 2013.

We now have a plan to strengthen the capital position of the Bank and we are also progressing plans to simplify and rebuild the Bank focused on serving the needs of individuals and small business customers. In our announcement on 17 June 2013, we noted that significant additional impairment charges were expected for this current financial year and the results today have been primarily driven by credit impairment on the non-core corporate assets.

The question of 'what went wrong?' is very relevant and we have asked Sir Christopher Kelly to undertake a comprehensive independent review into the events that led to the Bank announcing a £1.5bn capital shortfall. The findings of Sir Christopher Kelly's review will be reported by May next year. The aim of that review is to independently establish the facts, and speculation is a diversion from finding out the truth, and repairing the Bank's financial position and reputation.

The critical first step in our recovery is completing the Exchange Offer, as part of the recapitalisation plan announced on 17 June. The completion of the Exchange Offer, in which both The Co-operative Group and holders of the Bank's subordinated capital securities will contribute broadly equal amounts, will generate £1bn of the total additional £1.5bn core capital required to secure the Bank's future. In addition, in 2014, contingent on a successful Exchange Offer, The Co-operative Group will contribute up to a further £0.5bn expected to be funded primarily through the sale of its insurance businesses. The execution of the Exchange Offer is vital to stabilising the Bank's capital position; indeed, we will not remain a going concern without it. We expect to announce further details of the Exchange Offer in the fourth quarter.

The UK retail banking market continues to suffer from a lack of choice and, we believe, The Co-operative Bank has an important role in providing a viable alternative to the traditional banks. We are planning to rebuild the Bank into what it always should have been, and indeed, what it used to be. The support we have received from customers and colleagues is hugely appreciated and demonstrates why this project to rebuild The Co-operative Bank is so worthwhile.

Richard Pym
Chairman, The Co-operative Banking Group

Chief Executive's overview

We recognise the disappointment all stakeholders must feel about the financial performance we are reporting for the half year to 30 June 2013. This in turn reflects the deep rooted problems that the Bank faces which led to the £1.5bn recapitalisation plan announced in June, as agreed with the PRA. These results reaffirm that capital requirement, which covers the losses reported in these results as well as currently anticipated future impairments.

The underlying issues are not new and are a result of the same issues impacting the profitability of the business as at year end 2012. The Bank Board noted in the announcement on 17 June 2013 that significant additional impairment charges were expected for the current financial year and these were factored into the recapitalisation plan announced at the time. These credit impairments, which primarily sit in the Corporate business which is no longer core to the Bank's strategy, are the main driver behind the level of operating loss for the first half of this year. Our ongoing strategy has been to continue to review those assets which no longer fit the Bank's risk appetite and develop exit plans for these portfolios. We are selling these assets at appropriate price levels and at the appropriate time and in the meantime continue to develop work out strategies which balance maximum value, capital preservation, liquidity and the need to strengthen our balance sheet.

Looked at in a little more detail, the losses are predominantly driven by an impairment charge of £496.0m after a reconsideration of the carrying value of the Bank's loans – £165.5m on the core business and £330.5m on non-core. We also took a further writedown on our IT assets of £148.4m as well as making customer redress provisions of £61.0m, which includes a further provision of £25.0m for PPI. In addition we took a £34.6m charge for other significant items.

Moving forward, there is no doubt that the short-term outlook continues to be challenging. Whilst we have a recapitalisation plan in place that has been discussed with the regulator, there are a number of hurdles to overcome in order to secure the future of the business. The immediate priority for me and my new management team is on improving the capital position of the Bank through the successful execution of our recapitalisation plan, particularly the Exchange Offer in the fourth quarter. As detailed in our announcement in June, our plans will provide additional aggregate Common Equity Tier 1 capital of £1.5 billion over the next 18 months. With £1 billion of the capital to be generated through the Exchange Offer, its successful completion is critical to stabilising the Bank's position and, as such, is in the long term interest of our stakeholders as a whole. The Exchange Offer and sufficiency of capital going forward are of course subject to risk and uncertainty. The directors consider the Bank a going concern, contingent on the success of the recapitalisation plan.

During 2012, the Bank had already begun to separate the business into two distinct areas: core and non-core. As part of our plan to simplify and reshape the Bank this has been accelerated. We have created two business areas: Co-operative Asset Management (CoAM) and the core bank. Our core banking division will continue to concentrate on supporting retail banking and smaller business customers, where we feel we have strong existing market credentials, customer relationships and expertise. Our CoAM business includes those businesses and assets which are not consistent with our business strategy going forward. We are establishing an experienced team who will actively manage this business for value and oversee the controlled reduction in the assets. Over the last few weeks we have had success in selling part of the portfolio at values which have been capital accretive. Work is continuing to finalise the exact details of the shape and structure of the core bank, the systems underpinning it, the product range and target customer base as well as the cost take out required to return the business to profitability. This evolution of the Bank's plans, including the rate of reduction in the non-core business and its impact on the amount and timing of impairment provisions and the impact of any additional provisions, will have an effect on our Common Equity Tier 1 capital and leverage ratio. In the announcement of 17 June we said, assuming completion of the Exchange Offer, we expect this to be above 9% at the year end. We now, however, believe that this will be below 9% but above the regulatory minimum requirement, and the leverage ratio may not reach 3% by the year end.

Throughout this turbulent period and despite the unprecedented circumstances the Bank faces, we believe there are some real positives. In the year to June, customer satisfaction has remained strong and retail income and retail deposits broadly stable. We have actually recruited more retail customers than we have lost, reflecting the strength of our brand. Our work to protect liquidity during this period has been successful and liquidity remains in excess of regulatory guidance. In addition, the Bank has continued to lend, maintaining its focus on supporting its customers. 45% of the £1.6bn of new lending in H1 2013 related to house purchases, of which 42% was provided to first time buyers. In addition, we lent £500m to businesses, underlining our on-going commitment to supporting Britain's small and medium-sized businesses. This is a fall from £700m in the corresponding period last year, reflecting our changed business focus and the decision to stop lending to new larger corporate customers.

Clearly there are lessons to be learned from the last few years but it is vital that the new management team focuses on navigating the short-term issues and building the strategy that is targeted at returning the business to health in the future. We have already taken a number of actions but it is clear that we are in the early stages of turning the Bank around. Indeed, we do not expect to be profitable for some years and legacy issues will continue to have an impact on the Bank for some time. However, we have a plan to strengthen our capital base and return the Bank to profitability based on our distinctive heritage, the loyalty of our customers and members and continued support of our staff and I firmly believe this is achievable over time.

Niall Booker
Chief Executive Officer, The Co-operative Bank

Business and financial review

	June 2013 £m	June 2012 £m	Change £m
Retail and Treasury	**18.8**	45.7	(26.9)
Corporate and Business Banking – core	**(101.5)**	29.0	(130.5)
Core operating result	**(82.7)**	74.7	(157.4)
Non-core	**(374.9)**	(73.5)	(301.4)
Operating result	**(457.6)**	1.2	(458.8)
Loss before taxation	**(709.4)**	(58.6)	(650.8)
Loss after taxation	**(781.5)**	(45.3)	(736.2)

The financial results for the first half of 2013 reflect the underlying issues outlined at year end 2012 and the stage of the journey that The Co-operative Bank ('the Bank') is at to address these. The main factors that have continued to significantly impact the profitability of the business are credit impairment, intangible asset impairment and high operating costs. These are reflected in a statutory loss before taxation of £709.4m (2012: loss of £58.6m), and after taxation of £781.5m (2012: £45.3m).

The presentation of these results reflects how the business was managed in terms of the split of core and non-core as set out in the 2012 year end financial statements. Throughout the first half of 2013, in line with 2012, the core business included the Retail Banking business (trading as the Co-operative Bank, Britannia and **smile**), Platform (the intermediary mortgage business), Treasury and Unity Trust Bank. Some elements of Corporate Banking were also classified as core which, going forward, will be classified as non-core.

Non-core business lines predominantly include the Corporate Banking lending business, Optimum (the closed book of intermediary and acquired loan book assets) and Illius (the residential property company) businesses which originated from the non-member Britannia business prior to merger. Non-core will be managed for value and to minimise risk. This strategy will balance our requirements to preserve capital with the need to run down the portfolio.

	June 2013 £m	June 2012 £m	Change £m
Net income	**355.8**	385.1	(29.3)
Operating costs – steady state	**(303.1)**	(282.8)	(20.3)
Operating costs – strategic initiatives	**(14.3)**	(9.2)	(5.1)
	38.4	93.1	(54.7)
Impairment losses	**(496.0)**	(91.9)	(404.1)
Operating result	**(457.6)**	1.2	(458.8)
Significant items	**(34.6)**	(39.3)	4.7
Intangible asset impairment	**(148.4)**	–	(148.4)
Customer redress (including PPI)	**(61.0)**	(40.0)	(21.0)
Share of post tax profits from joint ventures	**0.3**	0.6	(0.3)
Financial Services Compensation Scheme levies	**0.1**	(0.8)	0.9
Fair value amortisation	**(8.2)**	19.7	(27.9)
Loss before taxation	**(709.4)**	(58.6)	(650.8)
Taxation	**(72.1)**	13.3	(85.4)
Loss after taxation	**(781.5)**	(45.3)	(736.2)
Note			
Operating result before strategic initiatives	**(443.3)**	10.4	(453.7)

The results for the half year were affected by the following factors:

1. Credit impairment (£496.0m, 2012 £91.9m)
2. Intangible asset impairment, being the impairment of the replacement of the core banking platform (£148.4m, 2012 £nil)
3. Customer redress provisions (including PPI) of £61.0m (2012: £40.0m)
4. Operating costs and significant items

1. Credit impairment

The directors have reconsidered the carrying value of the Bank's loans which has led to a substantial impairment charge of £496.0m (2012: £91.9m). The total charge is made up of £165.5m in the core business (principally Retail £24.8m, Corporate £140.0m) and £330.5m in the non-core business (Corporate £294.3m and Optimum £36.2m). There are a number of reasons for the increase in the overall charge. Firstly, as indicated in the 2012 year end financial statements, the Bank intended to target non-core loans for run-down or exit. In the first half of 2013, the amount of assets designated as non-core has increased, the Bank has continued to review its loan book on a case-by-case basis to assess credit risk impairment requirements and there has been a change in the work out approach on a significant number of assets. This accounts for approximately half of the overall charge. Secondly, there have been further improvements to our credit risk management approach, improving the data on which impairment assessments are made and resulting in increased impairments. Impairments which occur in the ordinary course of the business due to changes in customer circumstances have also been incurred in both the core and non-core business.

2. Intangible asset impairment

The directors have concluded that the IT assets previously under creation to replace the core banking platform will no longer be implemented as they are inconsistent with the Bank's strategy going forward, resulting in a write down of £148.4m.

3. Customer redress provisions

A further provision of £25.0m (2012: £40.0m) for redress relating to payment protection insurance (PPI) has been made, primarily covering increased operating and ombudsman costs. £26.0m (2012: £nil) has also been provided for alleged failings relating to the introduction of third-party sales of card and identity protection products. A provision of £10.0m (2012: £nil) has been made relating to interest rate swap misselling.

4. Operating costs and significant items

Operating costs (excluding fair value amortisation and strategic investment costs) for the first six months of the year are £303.1m (2012: £282.8m). The increase is due to inflation and a provision of £13.9m for additional one-off costs of a change in ATM rateable values. The significant items reflect one-off costs of £34.6m relating to Project Verde, the transformation of the business and certain asset impairments.

The overall operating result fell to a loss of £457.6m in the first half of 2013 from a profit of £1.2m in H1 2012. The core business delivered an operating loss of £82.7m (2012: profit of £74.7m) – £82.8m profit before impairments (2012: £108.2m). The non-core business generated an operating loss of £374.9m (2012: £73.5m).

The loss before taxation of £709.4m (2012: loss of £58.6m) includes a charge of £8.2m (2012: credit £19.7m) arising on fair value amortisation. After tax, minority interests and the change in value in other reserves, equity reduced by £845.0m (2012: increase of £15.0m).

Net income in 2013 (excluding fair value amortisation) has fallen by £29.3m, reflecting the decision to stop new lending to larger corporates and a £19m downward revaluation in the carrying value of the Bank's residential investment properties (in Illius) following changes in the Bank's workout approach for this portfolio.

Business and financial review continued

Balance sheet

The Bank has maintained its focus on supporting its customers: £1.6bn has been lent to retail mortgage customers (2012: £1.5bn) while loans to businesses totalled £0.5bn (2012: £0.7bn). The fall in new business lending reflects the decision to stop new lending to larger corporates in light of the recapitalisation plan and the decision to designate other assets as non-core.

Retail asset balances remained broadly stable, at £17.8bn (December 2012: £17.7bn), while Corporate core assets were £5.3bn, down from £5.4bn at the end of 2012. The Corporate non-core balance, net of provisions, has decreased from £2.8bn at the end of 2012 to £2.3bn, and the closed Optimum portfolio has remained flat at £7.6bn.

The loan to deposit ratio was 94% (December 2012: 92%), and liquidity continues to exceed regulatory guidance.

The Core Tier 1 capital position has been impacted by on-going statutory losses and currently stands at 4.9% (2012: 8.8%) and at 3.2% on a fully phased Common Equity Tier 1 capital basis. The recapitalisation plan announced on 17 June 2013, which on completion should improve this position, is discussed later in this Business and Financial Review.

Retail

	June 2013 £m	June 2012 £m	Change £m
Net interest income	**203.5**	196.6	6.9
Non-interest income	**65.0**	68.4	(3.4)
Net income	**268.5**	265.0	3.5
Operating costs – steady state	**(235.0)**	(216.3)	(18.7)
Operating costs – strategic initiatives	**(7.8)**	(6.7)	(1.1)
Impairment losses	**(24.8)**	(18.2)	(6.6)
Operating result	**0.9**	23.8	(22.9)
Note			
Operating result before strategic initiatives	**8.7**	30.5	(21.8)

The Retail operating result for the first half of 2013 is a profit of £0.9m (2012: profit of £23.8m). Net income was stable, however operating costs have increased, mainly relating to the running of the distribution platform. A significant part of this cost is one-off in nature being a provision for additional rates payable on ATMs situated outside stores (£13.9m), an issue common across the retail industry.

There have been further improvements to the credit risk management approach, improving the data on which impairment assessments are made. This is the primary driver behind the increase in retail impairments. Asset quality for the secured portfolio has remained stable in H1 2013 with the number of accounts greater than 2.5% in arrears at 0.29% (December 2012: 0.30%). The Bank remains focused on delivering good quality mortgage assets, with 65.0% loan to value ratio on new lending (December 2012: 61.0%) and 44.3% (December 2012: 44.3%) across the portfolio.

Treasury/other businesses

	June 2013 £m	June 2012 £m	Change £m
Net interest income	**6.6**	7.1	(0.5)
Non-interest income	**28.3**	26.0	2.3
Net income	**34.9**	33.1	1.8
Operating costs – steady state	**(14.8)**	(12.7)	(2.1)
Operating costs – strategic initiatives	**(1.5)**	(0.7)	(0.8)
Impairment losses	**(0.7)**	2.2	(2.9)
Operating result	**17.9**	21.9	(4.0)
Note			
Operating result before strategic initiatives	**19.4**	22.6	(3.2)

The Treasury operation has continued to deliver on its core responsibilities of managing the liquidity base, providing diverse sources of wholesale funding to the Bank and managing market risk.

During the first half of 2013, significant focus was placed on increasing liquidity whilst at the same time reducing the non-liquidity buffer investment portfolio where strategically appropriate. This resulted in £40.4m profit from asset sales in the period (2012: £10.7m).

In the first half of 2013, the Bank accessed the Bank of England 'Funding for Lending' scheme, drawing £900m.

Corporate and Business Banking (CABB) – core

	June 2013 £m	June 2012 £m	Change £m
Net interest income	**58.4**	54.0	4.4
Non-interest income	**23.8**	32.2	(8.4)
Net Income	**82.2**	86.2	(4.0)
Operating costs – steady state	**(39.6)**	(38.3)	(1.3)
Operating costs – strategic initiatives	**(4.1)**	(1.4)	(2.7)
Impairment losses	**(140.0)**	(17.5)	(122.5)
Operating result	**(101.5)**	29.0	(130.5)
Note			
Operating result before strategic initiatives	**(97.4)**	30.4	(127.8)

The core Corporate and Business Banking operation delivered an operating loss of £101.5m during the first half of 2013 (2012: profit of £29.0m), reflecting significant impairment charges, the reasons for which are discussed above. Impairment charges increased to £140.0m in the first half of 2013 (2012 : £17.5m).

Net interest income, at £58.4m, increased by £4.4m mainly as a result of improved asset margins partially offset by increased costs of fixed-term deposits. The reduction in non-interest income is due to the decision to stop new lending to larger corporates.

Non-core business

	June 2013 £m	June 2012 £m	Change £m
Net interest income	**(19.5)**	(8.5)	(11.0)
Non-interest income	**(10.3)**	9.3	(19.6)
Net income	**(29.8)**	0.8	(30.6)
Operating costs – steady state	**(13.7)**	(15.5)	1.8
Operating costs – strategic initiatives	**(0.9)**	(0.4)	(0.5)
Impairment losses	**(330.5)**	(58.4)	(272.1)
Operating result	**(374.9)**	(73.5)	(301.4)
Note			
Operating result before strategic initiatives	**(374.0)**	(73.1)	(300.9)

A priority for the Bank is to actively reduce the level of non-core assets.

The non-core operating result for 2013 was a loss of £374.9m (2012: loss of £73.5m). This included a loss of £304.8m (2012: loss of £70.1m) for the non-core Corporate portfolio, driven principally by the impairment losses, the reasons for which are discussed above.

The Optimum portfolio, a closed book of intermediary and acquired mortgage book assets, delivered a loss of £50.5m (2012: loss of £2.6m). This reflected increased provisions for loans both in default and forborne. The loss attributed to the Illius business, a closed residential property portfolio, is £19.6m (2012: £0.8m).

Outlook

The Bank has developed a recapitalisation plan ('the Plan'), as announced on 17 June 2013, which has been discussed with the relevant regulatory bodies. The key objective of the Plan is to significantly strengthen the Bank's Common Equity Tier 1 (CET1) capital base and to refocus its strategy around its strength in core relationship banking providing current accounts, residential mortgages and savings products to individuals and small business banking customers. The main deliverables of this Plan include:

- An increase in CET1 capital of £1.5bn from a combination of capital injection from The Co-operative Group and Exchange Offer met in three broadly equal proportions from:
  1. The CET1 capital generated from new shares in the Bank as part of an Exchange Offer to be made to holders of the Bank's subordinated debt securities (bondholders) scheduled to take place later this year.
  2. A contribution from The Co-operative Group (which is conditional on the consent of its syndicated lenders) financed indirectly by a fixed income bond in exchange for new shares.
  3. A further contribution to the Bank expected in 2014, underwritten by the Co-operative Group, expected to be sourced primarily from the sale proceeds of the insurance businesses. This is contingent on a successful Exchange Offer.

For the avoidance of doubt, the capital generated for the Bank through the Exchange Offer will be derived not only from items 1. and 2. above, but also as a result of redeeming the subordinated debt securities in the Exchange Offer below the Bank's current book value.

- Reduction in the non-core asset portfolio
- A simplification and restructuring programme supporting the core relationship bank specifically focusing on the existing cost base

Work is continuing to finalise the exact details of the shape and structure of the core Bank, the systems underpinning it, the product range and target customer base as well as the changes to the cost base needed to return the business to profitability. This evolution of the Bank's plans, including the rate of reduction in the non-core business and its impact on the amount and timing of impairment provisions, now and going forwards, will have an effect on our Common Equity Tier 1 capital and leverage ratio. In the announcement of 17 June we said, assuming completion of the Exchange Offer, we expect this to be above 9% at the year end. We now, however, believe that this will be below 9% but above the regulatory minimum requirement, and the leverage ratio may not reach 3% by the year end.

In terms of the existing cost base, the Bank recognises that its cost to income ratio remains high and reducing the cost base is a priority for the business following a successful completion of the Exchange Offer.

The short-term outlook continues to be challenging for the Bank but, on the basis that the Bank effectively navigates its way through the short term issues it is facing, the Board and management team believe that this recapitalisation plan, combined with the work currently underway to develop a strategy and business plan to return the Bank to profitability over time, will allow all stakeholders to share in the potential benefits from the transformation of the Bank in the longer term.

At year end 2012, the Bank outlined the need to de-risk non-core corporate assets as part of further strengthening the balance sheet. Selling these assets, which carry the majority of the impairment risk for the Bank, remains an immediate priority for the Bank. Over the last six months £0.7bn of non-core assets have been sold or repaid.

Business and financial review continued

Cautionary statements

These results contain or incorporate by reference certain "forward-looking statements" regarding the belief or current expectations of the Bank or the Bank Board (as applicable) about the Bank's financial condition, results of operations and business and the transactions described in these results. Generally, but not always, words such as "may", "could", "should", "will", "expect", "intend", "estimate", "anticipate", "assume", "believe", "plan", "seek", "continue", "target", "goal", "would" or their negative variations or similar expressions identify forward-looking statements. Such forward-looking statements are not guarantees of future performance. Rather, they are based on current views and assumptions and involve known and unknown risks, uncertainties and other factors, many of which are outside the control of the Bank and are difficult to predict, that may cause the actual results, performance, achievements or developments of the Bank or the industries in which they operate to differ materially from any future results, performance, achievements or developments expressed or implied from the forward-looking statements. A number of material factors could cause actual results to differ materially from those contemplated by the forward-looking statements. In particular, the recapitalisation plan is subject to finalisation and its implementation is subject to a number of inherent risks. Risks include a failure by bondholders to participate in the Exchange Offer, a legal challenge by affected Bank bondholders to the Exchange Offer and a failure by, or inability of, The Co-operative Group to make its proposed contribution. The contribution from The Co-operative Group is conditional upon the consent of its syndicated lenders. Failure to implement the recapitalisation plan may result in regulatory intervention that could reduce or eliminate the value of the equity and modify, reduce or eliminate debt payment obligations. Even if the recapitalisation plan is successfully implemented, the Bank may, from time to time, require additional capital. Factors which could adversely affect the Bank's capital position and which may result in additional capital being required include worsening economic or market conditions, continuing deterioration of asset quality, the unavailability or withdrawal of funding, failure to implement the Bank's restructuring and cost reduction programme, and changes in regulatory capital requirements. Should such factors occur prior to completion of the recapitalisation plan, they might impact the launch or successful implementation of the recapitalisation plan. The Bank's new strategy is also untested and the Bank may ultimately be unsuccessful in implementing its strategy, in particular in reducing its non-core assets and restructuring its cost base as and within the timeframe currently anticipated. These, and other risks and uncertainties, could, individually or cumulatively, have a material adverse effect on the Bank's business, results of operation, financial conditions or prospects. The forward-looking statements contained in these results speak only as of the date of these results.

Neither these results, the publication in which they are contained nor any copy of it may be made or transmitted into the United States of America (including its territories or possessions, any state of the United States of America and the District of Columbia) (the "United States"). Neither these results, the publication in which they are contained nor any copy of them may be taken, transmitted or distributed, directly or indirectly, into Australia, New Zealand, South Africa, Japan, Canada or Switzerland or any jurisdiction where to do so would constitute a violation of the relevant laws of such jurisdiction. Any failure to comply with this restriction may constitute a violation of securities law in those jurisdictions. The distribution of this document in other jurisdictions may also be restricted by law and persons into whose possession this document comes should inform themselves about, and observe, any such restrictions.

This document does not constitute or form part of any offer or invitation to sell or issue, or any solicitation of any offer to purchase or subscribe for any shares or any other securities nor shall it (or any part of it) or the fact of its distribution, form the basis of, or be relied on in connection with, any contract therefore. The availability of the Exchange Offer and the distribution of this document in certain jurisdictions may be restricted by law and persons into whose possession any document or other information referred to herein comes should inform themselves about, and observe, any such restrictions. Any failure to comply with these restrictions may constitute a violation of the securities laws of any such jurisdiction.

In particular, this document does not constitute an offer for sale of, or a solicitation to purchase or subscribe for, any securities in the United States. No securities of Co-operative Group or Co-operative Bank have been, or will be, registered under the US Securities Act of 1933, as amended (the "Securities Act"), and securities of Co-operative Group or Co-operative Bank may not be offered or sold in the United States absent an exemption from, or in a transaction not subject to, the registration requirements of the Securities Act and in compliance with any applicable securities laws of any state or other jurisdiction of the United States. There will be no public offering of the securities in the United States.

Investors should not make any investment decision regarding any transferable securities referred to in this document except on the basis of information contained in prospectuses and exchange offer memorandum in their final form to be published by The Co-operative Group and the Bank in due course in connection with the Exchange Offer. The Co-operative Group and the Bank expressly reserve the right to adjust or amend the terms of the Exchange Offer and the Output Securities prior to the launch of the Exchange Offer.

Risk management

For the period ended 30 June 2013 (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.

The short term outlook continues to be challenging for the Bank. The Bank has developed a recapitalisation plan ('the Plan'), which has the key objective to significantly strengthen the Bank's capital base and to refocus its strategy around its strength in core relationship banking providing current accounts, residential mortgages and savings products to individuals and small business banking. Its successful completion is critical to stabilising the Bank's position and, as such, is in the long term interest of all stakeholders.

Other risks are consistent with those described in the Bank's risk management section of the 2012 financial statements on pages 54 to 79.

1. Credit risk

1.1 Overview

Credit risk is one of the principal risks identified in the risk management framework and is an integral part of our business activities. It is inherent in both traditional banking products (revolving credit lines, loans, mortgages, 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 Officer (CEO) and then on to other individuals. The level of credit risk authority delegated depends on seniority and experience, and varies according to the quality of the counterparty, associated security or collateral held.

1.2 Credit risk policy

The principal risk policy for credit risk is approved annually by the Executive Risk Committee (ERC) and defines appropriate standards and principles for the effective management of credit risk throughout the Bank.

The key principles of the policy are:

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

1.3 Credit exposure

1.3.1 Definitions

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

During the period to 30 June 2013, the only amendment to impairment definitions is to corporate loans. Watchlist cases are now included within impaired.

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

1.3.2 Analyses of credit exposure

The following analysis of credit exposure shows:

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

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

30 June 2013	Loans and advances to banks	Loans and advances to customers	Investment securities	Derivative financial instruments	Total
Analysis of balance in note		6	7		
Gross balance	**1,737.5**	**33,785.5**	**5,102.6**	**804.3**	**41,429.9**
Less: allowance for losses	**–**	**(1,069.6)**	**(20.0)**	**–**	**(1,089.6)**
	1,737.5	**32,715.9**	**5,082.6**	**804.3**	**40,340.3**
Analysis of credit risk exposure					
Not impaired	**1,737.5**	**29,954.0**	**5,082.6**	**797.4**	**37,571.5**
Impaired	**–**	**4,138.8**	**20.0**	**6.9**	**4,165.7**
	1,737.5	**34,092.8**	**5,102.6**	**804.3**	**41,737.2**
Credit commitments	**48.0**	**4,524.0**	**–**	**–**	**4,572.0**
Gross credit risk exposure	**1,785.5**	**38,616.8**	**5,102.6**	**804.3**	**46,309.2**
Less:					
Fair value adjustments	**–**	**(307.3)**	**–**	**–**	**(307.3)**
Allowance for losses	**–**	**(1,069.6)**	**(20.0)**	**–**	**(1,089.6)**
Net credit risk exposure	**1,785.5**	**37,239.9**	**5,082.6**	**804.3**	**44,912.3**

Risk management continued

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

31 December 2012	Loans and advances to banks	Loans and advances to customers	Investment securities	Derivative financial instruments	Total
Analysis of balance in note		6	7		
Gross balance	1,904.1	33,982.5	6,928.8	818.8	43,634.2
Less: allowance for losses	–	(643.0)	(39.0)	–	(682.0)
	1,904.1	33,339.5	6,889.8	818.8	42,952.2
Analysis of credit risk exposure					
Not impaired	1,904.1	30,251.9	6,900.8	818.8	39,875.6
Impaired	–	4,067.6	39.0	–	4,106.6
	1,904.1	34,319.5	6,939.8	818.8	43,982.2
Credit commitments	54.1	4,885.0	–	–	4,939.1
Gross credit risk exposure	1,958.2	39,204.5	6,939.8	818.8	48,921.3
Less:					
Fair value adjustments	–	(337.0)	(11.0)	–	(348.0)
Allowance for losses	–	(643.0)	(39.0)	–	(682.0)
Net credit risk exposure	1,958.2	38,224.5	6,889.8	818.8	47,891.3

Impaired balances have been restated to show all corporate watchlist cases as impaired, in line with revised 2013 treatment, increasing the impaired balance within loans and advances to customers by £380.9m and decreasing the not impaired balance by the same amounts.

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

On pages 10 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 to assess impairment. A loan is deemed to be impaired when there is objective evidence that a loss event has occurred at 30 June 2013.

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

Full details are contained in the significant accounting policies on page 45 of the 2012 financial statements and in the following credit risk sections.

The tables below analyse the gross balance by impairment classification for the Retail and Corporate and Business Banking (CABB) business segments. They include credit commitments, impairment provisions, fair value adjustments and a reconciliation to gross customer balances as this is the basis on which the business manages risk.

There has been an increase in impairment provisions in the period to 30 June 2013 driven primarily by a decision to reduce non-core assets, revised collateral values for the corporate business and updated experience in support of our credit risk impairment policy.

1. Credit risk continued

30 June 2013	Retail Secured	Retail Unsecured	CABB Corporate Core	CABB Corporate Non-core	Optimum	Total
Analysis of balance in note 6						
Gross balance	**16,358.4**	**1,402.1**	**5,870.9**	**2,994.9**	**7,159.2**	**33,785.5**
Less: allowance for losses	**(4.6)**	**(172.0)**	**(272.7)**	**(576.4)**	**(43.9)**	**(1,069.6)**
	16,353.8	**1,230.1**	**5,598.2**	**2,418.5**	**7,115.3**	**32,715.9**
Analysis of credit risk exposure						
Not impaired	**16,209.7**	**1,204.4**	**5,134.3**	**1,337.0**	**6,068.6**	**29,954.0**
Impaired	**153.2**	**197.7**	**736.6**	**1,856.5**	**1,194.8**	**4,138.8**
	16,362.9	**1,402.1**	**5,870.9**	**3,193.5**	**7,263.4**	**34,092.8**
Credit commitments	**486.5**	**2,303.5**	**1,694.3**	**39.7**	**–**	**4,524.0**
Gross credit risk exposure	**16,849.4**	**3,705.6**	**7,565.2**	**3,233.2**	**7,263.4**	**38,616.8**
Less:						
Fair value adjustments	**(4.5)**	**–**	**–**	**(198.6)**	**(104.2)**	**(307.3)**
Allowance for losses	**(4.6)**	**(172.0)**	**(272.7)**	**(576.4)**	**(43.9)**	**(1,069.6)**
Net credit risk exposure	**16,840.3**	**3,533.6**	**7,292.5**	**2,458.2**	**7,115.3**	**37,239.9**
Reconciliation of accounting to customer balances						
Gross balance	**16,358.4**	**1,402.1**	**5,870.9**	**2,994.9**	**7,159.2**	**33,785.5**
Fair value adjustments	**4.5**	**–**	**–**	**198.6**	**104.2**	**307.3**
Other accounting adjustments	**(57.7)**	**(22.5)**	**(58.3)**	**3.9**	**18.0**	**(116.6)**
Gross customer balances	**16,305.2**	**1,379.6**	**5,812.6**	**3,197.4**	**7,281.4**	**33,976.2**

31 December 2012	Retail Secured	Retail Unsecured	CABB Corporate Core	CABB Corporate Non-core	Optimum	Total
Analysis of balance in note 6						
Gross balance	15,987.2	1,393.1	6,097.1	3,166.4	7,338.7	33,982.5
Less: allowance for losses	(3.2)	(172.8)	(137.3)	(318.7)	(11.0)	(643.0)
	15,984.0	1,220.3	5,959.8	2,847.7	7,327.7	33,339.5
Analysis of credit risk exposure						
Not impaired	15,836.3	1,179.4	5,556.8	1,507.6	6,171.8	30,251.9
Impaired	156.1	213.7	540.3	1,874.7	1,282.8	4,067.6
	15,992.4	1,393.1	6,097.1	3,382.3	7,454.6	34,319.5
Credit commitments	389.8	2,332.2	2,114.3	48.4	0.3	4,885.0
Gross credit risk exposure	16,382.2	3,725.3	8,211.4	3,430.7	7,454.9	39,204.5
Less:						
Fair value adjustments	(5.2)	–	–	(215.9)	(115.9)	(337.0)
Allowance for losses	(3.2)	(172.8)	(137.3)	(318.7)	(11.0)	(643.0)
Net credit risk exposure	16,373.8	3,552.5	8,074.1	2,896.1	7,328.0	38,224.5
Reconciliation of accounting to customer balances						
Gross balance	15,987.2	1,393.1	6,097.1	3,166.4	7,338.7	33,982.5
Fair value adjustments	5.2	–	–	215.9	115.9	337.0
Other accounting adjustments	(61.4)	95.4	32.5	(64.1)	37.6	40.0
Gross customer balances	15,931.0	1,488.5	6,129.6	3,318.2	7,492.2	34,359.5

Corporate impaired balances have been restated to show all watchlist cases as impaired, in line with revised 2013 treatment, increasing the core and non-core impaired balances by £271.0m and £109.9m respectively and decreasing the not impaired balances by the same amounts.

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

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

Risk management continued

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

1.4.1.3 Secured residential credit risk

Acquisition and account management

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

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

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

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

	Period to 30 June 2013			Period to 30 June 2012		
	Amount advanced	**Average LTV %**	**Interest only %**	Amount advanced	Average LTV %	Interest only %
Retail prime	**1,076.9**	**63.5**	**1.3**	972.9	57.8	10.6
Platform prime	**404.2**	**68.5**	**–**	180.3	58.6	25.0
Total prime	**1,481.1**	**65.0**	**0.9**	1,153.2	57.9	12.2
Buy-to-let	**57.0**	**65.8**	**84.9**	306.6	62.8	84.5
Almost prime	**1.6**	**54.8**	**–**	3.4	56.1	2.8
Total completions	**1,539.7**	**65.0**	**4.2**	1,463.2	59.0	25.6

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

Mortgages originated by Platform or acquired by Britannia prior to 2009 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.

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

	30 June 2013			31 December 2012		
	Retail secured	**Optimum**	**Total**	Retail secured	Optimum	Total
Less than 50%	**5,613.4**	**471.5**	**6,084.9**	5,459.9	460.3	5,920.2
50% to 60%	**2,389.1**	**380.3**	**2,769.4**	2,233.1	358.6	2,591.7
60% to 70%	**2,802.5**	**708.5**	**3,511.0**	2,621.6	657.1	3,278.7
70% to 80%	**2,704.4**	**1,122.8**	**3,827.2**	2,698.0	1,013.8	3,711.8
80% to 90%	**2,021.9**	**1,407.9**	**3,429.8**	1,914.6	1,470.2	3,384.8
90% to 100%	**475.0**	**1,450.5**	**1,925.5**	621.0	1,537.9	2,158.9
Greater than 100%	**298.9**	**1,739.9**	**2,038.8**	382.8	1,994.3	2,377.1
	16,305.2	**7,281.4**	**23,586.6**	15,931.0	7,492.2	23,423.2

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

	30 June 2013			31 December 2012		
	Gross Customer Balance	**Average LTV %**	**Interest only %**	Gross Customer Balance	Average LTV %	Interest only %
Prime residential	**15,743.5**	**44.5**	**20.2**	15,377.2	44.5	22.3
Buy-to-let	**3,194.2**	**73.5**	**90.6**	3,256.0	74.9	90.5
Self-certified	**2,031.1**	**75.8**	**78.1**	2,091.5	76.8	77.7
Almost prime	**912.7**	**88.7**	**68.0**	940.9	89.8	67.4
Non-conforming	**1,705.1**	**76.3**	**67.2**	1,757.6	77.6	66.7
	23,586.6	**53.1**	**40.0**	23,423.2	53.6	41.9

1. Credit risk continued

Collateral

Mortgages are secured by a first charge over the property being purchased or remortgaged. Valuation of the property is normally assessed by a RICS certified surveyor from the Bank's approved panel. For low LTV remortgages, valuation may be assessed through the use of an automated valuation model (AVM).

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

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

	30 June 2013			31 December 2012		
	Gross Customer Balance	**Collateral**	**Cover %**	Gross Customer Balance	Collateral	Cover %
Impaired	**1,350.9**	**1,297.0**	**96.0**	1,445.3	1,386.3	95.9
Not impaired	**22,235.7**	**22,111.9**	**99.4**	21,977.9	21,831.7	99.3
	23,586.6	**23,408.9**	**99.2**	23,423.2	23,218.0	99.1

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

Impairment

A loan is identified as impaired when:

- arrears outstanding are equivalent to one monthly instalment or more; or
- the loan is more than 90 days past its term but has not repaid; or
- the account is in litigation or the property is in possession; or
- the estimated forced sale value of the collateral on a roll up mortgage has reduced below the loan balance outstanding.

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

Loans that are not identified as impaired are collectively assessed for unidentified impairment (where a loss event has occurred, but objective evidence of impairment has not manifested).

Certain segments are separated into discrete pools for assessment where there are potential indicators of impairment that are not, by themselves, sufficient to identify a loan as impaired. These are:

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

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

The table below shows:

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

	30 June 2013			31 December 2012		
	Retail secured	**Optimum**	**Total**	Retail secured	Optimum	Total
Gross customer balances	**16,305.2**	**7,281.4**	**23,586.6**	15,931.0	7,492.2	23,423.2
Impaired customer balances	**153.1**	**1,197.8**	**1,350.9**	156.0	1,289.3	1,445.3
Impaired as a % of gross customer balances	**0.9%**	**16.5%**	**5.7%**	1.0%	17.2%	6.2%
Credit protection						
Impairment provisions	**4.6**	**43.9**	**48.5**	3.2	11.0	14.2
Fair value adjustments	**4.5**	**104.2**	**108.7**	5.2	115.9	121.1
	9.1	**148.1**	**157.2**	8.4	126.9	135.3
Credit protection as a % of impaired customer balances	**5.9%**	**12.4%**	**11.6%**	5.4%	9.8%	9.4%

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

	30 June 2013			31 December 2012		
	Retail secured	**Optimum**	**Total**	Retail secured	Optimum	Total
Low to medium risk	**15,826.0**	**4,522.0**	**20,348.0**	15,433.3	4,546.7	19,980.0
Medium to high risk	**326.1**	**1,561.6**	**1,887.7**	341.7	1,656.2	1,997.9
	16,152.1	**6,083.6**	**22,235.7**	15,775.0	6,202.9	21,977.9

Risk management continued

For the period ended 30 June 2013 (unaudited)
All amounts are stated in £m unless otherwise indicated

1. Credit risk continued
Low to medium risk is defined as exposures with a probability of default (PD) in the next year of 1% or below using the internal ratings based (IRB) approach under Basel II. Medium to high risk is defined as exposures with a PD in the next year of greater than 1%. 2012 balances have been restated based on the same risk classification used at 30 June 2013.

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

- arrangements to repay outstanding arrears over a period of time, by making payments above the contractual amount. The loan is deemed to be impaired, until the arrears have been cleared in full;
- short term concessions, where the borrower is allowed to make reduced repayments (or, in exceptional circumstances, no repayments) on a temporary basis to assist with a short term financial hardship. In these cases the shortfall on the repayments will accrue as arrears and the loan is deemed to be impaired.
- payment holidays are allowed as part of a customer's flexible mortgage contract. Payment holidays are not knowingly allowed for customers experiencing financial hardship. However, in the absence of evidence to the contrary, loans that have had a payment holiday in the last two years are treated as being subject to forbearance;
- temporary conversion of a mortgage to interest only repayments. The capital repayments due in this period are spread over the remaining term on conversion back to capital repayment as part of an instalment recalculation exercise;
- permanent conversion to interest only repayments, is no longer allowed, however where this has been agreed in the past two years, a loan is considered to be subject to forbearance;
- an extension to the mortgage term to reduce the borrower's repayments. All loans that have had a term extension in the last two years are considered to be subject to forbearance, even where these were not agreed as a forbearance treatment;
- capitalisation, where outstanding arrears are added to the capital value of the loan to be repaid over the remaining term. This is only considered by exception with eight cases capitalised during the period to 30 June 2013 (31 December 2012: 20); and
- where applicable we will work with the customer as part of a government support scheme. Unmet loan payments will continue to accrue as arrears until such time as the loan is cleared, or the outstanding payments are brought up to date.

Loans subject to forbearance are only classed as impaired if they meet the impairment definition in this section on page 11.

The underlying basis for the calculation of residential mortgage impairment provisions remains unchanged. Mortgages subject to forbearance, once classified as impaired, are assessed for the appropriate impairment rate to apply.

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

30 June 2013	**Neither past due nor impaired**	**Impaired**	**Loans subject to forbearance**	**Impairment coverage**
Arrangements	**54.5**	**436.4**	**490.9**	**(51.8)**
Concessions	**1.0**	**3.4**	**4.4**	**(0.1)**
Payment holidays	**166.4**	**0.5**	**166.9**	**–**
Interest only switches	**276.1**	**46.8**	**322.9**	**(2.6)**
Term extensions	**334.8**	**5.3**	**340.1**	**(0.2)**
Capitalisations	**0.4**	**–**	**0.4**	**–**
	833.2	**492.4**	**1,325.6**	**(54.7)**

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

1. Credit risk continued

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. Customers are assessed using a combination of credit scoring and policy rules. Credit cards and overdrafts are subject to ongoing account management to increase or decrease credit limits and manage over limit authorisations.

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

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

	30 June 2013	31 December 2012
Loans	**723.2**	734.3
Credit cards	**2,597.2**	2,703.6
Overdrafts	**362.7**	382.8
	3,683.1	3,820.7

Impairment

Impairment provision is raised for:

- identified impairment – at one penny, one day past due or in excess, based on the probability of default and the discounted cash flow of recoveries from default;
- unidentified impairment – on the performing book, based on the probability of emerging as delinquent, the probability of default and the discounted cash flow of recoveries from default; and
- fraud upon identification.

The table below shows:

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

	30 June 2013	31 December 2012
Gross customer balances	**1,379.6**	1,488.5
Impaired customer balances	**230.8**	301.1
Impaired as a % of gross customer balances	**16.7%**	20.2%
Credit protection		
Impairment provisions	**172.0**	172.8
DCA balances charged off	**29.0**	86.8
	201.0	259.6
Credit protection as a % of impaired customer balances	**87.1%**	86.2%

The reduction observed in impaired customer balances between December 2012 and June 2013 is reflective of debt sale.

Forbearance

A number of forbearance options are available to borrowers in financial difficulty. Accounts classified as impaired, remain so until the arrears are cleared in full. This will be achieved through making arrangements either with customers directly or through a third party whom they have chosen to represent them.

1.4.1.5 Corporate credit risk

Acquisition and account management

The Bank is managed through two distinct classifications. Currently the core business represents activity consistent with the strategy and risk appetite for the Bank and within corporate comprises corporate banking, business banking and business services. Non-core business lines predominantly include Corporate Banking business (Optimum and Illius (the residential property company) business which originated from the non-member Britannia prior to merger are reported elsewhere in this report). The non-core business is managed for value and targeted for run down or exit.

The Bank operates to a new lending policy which is subject to meeting criteria as laid down in the corresponding sector strategy guidelines and strict policy with regards single name and sector concentrations. New lending is approved within the centrally based credit underwriting team, independent from income generation. Lending discretions are based on the risk profile of the customer and the amount of exposure. The lending discretions of the Credit Risk Sanctions Committee, Chief Risk Officer, Credit Risk Director, the Chief Executive and the Credit Approvals Committee are operated to sanction the largest credit applications. In the context of the non-core strategy this is limited to annual reviews and renewals and in certain circumstances where additional lending may protect value in the work out of a customer asset. Following the Bank's decision to change business focus a challenge process has been applied by senior management to the pipeline business.

Risk management continued

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

The credit underwriting team uses appropriate rating systems and other tools to analyse the underlying business and the counterparty's management to assess the risk of each lending proposition and its ability to repay the borrowing. Other factors considered include the potential impact of economic changes, availability of supporting collateral, the financial stability of the counterparty and its ability to withstand such change.

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

The Credit Risk Management Committee (CRMC) and ERC (and by exception Board Risk Committee (BRC)) receive regular reports on the performance of the portfolio.

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

	Standardised	Strong	Good	Satisfactory	Weak	Default	Total
30 June 2013							
Core							
Accommodation, food and licensed services	**214.5**	**136.2**	**125.1**	**20.2**	**21.7**	**40.7**	**558.4**
Care	**182.0**	**18.6**	**73.0**	**23.3**	**3.7**	**16.8**	**317.4**
Education	**87.3**	**34.5**	**2.9**	**1.0**	**–**	**–**	**125.7**
Financial services	**65.9**	**77.6**	**28.4**	**4.4**	**–**	**4.5**	**180.8**
Football clubs	**–**	**33.1**	**–**	**0.4**	**0.1**	**0.8**	**34.4**
Housing associations	**7.8**	**252.6**	**1.8**	**–**	**–**	**–**	**262.2**
Manufacturing	**45.5**	**25.1**	**24.2**	**16.6**	**12.2**	**8.6**	**132.2**
Motor trade and garages	**24.2**	**55.5**	**24.3**	**3.5**	**0.7**	**1.7**	**109.9**
PFI	**–**	**32.0**	**1,179.0**	**13.3**	**20.9**	**4.8**	**1,250.0**
Professional services	**73.0**	**15.4**	**21.7**	**14.2**	**0.7**	**3.4**	**128.4**
Property and construction:							
Commercial investment	**16.5**	**80.6**	**1,039.8**	**174.8**	**4.8**	**158.0**	**1,474.5**
Residential investment	**8.1**	**0.7**	**111.4**	**18.5**	**7.0**	**7.8**	**153.5**
Commercial development	**1.6**	**2.5**	**177.0**	**72.9**	**2.4**	**54.0**	**310.4**
Residential development	**5.9**	**1.9**	**62.3**	**14.8**	**2.9**	**11.1**	**98.9**
Public sector entities	**172.9**	**0.3**	**–**	**–**	**–**	**–**	**173.2**
Renewable energy	**611.0**	**–**	**–**	**–**	**–**	**9.3**	**620.3**
Retail and wholesale trade	**69.7**	**402.5**	**27.8**	**11.9**	**1.1**	**19.3**	**532.3**
Services	**398.6**	**127.5**	**36.1**	**30.3**	**0.6**	**33.8**	**626.9**
Transport, storage and communication	**24.8**	**15.5**	**3.9**	**6.6**	**1.3**	**28.7**	**80.8**
Utilities	**42.9**	**1.2**	**1.3**	**1.0**	**–**	**0.6**	**47.0**
Business banking	**1.1**	**41.8**	**7.9**	**3.0**	**0.5**	**0.5**	**54.8**
Other	**6.9**	**2.4**	**1.4**	**2.2**	**–**	**2.1**	**15.0**
	2,060.2	**1,357.5**	**2,949.3**	**432.9**	**80.6**	**406.5**	**7,287.0**
Non-core							
Accommodation, food and licensed services	**–**	**–**	**38.3**	**–**	**–**	**259.4**	**297.7**
Football clubs	**–**	**–**	**–**	**–**	**–**	**15.1**	**15.1**
Housing associations	**–**	**830.2**	**45.0**	**–**	**–**	**–**	**875.2**
Professional services	**–**	**–**	**–**	**–**	**–**	**0.3**	**0.3**
Property and construction:							
Commercial investment	**24.0**	**23.3**	**214.2**	**66.5**	**50.1**	**1,344.7**	**1,722.8**
Residential investment	**–**	**–**	**77.0**	**26.4**	**56.7**	**131.4**	**291.5**
Commercial development	**–**	**–**	**–**	**–**	**–**	**6.4**	**6.4**
Renewable energy	**28.1**	**–**	**–**	**–**	**–**	**–**	**28.1**
	52.1	**853.5**	**374.5**	**92.9**	**106.8**	**1,757.3**	**3,237.1**
Total exposure	**2,112.3**	**2,211.0**	**3,323.8**	**525.8**	**187.4**	**2,163.8**	**10,524.1**

1. Credit risk continued

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

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

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

Risk management continued

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

Collateral

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

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

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

The table below analyses the fair value of the property collateral held against assets in the property and construction sectors. Property valuations are obtained when the facility is first approved and the current lending procedures requires collateral to be revalued every two years or more frequently in higher risk situations (typically annually or when a material change has occurred that is likely to affect the value and recoverability of debt). In certain circumstances, such as syndicates, the Bank may be unable to obtain regular revaluations or may exercise discretion to not seek a revaluation for a longer period of time. However, the Bank has adopted a review and challenge process on valuations to assure itself on current valuations held in the Bank's systems. The values held in the Bank's systems are indexed using the appropriate regional and asset type indexes where available, otherwise average national index is applied:

	30 June 2013			31 December 2012		
Core	**Exposure**	**Collateral**	**Impairment provision**	Exposure	Collateral	Impairment provision
Non-default loans with <= 1 year and all defaulted exposures regardless of term						
Less than 50%	**72.1**	**72.0**	**0.1**	69.3	69.3	–
50% to 60%	**53.7**	**53.7**	**–**	85.7	85.3	0.4
60% to 70%	**132.1**	**132.1**	**–**	106.6	106.6	–
70% to 80%	**112.0**	**107.3**	**4.8**	113.6	113.6	–
80% to 90%	**42.6**	**37.4**	**5.2**	26.7	26.2	0.5
90% to 100%	**50.1**	**42.9**	**7.2**	30.9	30.6	0.3
Greater than 100%	**204.8**	**126.5**	**59.4**	156.2	96.9	36.4
Unsecured	**33.9**	**–**	**7.5**	36.0	–	7.6
	701.3	**571.9**	**84.2**	625.0	528.5	45.2
Non-default loans with > 1 year						
Less than 50%	**206.4**	**206.4**	**–**	245.5	245.5	–
50% to 60%	**297.9**	**297.9**	**–**	292.5	292.5	–
60% to 70%	**424.4**	**424.4**	**–**	402.4	402.4	–
70% to 80%	**264.9**	**264.9**	**–**	309.1	309.1	–
80% to 90%	**32.0**	**32.0**	**–**	61.8	61.8	–
90% to 100%	**16.6**	**16.6**	**–**	33.5	33.5	–
Greater than 100%	**42.7**	**27.7**	**–**	105.2	78.3	–
Unsecured	**51.1**	**–**	**–**	70.1	–	–
	1,336.0	**1,269.9**	**–**	1,520.1	1,423.1	–
	2,037.3	**1,841.8**	**84.2**	2,145.1	1,951.6	45.2

1. Credit risk continued

	30 June 2013			31 December 2012		
Non-core	**Exposure**	**Collateral**	**Impairment provision**	Exposure	Collateral	Impairment provision
Non-default loans with <= 1 year and all defaulted exposures regardless of term						
Less than 50%	**2.6**	**1.0**	**1.6**	0.6	0.5	0.1
50% to 60%	**27.0**	**25.6**	**1.4**	1.5	1.5	–
60% to 70%	**49.8**	**43.7**	**6.1**	36.8	34.2	2.6
70% to 80%	**13.3**	**13.0**	**0.3**	2.4	2.4	–
80% to 90%	**62.8**	**60.4**	**2.4**	45.8	44.5	1.3
90% to 100%	**31.1**	**27.8**	**3.3**	72.3	47.8	24.4
Greater than 100%	**1,173.1**	**750.9**	**402.8**	1,185.7	816.1	299.8
Unsecured	**212.4**	**–**	**153.7**	177.8	–	59.8
	1,572.1	**922.4**	**571.6**	1,522.9	947.0	388.0
Non-default loans with > 1 year						
Less than 50%	**39.2**	**39.2**	**–**	30.1	30.1	–
50% to 60%	**37.9**	**37.9**	**–**	63.7	63.7	–
60% to 70%	**111.3**	**111.3**	**–**	185.5	185.5	–
70% to 80%	**74.3**	**74.3**	**–**	30.5	30.5	–
80% to 90%	**63.1**	**63.1**	**–**	90.5	90.5	–
90% to 100%	**47.5**	**47.5**	**–**	67.9	67.9	–
Greater than 100%	**32.4**	**18.4**	**–**	124.2	93.1	–
Unsecured	**42.9**	**–**	**–**	17.8	–	–
	448.6	**391.7**	**–**	610.2	561.3	–
	2,020.7	**1,314.1**	**571.6**	2,133.1	1,508.3	388.0

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

Of the above at 30 June 2013, £46.1m (31 December 2012: £50.0m) is not held as first charge.

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

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

After a period of satisfactory performance and dependent on the Bank's satisfaction that the triggers which led to inclusion on the watchlist no longer apply, customers who stop exhibiting higher risk traits may be removed from the watchlist.

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

Risk management continued

For the period ended 30 June 2013 (unaudited)
All amounts are stated in £m unless otherwise indicated

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

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

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

Credit risk impairment will be required on some or all of the entire shortfall between the security held and the loan balance outstanding and represents an assessment of the likely net loss after realisation of any security.

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

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

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

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 2013		31 December 2012	
	Core	**Non-core**	Core	Non-core
Gross customer balances	**5,812.6**	**3,197.4**	6,129.6	3,318.2
Impaired customer balances	**687.9**	**1,893.8**	507.1	1,962.4
Impaired as a % of gross customer balances	**11.8%**	**59.2%**	8.3%	59.1%
Credit protection				
Impairment provisions	**272.7**	**576.4**	137.3	318.7
Fair value adjustments	**–**	**198.6**	–	215.9
	272.7	**775.0**	137.3	534.6
Credit protection as a % of impaired customer balances	**39.6%**	**40.9%**	27.1%	27.2%

The level of cover as a percentage of impaired non-core customer balances has increased to 40.9% in June 2013 from 27.2% in December 2012 following a further increase in the level of impairment provisions. The increased impairment provisions for corporate core loans has also increased causing the cover to rise to 39.6% in June 2013 from 27.1% in December 2012.

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

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

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

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

1. Credit risk continued

The table below analyses the exposures subject to forbearance:

	30 June 2013			31 December 2012		
Core	**Forborne**	**Non-forborne**	**Total**	Forborne	Non-forborne	Total
Default	**244.8**	**161.8**	**406.6**	139.4	112.2	251.6
On watchlist	**138.8**	**178.2**	**317.0**	204.9	67.3	272.2
Neither default nor on watchlist	**77.5**	**6,485.9**	**6,563.4**	197.9	7,313.7	7,511.6
	461.1	**6,825.9**	**7,287.0**	542.2	7,493.2	8,035.4
Non-core						
Default	**1,145.5**	**611.6**	**1,757.1**	1,118.4	624.7	1,743.1
On watchlist	**107.1**	**32.0**	**139.1**	159.1	64.1	223.2
Neither default nor on watchlist	**31.5**	**1,309.4**	**1,340.9**	95.2	1,305.1	1,400.3
	1,284.1	**1,953.0**	**3,237.1**	1,372.7	1,993.9	3,366.6
	1,745.2	**8,778.9**	**10,524.1**	1,914.9	9,487.1	11,402.0

Impairment provisions are made for accounts subject to forbearance which are in default and 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 provided that the loan has been kept up to date during that period and all covenants continue to be met.

1.4.2 Investment securities

At the balance sheet date, the Bank has a total investment securities portfolio of £5,102.6m (31 December 2012: £6,928.8m) of which £20.0m (31 December 2012: £39.0m) is considered impaired and against which £20.0m (31 December 2012: £39.0m) of provisions are held.

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

		Investment securities			
30 June 2013	**Loans and receivables**	**Available for sale**	**Fair value through income or expense**	**Held for trading**	**Total**
Analysis of balance per note 7					
Gross balance	**30.6**	**3,449.7**	**1,622.3**	**–**	**5,102.6**
Less: allowance for losses	**–**	**(20.0)**	**–**	**–**	**(20.0)**
	30.6	**3,429.7**	**1,622.3**	**–**	**5,082.6**
Analysis of credit risk exposure					
Not impaired	**30.6**	**3,429.7**	**1,622.3**	**–**	**5,082.6**
Impaired	**–**	**20.0**	**–**	**–**	**20.0**
Gross credit risk exposure	**30.6**	**3,449.7**	**1,622.3**	**–**	**5,102.6**
Less:					
Fair value adjustments	**–**	**–**	**–**	**–**	**–**
Allowance for losses	**–**	**(20.0)**	**–**	**–**	**(20.0)**
Net credit risk exposure	**30.6**	**3,429.7**	**1,622.3**	**–**	**5,082.6**

Risk management continued

For the period ended 30 June 2013 (unaudited)
All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

31 December 2012	Loans and receivables	Investment securities Available for sale	Investment securities Fair value through income or expense	Held for trading	Total
Analysis of balance per note 7					
Gross balance	295.0	3,828.4	1,845.2	960.2	6,928.8
Less: allowance for losses	–	(39.0)	–	–	(39.0)
	295.0	3,789.4	1,845.2	960.2	6,889.8
Analysis of credit risk exposure					
Not impaired	306.0	3,789.4	1,845.2	960.2	6,900.8
Impaired	–	39.0	–	–	39.0
Gross credit risk exposure	306.0	3,828.4	1,845.2	960.2	6,939.8
Less:					
Fair value adjustments	(11.0)	–	–	–	(11.0)
Allowance for losses	–	(39.0)	–	–	(39.0)
Net credit risk exposure	295.0	3,789.4	1,845.2	960.2	6,889.8

1.4.2.1 Collateral

Policies are in place with regard to the management and valuation of collateral. Repos and secured lending positions are revalued daily. Margin calls on collateralised swaps are 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 collateralised swap arrangements. The guarantees relied upon are either parental guarantees held against subsidiary exposures within bank groups or sovereign guarantees.

1.4.2.2 Impaired assets

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

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

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

1.4.2.3 Not impaired

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

1.4.3 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 2013 the Bank had a £306.6m (31 December 2012: £306.7m) gross exposure to the Government of Finland, £91.2m (31 December 2012: £89.9m) to the Swedish Export Credit Corporation and £116.5m (31 December 2012: £187.7m) to FMS Wertmanagement (the German Federal Government's winding up institution for the nationalised Hypo Real Estate Holding AG), repayable in over one year. It held no other non-UK sovereign debt. The exposure of £12.3m to the Government of the Netherlands at 31 December 2012 was sold during the period.

Other than a £25k (31 December 2012: £25k) exposure to the London subsidiary of a Greek bank, the Bank has no direct exposure to Greek financial institutions or any other counterparty types.

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.

1. Credit risk continued

The Bank has exposures to financial institutions in the following European countries at 30 June 2013:

Country	Repayable within 30 days	Repayable within 1 year but more than 30 days	Repayable in over 1 year	Total gross exposure	Credit risk mitigation	Total net exposure
30 June 2013						
Denmark	**6.2**	**–**	**–**	**6.2**	**–**	**6.2**
Finland	**–**	**–**	**9.0**	**9.0**	**–**	**9.0**
France	**212.0**	**24.8**	**58.4**	**295.2**	**(11.3)**	**283.9**
Germany	**25.9**	**21.0**	**338.9**	**385.8**	**(323.1)**	**62.7**
Ireland	**0.1**	**–**	**–**	**0.1**	**–**	**0.1**
Italy	**–**	**–**	**–**	**–**	**–**	**–**
Netherlands	**18.1**	**35.1**	**259.5**	**312.7**	**–**	**312.7**
Norway	**–**	**–**	**–**	**–**	**–**	**–**
Sweden	**1.4**	**–**	**–**	**1.4**	**–**	**1.4**
Switzerland	**45.3**	**420.0**	**83.0**	**548.3**	**(362.4)**	**185.9**
	309.0	**500.9**	**748.8**	**1,558.7**	**(696.8)**	**861.9**

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

For the purposes of the above table, exposures to counterparties which comprise subsidiaries of larger banking groups within which Treasury maintains additional counterparty relationships are aggregated at the group level with the associated risk country being that of the ultimate parent entity. As at 30 June 2013 an exposure of £5.7m (31 December 2012: £13.4m) to an Irish subsidiary of a major American bank group was accordingly reported as exposure to the American based parent and is thus excluded from the analysis above. This exposure is fully guaranteed by the group holding company.

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

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 net exposure
30 June 2013					
Denmark	**0.6**	**–**	**–**	**5.6**	**6.2**
Finland	**–**	**9.0**	**–**	**–**	**9.0**
France	**–**	**50.9**	**21.0**	**212.0**	**283.9**
Germany	**1.4**	**18.0**	**18.7**	**24.6**	**62.7**
Ireland	**0.1**	**–**	**–**	**–**	**0.1**
Italy	**–**	**–**	**–**	**–**	**–**
Netherlands	**18.1**	**294.6**	**–**	**–**	**312.7**
Sweden	**0.2**	**–**	**–**	**1.2**	**1.4**
Switzerland	**0.4**	**–**	**55.2**	**130.3**	**185.9**
	20.8	**372.5**	**94.9**	**373.7**	**861.9**

Risk management continued

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

1. Credit risk continued

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

The other asset types comprise repo, reverse repo, foreign exchange transactions, post collateral and exposure within the Bank's securitisation vehicles.

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 2013 totalled £172.9m (31 December 2012: £170.8m). There are no exposures to retail customers based outside of the UK and Channel Islands;
- gross exposure to European multilateral development banks (not included in the above table given the supranational status associated with these institutions) stood at £1,764.7m (31 December 2012: £1,444.0m) before credit risk mitigation (£971.1m post credit risk mitigation (31 December 2012: £997.8m)) of which £868.7m matures within a year (31 December 2012: £543.8m); and
- ABS/MBS exposures of £10.8m and £2.8m (31 December 2012: £10.8m and £2.8m) to Spanish and Belgian special purpose entities respectively were outstanding as at 30 June 2013.

The Bank continues to monitor developments daily across all countries as they affect the Treasury portfolio. As a result of proactive management actions taken throughout the eurozone crisis in order to reduce the associated risk within the Treasury portfolio the focus for existing exposures is with counterparties in Northern Europe (eg Germany, the Netherlands, Finland, Norway and Sweden) where economies are more robust. Credit quality and liquidity within the portfolio remains strong given the prevalence of shorter dated debt securities issued by AAA rated supranational financial institutions, government agencies and sovereign or state owned banks. Ongoing activity with financial institutions within the peripheral eurozone is currently restricted to Treasury's nostro accounts and selective vostro overdraft arrangements.

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

The Treasury risk team reviews the entire portfolio and watchlists monthly for appropriate risk status bandings and any associated management actions.

As at 30 June 2013 there were no red (highest risk) eurozone exposures outstanding.

1.5.2 Indirect exposures

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

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

2. Liquidity risk

In the period to 30 June 2013, the Bank has continued to maintain a sufficiently strong liquidity position, with a liquid asset ratio of 13.2% at the balance sheet date (31 December 2012: 14.6%). In addition, during the first half of 2013, the Bank proactively managed its liquidity position, maintaining a regulatory liquidity buffer, and has continued to restructure existing exposures to further improve the funding profile and ensure its financial obligations are met as and when they fall due. From a management perspective, liquidity is monitored on a daily basis via a suite of liquidity risk metrics supported by cashflow forecasts and stress tested forecasts.

2. Liquidity risk continued

2.1 Capital and liquidity framework

The Bank's liquidity risk management framework comprises:

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

2.2 Liquidity risk

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

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

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

The strategic measures reviewed by the Board include:

- customer loan/deposit ratio, 94% (31 December 2012: 92%) – the ratio of customer loans to customer deposits;
- encumbrance ratio, 30% (31 December 2012: 27%) – the ratio of encumbered assets divided by total assets;
- regulatory framework – Net Stable Funding ratio and Individual Liquidity Guidance; and
- internal liquidity stress tests – the survival period of the Bank under a range of stressed scenarios.

2.3 Liquidity risk management overview

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

The Bank monitors its liquidity position on a daily basis via liquidity risk metrics and at weekly LMCs which operate to oversee the operational liquidity management. A range of indicators, details of cash flows and media coverage are monitored to attempt to detect early signs of liquidity risk either in the market or specific to the Bank. The LMC, ALCO and the Board discuss the actual liquidity position and projected position incorporating business plans. More frequent meetings are held if necessary, ie, when the markets have a heightened period of stress or liquidity shortage.

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

2.3.1 Liquid asset portfolios

The Bank holds a number of marketable asset pools that can be utilised for liquidity management through the Treasury operation. These asset pools have reduced over the period whilst remaining in excess of regulatory minimum as a result of the Bank's announcements and credit rating downgrades in the first half of 2013. These include:

- liquid asset buffer (LAB); the highest quality debt and comprise cash held at the Bank of England, gilts and central government and multilateral development bank bonds. The table below shows the market value and composition of the LAB:

	30 June 2013	31 December 2012
Qualifying stock		
Operational balances with central banks	**5,060.4**	5,121.0
Gilts	**272.5**	664.8
Central government and multilateral development bank bonds	**804.7**	1,455.1
	6,137.6	7,240.9

- non-buffer assets, these assets are not as highly liquid as LAB assets, however they exist to diversify the liquid asset pool; and
- own retained asset pool, the Bank has securitised part of its asset balance sheet and retained the issued notes. These assets are able to be used to obtain funding from third parties and form part of the Bank's contingent funding plans.

Risk management continued

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

2. Liquidity risk continued

The Bank uses any combination of these asset pools to manage its liquidity position, with LAB and non-buffer assets used predominantly for short term cash flow movements, with the own retained asset pool creating longer term or contingent liquidity. Regular realisation through repo transactions and outright sales provide assurance that these asset pools are marketable, or otherwise realisable.

2.3.2 Wholesale funding

The majority of the Bank's funding comes from retail and corporate customer accounts. The Bank's primary objective in respect of wholesale funding is to supplement retail and corporate deposits by raising longer term funds (over one year in duration) and to diversify the source of funds to support the business plan of the Bank.

The Bank also has a variety of long term wholesale funding sources outstanding including securitisations, covered bonds and Euro Medium Term Notes. The majority of these programmes are being restructured due to the downgrades received by the Bank from Rating Agencies in the first half of 2013. The Bank will consider further issuance from these programmes after these restructures are complete and if market conditions permit. The Bank has a small presence in the shorter term wholesale liability markets which reduced in the first half of 2013 following downgrades to the Bank.

2.4 Liquidity gap

Details of contractual maturities for assets and liabilities underpin the management of liquidity risk. However in order to reflect more accurately the expected behaviour of the Bank's assets and liabilities, measurement and modelling of the behavioural aspect of each is constructed.

Gross cash flows include interest and other revenue cash flows. The following table is an analysis of:

- gross undiscounted contractual cash flows of financial liabilities held at the balance sheet date; and
- behavioural adjustments that reflect the actual behaviour of customers based on historic cashflow profiles over a period of ten years.

30 June 2013	Carrying value	Gross nominal outflow	Less than 1 month	1–3 months	3–12 months	1–5 years	Over 5 years
Contractual cash flows							
Non-derivative liabilities							
Deposits by banks	3,517.8	3,809.5	1,210.5	1,903.7	248.1	447.2	–
Customer accounts	34,166.3	35,303.5	23,441.5	2,262.8	4,738.0	4,861.2	–
Customer accounts – capital bonds	756.0	713.6	21.6	33.1	276.1	382.8	–
Debt securities in issue	4,610.0	5,871.4	4.0	194.1	378.8	4,370.9	923.6
Other borrowed funds	1,248.1	2,247.8	7.2	4.5	124.4	702.7	1,409.0
Amounts owed to other Co-operative Group undertakings	123.9	123.9	123.9	–	–	–	–
	44,422.1	48,069.7	24,808.7	4,398.2	5,765.4	10,764.8	2,332.6
Derivative liabilities							
Net outflow	662.7	1,382.2	16.8	41.2	154.7	482.3	687.2
	45,084.8	49,451.9	24,825.5	4,439.4	5,920.1	11,247.1	3,019.8
Other liabilities	438.8	–	–	–	–	–	–
Total recognised liabilities	45,523.6	49,451.9	24,825.5	4,439.4	5,920.1	11,247.1	3,019.8
Unrecognised loan commitments	4,475.5	4,475.5	4,388.9	85.6	1.0	–	–
Total liabilities	49,999.1	53,927.4	29,214.4	4,525.0	5,921.1	11,247.1	3,019.8
Behavioural adjustments							
Customer accounts	–	–	(18,705.5)	2,602.1	(1,504.0)	17,607.4	–
Total liabilities – behavioural	49,999.1	53,927.4	10,508.9	7,127.1	4,417.1	28,854.5	3,019.8

2. Liquidity risk continued

31 December 2012	Carrying value	Gross nominal outflow	Less than 1 month	1–3 months	3–12 months	1–5 years	Over 5 years
Contractual cash flows							
Non-derivative liabilities							
Deposits by banks	3,612.0	3,888.1	2,415.6	412.3	551.0	509.2	–
Customer accounts	35,884.4	36,167.4	24,146.9	1,860.6	6,393.0	3,766.9	–
Customer accounts – capital bonds	888.1	886.8	25.5	64.1	255.8	541.4	–
Debt securities in issue	4,713.7	5,860.6	67.0	127.4	214.4	4,737.4	714.4
Other borrowed funds	1,258.6	2,292.9	7.2	4.5	86.6	748.6	1,446.0
Amounts owed to other Co-operative Group undertakings	112.0	112.0	112.0	–	–	–	–
	46,468.8	49,207.8	26,774.2	2,468.9	7,500.8	10,303.5	2,160.4
Derivative liabilities							
Net outflow	967.6	1,650.6	20.0	48.2	180.4	588.2	813.8
	47,436.4	50,858.4	26,794.2	2,517.1	7,681.2	10,891.7	2,974.2
Other liabilities	408.2	–	–	–	–	–	–
Total recognised liabilities	47,844.6	50,858.4	26,794.2	2,517.1	7,681.2	10,891.7	2,974.2
Unrecognised loan commitments	4,770.3	4,770.3	4,751.2	19.1	–	–	–
Total liabilities	52,614.9	55,628.7	31,545.4	2,536.2	7,681.2	10,891.7	2,974.2
Behavioural adjustments							
Customer accounts	–	–	(21,219.3)	570.8	2,410.2	18,238.3	–
Total liabilities – behavioural	52,614.9	55,628.7	10,326.1	3,107.0	10,091.4	29,130.0	2,974.2

2.5 Encumbrance

The Bank aims to have sufficient eligible and unencumbered assets available to meet the needs of its secured funding programmes. Details of the Bank's encumbered assets are shown in note 39 Fair value of transferred assets and associated liabilities in the Bank's 2012 financial statements.

During the period, encumbrance was reduced by capital repayments of securitised and covered bond notes totalling £746.9m and increased by £985.4m relating to investment securities sold under repurchase agreements, a net increase of £238.5m. Additional assets have been encumbered since the period end; for further details, see note 16.

3. Market risk

Market risk is the risk of loss as a result of the value of financial assets or liabilities (including off-balance sheet instruments) being adversely affected by movements in market rates or prices. This loss can be reflected in the near term earnings by changing net interest income, or in the longer term because of changes in the economic value of future cash flows.

The main source of market risk within the Bank is driven by mismatches between the repricing profiles of asset and liability customer products within the retail and corporate businesses and certain characteristics embedded within these products and basis risk. Treasury also create market risk through its various portfolio management and trading activities along with currency risk.

3.1 Interest rate risk

Interest rate risk policy statements, approved by the ERC on behalf of the Board, specify the scope of the Bank's wholesale market activity, market risk limits and delegated authorities. The policy is managed by the Bank Market Risk Committee (BMRC) and ALCO. Their prime task is to assess the interest rate risk inherent in the maturity and repricing characteristics of the Bank's assets and liabilities. The Bank seeks to minimise the volatility of future earnings from interest rate changes and all interest rate risk exposure is removed from the 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 BMRC and ALCO review the balance sheet risk positions and the utilisation of wholesale market risk limits.

3.1.1 Non-treasury interest rate risk

The Bank (excluding wholesale) 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.

BMRC 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's 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) are no more than a set limit.

Risk management continued

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

3. Market risk continued

Non-maturity deposits which are non-interest bearing are separated into a stable 'core' element, based on a long run average, and the residual balance, which can fluctuate. In the gap report, the residual balances (along with interest bearing non-maturity deposits) are deemed to re-price or mature within one month. The 'core' non-maturity deposits are within the non-sensitive balance on the gap report, along with non-dated capital and other non-sensitive balances. ALCO sets guidance around the treatment of non-sensitive balances to reinvest in fixed rate assets in periods up to five years to smooth the income based upon the prevailing interest rate environment.

Risk limits are formally calculated at each month end. Interest rate risk and effectiveness of hedging is monitored daily using gap positions, incorporating new business requirements. Draw down risk, in particular for fixed rate mortgages, is managed through weekly balance sheet meetings. The asset and liability management team undertake hedges for interest rate risk using derivative instruments and investment securities which are executed via the Treasury markets team to external wholesale markets, and loans and deposits which are executed internally with the Treasury markets team.

Basis risk is the risk that different assets and liabilities reprice with reference to different indices and at different times. This exposes the Bank's to income volatility if indices do not move in a ratio of one to one. The overall exposure to basis risk has remained a net base rate asset throughout the first half of 2013 as customers continue to favour variable rate mortgages (where the introductory rate is linked to Bank of England base rate) and administered and fixed rate savings. Basis risk is monitored by BMRC and ALCO monthly and action is taken as required, which includes pricing, new products or external hedging.

The table illustrates the greater than 12 month net gap position at the end of the period on the Bank's balances, excluding wholesale treasury and customer currency balances which are managed within the treasury risk framework. The gap is driven by product pricing and product mix. The gap is calculated by placing all assets and liabilities at the earliest of their 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. The maximum sensitivity for the period shown below equates to approximately a £6.0m (31 December 2012: £10.9m) decrease in income if rates increased by 1%.

Net greater than 12 month gap position	**30 June 2013**	31 December 2012
At the period end	**(341)**	(928)
Average for the period	**(434)**	(612)
Maximum sensitivity for the period	**(600)**	(1,090)
Minimum sensitivity for the period	**(341)**	(248)

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. There are two prime measures of risk supplemented by additional controls such as maturity and stop loss limits.

3.1.2.1 Value at risk (VaR)

VaR measures the daily maximum potential gain or loss due to market volatility within a statistical confidence level of 95% and a one day holding period. The VaR methodology employed is historical simulation using a time series of one year to latest day and was £0.4m at 30 June 2013 for the trading portfolios (31 December 2012: £0.4m). The VaR methodology has inherent limitations in that market volatility in the past may not be a reliable predictor of the future, and may not reflect the time required to hedge or dispose of the position, hence VaR is not used as the sole measure of risk.

3.1.2.2 PV100

This illustrates the change in valuation on a fixed income portfolio experienced given a 1% increase and decrease in interest rates, representing the treasury banking book and treasury trading book. PV100 is the effect on the net present value (NPV) of the wholesale portfolio to a parallel shift of 100 basis points upon the base yield curve. The effects of a 1% increase in interest rates are (£6.8m) (31 December 2012: (£3.0m)) and a 1% decrease £8.3m (31 December 2012: £14.6m).

3.2 Currency risk

The Bank's treasury foreign exchange activities primarily involve:

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

3. Market risk continued

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

	30 June 2013					31 December 2012				
	£	**$**	**€**	**Other**	**Total**	£	$	€	Other	Total
Assets										
Cash and balances at central banks	**5,402.1**	**–**	**–**	**–**	**5,402.1**	5,433.0	–	–	–	5,433.0
Loans and advances to banks	**1,607.7**	**29.3**	**97.8**	**2.7**	**1,737.5**	1,738.4	38.4	124.5	2.8	1,904.1
Loans and advances to customers	**32,528.0**	**38.7**	**128.5**	**20.7**	**32,715.9**	33,121.3	40.2	153.4	24.6	33,339.5
Fair value adjustments for hedged risk	**217.0**	**–**	**–**	**–**	**217.0**	354.2	–	–	–	354.2
Investment securities										
Loans and receivables	**30.6**	**–**	**–**	**–**	**30.6**	237.7	12.8	44.5	–	295.0
Available for sale	**3,429.7**	**–**	**–**	**–**	**3,429.7**	3,669.4	70.8	49.2	–	3,789.4
At FV through income or expense	**1,622.3**	**–**	**–**	**–**	**1,622.3**	1,821.9	12.3	11.0	–	1,845.2
Held for trading	**–**	**–**	**–**	**–**	**–**	870.2	17.3	72.7	–	960.2
Derivative financial instruments	**804.3**	**–**	**–**	**–**	**804.3**	818.6	–	0.2	–	818.8
Equity shares	**5.7**	**–**	**–**	**–**	**5.7**	5.7	–	–	–	5.7
Investments in joint ventures	**4.3**	**–**	**–**	**–**	**4.3**	3.9	–	–	–	3.9
Intangible fixed assets	**29.9**	**–**	**–**	**–**	**29.9**	34.9	–	–	–	34.9
Investment properties	**153.0**	**–**	**–**	**–**	**153.0**	173.0	–	–	–	173.0
Property, plant and equipment	**48.4**	**–**	**–**	**–**	**48.4**	64.1	–	–	–	64.1
Amounts owed by other Co-operative Group undertakings	**0.5**	**–**	**–**	**–**	**0.5**	256.4	–	–	–	256.4
Other assets	**43.8**	**–**	**0.5**	**0.1**	**44.4**	69.7	0.2	0.4	–	70.3
Prepayments and accrued income	**16.9**	**–**	**–**	**–**	**16.9**	14.9	–	–	–	14.9
Current tax assets	**266.3**	**–**	**–**	**–**	**266.3**	172.6	–	–	–	172.6
Deferred tax assets	**–**	**–**	**–**	**–**	**–**	159.6	–	–	–	159.6
Total assets	**46,210.5**	**68.0**	**226.8**	**23.5**	**46,528.8**	49,019.5	192.0	455.9	27.4	49,694.8
Liabilities										
Deposits by banks	**3,265.4**	**78.1**	**174.3**	**–**	**3,517.8**	2,995.4	173.5	443.0	0.1	3,612.0
Customer accounts	**34,084.1**	**33.5**	**46.0**	**2.7**	**34,166.3**	35,784.6	47.5	49.7	2.6	35,884.4
Customer accounts – capital bonds	**756.0**	**–**	**–**	**–**	**756.0**	888.1	–	–	–	888.1
Debt securities in issue	**4,610.0**	**–**	**–**	**–**	**4,610.0**	4,705.5	–	8.2	–	4,713.7
Derivative financial instruments	**662.7**	**–**	**–**	**–**	**662.7**	967.4	–	0.2	–	967.6
Other borrowed funds	**1,218.1**	**–**	**30.0**	**–**	**1,248.1**	1,230.0	–	28.6	–	1,258.6
Amounts owed to other Co-operative Group undertakings	**123.9**	**–**	**–**	**–**	**123.9**	112.0	–	–	–	112.0
Other liabilities	**88.1**	**0.2**	**0.2**	**–**	**88.5**	103.6	0.2	0.2	–	104.0
Accruals and deferred income	**33.9**	**–**	**–**	**–**	**33.9**	20.1	–	–	–	20.1
Provisions for liabilities and charges	**191.0**	**–**	**–**	**–**	**191.0**	162.7	–	–	–	162.7
Deferred tax liabilities	**125.4**	**–**	**–**	**–**	**125.4**	121.4	–	–	–	121.4
Total liabilities	**45,158.6**	**111.8**	**250.5**	**2.7**	**45,523.6**	47,090.8	221.2	529.9	2.7	47,844.6
Net on balance sheet position	**1,051.9**	**(43.8)**	**(23.7)**	**20.8**	**1,005.2**	1,928.7	(29.2)	(74.0)	24.7	1,850.2

At the 30 June 2013 the Bank's net currency position was the equivalent of £1.8m (31 December 2012: £2.7m) and represented a potential loss of £0.1m given a 3% depreciation in sterling (31 December 2012: £0.1m). The Bank manages its currency positions against both an overall limit and individual currency limits.

Risk management continued

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

4. Strategic and business risk

Strategic and business risk arises from changes to the Bank's business and the environment in which it operates, specifically the risk of not being able to carry out the Bank's business plan and desired strategy.

During 2012, the Bank had already begun to separate the business into two distinct areas: core and non-core. As part of the plan to simplify and reshape the Bank, this has been accelerated. Two business areas have been created: Co-operative Asset Management (CoAM) and the core bank. The core bank will continue to concentrate on supporting retail banking and smaller business customers. The CoAM business includes those businesses and assets which are not consistent with the new business strategy going forward. A separate team will actively manage this business for value and oversee the controlled reduction in the assets. Work is continuing to finalise the exact details of the shape and structure of the core bank, the systems underpinning it, the product range and target customer base as well as the cost take out required to return the business to profitability. This work will form the basis of the prospectus to be published around the time of the Exchange Offer.

In particular, the Recapitalisation Plan (the Plan) is subject to finalisation and its implementation is subject to a number of inherent risks. Risks include a failure by bondholders to participate in the Exchange Offer, a legal challenge by bondholders to the Exchange Offer and a failure by, or inability of, The Co-operative Group to make its proposed contribution. The contribution from The Co-operative Group is conditional upon the consent of its syndicated lenders. Failure to implement the Plan may result in regulatory intervention that could reduce or eliminate the value of the equity and modify, reduce or eliminate debt payment obligations.

Even if the Plan is successfully implemented, the Bank may, from time to time, require additional capital. Factors which could adversely affect the Bank's capital position and which may result in additional capital being required include worsening economic or market conditions, continuing deterioration of asset quality, the unavailability or withdrawal of funding, failure to implement the Bank's restructuring and cost reduction programme, and changes in regulatory capital requirements. Should such factors occur prior to completion of the Plan, they might impact the launch or successful implementation of the Plan.

The Bank's new strategy is also untested and the Bank may ultimately be unsuccessful in implementing its strategy, in particular in reducing its non-core assets and restructuring its cost base as and within the timeframe currently anticipated. These, and other risks and uncertainties, could, individually or cumulatively, have a material adverse effect on the Bank's business, results of operation, financial conditions or prospects.

The Board and Executive set and monitor the strategic plan in the light of this background having considered the effect that stress scenarios could have upon it.

5. Conduct risk

Conduct risk is the risk that the Bank's behaviours, offerings or interactions will result in unfair outcomes for customers. Accordingly, conduct risk may arise from any aspect of the way a business is conducted, the sole test being whether the outcome is an unfair one for customers.

The Bank considers emerging conduct risk through established systems and controls including ongoing oversight and monitoring from risk functions.

Significant conduct risks are reported through existing management structures and committees and challenged by the BRC.

The quantifiable risks that the Bank currently faces have been identified in note 10 provisions for liabilities and charges.

Capital management

For the period ended 30 June 2013 (unaudited)
All the amounts are stated in £m unless otherwise indicated

Capital resources
Capital is held by the Bank to protect its depositors, to cover its inherent risks, to provide a cushion for unexpected losses and to support the development of the business.

Basel III rules in the EU (collectively known as CRD IV) will be implemented on a transitional basis from 1 January 2014 to full implementation in 2022 (at the earliest). During the transitional period to full implementation of Basel III the Bank will have the opportunity to generate additional capital from earnings and to implement management actions in order to mitigate the impact of Basel III and meet capital ratios.

In March 2013, the Financial Policy Committee ('FPC') directed the Prudential Regulation Authority ('PRA') to ensure that by December 2013 major UK banks hold capital resources equivalent to at least 7% of their risk-weighted assets, using a Basel III definition of Common Equity Tier 1 but after taking deductions to reflect the FPC's assessment of expected future losses and future costs of conduct redress, and adjusting for a more prudent calculation of risk weights.

The Bank has developed and agreed a recapitalisation plan ('the Plan'), as announced on 17 June, which has been discussed with the relevant regulatory bodies. The key objective of the Plan is to significantly strengthen the Bank's fully phased Common Equity Tier 1 capital and to refocus its strategy around its strength in core relationship banking providing current accounts, residential mortgages and savings products to individuals and small business banking. The main deliverables of this plan include;

- An increase in Common Equity Tier 1 capital of £1.5 billion from a combination of injection from The Co-operative Group and Exchange Offer met in three broadly equal proportions from:

  1. The capital generated from new shares in the Bank as part of the Exchange Offer to be made to holders of the Bank's subordinated capital securities.
  2. A contribution from the Group by way of a fixed income instrument as part of an exchange offer.
  3. A further contribution, underwritten by The Co-operative Group, to the Bank, expected to be sourced primarily from the sale proceeds of the insurance businesses, contingent on a successful Exchange Offer.

- Reduction in the non-core asset portfolio
- A simplification and restructuring programme supporting the 'Core Relationship Bank' specifically focusing on the existing cost base

Additional disclosures including Basel III leverage ratios and capital at 30 June 2013 can be found in the 'Additional Regulatory Disclosures – Interim 2013' on the financial results page of the Bank's website at www.co-operativebankinggroup.co.uk.

The PRA sets Basel II capital requirements and receives information on these requirements for the Bank. The Bank expects its Core Tier 1 ratio to continue to be above the regulatory minimum. Whilst the Bank has recently moved below its individual capital guidance, it continues to meet the Pillar 1 requirements.

The Bank is currently required to disclose its regulatory capital on a Basel II basis. The following disclosures:

- reconcile the Bank's total equity per the balance sheet to its Basel II Core Tier 1 capital
- analyse the Bank's Basel II capital resources, capital ratios and risk weighted assets

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

Tier 1 capital
Tier 1 capital includes share capital, retained earnings, and non-cumulative irredeemable preference shares. Retained earnings exclude gains or losses on cashflow hedges and available for sale assets.

Tier 2 capital
Tier 2 capital includes subordinated debt issues and perpetual subordinated bonds (PSBs). The rights of payment to the holders of this debt are subordinated to the claims of depositors and other creditors of the Bank. More information on these can be found in the 2012 financial statements.

Revaluation reserves relating to net gains on equity held in the available for sale financial assets category are included in Tier 2 capital.

	30 June 2013	31 December 2012
Reconciliation of equity per balance sheet to Core Tier 1 capital		
Total equity per balance sheet	**1,005.2**	1,850.2
Regulatory adjustments:		
Minority interests	**(0.3)**	(0.4)
Available for sale reserve	**(5.9)**	(30.0)
Cashflow hedging reserve	**(24.8)**	(63.7)
Core Tier 1 capital before regulatory deductions	**974.2**	1,756.1

Capital management continued

For the period ended 30 June 2013 (unaudited)

All the amounts are stated in £m unless otherwise indicated

Capital resources continued

	30 June 2013	31 December 2012
Core Tier 1 capital before regulatory adjustments:		
Permanent share capital	**410.0**	410.0
Retained earnings	**1,304.1**	1,813.4
Minority interests	**32.8**	32.0
Losses for the period	**(781.5)**	(508.1)
Share premium account	**8.8**	8.8
Total Core Tier 1 capital before regulatory adjustments	**974.2**	1,756.1
Regulatory adjustments from Core Tier 1 capital:		
Intangible assets	**(115.6)**	(27.9)
50% of excess of expected losses over impairment (net of tax)	**(58.8)**	(159.7)
50% of securitisation positions	**(21.0)**	(0.7)
Total Core Tier 1 capital after regulatory adjustments	**778.8**	1,567.8
Other Tier 1 capital:		
Non-cumulative irredeemable preference shares	**60.0**	60.0
Regulatory adjustments from other Tier 1 capital:		
50% of tax on excess of expected losses over impairment	**17.8**	51.8
50% of material holdings	**(2.2)**	(2.0)
Total Tier 1 capital after regulatory adjustments	**854.4**	1,677.6
Tier 2 capital before regulatory adjustments:		
Revaluation reserves	**2.0**	2.0
Collective provisions	**0.9**	0.7
Subordinated notes and perpetual subordinated bonds	**1,116.8**	1,112.1
Excess on limits for lower Tier 2 capital	**(366.4)**	–
Total Tier 2 capital before regulatory adjustments	**753.3**	1,114.8
Regulatory adjustments from Tier 2 capital:		
50% of excess of expected losses over impairment (gross of tax)	**(76.6)**	(211.5)
50% of securitisation positions	**(21.0)**	(0.7)
50% of material holdings	**(2.2)**	(2.0)
Total Tier 2 capital after regulatory adjustments	**653.5**	900.6
Total capital resources	**1,507.9**	2,578.2

The Bank contracts with CFS Management Services Ltd (CFSMS), a fellow Banking Group subsidiary, to build certain assets, including IT developments. Whilst these intangible assets are on the balance sheet of CFSMS, at 30 June 2013 the share attributable to the Bank has been deducted from the Bank's capital resources. The £115.6m includes £91.8m of intangibles included on the CFSMS balance sheet. This is in line with the Bank's regulatory reporting to the PRA.

£366.4m of lower Tier 2 capital is currently ineligible due to gearing rules as lower Tier 2 capital cannot exceed 50% of Tier 1 capital after deductions.

The capital ratios reported in the business and financial review are based on the Pillar 1 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.

Capital ratios and risk-weighted assets

	30 June 2013	31 December 2012
Capital ratios		
Core Tier 1 ratio	**4.9%**	8.8%
Tier 1 ratio	**5.3%**	9.4%
Total capital ratio	**9.4%**	14.4%
Risk-weighted assets		
Credit risk	**14,758.0**	15,974.8
Market and counterparty risk	**2.1**	492.6
Operational risk	**1,255.2**	1,441.3
Total risk-weighted assets	**16,015.3**	17,908.7
Segmental analysis of credit risk risk-weighted assets		
Core		
Retail	**2,384.7**	2,410.1
CABB core	**5,396.0**	6,081.9
Treasury/other	**1,511.8**	1,443.2
	9,292.5	9,935.2
Non-core		
Corporate	**1,469.6**	1,678.4
Other	**3,995.9**	4,361.2
	5,465.5	6,039.6
Total credit risk risk-weighted assets	**14,758.0**	15,974.8

Core Tier 1 ratio has reduced by 3.9% to 4.9% as at 30 June 2013. This is due to a 50% (£789.0m) decrease in Core Tier 1 after deductions offset by a 11% (£1,893.4m) decrease in risk-weighted assets.

The reduction in Core Tier 1 is primarily due to the statutory loss of £709.4m before tax and £781.5m after tax.

The reduction in risk-weighted assets is primarily due to a 12% (£894.7m) reduction in total corporate risk-weighted assets. The change is driven by asset sales and the reassessment of the carrying value of corporate real estate exposures together with an ongoing review of regulatory capital requirements. Slotting models are used to analyse and monitor specialised lending exposures to property which are assigned to PRA supervisory categories with predefined risk-weights. A significant proportion of loans have been downgraded with many moving into default. Loans in default have a zero risk-weight (but a 50% Expected Loss). Movement to default is the primary reason for the reduction in corporate risk-weighted assets.

In addition, other non-core risk-weighted assets have decreased by 8% (£365.3m). On 28 January 2013, the Bank entered into a transaction to transfer a mezzanine portion of the risk in a portfolio of residential mortgage loans to third party investors, via a special purpose vehicle, Calico Finance Number One Limited. As a result of this transaction, risk-weighted assets reduced by c£1.2bn. An exercise to review the risk weightings of assets at 30 June 2013 increased risk-weighted assets by c£1.0bn. Also, Optimum risk-weighted assets have decreased by 5% (c£200m) due to ongoing reduction in arrears and the continued run off of the book.

Market and counterparty risk capital requirements have also decreased, by £490.5m due to the sale of the Bank's held for trading assets.

Total excess of expected loss over impairment, a deduction from capital resources, has decreased by £269.8m. Credit impairments have increased significantly, partially offset by higher expected loss driven by corporate downgrades.

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 2013 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 Conduct Authority ('the UK FCA'). 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 FCA.

As disclosed in the basis of preparation, the annual financial statements of the group 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 2013 is not prepared, in all material respects, in accordance with IAS 34 as adopted by the EU and the DTR of the UK FCA.

Emphasis of matter – Going concern

In forming our conclusion on the condensed set of financial statements, which is not modified, we have considered the adequacy of the disclosures made in part 3 of the Basis of Preparation section of the condensed set of financial statements concerning the Bank's ability to continue as a going concern; in that section the directors set out the risks associated with the successful execution of the recapitalisation plan. These conditions indicate the existence of a material uncertainty which may cast significant doubt on the Bank's ability to continue as a going concern. These condensed financial statements do not include the adjustments that would result if the Bank was unable to continue as a going concern.

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

28 August 2013

Consolidated income statement

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

		Period to 30 June 2013			Period to 30 June 2012		
	Notes	**Before significant items**	**Significant items**	**After significant items**	Before significant items	Significant items	After significant items
Interest receivable and similar income		**715.6**	**(10.0)**	**705.6**	744.7	–	744.7
Interest expense and similar charges		**(470.8)**	**–**	**(470.8)**	(473.5)	–	(473.5)
Net interest income	2	**244.8**	**(10.0)**	**234.8**	271.2	–	271.2
Fee and commission income		**116.2**	**(51.0)**	**65.2**	128.0	(40.0)	88.0
Fee and commission expense		**(36.2)**	**–**	**(36.2)**	(41.2)	–	(41.2)
Net fee and commission income	3	**80.0**	**(51.0)**	**29.0**	86.8	(40.0)	46.8
Net trading income		**1.1**	**–**	**1.1**	9.3	–	9.3
Other operating income		**26.0**	**–**	**26.0**	39.8	–	39.8
Operating income		**351.9**	**(61.0)**	**290.9**	407.1	(40.0)	367.1
Operating expenses	4	**(321.7)**	**(183.0)**	**(504.7)**	(294.3)	(39.3)	(333.6)
Financial Services Compensation Scheme levies	10	**0.1**	**–**	**0.1**	(0.8)	–	(0.8)
Impairment losses on loans and advances	6	**(496.0)**	**–**	**(496.0)**	(94.6)	–	(94.6)
Impairment gains on investments	7	**–**	**–**	**–**	2.7	–	2.7
Operating (loss)/profit		**(465.7)**	**(244.0)**	**(709.7)**	20.1	(79.3)	(59.2)
Share of post tax profits from joint ventures		**0.3**	**–**	**0.3**	0.6	–	0.6
(Loss)/profit before taxation		**(465.4)**	**(244.0)**	**(709.4)**	20.7	(79.3)	(58.6)
Income tax	5	**(128.8)**	**56.7**	**(72.1)**	(6.1)	19.4	13.3
(Loss)/profit for the period		**(594.2)**	**(187.3)**	**(781.5)**	14.6	(59.9)	(45.3)
Attributable to:							
Equity shareholders		**(594.5)**	**(187.3)**	**(781.8)**	13.8	(59.9)	(46.1)
Minority interests		**0.3**	**–**	**0.3**	0.8	–	0.8
		(594.2)	**(187.3)**	**(781.5)**	14.6	(59.9)	(45.3)
Earnings per share		**(7.25)p**	**(2.28)p**	**(9.53)p**	0.17p	(0.73)p	(0.56)p

The significant items in 2013 relate to:

- £10.0m (2012: £nil) of provisions made for potential customer redress relating to past sales of interest rate swaps (notes 2 and 10);
- £25.0m (2012: £40.0m) of provisions made for potential customer redress relating to past sales of payment protection insurance (notes 3 and 10);
- £26.0m (2012: £nil) of provisions made for potential customer redress relating to alleged failings in the introduction of third party sales of card and identity protection products (notes 3 and 10);
- £10.0m (2012: £20.0m) of costs incurred as a result of the bid for the Lloyds Bank branches (note 4);
- £14.7m (2012: £19.3m) of costs incurred on a programme of investment and integration (note 4);
- £9.9m (2012: £nil) of impairment of property, plant and equipment (note 4); and
- £148.4m (2012: £nil) of recharged costs relating to intangible asset impairment regarding the development of new banking systems (note 4).

The accounting policies and notes on pages 38 to 59 form part of these financial statements.

Consolidated statement of comprehensive income

For the period ended 30 June 2013 (unaudited)
All amounts are stated in £m unless otherwise indicated

	Period to 30 June 2013			Period to 30 June 2012		
	Equity shareholders	**Minority interests**	**Total**	Equity shareholders	Minority interests	Total
(Loss)/profit for the period	**(781.8)**	**0.3**	**(781.5)**	(46.1)	0.8	(45.3)
Other comprehensive (expense)/income that may be recycled to profit or loss:						
Changes in cashflow hedges:						
Net changes in fair value recognised directly in equity	**(39.9)**	**(0.5)**	**(40.4)**	32.4	(0.3)	32.1
Income tax	**9.2**	**0.1**	**9.3**	(3.9)	0.1	(3.8)
Transfers from equity to income or expense	**(10.6)**	**–**	**(10.6)**	(23.1)	(0.1)	(23.2)
Income tax	**2.4**	**–**	**2.4**	2.5	–	2.5
Changes in available for sale assets:						
Net changes in fair value recognised directly in equity	**(44.4)**	**–**	**(44.4)**	159.3	–	159.3
Income tax	**10.0**	**–**	**10.0**	(40.7)	–	(40.7)
Transfers from equity to income or expense	**13.4**	**–**	**13.4**	(89.3)	–	(89.3)
Income tax	**(3.1)**	**–**	**(3.1)**	23.7	–	23.7
Other comprehensive (expense)/income for the period, net of income tax	**(63.0)**	**(0.4)**	**(63.4)**	60.9	(0.3)	60.6
Total comprehensive (expense)/income for the period	**(844.8)**	**(0.1)**	**(844.9)**	14.8	0.5	15.3

The accounting policies and notes on pages 38 to 59 form part of these financial statements.

Consolidated balance sheet

At 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

	Notes	**30 June 2013**	31 December 2012
Assets			
Cash and balances at central banks		**5,402.1**	5,433.0
Loans and advances to banks		**1,737.5**	1,904.1
Loans and advances to customers	6	**32,715.9**	33,339.5
Fair value adjustments for hedged risk	6	**217.0**	354.2
Investment securities – loans and receivables	7	**30.6**	295.0
Investment securities – available for sale	7	**3,429.7**	3,789.4
Investment securities – fair value through income or expense	7	**1,622.3**	1,845.2
Investment securities – held for trading	7	**–**	960.2
Derivative financial instruments		**804.3**	818.8
Equity shares		**5.7**	5.7
Investments in joint ventures		**4.3**	3.9
Intangible fixed assets		**29.9**	34.9
Investment properties		**153.0**	173.0
Property, plant and equipment		**48.4**	64.1
Amounts owed by other Co-operative Group undertakings		**0.5**	256.4
Other assets		**44.4**	70.3
Prepayments and accrued income		**16.9**	14.9
Current tax assets		**266.3**	172.6
Deferred tax assets	11	**–**	159.6[1]
Total assets		**46,528.8**	49,694.8
Liabilities			
Deposits by banks		**3,517.8**	3,612.0
Customer accounts	8	**34,166.3**	35,884.4
Customer accounts – capital bonds	9	**756.0**	888.1
Debt securities in issue		**4,610.0**	4,713.7
Derivative financial instruments		**662.7**	967.6
Other borrowed funds		**1,248.1**	1,258.6
Amounts owed to other Co-operative Group undertakings		**123.9**	112.0
Other liabilities		**88.5**	104.0
Accruals and deferred income		**33.9**	20.1
Provisions for liabilities and charges	10	**191.0**	162.7
Deferred tax liabilities	11	**125.4**	121.4[1]
Total liabilities		**45,523.6**	47,844.6
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		**522.5**	1,304.3
Available for sale reserve		**5.9**	30.0
Cashflow hedging reserve		**24.8**	63.7
		972.0	1,816.8
Minority interests		**33.2**	33.4
Total equity		**1,005.2**	1,850.2
Total liabilities and equity		**46,528.8**	49,694.8

(1) The 2012 balance sheet comparatives have been restated to reflect that certain deferred tax liabilities cannot be offset against the deferred tax assets.

The accounting policies and notes on pages 38 to 59 form part of these financial statements.

Consolidated statement of cash flows

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

	Period to 30 June 2013	Period to 30 June 2012
Cash flows from operating activities		
Loss before taxation	**(709.4)**	(58.6)
Adjustments for:		
Increase in prepayments and accrued income	**(7.7)**	(0.2)
Increase/(decrease) in accruals and deferred income	**23.9**	(18.9)
Interest payable in respect of other borrowed funds	**45.3**	36.3
Effect of exchange rate movements	**(12.8)**	8.6
Fair value movement on investment properties	**18.9**	(0.1)
Impairment losses on loans and advances	**495.8**	95.8
Movements on investment impairments	**(19.0)**	(2.7)
Depreciation and amortisation	**4.8**	8.4
Impairment of intangible fixed assets	**2.0**	–
Interest amortisation	**(0.2)**	(4.7)
Fair value movements and amortisation of investment securities	**44.0**	(55.6)
Impairment of property, plant and equipment	**9.9**	–
Profit on disposal of property, plant and equipment	**–**	(0.4)
Unwind of fair value adjustments arising on transfer of engagements	**8.2**	(19.7)
Preference dividend	**2.8**	2.8
	(93.5)	(9.0)
(Decrease)/increase in deposits by banks	**(94.2)**	1,113.3
Decrease in customer accounts and capital bonds	**(1,850.1)**	(2,223.7)
Decrease in debt securities in issue	**(148.4)**	(59.7)
(Increase)/decrease in loans and advances to banks	**(41.4)**	76.9
Decrease/(increase) in loans and advances to customers	**291.2**	(278.5)
Decrease/(increase) in amounts owed by other Co-operative Group undertakings	**255.9**	(109.7)
Increase/(decrease) in amounts owed to other Co-operative Group undertakings	**11.9**	(34.6)
Net movement of other assets and other liabilities	**(326.7)**	(128.8)
Income tax received/(paid)	**16.4**	(0.7)
Net cash flows from operating activities	**(1,978.9)**	(1,654.5)
Cash flows from investing activities		
Purchase of tangible and intangible fixed assets	**(0.5)**	(0.5)
Proceeds from sale of fixed assets	**–**	0.8
Proceeds from sale of investment property	**1.3**	0.7
Purchase of investment securities	**(2,033.8)**	(2,176.7)
Proceeds from sale and maturity of investment securities	**3,875.2**	1,981.5
Net cash flows from investing activities	**1,842.2**	(194.2)
Cash flows from financing activities		
Interest paid on other borrowed funds	**(44.3)**	(48.1)
Dividends paid to minority interests	**(0.1)**	(0.3)
Preference share dividends paid	**(2.8)**	(2.8)
Net cash flows from financing activities	**(47.2)**	(51.2)
Decrease in cash and cash equivalents	**(183.9)**	(1,899.9)
Cash and cash equivalents at beginning of the period	**6,314.2**	7,888.4
Cash and cash equivalents at end of the period	**6,130.3**	5,988.5
Cash and balances with central banks	**5,331.7**	4,278.3
Loans and advances to banks	**673.6**	1,450.2
Short term investments (note 7)	**125.0**	260.0
	6,130.3	5,988.5

The cash flows cannot be directly reconciled to the 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 2012 comparatives have been restated to reflect a correction of the analysis of loans and advances to banks between the cash and cash equivalents analysis and the increase/decrease in loans and advances to banks line.

The accounting policies and notes on pages 38 to 59 form part of these financial statements.

Consolidated statement of changes in equity

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

	Attributable to equity holders of the Bank							
	Share capital	**Share premium**	**Available for sale reserve**	**Cashflow hedging reserve**	**Retained earnings**	**Total**	**Minority interests**	**Total equity**
Period from 1 January 2013 to 30 June 2013								
At the beginning of the period	**410.0**	**8.8**	**30.0**	**63.7**	**1,304.3**	**1,816.8**	**33.4**	**1,850.2**
Total comprehensive income for the period	**–**	**–**	**(24.1)**	**(38.9)**	**(781.8)**	**(844.8)**	**(0.1)**	**(844.9)**
Transactions with owners recorded directly in equity:								
Dividend	**–**	**–**	**–**	**–**	**–**	**–**	**(0.1)**	**(0.1)**
At the end of the period	**410.0**	**8.8**	**5.9**	**24.8**	**522.5**	**972.0**	**33.2**	**1,005.2**
Period from 1 July 2012 to 31 December 2012								
At the beginning of the period	410.0	8.8	72.5	75.5	1,687.7	2,254.5	33.6	2,288.1
Total comprehensive income for the period	–	–	(42.5)	(11.8)	(463.1)	(517.4)	(0.2)	(517.6)
Transactions with owners recorded directly in equity:								
Capital contribution	–	–	–	–	80.0	80.0	–	80.0
Dividend	–	–	–	–	(0.3)	(0.3)	–	(0.3)
At the end of the period	410.0	8.8	30.0	63.7	1,304.3	1,816.8	33.4	1,850.2
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

The accounting policies and notes on pages 38 to 59 form part of these financial statements.

Basis of preparation and accounting policies

For the period ended 30 June 2013 (unaudited)

1. Basis of preparation

This condensed consolidated interim financial report for the half year ended 30 June 2013 has been prepared in accordance with the Disclosure and Transparency Rules of the Financial Conduct 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 2012 financial statements, which have been prepared in accordance with IFRS as adopted by the European Union.

EU law (IAS Regulation EC1606/2002) requires that the annual consolidated financial statements for the year ended 31 December 2013 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 adopted by the European Union.

The information in this interim financial report 2013 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 2012 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 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 2013 was approved by the Board of Directors on 28 August 2013.

Reference is made to the Bank, the consolidated Co-operative Banking Group and the wider Co-operative Group throughout these financial statements. Information in relation to the Bank and its subsidiary undertakings is referred to as 'the Bank', information relating to the consolidated Co-operative Banking Group is referred to as 'the Banking Group' and information relating to the wider Co-operative Group is referred to as 'the Group'.

2. Accounting policies

Whilst there have been no changes in accounting policies in the period, certain methods of computation and presentation have been adopted by the Bank in the preparation of its interim financial report 2013 and which the Bank currently expects to adopt in its 2013 financial statements. In particular IFRS 13, 'Fair value measurement', is effective from 1 January 2013 and additional fair value disclosures have been included, but have not had a material impact on the financial statements. Significant additions and changes to underlying methodologies are discussed within the critical judgements and estimates section on pages 40 to 41.

In addition, the 2012 comparatives have been restated for the cashflow statement and the deferred tax asset/liability presentation. Further detail is provided on the cashflow statement and in note 11 respectively.

3. Going concern

a. Introduction

These condensed financial statements are prepared on a going concern basis. The directors have a reasonable expectation that the Bank will have the resources to continue in business for the foreseeable future, subject to the comments below.

The assessment of the going concern basis of preparation has been subject to a thorough process involving analysis and discussion by management, Executive and Board committees and the Board, in line with our governance processes and discussion with the PRA. Analysis covered forecast information for the planning period, 2013–2018, with a particular focus on the period up to and including 2015, as well as the management actions agreed as part of the recapitalisation plan detailed below. The forecasts covering the planning period included a stressed scenario, which the Board considered to be reasonable and appropriate. These forecasts continue to be refined with the aim of identifying further opportunities for improvement in the Bank's operating performance, capital position and liquidity and will be finalised in advance of the implementation of the recapitalisation plan ("the forecasts"). This work is not yet complete. However, based on the work done to date the directors believe, that when this process is complete it will show that, assuming the capital injection of £1.5bn referred to below is successful, the Bank should have capital sufficient to satisfy the PRA's requirements for the planning period, in particular the period up to and including 2015.

Nevertheless, at present, there is material uncertainty around the implementation of the recapitalisation plan, the main cornerstone of which is the Exchange Offer, as outlined below. The execution of the recapitalisation plan, announced on 17 June 2013, is designed to significantly strengthen the capital base through the addition of £1.5bn of Common Equity Tier 1 capital, and provide the foundation from which the reshaping of the business as a core relationship bank can be undertaken.

b. Recapitalisation Plan

Continuing losses in the first half of 2013 have reduced capital to a point where if the Exchange Offer, discussed below, does not take place, the Bank would not remain a going concern for the foreseeable future. Total Basel II capital resources as at 30 June 2013 are £1.5bn (31 December 2012: £2.6bn) with Core Tier 1 capital after regulatory deductions of £0.8bn (31 December 2012: £1.6bn). The Bank's Common Equity Tier 1 stands at 3.2% on a fully phased Common Equity Tier 1 basis, representing a shortfall to the PRA's direction that major UK banks should hold capital resources of at least 7% of their risk weighted assets by December 2013.

In the Bank's 17 June 2013 announcement, the directors acknowledged a £1.5bn Common Equity Tier 1 capital shortfall and announced a plan to address it, which encompasses the following:

i. The Exchange Offer;
ii. A further contribution in 2014 of £0.5bn, underwritten by The Co-operative Group, to the Bank, is expected to be sourced primarily from the sale proceeds of the Insurance businesses. This is contingent on a successful Exchange Offer; and
iii. Refocus of strategy around a core relationship banking proposition.

The short term objectives of the recapitalisation plan focus mainly on the Bank's current capital position. As announced on 17 June 2013, the execution of the plan should strengthen the Bank's Common Equity Tier 1 capital position by £1.5bn.

3. Going concern continued

i. Exchange Offer

The Exchange Offer is forecast to generate £1bn towards the end of 2013 and comprises the following broadly equal components:

a) The Common Equity Tier 1 capital generated from new shares in the Bank as part of an Exchange Offer to be made to holders of the Bank's subordinated capital securities (bondholders) scheduled to take place later this year; and
b) A contribution from The Co-operative Group indirectly financed by a fixed income bond in exchange for new shares.

ii. Further contribution in 2014

A further contribution in 2014 of £0.5bn, underwritten by The Co-operative Group, to the Bank, is expected to be sourced primarily from the sale proceeds of the Insurance businesses. This is contingent on a successful Exchange Offer.

iii. Refocus on core relationship banking proposition

The Co-operative Bank remains a strong brand and continues to maintain a loyal customer base. Moving forward, the strategy is to reshape the business as a core relationship bank providing current accounts, business banking, residential mortgages and savings products to individuals and small businesses with a return to profit in the medium to long term.

Profitability in the core business is expected to improve in the medium to long term largely through a restructure of the business to drive a significant reduction of the cost base.

A key underpin of the reshaping of the business is the reduction in the non-core banking business and assets, which carry the majority of the impairment risk for the Bank currently. This will reduce the risk weighted assets of the Bank, thereby improving its Basel III Common Equity Tier 1 and leverage ratios.

Risks and uncertainties

Risks associated with successful execution of the recapitalisation plan include:

i. Acceptance of the Exchange Offer by the bondholders, without which the Exchange Offer cannot proceed;
ii. Continued willingness and ability of The Co-operative Group to enhance the capital of the Bank through subscription for new shares and by contribution. The ability of The Co-operative Group to contribute is dependent on approval by its banking syndicate;
iii. Timing and amount of sales proceeds from the insurance businesses by The Co-operative Group which may affect its ability to make, or the timing of, the planned contribution to the Bank;
iv. Failure to achieve the targeted cost savings and the timing and quantum of capital improvements from the asset reduction exercise; and
v. Continued constructive engagement with the PRA in relation to the recapitalisation plan; in particular, the Bank is currently updating its forecasts, which formed the basis of the 17 June announcement, and applying appropriate stresses to them. When finalised and approved by the Bank Board, the forecasts and associated stressed scenarios will be shared with the PRA and it is possible the PRA could conclude these forecasts are not acceptable or impose additional systemic or specific capital requirements or other actions.

The Exchange Offer is forecast to increase Common Equity Tier 1 by £1.0bn in 2013 and an additional £0.5bn generated in 2014 from The Co-operative Group's contribution (contingent on a successful Exchange Offer). The Bank's fully phased Common Equity Tier 1 ratio is forecast to move above 7% following the successful completion of the Exchange Offer. These strengthened capital ratios will put the Bank in a better position to withstand future market wide or idiosyncratic stresses.

c. Liquidity

The Bank has continued to maintain an acceptable liquidity position through the period to 30 June 2013, with a liquid asset ratio of 13.2% (31 December 2012: 14.6%). In addition, during the first half of 2013, the Bank proactively managed its liquidity position, maintaining a regulatory liquidity buffer, and has continued to restructure existing exposures to improve the funding profile.

Customer satisfaction remains strong and retail deposits have remained broadly stable since the end of 2012, however the Bank recognises that liquidity risk is particularly elevated until the short term objectives under the recapitalisation plan have been achieved.

d. Conclusion

The directors have concluded that risks set out above in connection with the recapitalisation plan, the cornerstone of which is the Exchange Offer, and their potential consequential effects, represents a material uncertainty which may cast significant doubt upon the Bank's ability to continue as a going concern. The Bank may, therefore, be unable to continue realising its assets and discharging its liabilities in the normal course of business. Nevertheless, after making enquiries and considering the current forecasts, in particular those for the period up to and including 2015, and taking into account the material uncertainty described above, the directors have a reasonable expectation that the Bank will have adequate resources to continue in business over this period. For these reasons, they continue to adopt the going concern basis in preparing these financial statements. This condensed set of financial statements does not include the adjustments that would result if the Bank was unable to continue as a going concern.

Basis of preparation and accounting policies continued
For the period ended 30 June 2013 (unaudited)

4. Critical judgments and estimates
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.

The judgments and assumptions that are considered to be the most important to the portrayal of the Bank's financial condition are those relating to loan impairment provisions, intangible and tangible assets impairment and deferred tax. These critical accounting policies and judgments are described on pages 51 to 53 of the 2012 financial statements.

a. Loan impairment provisions
i. Overview
The loan portfolios are reviewed on a continual basis to assess impairment. In determining whether an impairment provision should be recorded, judgments are made as to whether there is objective evidence that a financial asset or portfolio of financial assets is impaired as a result of loss events that occurred after recognition of the asset and by the balance sheet date.

The calculation of impairment loss includes expectations of levels of future cash flows, and is based on both the likelihood of a loan or advance being written off and the estimated loss on such a write off.

The changes in impairment provisions for Corporate, Optimum and Retail result from a management review of assumptions, with respect to the determination and operational alignment of the probability of possession given default (PPD); treatment of forbearance; length of emergence periods, timing of impairment recognition and the formalising of charge off policy. Where required, management also periodically overlay collective provisions for additional risk parameters upon existing individual and collective impairment models.

Further explanation of the treatment of forborne balances is included in the Bank's risk management disclosures in sections 1.4.1.3, 1.4.1.4 and 1.4.1.5 on pages 10 to 19.

ii. Collective provisions
a) Unsecured and secured residential
The Bank's collective provision for retail personal advances has increased to £217m (31 December 2012: £176.4m). Loans are identified as impaired by taking account of the age of the debt's delinquency, the product type and the regularity of payments made whilst in arrears. The provision is calculated by applying a percentage rate to different categories and ages of impairment debt. The provision rates reflect the likelihood that the debt in that category/age will be written off or charged off at some point in the future. The rates are based on historical experience and current trends, which incorporate the effects of discounting at the customer interest rate and are subject to regular review. The provision is the product of the rate and the balance for the relevant arrears segment.

During 2013 the Bank has strengthened its methodology to treat accounts that are in arrears for over 180 days as charge off. These accounts will be operationally charged off during the second half of 2013. The Bank has also used improved management information which has resulted in a better understanding of the probability of possession given default on its exposure to residential mortgage assets. The status level for PPD has changed to 180 days past due for non-forborne customers and all customers that are on a forbearance plan from the previous state of possession. The material impact of this change was a PPD charge of £53.5m for Optimum. Consequently, the prevailing collective Optimum management overlay covering additional risks now stands at £25.7m (2012: £65.8m). Loss emergence periods have been extended to 12 months.

Further explanation of collective residential loan impairment method is included in the Bank's risk management disclosures in sections 1.4.1.3, 1.4.1.4 and 1.4.1.5 on pages 10 to 19.

The majority of provisions are made against unsecured loans. A key estimate within this provisioning model is the percentage provision rate applied to regular visa payers. A 5% change would change the collective provision by £2.5m.

b) Corporate
The Bank's corporate collective provision has increased to £100.1m (2012: £22.4m), reflecting the continuing difficulties and uncertainties currently being experienced in this sector.

The methodology's key components comprise risk parameters defined by the Bank. It incorporates normal course of business default cases, improving management information to support decisions, improved credit processes where there have been changes to accounting estimates, and progression of the Bank's stated intent to reduce the assets held. It is a broad based approach, covering all live accounts not individually reviewed and where a trigger event could have occurred but has not yet been observed.

During 2013, the Bank has amended its methodology by reclassifying out of collective, into individual, those accounts which are being observed on a watch list. These accounts may not carry any actual impairment, but display performance characteristics which indicate the emergence of such cases. No management overlay has been applied. Loss emergence period has changed from six to nine months. The definition of exposure within the calculation of impairment has been changed to exposure at default in order to exclude an element of balances which have not yet been drawn.

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

Exposure at Default x Probability of Default x Loss Given Default x Loss emergence period of nine months. Both the Probability of Default and Loss Given Default are based on observed default rate in this portfolio.

A key estimate within the corporate collective model is the loss emergence period. A movement of one month in this estimate would change the provision by £14m.

4. Critical judgments and estimates continued

iii. Individual provisions

a) Secured residential

The Bank's provision for credit protection on secured residential has increased. It is split between Retail £9.1m (2012: £8.4m) and Optimum £148.1m (2012: £126.9m) mortgages. Mortgage accounts are identified as impaired and provided for on an individual basis by taking account of the age of the debt's delinquency on a case by case basis.

Due to continuing difficulties and uncertainties currently being experienced in this sector, the Bank classifies all accounts with arrears outstanding for one monthly instalment or more as individually impaired.

During 2013 the Bank has amended its methodology to treat accounts that are in arrears for over 180 days as charge off. These accounts will be operationally charged off during the second half of 2013. The Bank has also used improved management information which has resulted in a better understanding of the probability of possession given default on its exposure to residential mortgage assets. The status level for PPD has changed to 180 days past due for non-forborne customers and all customers that are on a forbearance plan from the previous state of possession. The key management overlay for individual provisions covering such additional risks crystallising currently stands within Optimum at £25.7m (2012: £65.8m) and is being made on a collective basis. Loss emergence periods have been extended from three months to 12 months.

A key assumption in the judgment of estimated future credit losses is our estimate of future HPI movements, the material element of which sits in Optimum. If Optimum's future HPI movements were to differ from expectations by 5%, the impact on the estimate would be £22.1m.

b) Corporate

The Bank's corporate individual provision has increased to £749.1m (2012: £433.6m). It reflects the change in Bank strategy which is now focused on accelerating the reduction of its non-core assets. Impairments are further exacerbated because the Bank has exhausted its associated fair value adjustment for credit risk in 2012, alongside a deterioration of expected future recoveries against impaired loans which are now being managed for exit.

The methodology's key components comprise risk parameters defined by the Bank. It incorporates normal course of business default cases, improving management information to support decisions, improved credit processes where there have been changes to accounting estimates and progression of the Bank's stated intent to reduce the assets held.

Given the continuing and persistent weakness in economic recovery and the increasing levels of risk associated with refinancing and interest payment cover currently being experienced in this sector, a significantly higher number of cases meet the definition of corporate loans identified as being individually impaired.

The increase in cases arises from a change in methodology which allocates any account previously held on a watch list to one which is individually assessed for impairment, irrespective of whether any actual impairment has been made.

Each corporate account is assessed and allocated a 'risk grade' to enable the Bank to monitor the overall quality of its lending assets. Those of lesser quality, where the lending is potentially at risk and loss provisions may be required, are centrally monitored with specific management actions taken at each stage within laid down procedures and specific provisioning criteria. Provisions represent the likely net loss after realisation of any security.

A key estimate within the corporate individual impairment model is collateral valuation. A 10% movement in this estimate would change the provision by £140.8m.

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

b. Intangible and tangible asset impairment

The Bank had a strategic programme of investment around the replacement of the core banking system. This intangible asset, along with other assets bought or developed for the Bank and other Banking Group entities, is held on the balance sheet of CFS Management Services Limited, a sister company of the Bank. These assets undergo an annual impairment review, where the present values of projected future benefits are assessed against the carrying value of the asset plus estimated costs to complete.

The Banking Group has reviewed its IT strategy and has decided not to complete or implement the majority of the replacement of the core banking platform. £136.4m has therefore been written off and recharged to the Bank.

£36.4m of the total balance remains in use and this has been assessed for impairment in light of the current strategic direction and business plans of the Bank. Following that review, the asset has been impaired by £12.0m, making the total write down £148.4m.

The carrying value of the asset at 30 June 2013 is £24.4m and is no longer subject to any specific key sensitivity.

The Bank was also recharged £4m for the impairment of other intangible assets.

c. Deferred tax

The Bank has a deferred tax asset of £nil (2012: £159.6m) and a deferred tax liability balance of £125.4m (2012: £121.4m), making a net deferred tax liability balance of £125.4m (2012: asset of £38.2m). These balances represent the net of reversing taxable temporary differences; expected future tax deductions; carry forward of unused tax losses, and carry forward of unused tax credits.

Recognition of deferred tax assets is only possible to the extent it is probable that future taxable profits will be available against which the unused tax losses and tax credits can be utilised. Any deferred tax asset representing tax losses carried forward can only be offset against future taxable profits in the Bank.

The Bank's forecasts covering the planning period are currently undergoing development as part of the Exchange Offer and the preparation of an equity prospectus. Given these plans continue to evolve, and in light of the uncertainties surrounding the Recapitalisation Plan and its dependency on the Exchange Offer, the directors have decided not to recognise any deferred tax assets relating to unused tax losses as their recoverability is uncertain within the Bank's five year planning horizon. Following the conclusion of the planning exercise, the Bank will reconsider the deferred tax position in light of plans approved by the Board at that time.

Notes to the interim financial report

For the period ended 30 June 2013 (unaudited)
All amounts are stated in £m unless otherwise indicated

1. Segmental information

In the period under review, the Bank was managed through two distinct divisions:

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

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

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

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

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

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.

	Core				Non-core			
Period to 30 June 2013	Retail	CABB core	Treasury/ other	**Total Core**	Corporate non-core	Other non-core	**Total Non-core**	**Total**
Interest margin	203.5	58.4	6.6	**268.5**	(8.9)	(10.6)	**(19.5)**	**249.0**
Non-interest income	65.0	23.8	28.3	**117.1**	1.0	(11.3)	**(10.3)**	**106.8**
Operating income	268.5	82.2	34.9	**385.6**	(7.9)	(21.9)	**(29.8)**	**355.8**
Operating expenses	(242.8)	(43.7)	(16.3)	**(302.8)**	(2.6)	(12.0)	**(14.6)**	**(317.4)**
Impairment losses on loans and advances	(24.8)	(140.0)	(0.7)	**(165.5)**	(294.3)	(36.2)	**(330.5)**	**(496.0)**
Operating (loss)/profit	0.9	(101.5)	17.9	**(82.7)**	(304.8)	(70.1)	**(374.9)**	**(457.6)**
Significant items (notes 2, 3 and 4)								**(244.0)**
Share of post tax profits from joint ventures								**0.3**
Financial Services Compensation Scheme levies								**0.1**
Fair value amortisation								**(8.2)**
Loss before taxation								**(709.4)**
Income tax								**(72.1)**
Loss for the period								**(781.5)**

The Board relies primarily on net interest revenue to assess the revenue 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.

1. Segmental information continued

Reconciliation to statutory income statement	Period to 30 June 2013
Interest margin	
Total interest margin for reportable segments	**249.0**
Fair value amortisation	**(4.2)**
Net interest income	**244.8**
Non-interest income	
Total non-interest income for reportable segments	**106.8**
Fair value amortisation	**0.3**
Non-interest income	**107.1**
Operating expenses	
Total operating expenses for reportable segments	**(317.4)**
Fair value amortisation	**(4.3)**
Operating expenses	**(321.7)**
Fair value amortisation	
Total interest unwind for reportable segments	**(8.2)**
Interest margin unwind	**4.2**
Non-interest income unwind	**(0.3)**
Operating expenses unwind	**4.3**
Fair value amortisation	**–**

	Core				Non-core			
Period to 30 June 2012	Retail	CABB core	Treasury/ other	Total Core	Corporate non-core	Other non-core	Total Non-core	Total
Interest margin	196.6	54.0	7.1	257.7	(11.5)	3.0	(8.5)	249.2
Non-interest income	68.4	32.2	26.0	126.6	1.2	8.1	9.3	135.9
Operating income	265.0	86.2	33.1	384.3	(10.3)	11.1	0.8	385.1
Operating expenses	(214.8)	(38.6)	(13.1)	(266.5)	(2.8)	(12.6)	(15.4)	(281.9)
Impairment losses on loans and advances	(18.2)	(17.5)	(0.5)	(36.2)	(56.9)	(1.5)	(58.4)	(94.6)
Impairment gains on investments	–	–	2.7	2.7	–	–	–	2.7
Operating profit/(loss) before group recharges	32.0	30.1	22.2	84.3	(70.0)	(3.0)	(73.0)	11.3
Group recharges	(8.2)	(1.1)	(0.3)	(9.6)	(0.1)	(0.4)	(0.5)	(10.1)
Operating profit/(loss) after re-allocating group recharges	23.8	29.0	21.9	74.7	(70.1)	(3.4)	(73.5)	1.2
Significant items (notes 3 and 4)								(79.3)
Share of post tax profits from joint ventures								0.6
Financial Services Compensation Scheme levies								(0.8)
Fair value amortisation								19.7
Loss before taxation								(58.6)
Income tax								13.3
Loss for the period								(45.3)

Notes to the interim financial report continued

For the period ended 30 June 2013 (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
Non-interest income	
Total non-interest income for reportable segments	135.9
Fair value amortisation	–
Non-interest income	135.9
Operating expenses	
Total operating expenses for reportable segments (including group recharges)	(292.0)
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	–

30 June 2013	**Retail**	**Corporate core**	**Corporate non-core**	**Optimum**	**Treasury**	**Total**
Segment assets	**17,797.1**	**5,314.0**	**2,267.7**	**7,562.2**	**11,245.2**	**44,186.2**
Unallocated assets						**1,633.9**
Total assets for reportable segments						**45,820.1**
Statutory reclassifications						**708.7**
Consolidated total assets						**46,528.8**
Segment liabilities	**27,969.4**	**6,140.9**	**–**	**–**	**9,791.5**	**43,901.8**
Unallocated liabilities						**724.6**
Total liabilities for reportable segments						**44,626.4**
Statutory reclassifications						**897.2**
Consolidated total liabilities						**45,523.6**

31 December 2012	Retail	Corporate core	Corporate non-core	Optimum	Treasury	Total
Segment assets	17,662.7	5,412.5	2,837.5	7,645.2	13,170.9	46,728.8
Unallocated assets						1,858.5
Total assets for reportable segments						48,587.3
Statutory reclassifications						1,107.5
Consolidated total assets						49,694.8
Segment liabilities	28,141.5	7,582.8	–	–	9,884.7	45,609.0
Unallocated liabilities						863.9
Total liabilities for reportable segments						46,472.9
Statutory reclassifications						1,371.7
Consolidated total liabilities						47,844.6

The 2012 comparatives include balance sheet reclassifications of deferred tax assets and liabilities as shown in note 11.

2. Net interest income

	Period to 30 June 2013			Period to 30 June 2012		
	Before significant items	**Significant items**	**After significant items**	Before significant items	Significant items	After significant items
Interest receivable and similar income						
On financial assets not at fair value through income or expense:						
On loans and advances to customers	**643.1**	**–**	**643.1**	693.6	–	693.6
On loans and advances to banks	**15.4**	**–**	**15.4**	15.7	–	15.7
On investment securities	**75.3**	**–**	**75.3**	77.3	–	77.3
	733.8	**–**	**733.8**	786.6	–	786.6
On financial assets at fair value through income or expense:						
Net expense on financial instruments hedging assets	**(59.4)**	**(10.0)**	**(69.4)**	(63.1)	–	(63.1)
Net interest income on financial instruments not in a hedging relationship	**41.2**	**–**	**41.2**	21.2	–	21.2
	715.6	**(10.0)**	**705.6**	744.7	–	744.7
Interest expense and similar charges						
On financial liabilities not at fair value through income or expense:						
On customer accounts	**255.3**	**–**	**255.3**	268.2	–	268.2
On bank and other deposits	**127.5**	**–**	**127.5**	121.4	–	121.4
On subordinated liabilities	**40.1**	**–**	**40.1**	39.6	–	39.6
On perpetual subordinated debt	**20.8**	**–**	**20.8**	16.8	–	16.8
	443.7	**–**	**443.7**	446.0	–	446.0
On financial liabilities at fair value through income or expense:						
Net interest expense on financial instruments hedging liabilities	**9.5**	**–**	**9.5**	9.2	–	9.2
Net interest expense on financial instruments not in a hedging relationship	**17.6**	**–**	**17.6**	18.3	–	18.3
	470.8	**–**	**470.8**	473.5	–	473.5

The significant item is a provision for potential customer redress of £10.0m (2012: £nil) relating to past sales of interest rate swaps.

Included within interest receivable is £7.2m (2012: £11.0m) relating to profit on sale of investment securities – available for sale.

The 2012 comparatives for interest receivable and similar income and interest expense and similar charges reflect reclassifications within interest categories.

3. Net fee and commission income

	Period to 30 June 2013			Period to 30 June 2012		
	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	**116.0**	**(51.0)**	**65.0**	127.9	(40.0)	87.9
On trust or fiduciary activities that result from holding or investing in assets on behalf of others	**0.2**	**–**	**0.2**	0.1	–	0.1
	116.2	**(51.0)**	**65.2**	128.0	(40.0)	88.0
Fee and commission expense						
On items not at fair value through income or expense	**34.3**	**–**	**34.3**	35.0	–	35.0
On items at fair value through income or expense	**1.9**	**–**	**1.9**	6.2	–	6.2
	36.2	**–**	**36.2**	41.2	–	41.2

The significant item is a provision for potential customer redress of £25.0m (2012: £40.0m) relating to past sales of payment protection insurance, and £26.0m (2012: £nil) for potential customer redress relating to alleged failings in the introduction of third party sales of card and identity protection products.

Notes to the interim financial report continued

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

4. Operating expenses

	Period to 30 June 2013			Period to 30 June 2012		
	Before significant items	**Significant items**	**After significant items**	Before significant items	Significant items	After significant items
Staff costs:						
Wages and salaries	**93.7**	**1.2**	**94.9**	97.3	7.3	104.6
Social security costs	**7.2**	**0.4**	**7.6**	7.5	0.6	8.1
Pension costs – defined benefit plans	**0.1**	**–**	**0.1**	0.1	–	0.1
Pension costs – defined contribution plans	**13.6**	**0.4**	**14.0**	18.5	0.7	19.2
Other staff costs	**16.9**	**4.3**	**21.2**	14.7	8.3	23.0
	131.5	**6.3**	**137.8**	138.1	16.9	155.0
Administrative expenses	**158.7**	**166.8**	**325.5**	128.9	22.4	151.3
Depreciation of property, plant and equipment	**6.0**	**–**	**6.0**	7.7	–	7.7
Amortisation of intangible fixed assets	**3.0**	**–**	**3.0**	3.1	–	3.1
Impairment of intangible fixed assets	**2.0**	**–**	**2.0**	–	–	–
Profit on sale of property, plant and equipment	**–**	**–**	**–**	(0.4)	–	(0.4)
Impairment of property, plant and equipment	**–**	**9.9**	**9.9**	–	–	–
Operating lease rentals	**15.6**	**–**	**15.6**	14.7	–	14.7
Property provisions for liabilities and charges provided in the period (note 10)	**3.6**	**–**	**3.6**	1.0	–	1.0
Property provisions for liabilities and charges released during the period (note 10)	**(0.4)**	**–**	**(0.4)**	(0.3)	–	(0.3)
Other provisions for liabilities and charges provided in the period (note 10)	**–**	**–**	**–**	0.1	–	0.1
Other provisions for liabilities and charges released during the period (note 10)	**(0.1)**	**–**	**(0.1)**	–	–	–
Direct expenses from investment properties that generated rental income in the period	**1.7**	**–**	**1.7**	1.4	–	1.4
Direct expenses from investment properties that did not generate rental income in the period	**0.1**	**–**	**0.1**	–	–	–
	321.7	**183.0**	**504.7**	294.3	39.3	333.6

The significant items relate to £14.7m (2012: £19.3m) of costs incurred on a programme of investment and integration, £10.0m (2012: £20.0m) of costs incurred as a result of the bid for the Lloyds Bank branches, £148.4m (2012: £nil) of recharged costs relating to impairment of intangible fixed assets and £9.9m (2012: £nil) of impairment of property, plant and equipment.

5. Income tax

	Period to 30 June 2013			Period to 30 June 2012		
	Before significant items	**Significant items**	**After significant items**	Before significant items	Significant items	After significant items
Current tax – current year	**(46.4)**	**(56.7)**	**(103.1)**	(9.7)	(17.0)	(26.7)
Current tax – prior year	**–**	**–**	**–**	(13.2)	–	(13.2)
Deferred tax – current year (note 11)	**(4.0)**	**–**	**(4.0)**	30.1	(2.4)	27.7
Write off of prior year deferred tax asset (note 11)	**179.2**	**–**	**179.2**	–	–	–
Deferred tax – prior year (note 11)	**–**	**–**	**–**	(1.1)	–	(1.1)
	128.8	**(56.7)**	**72.1**	6.1	(19.4)	(13.3)

5. Income tax continued

Further information on deferred income tax is presented in note 11. The tax on the Bank's loss before taxation differs from the theoretical amount that would arise using the corporation tax rate in the UK as follows:

	Period to 30 June 2013	Period to 30 June 2012
Loss before taxation	**(709.4)**	(58.6)
Tax calculated at a rate of 23.25% (30 June 2012: 24.5%)	**(164.9)**	(14.4)
Effects of:		
Preference share interest not deductible for tax purposes	**0.7**	0.7
Expenses not deductible for tax purposes	**2.9**	0.3
Depreciation of expenditure not qualifying for capital allowances	**2.9**	0.1
Profits taxed at lower rates	**0.1**	0.2
Non-taxable income	**(0.7)**	(0.6)
Adjustments to tax charge in respect of prior periods	**–**	0.5
Change in rate of deferred tax (note 11)	**0.7**	(0.2)
Losses and temporary differences in period where no deferred tax asset recognised	**51.1**	–
Write off of prior year deferred tax asset (note 11)	**179.2**	–
Other differences	**0.1**	0.1
	72.1	(13.3)

The tax charge for the half year ended 30 June 2013 is higher than expected due to the non-recognition of deferred tax assets in the current period and the write off of the prior year deferred tax asset.

6. Loans and advances to customers

	30 June 2013	31 December 2012
Gross loans and advances	**33,785.5**	33,982.5
Less: allowance for losses	**(1,069.6)**	(643.0)
	32,715.9	33,339.5

Loans and advances to customers include £144.2m (31 December 2012: £153.6m) of financial assets at fair value through income or expense designated at initial recognition to eliminate or significantly reduce a measurement or recognition inconsistency. Of these, £55.1m (31 December 2012: £48.7m) are secured by real estate collateral.

Loans and advances to customers include £10,276.7m (31 December 2012: £10,997.3m) securitised under the Bank's securitisation and covered bond programmes. The Bank remains exposed to substantially all of the risks and rewards of ownership of these assets.

Concentration of exposure

The Bank's exposure is virtually all within the UK. There is a detailed analysis of the concentration of exposure within the risk management disclosures, on pages 14 and 15.

Notes to the interim financial report continued

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

6. Loans and advances to customers continued

Allowance for losses on loans and advances

	Individual retail	Individual corporate	Collective retail	Collective corporate	Total
Period to 30 June 2013					
At the beginning of the period	**10.6**	**433.6**	**176.4**	**22.4**	**643.0**
(Release)/charge against profits	**(3.7)**	**355.9**	**64.2**	**78.0**	**494.4**
Amounts written off	**(3.5)**	**(37.0)**	**(21.8)**	**(0.3)**	**(62.6)**
Unwind of discount allowance	**–**	**(3.5)**	**(1.8)**	**–**	**(5.3)**
Interest charged on impaired loans	**–**	**0.1**	**–**	**–**	**0.1**
At the end of the period	**3.4**	**749.1**	**217.0**	**100.1**	**1,069.6**
Period to 31 December 2012					
At the beginning of the year	9.0	105.1	165.7	12.2	292.0
Charge against profits for the period to 30 June 2012	2.8	68.7	18.1	6.2	95.8
Charge against profits for the period to 31 December 2012	5.7	310.9	25.4	5.4	347.4
Amounts written off	(6.9)	(47.5)	(29.4)	(1.4)	(85.2)
Unwind of discount allowance	–	(3.7)	(3.4)	–	(7.1)
Interest charged on impaired loans	–	0.1	–	–	0.1
At the end of the year	10.6	433.6	176.4	22.4	643.0

The net impairment charge in the income statement is £496.0m (30 June 2012: £94.6m). This includes a net cost of £0.2m (30 June 2012: net gain of £1.2m) relating to amounts recovered by the Bank against amounts previously written off and costs incurred in relation to those recoveries. The recoveries have been made from the mortgagors and from other parties involved in the origination or acquisition of the mortgages.

The impairment charge also includes a provision of £1.4m (30 June 2012: £nil) made against fair value adjustments for hedged risk during the year (as shown in the fair value adjustments for hedged risk tables).

As discussed in the Business and Financial Review, there are a number of reasons for the increase in the overall impairment charge. Firstly, in the first half of 2013, the amount of assets designated as non-core has increased, the Bank has continued to review its loan book on a case-by-case basis and there has been a change in the work out approach on a significant number of assets. Secondly, there have been further improvements to our credit risk management approach, improving the data on which impairment assessments are made and resulting in increased impairments. This has taken into account the continuing impacts of the corporate real estate environment, prolonged real wage deflation and the lower apparent crystallisation of losses while base rate continues to be low. Impairments which occur in the ordinary course of the business due to changes in customer circumstances have also been incurred in both the core and non-core business.

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.

	30 June 2013	31 December 2012
Gross fair value adjustments for hedged risk	**255.4**	391.2
Less: impairment provision	**(38.4)**	(37.0)
	217.0	354.2

Impairment provision on fair value adjustments for hedged risk

	30 June 2013	31 December 2012
At the beginning of the period	**37.0**	–
Charge against profits for the period to 30 June 2013 (30 June 2012)	**1.4**	–
Charge against profits for the period to 31 December 2012	**–**	37.0
At the end of the period	**38.4**	37.0

7. Investment securities

	30 June 2013	31 December 2012
Loans and receivables		
Unlisted	**30.6**	295.0
	30.6	295.0
Less: allowance for losses	**–**	–
	30.6	295.0
Included in cash and cash equivalents	**–**	–

7. Investment securities continued

Impairment analysis of investment securities – loans and receivables

	30 June 2013	31 December 2012
At the beginning of the period	–	2.7
Release for the period to 30 June 2013 (30 June 2012)	–	(2.7)
Release for the period to 31 December 2012	–	–
Release for the period	–	(2.7)
At the end of the period	–	–

Investment securities – loans and receivables have decreased during the period due to sales and maturities. Included within other operating income is £40.4m (30 June 2012: £21.1m) of profit relating to sales of these investments.

	30 June 2013	31 December 2012
Available for sale		
Listed	**3,209.4**	3,552.3
Unlisted	**240.3**	276.1
	3,449.7	3,828.4
Less: allowance for losses	**(20.0)**	(39.0)
	3,429.7	3,789.4
Included in cash and cash equivalents	**125.0**	70.0

Impairment analysis of investment securities – available for sale

	30 June 2013	31 December 2012
At the beginning of the period	**39.0**	42.5
Release for the period to 30 June 2013 (30 June 2012)	–	–
Release for the period to 31 December 2012	–	(2.7)
Release for the period	–	(2.7)
Utilised during the period	**(19.0)**	–
Exchange adjustments	–	(0.8)
At the end of the period	**20.0**	**39.0**

Investment securities – available for sale have decreased during the period due to sales and maturities. The £19.0m utilised during the period relates to a provision on an investment that was sold in the period.

	30 June 2013	31 December 2012
Fair value through income or expense		
Listed	**1,622.3**	1,845.2
	1,622.3	1,845.2
Less: allowance for losses	–	–
	1,622.3	1,845.2
Included in cash and cash equivalents	–	–

	30 June 2013	31 December 2012
Held for trading		
Listed	–	960.2
	–	960.2
Less: allowance for losses	–	–
	–	960.2
Included in cash and cash equivalents	–	–

Investment securities – held for trading have decreased during the period due to sales and maturities and reclassifications to investment securities – fair value through income or expense.

Notes to the interim financial report continued

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

7. Investment securities continued

Analysis of investment securities by issuer

	30 June 2013	31 December 2012
Investment securities issued by public bodies:		
Government securities	**2,022.4**	2,184.9
Other public sector securities	**1,498.7**	2,208.5
	3,521.1	4,393.4
Investment securities issued by other issuers:		
Bank and building society certificates of deposits	**240.3**	225.5
Other debt securities:		
Other floating rate notes	**1,290.6**	1,975.9
Mortgage backed securities	**30.6**	295.0
	1,321.2	2,270.9
	5,082.6	6,889.8

Other floating rate notes (FRNs) relate to sterling denominated FRNs with maturities ranging from nine months to five years from the balance sheet date.

8. Customer accounts

	30 June 2013	31 December 2012
Customer accounts	**34,166.3**	35,884.4

The maturity profile of customer accounts is shown within the risk management section on pages 24 and 25.

9. Customer accounts – capital bonds

	30 June 2013	31 December 2012
Retail	**756.0**	888.1

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

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

The fair values for the capital bonds are obtained on a monthly basis from the swap counterparties. These external valuations are reviewed independently using valuation software to ensure the fair values are priced on a consistent basis.

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

The maximum amount the Bank would contractually be required to pay at maturity for all the capital bonds is £756.0m (31 December 2012: £888.7m).

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 £9.4m (30 June 2012: £11.0m). 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 £0.3m (30 June 2012: £0.2m).

10. Provisions for liabilities and charges

Period to 30 June 2013	Property	FSCS levies	PPI	Other	Total
At the beginning of the period	**7.3**	**38.6**	**116.0**	**0.8**	**162.7**
Income statement movements:					
Provided in the period – net interest income	**–**	**–**	**–**	**13.7**	**13.7**
Provided in the period – operating expense	**3.6**	**0.1**	**–**	**–**	**3.7**
Provided in the period – net fee and commission income	**–**	**–**	**25.0**	**26.0**	**51.0**
Released in the period – operating expense	**(0.4)**	**(0.2)**	**–**	**(0.1)**	**(0.7)**
Utilised during the period	**(0.3)**	**(0.1)**	**(38.9)**	**(0.1)**	**(39.4)**
At the end of the period	**10.2**	**38.4**	**102.1**	**40.3**	**191.0**
Provisions were analysed as follows:					
Amounts falling due within one year	**2.5**	**25.6**	**78.6**	**27.3**	**134.0**
Amounts falling due after one year	**7.7**	**12.8**	**23.5**	**13.0**	**57.0**
	10.2	**38.4**	**102.1**	**40.3**	**191.0**

10. Provisions for liabilities and charges continued

Period to 31 December 2012	Property	FSCS levies	PPI	Other	Total
At the beginning of the year	6.9	25.0	61.7	8.4	102.0
Income statement movements:					
Provided in the period to 30 June 2012 – operating expense	1.0	0.8	–	0.1	1.9
Provided in the period to 31 December 2012 – operating expense	(0.2)	24.0	–	0.4	24.2
Provided in the period to 30 June 2012 – fee and commission income	–	–	40.0	–	40.0
Provided in the period to 31 December 2012 – fee and commission income	–	–	109.7	–	109.7
Released in the period to 30 June 2012 – operating expense	(0.3)	–	–	–	(0.3)
Released in the period to 31 December 2012 – operating expense	–	–	–	(0.6)	(0.6)
Utilised during the year	(0.1)	(11.2)	(95.4)	(7.5)	(114.2)
At the end of the year	7.3	38.6	116.0	0.8	162.7
Provisions were analysed as follows:					
Amounts falling due within one year	3.2	24.9	77.2	0.8	106.1
Amounts falling due after one year	4.1	13.7	38.8	–	56.6
	7.3	38.6	116.0	0.8	162.7

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 3.8%.

Financial Services Compensation Scheme (FSCS) levies

The FSCS has provided compensation to customers of financial institutions following the collapse of deposit takers in 2008. The compensation paid out to consumers is currently funded through loans from HM Treasury. The Bank will be liable to pay a proportion of the outstanding borrowings that the FSCS has borrowed from HM Treasury. Additionally the Bank is obliged to pay its share of management expenses and compensation based upon the Bank's proportion of the total market protected deposits at 31 December of each year.

The ultimate FSCS levy to the industry as a result of the 2008 collapses cannot currently be estimated reliably as it is dependent on other factors that may affect amounts payable and the timing of amounts payable, including changes in interest rates, potential recoveries of assets by the FSCS and the level of protected deposits.

The Bank has provided £38.4m (31 December 2012: £38.6m) for its share of the levies raised by the FSCS including the interest on the loan from HM Treasury in respect of the levy years to 31 March 2014. The provision includes £26.8m in respect of the interest levy (31 December 2012: £27.7m). The Bank's interest levy provision calculation includes estimates of the total FSCS levy in each levy year and estimates of the Bank's market participation in each levy year. During 2012, the FSCS indicated that it expected to raise a capital levy to cover the estimated shortfall in the amounts recovered from the failed banks to repay HM Treasury loans made to the FSCS. The Bank has provided £11.6m (31 December 2012: £10.9m) in respect of its share of this levy.

PPI

Provisions have been made in respect of potential customer compensation claims relating to past sales of PPI. Claims are investigated on an individual basis and, where appropriate, compensation payments are made. For a number of years, the Bank, along with many other financial services providers, sold PPI alongside mortgage and non-mortgage credit products and the Bank continues to service its existing PPI business. The Bank stopped selling non-mortgage PPI in January 2009 and stopped selling mortgage PPI in March 2012.

The FSA issued a policy statement in August 2010 which amended the 'Disputes Resolution: Complaints' section of its Handbook, setting out new rules for handling complaints, including complaints of PPI misselling. 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 missold policies where no complaint has been made. An additional provision of £25.0m (30 June 2012: £40.0m) has been recognised in the period (note 3), in respect of the total expected cost to the Bank of carrying out this work and paying compensation, making total provisions raised of £269.0m (31 December 2012: £244.0m).

Other provisions

Other provisions include the estimated costs of other customer redress issues, including alleged failings in the introduction of third party sales of card and identity protection products, interest rate swap misselling and the charging of interest in a manner other than that shown in the customer illustration.

Notes to the interim financial report continued

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

11. Deferred tax

Deferred taxes are calculated on all temporary differences under the liability method using an effective tax rate of 23% (31 December 2012: 23%).

The movements on the deferred tax accounts are as follows:

	30 June 2013		31 December 2012	
	Deferred tax asset	**Deferred tax liability**	Deferred tax asset	Deferred tax liability
Deferred tax at the beginning of the period	**159.6**	**(121.4)**	130.2	(103.8)
Transfer between asset/liability	**19.6**	**(19.6)**	–	–
Income statement (charge)/credit	**(179.2)**	**4.0**	15.1	(6.3)
Prior year adjustments	**–**	**–**	9.3	(2.4)
Charged to equity:				
Fair value unwinds	**–**	**–**	8.9	(8.9)
Cashflow hedges	**–**	**11.6**	3.5	–
Available for sale	**–**	**–**	(7.4)	–
Deferred tax at the end of the period	**–**	**(125.4)**	159.6	(121.4)

The 2012 balance sheet comparatives have been restated to reflect that certain deferred tax liabilities cannot be offset against the deferred tax assets.

	30 June 2013		31 December 2012	
	Deferred tax asset	**Deferred tax liability**	Deferred tax asset	Deferred tax liability
Net deferred tax comprises:				
Capital allowances on fixed assets	**–**	**–**	33.4	–
Capital allowances on assets leased to customers	**–**	**–**	1.3	–
Pensions and other post-retirement benefits	**–**	**–**	0.9	–
Fair value adjustments – The Co-operative Bank plc	**–**	**–**	65.6	–
Other temporary differences	**–**	**–**	26.1	–
Tax losses carried forward	**–**	**–**	51.9	–
	–	**–**	179.2	–
Cashflow hedges	**–**	**(7.4)**	(18.9)	–
Unrealised appreciation on investments	**–**	**(0.6)**	(0.7)	–
Fair value adjustments – The Co-operative Bank subsidiaries	**–**	**(117.4)**	–	(121.4)
	–	**(125.4)**	159.6	(121.4)

Other temporary differences for the Bank of £nil (31 December 2012: £26.1m) include deferred tax assets/liabilities as a result of loss provisions on mortgage assets held by Special Purpose Entities (SPEs), taxation of SPEs under the securitisation regime and spreading of the tax effect of IFRS transitional adjustments.

The deferred tax (credit)/charge in the income statement comprises:

	Period to 30 June 2013	Period to 30 June 2012
Capital allowances on fixed assets	**–**	1.5
Capital allowances on assets leased to customers	**–**	(0.3)
Fair value adjustments	**(4.0)**	24.8
Other temporary differences	**–**	3.0
Tax losses carried forward	**–**	(2.4)
Write off of prior year deferred tax asset	**179.2**	–
	175.2	26.6

Deferred tax assets expected to be recoverable after one year are £nil (30 June 2012: £134.3m, 31 December 2012: £179.2m). Prior year deferred tax assets of £179.2m (30 June 2012: £nil, 31 December 2012: £nil) have been written off and deferred tax assets of £51.4m (30 June 2012: £nil, 31 December 2012: £nil) in respect of the current period have not been recognised, where doubt exists over the availability of future taxable profits. Therefore assets in connection with unutilised tax losses and credits not recognised at 30 June 2013 total £230.6m (31 December 2012: £nil).

Reductions in the UK corporation tax rate from 26% to 24% (effective from 1 April 2012) and to 23% (effective from 1 April 2013) were substantively enacted on 26 March 2012 and 3 July 2012 respectively. Further reductions to 21% (effective from 1 April 2014) and 20% (effective from 1 April 2015) were substantively enacted on 2 July 2013. This will reduce the Company's future current tax charge accordingly. The deferred tax assets and liabilities at 30 June 2013 have been calculated based on the rate of 23% substantively enacted at the balance sheet date. It has not yet been possible to quantify the full anticipated effect of the announced further 3% rate reduction, although this will further reduce the Bank's deferred tax balance accordingly.

11. Deferred tax continued

The Bank's plans are currently undergoing development as part of the Exchange Offer and the preparation of an equity prospectus. Given these plans continue to evolve, and in light of the uncertainties surrounding the Recapitalisation Plan and particularly its dependency on the Exchange Offer, the directors have decided not to recognise any deferred tax assets relating to unused tax losses as their recoverability is uncertain within the Bank's five year planning horizon. Following the conclusion of the planning exercise, the Bank will reconsider the deferred tax position in light of plans approved by the Board at that time.

12. Contingent liabilities and commitments

Given the high level of scrutiny regarding financial institutions' treatment of customers and business conduct from regulatory bodies, the media and politicians, there is a risk that certain aspects of the Bank's current or historic business, including, inter alia, mortgages and relationship banking, may be determined by the Financial Conduct Authority (FCA) and other regulatory bodies or the courts as not being conducted in accordance with applicable laws or regulations, or fair and reasonable treatment in their opinion.

13. Related party transactions

Related party transactions and transactions with key management personnel in the half year to 30 June 2013 are similar in nature to those for the year ended 31 December 2012. Details of the Bank's related party transactions and transactions with key management personnel for the year ended 31 December 2012 can be found in the 2012 financial statements.

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

14. Risk analysis

The Bank's principal risks relating to financial instruments are considered to be consistent with those reported in the 2012 financial statements. Further analysis is provided in the risk management section of this report.

15. Fair values of financial assets and liabilities

The fair values in this note are stated at a specific date and may be significantly different from the amounts which will actually be paid on the maturity or settlement dates of the instruments. As a wide range of valuation techniques are available, it may be inappropriate to compare this fair value information to that of independent market or other financial institutions. Assumptions changes and different valuation methodologies can have significant impacts, particularly on fair values which are based on unobservable inputs.

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 2013							
Assets							
Cash and balances at central banks	–	–	5,402.1	–	–	–	5,402.1
Loans and advances to banks	–	–	1,737.5	–	–	–	1,737.5
Loans and advances to customers	–	144.2	32,571.7	–	–	–	32,715.9
Fair value adjustments for hedged risk	–	–	217.0	–	–	–	217.0
Investment securities	–	1,622.3	30.6	3,429.7	–	–	5,082.6
Derivative financial instruments	–	728.6	–	–	–	75.7	804.3
Equity shares	–	–	–	5.7	–	–	5.7
Amounts owed by other Co-operative Group undertakings	–	–	0.5	–	–	–	0.5
Total financial assets	–	2,495.1	39,959.4	3,435.4	–	75.7	45,965.6
Non-financial assets							563.2
Total assets							46,528.8
Liabilities							
Deposits by banks	–	–	–	–	3,517.8	–	3,517.8
Customer accounts	–	–	–	–	34,166.3	–	34,166.3
Customer accounts – capital bonds	–	756.0	–	–	–	–	756.0
Debt securities in issue	–	–	–	–	4,610.0	–	4,610.0
Derivative financial instruments	–	619.0	–	–	–	43.7	662.7
Other borrowed funds	–	–	–	–	1,248.1	–	1,248.1
Amounts owed to other Co-operative Group undertakings	–	–	–	–	123.9	–	123.9
Total financial liabilities	–	1,375.0	–	–	43,666.1	43.7	45,084.8
Non-financial liabilities							438.8
Total liabilities							45,523.6
Total equity							1,005.2
Total liabilities and equity							46,528.8

Notes to the interim financial report continued
For the period ended 30 June 2013 (unaudited)
All amounts are stated in £m unless otherwise indicated

15. 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 2012							
Assets							
Cash and balances at central banks	–	–	5,433.0	–	–	–	5,433.0
Loans and advances to banks	–	–	1,904.1	–	–	–	1,904.1
Loans and advances to customers	–	153.6	33,185.9	–	–	–	33,339.5
Fair value adjustments for hedged risk	–	–	354.2	–	–	–	354.2
Investment securities	960.2	1,845.2	295.0	3,789.4	–	–	6,889.8
Derivative financial instruments	197.3	501.2	–	–	–	120.3	818.8
Equity shares	–	–	–	5.7	–	–	5.7
Amounts owed by other Co-operative Group undertakings	–	–	256.4	–	–	–	256.4
Total financial assets	1,157.5	2,500.0	41,428.6	3,795.1	–	120.3	49,001.5
Non-financial assets							693.3
Total assets							49,694.8
Liabilities							
Deposits by banks	–	–	–	–	3,612.0	–	3,612.0
Customer accounts	–	–	–	–	35,884.4	–	35,884.4
Customer accounts – capital bonds	–	888.1	–	–	–	–	888.1
Debt securities in issue	–	–	–	–	4,713.7	–	4,713.7
Derivative financial instruments	168.3	747.0	–	–	–	52.3	967.6
Other borrowed funds	–	–	–	–	1,258.6	–	1,258.6
Amounts owed to other Co-operative Group undertakings	–	–	–	–	112.0	–	112.0
Total financial liabilities	168.3	1,635.1	–	–	45,580.7	52.3	47,436.4
Non-financial liabilities							408.2
Total liabilities							47,844.6
Total equity							1,850.2
Total liabilities and equity							49,694.8

The 2012 comparatives include balance sheet reclassifications of deferred tax assets and liabilities as shown in note 11.

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.

Loans and advances to banks and investment securities
Loans and advances to banks and investment securities underpin the Bank's liquidity requirements and generate incremental net interest and trading income. Held for trading investments were traded solely for short term profit.

Deposits by banks and debt securities in issue
The Bank issues medium term notes within an established euro medium term note programme and also issues certificates of deposit and commercial paper as part of its normal treasury activities. These sources of funds, alongside other borrowed funds, are invested in marketable investment grade debt securities and short term wholesale market placements and are used to fund customer loans.

Other borrowed funds
The Bank utilises a broad spread of capital funds. In addition to ordinary share capital and retained earnings, when appropriate, the Bank issues preference shares and perpetual and fixed term subordinated notes.

15. 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, currency swaps and forward currency transactions. Terms and conditions are determined by using standard industry documentation. Derivatives are subject to the same market and credit risk control procedures as are applied to other wholesale market instruments and are aggregated with other exposures to monitor total counterparty exposure which is managed within approved limits for each counterparty.

Foreign exchange

The Bank undertakes foreign exchange dealing to facilitate customer requirements and to generate incremental income from short term trading in the major currencies. Structured risk and trading related risk are managed formally within position limits which are set by the Assets and Liabilities Committee, to which authority is delegated by the Board.

b. Valuation of financial instruments carried at fair value

The following tables analyse financial assets and liabilities carried at fair value by the three level fair value hierarchy defined as follows:

- Level 1 – Quoted market prices in active markets
- Level 2 – Valuation techniques using observable inputs
- Level 3 – Valuation techniques using unobservable inputs

	Fair value at end of the reporting period using:			
30 June 2013	**Level 1**	**Level 2**	**Level 3**	**Total**
Non-derivative financial assets				
Held for trading:				
Investment securities	–	–	–	–
Designated at fair value:				
Loans and advances to customers	–	**134.0**	**10.2**	**144.2**
Investment securities	**1,622.3**	–	–	**1,622.3**
Available for sale financial assets:				
Investment securities	**3,189.5**	**240.2**	–	**3,429.7**
Equity shares	–	–	**5.7**	**5.7**
Derivative financial instruments	–	**774.5**	**29.8**	**804.3**
Total assets carried at fair value	**4,811.8**	**1,148.7**	**45.7**	**6,006.2**
Non-derivative financial liabilities				
Designated at fair value:				
Customer accounts – capital bonds	–	**756.0**	–	**756.0**
Derivative financial instruments	–	**635.9**	**26.8**	**662.7**
Total liabilities carried at fair value	–	**1,391.9**	**26.8**	**1,418.7**

Notes to the interim financial report continued

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

15. Fair values of financial assets and liabilities continued

31 December 2012	Fair value at end of the reporting period using: Level 1	Level 2	Level 3	Total
Non-derivative financial assets				
Held for trading:				
Investment securities	960.2	–	–	960.2
Designated at fair value:				
Loans and advances to customers	–	142.4	11.2	153.6
Investment securities	1,845.2	–	–	1,845.2
Available for sale financial assets:				
Investment securities	2,184.9	1,604.5	–	3,789.4
Equity shares	–	–	5.7	5.7
Derivative financial instruments	–	783.4	35.4	818.8
Total assets carried at fair value	4,990.3	2,530.3	52.3	7,572.9
Non-derivative financial liabilities				
Designated at fair value:				
Customer accounts – capital bonds	–	888.1	–	888.1
Derivative financial instruments	–	955.2	12.4	967.6
Total liabilities carried at fair value	–	1,843.3	12.4	1,855.7

The carrying values of financial instruments measured at fair value are determined in compliance with the accounting policies on pages 40 to 50 of the 2012 financial statements and according to the following hierarchy:

Level 1 – Quoted market prices in active markets

Financial instruments with quoted prices for identical instruments in active markets. The best evidence of fair value is a quoted market price in an actively traded market.

Level 2 – Valuation techniques using observable inputs

Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

The valuation techniques used to value these instruments employ only observable market data and relate to the following assets and liabilities:

Loans and advances to customers

Loans and advances to customers include corporate loans of £134.0m (31 December 2012: £142.4m) which are fair valued through income or expense using observable inputs. Loans held at fair value are valued at the sum of all future expected cash flows, discounted using a yield curve based on observable market inputs.

Investment securities – available for sale

Fair value is based on available market prices. Where this information is not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics.

Derivative financial instruments

OTC (ie non-exchange traded) derivatives are valued using valuation models which are based on observable market data. Valuation models calculate the present value of expected future cash flows, based upon 'no arbitrage' principles. The Bank enters into vanilla foreign exchange and interest rate swap derivatives, for which modelling techniques are standard across the industry. Examples of inputs that are generally observable include foreign exchange spot and forward rates, and benchmark interest rate curves.

Customer accounts – capital bonds

The estimated fair value of customer accounts – capital bonds is based on independent third party valuations using forecast future movements in the appropriate indices.

Level 3 – Valuation techniques using unobservable inputs

This is used for financial instruments valued using models where one or more significant inputs are not observable.

15. Fair values of financial assets and liabilities continued

The small proportion of financial assets valued based on significant unobservable inputs are analysed as follows:

Loans and advances to customers

Loans and advances to customers include 25 year fixed rate mortgages of £10.2m (31 December 2012: £11.2m) which are fair valued through income or expense using unobservable inputs. 25 year fixed rate mortgages are valued using future interest cash flows at the fixed customer rate and estimated schedule of customer repayments. Cash flows are discounted at a credit adjusted discount rate; the credit adjustment is based on the average margin of new long dated (five years or greater) fixed rate business written in the last six months, and subject to quarterly review. The eventual timing of future cash flows may be different from that forecast due to unpredictable customer behaviour, particularly on a 25 year product. The valuation methodology takes account of credit risk. A reasonable change in the assumptions would not result in any material change in the valuation.

Equity shares

Equity shares primarily relate to investments held in Vocalink Limited which are unquoted shares. The valuation of these shares is based on the Bank's percentage shareholding and the net asset value of the company according to its most recently published financial statements.

Derivative financial instruments

Derivative financial instruments in the form of interest rate swaps have been entered into between the Bank and its subsidiaries, and external counterparties.

The purpose of the swaps is to convert the fixed and base rate linked revenue receipts of the pool of mortgage assets to the same LIBOR linked basis as the intercompany loan. Under this swap arrangement the Bank's subsidiaries pay to the swap counterparty, the monthly mortgage revenue receipts of the pool of assets and receives from the swap counterparty LIBOR plus a contractual spread on the same notional balance; the spread being sufficient to cover the intercompany loan and any expenses. The Bank has a 'back to back' swap that is the mirror image of the subsidiaries' swaps.

The swaps are valued based on an assumed amortisation profile of the pool of assets to the bond maturity date (assuming some annual prepayment), an assumed profile of customer receipts over this period, and LIBOR prediction using forward rates. Swap cash flows are discounted to present value using mid-yield curve zero coupon rates, ie no adjustment is made for credit losses, nor for transaction or any other costs.

Movements in fair values of instruments with significant unobservable inputs (level 3) were:

	Fair value at the beginning of the period	Purchases and transfers in	Sales and transfers out	Income or expense including impairment	Fair value at the end of the period
30 June 2013					
Loans and advances to customers	**11.2**	**(0.6)**	**–**	**(0.4)**	**10.2**
Derivative assets	**35.4**	**9.4**	**–**	**(15.0)**	**29.8**
Equity shares	**5.7**	**–**	**–**	**–**	**5.7**
Derivative liabilities	**(12.4)**	**(16.1)**	**–**	**1.7**	**(26.8)**
	39.9	**(7.3)**	**–**	**(13.7)**	**18.9**
31 December 2012					
Loans and advances to customers	12.4	–	–	(1.2)	11.2
Derivative assets	25.4	–	–	10.0	35.4
Equity shares	5.7	–	–	–	5.7
Derivative liabilities	(13.3)	–	–	0.9	(12.4)
	30.2	–	–	9.7	39.9

Notes to the interim financial report continued

For the period ended 30 June 2013 (unaudited)

All amounts are stated in £m unless otherwise indicated

15. Fair values of financial assets and liabilities continued

The following table 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 2013		31 December 2012	
	Carrying value	**Fair value**	Carrying value	Fair value
Financial assets				
Loans and receivables:				
Loans and advances to banks	**1,737.5**	**1.737.5**	1,904.1	1,904.1
Loans and advances to customers	**32,571.7**	**28,999.9**	33,185.9	33,222.7
Fair value adjustments for hedged risk	**217.0**	**217.0**	354.2	354.2
Investment securities	**30.6**	**20.2**	295.0	297.9
Financial liabilities				
Financial liabilities at amortised cost:				
Deposits by banks	**3,517.8**	**3,519.2**	3,612.0	3,614.4
Customer accounts	**34,166.3**	**34,153.5**	35,884.4	36,108.4
Debt securities in issue	**4,610.0**	**5,141.8**	4,713.7	5,433.5
Other borrowed funds	**1,248.1**	**851.2**	1,258.6	1,394.1

In 2013, the Bank reviewed and improved the methods used to calculate the fair values. The 2012 comparatives (with the exception of loans and advances to customers, fair value adjustment for hedged risk and customer accounts) have been re-presented accordingly to reflect these changes in methods.

Key considerations in the calculation of fair values for loans and receivables and financial liabilities at amortised cost are as follows:

Loans and advances to banks/deposits by banks

Loans and advances to banks include interbank placements and items in the course of collection.

The amortised cost value of all loans and advances to banks are deemed to be a close approximation of their fair value (there is a 0.01% difference) due to their short maturity. The estimated fair value of fixed interest bearing deposits is based on discounted cash flows using prevailing money market interest rates for debts with similar credit risk and remaining maturity.

Loans and advances to customers

The fair value of loans and advances to customers is calculated by segmenting the overall balance in to Retail, Optimum and Corporate.

a. Retail

Fixed rate loans and advances to customers are revalued to fair value based on future interest cash flows (at funding rates) and principal cash flows discounted using an appropriate market rate. Forecast principal repayments are based on redemption at the earlier of maturity or repricing date with some overlay for historical behavioural experience where relevant. The eventual timing of future cash flows may be different from the forecast due to unpredictable customer behaviour. It is assumed there is no fair value adjustment required in respect of interest rate movement on variable rate assets.

b. Optimum

Fair values have been calculated using an origination spread income approach. Under this approach, value is measured by determining discounted expected cash flows from the portfolio and applying an origination spread which reflects the difference between current market rates for products with similar characteristics and risk profiles and the actual rates the portfolio is generating.

c. Corporate

As part of the implementation of the Bank's exit strategy, certain assets have either already been sold after the half year end or plans to sell are well advanced. For these assets, the fair value can therefore be determined from the actual sale price achieved or expected to be received.

For other Corporate assets an expected cashflow income approach has been used. Under this approach, value is measured by determining expected cash flows from the portfolio and then considering credit costs, funding costs and tax to derive equity cash flows which are discounted at an appropriate blended cost of capital.

The fair value of loans and advances to customers is significantly lower than the carrying value as a result of changes to the fair values of the Corporate and Optimum portfolios, which reflect the improved methodology referenced above and enhanced market price information for the Corporate book. The 2012 comparatives for loans and advances to customers have not been re-presented to reflect the change in methods referred to above.

15. Fair values of financial assets and liabilities continued

Investment securities

Fair value is based on available market prices. Where this information is not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics.

Customer accounts

The estimated fair value of deposits with no stated maturity, which includes non-interest bearing deposits, is the amount repayable on demand. The estimated fair value of fixed interest bearing deposits and other borrowings without quoted market prices is based on future interest cash flows (at funding rates) and principal cash flows, discounted using an appropriate market rate.

Debt securities in issue and other borrowed funds

The aggregate fair values are calculated based on quoted market prices. For those notes where quoted market prices are not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics.

The fair value of debt securities in issue is significantly above the carrying value as a result of the carrying value being net of merger fair value adjustments. The fair value of other borrowed funds is significantly less than the carrying value as quoted market prices of issued debt capital have fallen.

16. Post balance sheet events

Since the period end, the Bank has encumbered an additional £2.2bn of assets for the purpose of strengthening the liquidity position of the Bank, raising and retaining funding balances of £2.9bn.

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

Niall Booker
Chief Executive

28 August 2013

The Co-operative Bank plc Board of Directors:

Executive directors:

Niall Booker	Chief Executive
Rodney Bulmer	

Non-Executive Directors:

Richard Pym	Chair
Duncan Bowdler	
Richard Coates	
Anne Gunther	
Richard Hardie	
Peter Harvey	
Merlyn Lowther	
Robert Newton	
Bennett Reid	
Leonard Wardle	

Notice to shareholders

As at the date of this report, the Board has not yet resolved whether the Bank will, or is permitted to, pay the half yearly dividend (ordinarily payable on 30 November) to Preference Shareholders. Further to the announcement of the recapitalisation plan on 17 June 2013, any decision to pay a dividend will be subject to Regulator approval. Notice will be given to Preference Shareholders once such decision has been taken by the Board.

Registered Office:
1 Balloon Street
Manchester
M60 4EP

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

28 August 2013

Registrar:
Computershare Investor Services PLC
P.O. Box 82
The Pavilions
Bridgwater Road
Bristol
BS99 7NH

Design by Radley Yeldar

Printed at APS Group, an ISO 14001 and FSC certified company.

We like our communications to have an impact on you – but not on the environment. This document is printed using vegetable oil-based inks on paper which is part recycled, Forest Stewardship Council certified and made in an elemental chlorine-free process. I'm not finished – please recycle me!

The Co-operative Bank plc
Registered office: 1 Balloon Street
Manchester M60 4EP
Registered number: 990937
www.co-operativebank.co.uk