



The Co-operative Group
Annual Report 2012

The co-operative
Here for you for life

Our 2012 Headlines

Group financial performance

Gross sales:

£13.5bn

Underlying operating profit:

£54m

Over **£100m** paid out to and on behalf of members

£528m

capital investment

Food

Underlying operating profit:

£288m

(down £30m)

New food stores:

83

£22m

invested in Avonmouth distribution centre

Banking Group

Underlying operating profit/loss:

Core business:
£120m profit (down £53m)

Non-core business:
£377m loss (down £380m)

Agreed **Heads of Terms** with Lloyds Banking Group for purchase of Verde business, including

632 branches

8.2%

increase in **primary account** openings

Specialist Businesses

Underlying operating profit:

£107m

(up £8m)

UK's first major consumer brand to be awarded an **ABS licence**

5

hospital outpatient dispensaries opened

Here for you for life

A **co-operative** is an autonomous association of persons united voluntarily to meet their common **economic, social, and cultural needs** and aspirations through a **jointly-owned and democratically-controlled** enterprise.

They are based on the values of **self-help, self-responsibility, democracy, equality, equity and solidarity**. In the tradition of their founders, co-operative members believe in the **ethical** values of **honesty, openness, social responsibility and caring for others**.

— International Co-operative Alliance

Inside this year's report:

Overview	Performance	Governance	Financials
2 About The Co-operative Group	12 Financial review	30 Board of Directors	54 Consolidated income statement
4 Range of interests	16 Food	32 Management Executive	55 Consolidated statement of comprehensive income
6 Chair's overview	18 Banking Group	33 Corporate Governance report including the Remuneration report	56 Consolidated balance sheet
8 Chief Executive's overview	20 Specialist Businesses	53 Independent auditor's report	58 Consolidated statement of changes in equity
10 Group vision and performance	22 Estates		60 Consolidated statement of cash flows
	23 Our people		61 General accounting policies
	24 Social goals		64 Notes to the financial statements
	26 Principal risks and uncertainties		185 Analysis of profits from regional business activities

Directors' Report

This is the Directors' Report for The Co-operative Group (the 'Group') for the 53 weeks ending 5 January 2013. It explains in detail how we have performed during 2012 and sets out a fair review of the business which includes: a balanced and comprehensive analysis of our performance, the use of financial and non-financial key performance indicators to explain the progress we have made, a description of the principal risks and uncertainties and an indication of likely future developments.

In preparing the report, the Group has referred to the guidance issued by the Accounting Standards Board in its Reporting Statement on Narrative Reporting. It is intended to provide members with a greater understanding of the Group, its position in the market and its prospects.

In assessing the Group's main risks and uncertainties, and indication of likely future developments, this report (and the wider financial statements) contain statements which, by their nature, cannot be considered indications of likelihood or certainty. The statements are based on the knowledge and information available at the date of preparation of the Directors' Report, and what are believed to be reasonable judgements. None of these statements should be construed as a profit forecast.

About The Co-operative Group



Evolution

The Co-operative Group has its origins in Rochdale, Lancashire. **The Rochdale Pioneers Society** was famously **established in 1844** based upon the notion of ethical trading and belief that the profits of the business should be shared amongst members according to their purchases.

By 1900 there were over 1,400 separate independent co-operative businesses in the UK, all members of a wider Co-operative Movement. During the 1900s, many of these independent societies began to merge. One of the most significant in recent times was in 2000, when The Co-operative Group was formed following the merger of the Co-operative Wholesale Society and Co-operative Retail Services. This was followed in 2007 by the merger of United Co-operatives with The Co-operative Group. In 2009 Britannia Building Society merged with The Co-operative Banking Group, the financial services arm of The Co-operative Group and in the same year The Co-operative Food business acquired Somerfield, a rival food business.

Member owned model

Membership lies at the heart of our business. The Co-operative Group believes in **open and voluntary** membership, democracy and member economic participation.

We are **owned by our members**, we manage our business for their benefit and share the profits with them. Along with all co-operative societies, The Co-operative Group is **democratically controlled** by its members.

However we differ from most other UK consumer co-operatives in that we have both independent society members and individual members. Anyone can become a member of the Group by subscribing for a £1 share.

Currently The Co-operative Group is jointly owned by over 7.6 million individual members and approximately 80 independent co-operative societies. We are in business to serve our members and their communities, and our business is run for their benefit. We listen to member opinions and integrate these into our business activities and our social and campaigning agenda.

The equitable nature of The Co-operative Group is exemplified through the opportunity for each and every member to get involved in running the business. In addition to having the right to vote on a one member, one vote basis, each member has the right to stand for election to an Area Committee, Area Committee members are in turn elected to Regional Boards and ultimately onto the main Co-operative Group Board – democracy in action.



Social goals

In the midst of the current global economic crisis, the co-operative model is being seen as increasingly relevant to a **more balanced, equitable and sustainable economy**. The Co-operative Movement was founded to serve a social purpose, as well as a commercial one.

Co-operative members believe in the ethical values of honesty, openness, social responsibility and caring for others. As an ethical leader, we exist not just to serve our communities but to contribute to their long term good health. Social responsibility is in our DNA. Since 2009, we have been benchmarking ourselves against the Corporate Responsibility Index (CRI) operated by Business in the Community (BitC). The full extent of our ethical credentials and commitment to social goals is included on pages 24 and 25.



Other stakeholders

Although The Co-operative Group is owned and governed by its members, there are other **key stakeholders** which are crucial to the co-operative principles upon which the business is conducted.

The communities in which we work and operate are important to us. We have a presence in every postal area in the UK and our work in these communities is highlighted in our Social Goals report.

Another of The Co-operative Group's key stakeholders are our people. Our people are vital to our success. From looking after our pensioners, to developing our current employees and recruiting apprentices to form the next generation of Co-operative leaders, we continually focus on our people. Co-operatives provide education and training for their managers and employees so they can contribute effectively to the development of their co-operatives. The section on 'Our people' on page 23 provides more details on our commitment in this area.

Involvement with the wider Co-operative Movement

Within the UK, **Co-operatives^{UK}** is the over-arching co-operative national trade body. The Co-operative Group accounts for **around 80%** of the total Co-operative Movement in the UK and as such we play a **leading** role within Co-operatives^{UK}.

Co-operation is not limited to the UK. The United Nations designated 2012 its International Year of Co-operatives. The Co-operative Group played an integral role in co-hosting a momentous event in Manchester which was the global culmination of the International Year.

Range of interests

The Co-operative Group is the **UK's largest** customer-owned business, **offering a wide range** of services including the following:



Trading across the Group

Our **large family** of businesses and loyal membership base gives us a unique opportunity to **offer a wide range of products and services** to members and customers. Our **profits are shared** with each member, in proportion to how much they trade with us, across all our businesses, in any one year.

We will continue to **encourage** and **reward** our members and customers for trading across the Group.

Find out more at
www.co-operative.coop

Food

We are the **5th largest** food retailer in the UK operating across the whole country in **2,816** local, convenience and medium sized stores. Our aim is to be the UK's leading community food retailer.

Find out more
See page 16

Banking Group

We are Europe's **most sustainable** bank*, offering banking and insurance services to personal and business customers. We operate through **342** high street branches and **22** corporate banking centres, telephony and online channels.

Find out more
See page 18

* Winner of Europe's Most Sustainable Bank, awarded by the Financial Times and the International Financial Corporation (part of the World Bank).



Specialist Businesses

Pharmacy

We are the **3rd largest** pharmacy chain in the UK, operating through over 750 branches.

Funeralcare

As the **UK's leading funeral director**, we carry out over 100,000 funerals each year and sell over 90,000 funeral plans.

Co-operative Legal Services

Co-operative Legal Services is **at the forefront** of regulatory changes, with the aim of becoming the preferred provider of consumer legal services in the UK.

Electrical

Our online electrical store, focuses on **excellent customer service** and **high quality** products.

Find out more
See page 20

Estates

We have a **portfolio of property** investments, and provide a **wide range** of property services across our family of businesses.

We also provide **energy purchasing expertise** across the Group and to our partners.

Find out more
See page 22

Investment decisions

In line with our **member-owned model**, investment decisions are not driven by the purely financial demands of shareholders, but by the wider concerns of our members.

For that reason, we can make **long term investment** decisions for the benefit of the **environment, communities, our members** and **employees** as well as profit.

In the midst of this recession
it will be vital that
we continue to **offer**
good value as well as
good values and ensure
that our customer **service**
remains high.



Chair's overview

2012 will be remembered for two great events: the **Olympics** and the **Queen's Diamond Jubilee**. But those moments of national pride took place against a back-drop of continued economic gloom.

Last year we also witnessed: a double dip recession, a further lack of trust in many large businesses and a continued lack of consumer confidence. We have also seen major brands go into administration as the face of our high streets is transformed by the downturn and changing patterns of consumer spending.

As Chair of The Co-operative Group, 2012 will remain in my memory for similar sharp contrasts of highs and lows. The United Nations International Year of Co-operatives, with its climax hosted by the Group in Manchester in November, was an outstanding triumph, showing the UK and beyond why co-operatives are a sustainable, ethical and socially responsible alternative to traditional business models. We not only showed the world that the way we do business is truly different, but that we can deliver thought-provoking, engaging and inclusive events on a grand scale. In the summer, we signed the Heads of Terms Agreement with Lloyds Banking Group for the purchase of the Verde business, which, if we satisfactorily complete our negotiations, will grow our Bank business three-fold.

These were our highs, but although we have demonstrated why co-operation really is the most sustainable way to do business, we do not operate in isolation from the wider economic environment. For the Group as a whole, we are reporting a solid performance in our food business, our core banking business has reported a credible result and our specialist businesses had another good year.

As you will see from Peter Marks' Chief Executive's overview on page 8, that is not the complete picture and overall, a number of one-off items particularly in the Banking Group resulted in the Group recording a disappointing loss. The Group Board and senior management understand the reason for this position and are already implementing a robust strategy to address it.

Our member-owned model

Most businesses, when faced with the challenging economic environment we are experiencing currently, will do all they can to protect the interests of their shareholders. All too often though, these become short term actions that work against the interests of ordinary customers.

As a co-operative we are different. We rely upon our members to influence the direction our business takes; and thanks to those many millions of people who trade with us and the thousands that are actively involved in their local communities, area and regional boards, we are able to shape our business for the long term. We can build on our strong foundations and continue to deliver our co-operative difference. In the midst of this recession it will be vital that we continue to offer good value as well as good values and ensure that our customer service remains high.

Our governance

As Chair, it is my role to ensure the organisation is governed to ensure the values and principles of co-operation and fairness for all are adhered to through every decision undertaken by the Group Board.

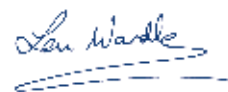
Our Board focuses on what is right for our business and what is right for our wider membership, based on co-operative values and principles. As co-operators, we are all guardians of our brand and our history and as we look to our 150th anniversary in 2013, it has never been more important for me to reinforce the Group's commitment to robust governance, sound reputation management and clear ethical standards. Our business model, which includes transparency of the way we make decisions, can be found on pages 2 and 3 of this report. You will also see the governance structure and arrangements on page 33.

Peter Marks and Euan Sutherland

As ever at The Co-operative Group, change is a constant and enables us to keep our co-operative message relevant to each new generation. This year will see a milestone change in our leadership, as we say farewell to Peter Marks as Group Chief Executive and welcome Euan Sutherland as his successor.

Since 2007 Peter Marks has been a strategic leader, a visionary businessman and a transformation catalyst. During his time as Group Chief Executive, we have undertaken significant mergers and acquisitions and seen our high street presence grow to the point of having a presence in every postal area. We re-vitalised our brand as 'The Co-operative', invested millions in our store and branch estate and renewed our commitment to a social agenda that demonstrates our Group vision to Build a Better Society. Peter will be remembered as an exceptional Chief Executive who helped to restore the fortunes of both the Group and the Co-operative Movement and we wish him a long, healthy and well-earned retirement.

As we bid farewell to Peter, we welcome his successor. Euan has already made his mark at the Group as a Non-Executive Director on our Food Board and has a successful background in retailing. Euan formally joins us in May and I look forward to developing a partnership between Euan, his senior team and our Board that will take the Group forward to the next stage of our renaissance.



Len Wardle
Chair, The Co-operative Group

Chief Executive's overview

Over the last five years we have invested **time, energy** and **capital** to radically transform The Co-operative Group. Through mergers, acquisitions, organic growth and a renewed focus on the needs of our customers and members, we have brought about a step change in how we operate.

All of this work has positioned us well to cope with the severity of the continuing recession.

Despite the unprecedented challenges presented by a stagnant economy, the Group performed well and we are reporting an underlying operating profit, albeit, one significantly down on the previous year. The performance in our Food stores and core retail Bank remains sound while our Pharmacy and Funeralcare businesses continue to report good results. Our strength and ability to make strategic decisions for the long term make us confident that we will come through the recession well placed to serve our customers and members.

Performance overview

We are reporting an underlying operating profit of £54m. However, our loss before member payments of £599m reflects unprecedented levels of corporate impairments in our banking business and a number of large one-off items in the Banking Group.

Business overview

During the second half of 2012 our Food business began to show clear signs of recovery after a flat first half and one of the wettest summers on record. Our Christmas and New Year sales figures showed a like-for-like improvement. We have developed an ambitious three year strategy that will see us build on the success of recent years and ensure we remain the convenience store of choice in a fiercely competitive market. Meanwhile, expansion continues, with 83 new stores opened, or acquired, including the purchase of Scottish chain David Sands.

Along with the rest of the UK banking sector, we have increased our provision for claims against the mis-selling of Payment Protection Insurance (PPI) as well as setting aside further provision for corporate bad debt. Meanwhile, we continue to negotiate with Lloyds Banking Group over the purchase of the Verde business with an emphasis on ensuring comprehensive due diligence is carried

out before any final deal is struck. While our talks with Lloyds Banking Group continue, our progress on the transformation plan has been restrained. The value ascribed to the investment made in developing the new banking systems has been reviewed and a proportion of the investment written off. Our future strategy is clear though, to grow and focus on our core high street retailing operation which remains profitable even in the current climate.

Funeralcare remains the leading funeral business in the UK and grew its portfolio by an additional 27 funeral homes in 2012. We are also looking to extend our management of crematoria. Our Pharmacy has achieved strong results with prescription and over the counter sales both on the increase. Our expansion plans for The Co-operative Legal Services demonstrates how we are using the trust customers place in our brand to open up new markets where proven integrity is a priority.

So despite the difficult trading environment for both retailing and financial services, across our family of businesses there is a picture of underlying strength and resilience.

Renewed confidence

As well as growing market share in all of our core businesses over the last six years, we have re-launched our brand and invested millions re-vamping our stores and branches. More recently, we have worked to unify our central support functions and bring our marketing strategy together to ensure we are maximising the potential of our brand across all our businesses.

We are now widely regarded as that rarity – a business that is both commercially focused and ethically driven. That will remain a compelling proposition for our members and customers as the economy slowly recovers from a recession brought about by boardrooms that chased short term profits at the expense of their customers' long term well-being.

As I approach my retirement after more than 45 years in the Co-operative Movement, I can see that The Co-operative Group is a very different business to the one I joined as Chief Executive in 2007. We have made incredible strides in recent years and everyone involved in The Co-operative Group over that period should take great pride in what has been achieved. We have certainly laid down solid foundations on which to build for the future.

Where once we may have doubted our abilities, and even questioned our relevance, today, even in the midst of a recession, we are self-confident about our worth and ambitious for our future. The Co-operative Group has rediscovered itself at a time when good business and sound values have never been more important.

It has been a privilege and a pleasure to lead The Co-operative Group through one of the most exciting periods in its development, and as I look forward to my retirement, I am sure that the next generation of co-operative leaders will take the Group onto new success and I wish them well in that task.



Peter Marks
Group Chief Executive

Our **strength and ability** to make strategic decisions for the **long term** makes us confident that we will **come through the recession** well placed to serve our customers and members.



Group vision and performance

Our vision

Our vision is to build a better society by excelling in everything we do.

In order to achieve this vision we have set ourselves a number of strategic aims, namely:

- To be a commercially successful business
- To meet the needs of our customers and the communities we serve
- To respond to our members and share our profits
- To be an exemplary employer
- To be an ethical leader

Our key performance indicators

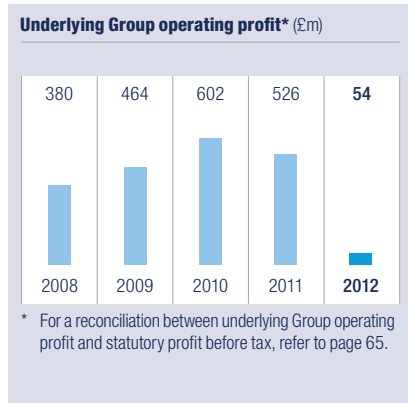
Our key performance indicators (KPIs) in each area are outlined in this section, together with a summary of how we have performed this year against each indicator. It should be noted that specific measures of performance may differ between operating businesses, but there is consistency at the Group level and these are aligned to our vision.

To further emphasise the importance of our KPIs, many of these are included in the performance metrics by which the Group Executive is rewarded as set out on page 43.



Financial

To be a commercially successful business



Why it's important

As a co-operative business we operate for the benefit of our members, with whom our profits are shared. The ability to run our business for our members depends on our financial success and stability. Our key financial aims are to grow profitably, measured in terms of underlying operating profit, and for our businesses, to deliver an acceptable return on capital employed (ROCE). In addition in Banking, liquidity and capital are considered as important as profit in ensuring we retain the appropriate stability and resilience.

How we performed

The Group's underlying operating profit for 2012 was £54m, a decrease of £472m on 2011. The majority of the fall was in the Banking Group which was down £433m due largely to a significant increase in corporate loan provisions (up £354m on 2011) and other one-off costs. The Trading Group's underlying profit was down £39m (11%). Our Food business showed an improving trend towards the end of the year and the Specialist Businesses division delivered another year of good growth.

Trading Group ROCE of 8.5% was down on 2011's 10.5% return. The Co-operative Bank loans to deposits ratio improved slightly to 92% while core Tier 1 capital fell to 8.8% at the year end due to the increased impairment and other significant one-off charges. Further information on financial performance can be found in the Financial review on page 12.



Customer

To meet the needs of our customers and the communities we serve



Why it's important

The Co-operative Group is here for its customers for life. They are key stakeholders and at the heart of everything we do. One of our strategic aims is to build trust and loyalty with our customers whilst at the same time sharing concern for each community in which we operate. Performance in customer satisfaction is measured through customer surveys. Food, Pharmacy and Funeralcare each carry out regular customer satisfaction surveys, while the Banking Group survey places greater focus on customer advocacy. Variance in the satisfaction scores between the different businesses is reflective of the different market sectors within which each operates, and the differing methodologies employed.

How we performed

Food A Customer Satisfaction Index (CSI) of 78.3% was achieved. This was slightly down on last year's actual of 79.1% and below the 2012 target of 80.6%.

Banking Group Customer advocacy measure exceeded its 2012 target of 8.5% in relation to the 'top five' peer group average, averaging 9.7% (2011: 10.3%) above the group across the year.

Pharmacy A CSI of 93.2% was achieved, exceeding the 2012 threshold target of 90% and exceeding the 2011 actual of 91.7%.

Funeralcare Satisfaction results remained extremely high with 98.6% (2011: 98.5%) of customers reporting they were either 'very satisfied' or 'fairly satisfied' with their overall experience. Customer service questionnaires are also used to calculate a Funeralcare Excellence Score (FES). The 2012 FES score was 93.3, up from the 92.4 achieved in 2011 and exceeding the threshold target of 90.



Membership

To respond to our members and share our profits



Why it's important

Membership engagement lies at the heart of our business. We aim to increase our membership to 20 million in the coming years. However, the key is not the quantity, but the quality of relationships forged. The more engaged our members, the more successful our business.

The Group measures membership engagement in three ways:

- Total number of members
- The number of members trading with more than one Group business
- Total customer dividend paid to members

How we performed

Our membership continues to increase and at the year end, we had 7.6 million members, up from 7.2 million last year. As a profit share, our dividend will fluctuate according to Group profitability and in 2012 we returned £51.4m to members, down on 2011's record level of £70.4m, due to reduced profits year on year. Membership remains a cornerstone of our business ethos and we are undertaking a wide-ranging review of our dividend strategy and considering a number of initiatives to encourage members to use a wider variety of our services, increase cross-trading across the Group, but most importantly to ensure we continue to reward members appropriately for their participation with the Group in accordance with co-operative principles.

** Because member payments are approved by members at the Annual General Meeting ('AGM'), the dividend paid to members in 2012 is based on 2011 trade with the Group and 2011 Group profitability.



People

To be an exemplary employer



Why it's important

Our people are vital to our success. Given the challenges of the market, the fragility of the economy and significant organisational change undertaken by the Group in recent years, it is essential that colleagues continue to feel a sense of belonging and commitment to the business. When considering our people, the Group's key performance indicator is employee engagement.

How we performed

Over the last five years the Group's regular Talkback survey has indicated consistently high engagement levels as shown above. Changes were made to the Talkback survey in 2011, with a narrower definition of engagement focusing on key behavioural and emotional commitment factors. Despite the new, more demanding metrics and during a period of re-organisation and cost control which is no doubt unsettling for our staff, Group employee engagement scores held up, marginally down in the Trading Group and up within the Banking Group which has joined the Talkback survey for the first time in 2012.



Social responsibility

To be an ethical leader



Why it's important

Social responsibility is in our DNA. Since 2009, we have been benchmarking ourselves against the Corporate Responsibility Index (CRI) operated by Business in the Community (BitC). This is the foremost UK corporate responsibility standard and assesses management practice in a range of environmental and social impact areas, including four key themes:

- Community
- Environment
- Marketplace
- Workplace

How we performed

In 2012, The Co-operative Group retained its 'Platinum Plus' status, a classification introduced in 2011 and achieved by only 15 businesses in 2012 and by only three other retail businesses. The Group again achieved a very high score of 98% derived from weighted scores achieved across five strategic areas.

Financial review

The Group's financial performance in 2012 is best viewed by breaking it down into its constituent parts. Although enduring adverse economic and market conditions have, to varying degrees, impacted many of our businesses, they have had a specific and disproportionate effect on banking, in particular corporate banking. In addition with several unprecedented, non-recurring charges against profits, this demands analysis of and focus on the underlying performance of the core business segments.

Such analysis reveals a Food business showing clear signs of stabilisation and recovery in the second half of the year; a Specialist Business division demonstrating true resilience through diversity with pockets of consistent growth and genuine future potential; a core, largely retail Banking business that has declined in profitability in line with market pressures but remains inherently strong; and a non-core, largely corporate, Banking business that has suffered quite markedly along with many other leading banks.

In this context, the Group has continued to invest in modernising and growing its strategically chosen core businesses through the downturn. To support this the Trading Group successfully refinanced during the year, replacing and enhancing its syndicated bank facilities and divesting a number of investment properties and non-core assets. Despite its many economic, market and regulatory challenges, the Banking Group maintained a strong liquidity position and has strengthened its capital position since year end.

Headlines	2012 £m	2011 £m	+/- change
Gross Sales:			
– Trading Group	11,264	11,053	+1.9%
– Banking Group	2,211	2,214	(0.1)%
Underlying Operating Profit:			
– Trading Group	311	350	(11.1)%
– Banking Group (core)	120	173	(30.6)%
– Banking Group (non-core)	(377)	3	n/a
Group Profit before member payments excluding significant items	(41)	583	n/a
Significant items	(558)	(210)	n/a
(Loss)/profit before member payments	(599)	373	n/a
Member payments	104	142	(26.8)%
Group Capital Expenditure	528	594	(11.1)%
Trading Group net debt	1,686	1,488	(£198m)
Bank Liquidity (Loans to Deposits)	92%	94%	+2% pts
Bank Capital (CT1)	8.8%	9.6%	(0.8)% pts

Financial Statements

The Financial Statements are prepared for the year ended 5 January 2013. For Trading Group and Corporate entities this represents a 53 week accounting period compared to 52 weeks for 2011. For the Banking Group the accounts are consolidated on a calendar basis up to 31 December.

In 2012, the apportionment of costs between the Corporate centre and the operating entities changed slightly in line with the reorganisation of certain support functions. All relevant figures in the prior year comparatives have been restated to show costs on a consistent basis.

Trading performance

Overall Group sales were up 1.6% on 2011 largely due to an increase in Food and Federal sales in the year and also an additional week's trade.

In Food, total sales (excluding VAT) were up 1.3% and like-for-like foodstore sales (including VAT, excluding fuel) were slightly down by 0.7%. Like-for-like sales were down only 0.2% in the second half of the year showing a marked improvement on the first half performance (down by 1.2%), which was impacted by very wet weather, in particular in April and June.

We continued to improve the store portfolio with 83 new convenience stores added to the estate and 63 closures and disposals during the year. Federal sales, which largely represent supply of groceries to other co-operative societies, were up by 8%.

Overall the Banking Group gross income was down £3m (0.1%) on the previous year. Gross bank interest, fees and commissions were up £22m (1.4%) on 2011. This was offset by a fall in net insurance premiums of £25m (4.1%).

Specialist Businesses division sales were flat year on year reflecting the disposal of some Motor dealerships and the Clothing business part way through 2012. Excluding disposed units, sales were up by 8%. This was driven by strong like-for-like prescription growth in Pharmacy, up 4.7% by volume and 1.3% by value, despite cuts in government funding. In Funeralcare, sales were up by over 6%. Our Co-operative Legal Services business was one of the first to be granted an Alternative Business Structure (ABS) licence, paving the way for expansion into new service lines such as Family law. Total Legal Services revenue for the year finished up 13%. Sales in our online electrical business were up by just over 1% in a market hit hard by the economic downturn and pressure on consumers' disposable income.

Underlying operating profit before significant items decreased by 11% in the Trading Group and by 31% in the core Banking Group.

Within the Trading Group, Food operating profits were down 9% for the full year but the business delivered a much improved second half supported by a better sales performance. Operating and overhead costs were tightly controlled to support ongoing investment in prices and promotions to improve value for customers. The integrated Farms business suffered from poor weather and low yields across several crops, depressing operating margins.

Specialist Businesses operating profits were up 8.7%. This was despite absorbing prescription funding cuts in Pharmacy, investing significant amounts to expand and grow our Legal Services business and absorbing operating losses in certain Motor dealerships prior to disposal later in the year. Funeralcare had a very positive year with underlying operating profit up 10%. The business maintained its leading market position underpinned by its unerring focus on offering the highest quality of service, and did so in the face of intense competition from new entrants. Despite funding cuts reducing profits by an estimated £15m, Pharmacy operating profits were only £1.4m down on last year driven by market leading volume growth in prescriptions and excellent margin and operating cost control. All the other businesses in the division contributed positively to operating profits.

The Banking Group core business produced an operating profit of £120m, down 31% on the previous year. Within this the general insurance business delivered a profit of £9m, down from £45m last year due mainly to a strengthening of claims provisions relating to prior years. The core Bank delivered an operating profit of £97m, down 29% on last year with continued margin compression linked to continuing low interest rates, increased cost of funding and competitive market pressures.

The non-core Banking Group business made an operating loss of £377m (2011: profit of £3m). Non-core is defined as those assets and activities which do not fit with the current Banking Group strategy and which are being managed for run down or exit. The significant deterioration in the result is primarily due to credit impairment on non-core assets totalling £351m in the year.

Financial strength and cashflow

During the year, the Trading Group replaced its syndicated bank facilities of c.£650m, originally taken out at the time of the Somerfield acquisition and due to mature in 2013, with new five year facilities totalling £950m. Together with the bond issuance in 2011 which totalled £800m, this gives the Group significant financing to fund its continuing investment plans and provides a high degree of certainty and stability well into the future. The Group has continued to invest in its Trading Group businesses through the economic downturn but with a decrease in profits in the last two years, the source of funds is not endless. With this in mind, in 2012, the Group divested of some non-core, non-trading assets and properties to release capital to support continued investment in customer-facing, trading businesses and to help keep overall debt at an acceptable level.

The Trading Group net debt increased by £197m in the year but subsequently reduced after the year end with the receipt of the proceeds in relation to the sale and leaseback transaction of the new head office building. As well as the temporary investment in the cost of building the new head office and other substantial capital investment in trading businesses, there was a material cash outflow in the year relating to non-recurring significant items of expenditure which are further detailed below.

The Co-operative Bank's loan to deposit ratio, strengthened in the year from 94% to 92%, while its key (CT1) capital ratio reduced from 9.6% to 8.8%. This was a direct consequence of absorbing the fall in operating profits in both the core and non-core elements of the business as well as suffering some substantial one-off significant charges noted below. Subsequent to the year end, the Bank has improved its CT1 ratio to 9.2% (on a pro forma basis) as a result of the first step in a wider programme of capital strengthening.

Reconciliation of underlying operating profit to profit before tax

Note 1 to the financial statements reconciles underlying operating profit, which is used as the primary indicator of business performance, to profit before tax as shown in the income statement. It highlights several non-trading, non-cash items within the income statement. These are explained in detail in the relevant notes to the accounts and are summarised below with the main reasons for their exclusion from underlying operating profit being their volatility and their non-trading nature.

Fair value amortisation in the year was £15m (2011: £86m). This item relates to the unwind of prevailing interest rates charged and received on both assets and liabilities following the fair value exercise when Britannia Building Society transferred engagements to The Co-operative Bank plc.

Finance income of £47m (2011: £75m) relates to net pension scheme interest derived from the difference between the interest on scheme liabilities and the expected return on scheme assets.

As well as underlying interest charges, finance costs include non-cash mark to market adjustments on quoted debt and interest swaps. These are both volatile items and collectively amounted to a £2m credit in 2012 compared with a £26m credit in 2011.

Other items consistently not included in underlying operating profit are gains/losses on property disposals, changes in the value of investment properties and the Financial Services Compensation Scheme levy.

Financial review continued

Significant items

In addition to being shown separately on the face of the income statement and analysed in notes 2, 3 and 4 to the accounts, the principal items classified as 'significant' are analysed and explained below. There are two particularly large charges in 2012 within the Banking Group and these are explained below. The majority of the other items relate to costs associated with substantial change events or programmes aimed at delivering step changes in the Group's efficiency, capability and scale.

	2012 £m	2011 £m
Items within revenue		
PPI provision	150	90
Items within operating expenses/income		
Impairment of non-current assets	163	8
Food store closure/disposal costs	56	–
Banking Group integration/transformation	57	90
Acquisition costs	53	5
Distribution network and other Food restructuring costs	31	70
Project Unity reorganisation costs	45	23
Reclaim Fund	–	(74)
Other	3	(2)
Total	558	210

PPI provision: In common with the rest of the banking industry, during 2012 there has been no let up in the volume of complaints being received in relation to legacy PPI business, driven to some extent by the activity of claims management companies. As a result the provision originally made in 2011 has been increased by £150m to cover the anticipated redress. This increases the total estimated cost of redress to £244m. There is still uncertainty as to the eventual total cost and the provision held is in line with our latest view of the final total cost based upon all current available data.

Impairment of non-current assets: This mainly consists of a £150m impairment of Banking Group assets being costs previously capitalised as part of its transformation programme. In light of the prolonged economic downturn these assets have been written down to their estimated future value in use.

Acquisition costs: This relates primarily to costs incurred in connection with the ongoing interest in acquiring the Verde assets from Lloyds Banking Group. Such costs are being expensed as incurred.

Food restructuring: This has two key elements. We are approaching the end of a distribution network strategy that has involved replacement, modernisation and rationalisation of the physical distribution network over several years, accommodating merger and acquisition impacts along the way. In addition, during the year there was a large scale reorganisation of central teams in the Food businesses involving significant realignment of responsibilities and material levels of one-off change and redundancy costs.

Banking Group integration/transformation: This relates to the ongoing integration and transformation of the enlarged Group following the merger with Britannia.

Food store closure/disposal costs: A full review of our stores following completion of the Somerfield integration has resulted in an exceptionally large number of closures and disposals in 2012. The integration and all costs associated with it are now complete.

Project Unity: This programme started in 2011 with the objectives of bringing together functional support teams to more efficiently and effectively serve the whole Group and, more importantly, to reap the benefits from all the Group's businesses working together to serve a common customer and member base. Costs associated with change and redundancies have been classified as non-recurring significant items.

Reclaim Fund: The Reclaim Fund Ltd ('The Fund') is a wholly-owned subsidiary of The Co-operative Banking Group which, with wider authorisation from the FSA, was established in 2011 to collect dormant customer account balances from UK financial institutions.

Under prevailing accounting rules the Group is obliged to consolidate The Fund in its financial statements. For clarity, the retained surplus for 2011 was separately reported in significant items.

Discontinued operations

Following a strategic review of the Group's Life and Savings business in 2011, it was decided to close the Financial Adviser sales channel and sell the remaining business. As such the business was classified as a discontinued operation at last year end. Although the sale did not complete during 2012, the Group is still in advanced negotiations with Royal London Group and continues to view the sale as highly probable. The pre-tax profits of £14m (2011: £15m) relate substantially to profit from the Asset Management company (TCAM) largely representing asset management fee and commission income.

Capital expenditure

	2012 £m	2011 £m
Trading Group	410	375
Banking Group	118	219
Total	528	594
Disposal proceeds	(58)	(30)

Gross capital investment in Trading businesses was £410m. The largest components of expenditure were the new head office building – £125m (2011: £53m), the acquisition of new stores/branches – £69m (2011: £40m), store/branch refurbishments – £63m (2011: £100m), distribution depots and equipment – £45m (2011: £50m) and vehicles – £34m (2011: £40m). Contracts were exchanged unconditionally before year end in relation to the sale and lease back arrangement for the new head office and therefore the transaction was accounted for within the year.

The Banking Group continues to invest in developing its IT hardware and software capabilities with notable progress in mobile banking and other customer facing technology areas during the year. Reappraisal of the value of previously capitalised expenditure and its future useful life led to a substantial write off in the year (see significant items above).

Disposal proceeds of £58m primarily relates to disposals of investment and other non-trading properties.

Tax

The tax credit on continuing business is £174m (2011: £49m charge) reflecting the loss in the year. The effective tax rate was 24% (2011: 21%) compared to a standard blended rate of tax of 24.5% (2011: 26.5%). The main reasons for the effective tax rate difference being different to the standard rate of tax are explained in note 8 to the financial statements. Due to the trading loss arising in the period, the Group will not be taxpaying in respect of the current year.

Pensions

The key movements in the pension schemes' valuations during the year were:

	2012 £m	2011 £m
Combined opening net surplus/net deficit	132	(4)
Service cost	(88)	(85)
Net pensions interest income	47	75
Actuarial gains	96	379
Actuarial losses	(126)	(379)
Contributions	146	136
Other	(16)	10
Combined closing net surplus	191	132

The International Accounting Standards (IAS) 19 net surplus increased by £59m during 2012. This was mainly due to the deficit contributions paid into the scheme, partially offset by actuarial losses following more prudent assumptions on the mortality of employees in the pension schemes.

Actuarial assumptions relating to discount rates and inflation continue to be prudent and remain the same as prior year.

The service cost increased by £3m compared to 2011. The sharp fall in discount rates in 2011 produced a higher percentage service charge on pensionable wage, increasing the service cost in 2012. However, this increase was negated by a lower pensionable wage for the Group following redundancies made in 2011.

Net pensions interest income fell by £28m compared to the prior year. This was due to a lower expected return on planned assets across the Group's various schemes. IAS 19 revised will be effective from 6 January 2013 for the Group. This will reduce the net pensions interest income further in future years as the new revised standard requires the Group to use asset returns equivalent to lower corporate bond rates.

'Other' in 2012 relates to International Financial Reporting Interpretations Committee 14 restrictions in the Britannia scheme. This scheme is now in net surplus of £13m, but as the Group does not have an unconditional right to a refund of surplus, this surplus is restricted to zero. 'Other' in 2011 mainly related to curtailments following the sale of the Travel business.

Member payments

Members can earn a share of Group profits (a 'dividend') based on their level of trade with the Group's family of businesses. The total dividend paid is based on the previous year's performance. The current policy follows a guideline of 40% of underlying trading profit less underlying finance costs, minority interests and tax, being available for distribution. This is calculated as the sum of profits from the two parts of the Group, being the Trading Group and the Banking Group. Subject to profitability, the ability and desirability of dividends to be paid up from the Banking Group is also dependent on the need to retain capital within that business.

Dividends are recorded in the income statement once they have been approved. In 2012 the Group approved and paid a final dividend relating to 2011 profits and an interim dividend relating to 2012 profits. The split of the dividend between the various member categories is subject to Board approval. Dividends paid in 2012 are summarised below:

Individual Dividend: The total dividend paid to customer members in 2012 was £51.4m. This consisted of the final dividend relating to 2011 trade with the Group of £43.2m and £8.2m relating to the interim dividend for 2012 trade.

Employee Dividend: In 2012, based on 2011 performance, over 96,000 employee members received a dividend each equating to a rate of £300 per full time employee. Employee dividend is paid to all employee members on an equal basis pro rated to hours worked, subject to them being a member and in employment for greater than 12 months prior to the start of the financial year.

Corporate Dividend: Corporate members receive a dividend based on their participation in co-operative buying groups operated by the Group, the largest of which is run within the Food business. In 2012 corporate members received a £17.3m dividend based on their federal trade with these various buying groups, at a rate of £1 per £100 of qualifying transactions.

Community Dividend: A Community Dividend of £10m was made available for the benefit of the communities in which we trade and to support Co-operative organisations. These initiatives are determined by our members through the Group Values and Principles Committee. Further details of many of the initiatives and good causes supported by Community Dividend are given in the Group's Sustainability Report.

Food

Slow market growth, wet weather and huge national events have combined to make 2012 a **most unique** year for retail, **particularly** the grocery sector.

	2012 £m	+/- change
Revenue	7,442.2	1.3%
Underlying operating profit	288.4	(9.5%)
2012 key facts		
		No.
Number of stores		2,816
Number of staff		72,670

Market overview

Trading conditions for the food retail market continue to be challenging and competition is fierce. Consumer confidence is still low and shoppers have continued to trade down, seen in the year's market growth which, in the main, remained below the rate of inflation.

The weather made 2012 one of the wettest summers on record, having a detrimental effect on the industry. Despite the positivity around the London Olympics and the Diamond Jubilee, overall trade remained flat. The full year saw market growth consistently below the rate of inflation. Whilst trading conditions remain challenging, our Food business has seen an increasingly encouraging performance towards the end of the year that bodes well for the year ahead.

Performance review

Against this backdrop, overall sales at The Co-operative Food were down on a like-for-like basis by 0.7% (including VAT, excluding fuel) but our convenience stores reported increased like-for-like sales of 1.9%.

Despite a disappointing first half, we began to build momentum in the second half of the year, particularly in the final 13 weeks, during which total food sales (including VAT, excluding fuel) were up 0.6% year on year and up 0.3% on a like-for-like basis. Christmas like-for-like sales rose 2.2%, with convenience stores reporting like-for-like growth of 5.5%.

The convenience sector has grown significantly, with retailers battling for market share, by way of aggressive marketing and acquisition plans. The convenience market is also attracting significant investment due to changing consumer habits, but with 2,816 Food stores (3,989 including Co-operative Retail Trading Group) located in the heart of our communities, we continue to be well placed to meet customers' needs.

In this challenging climate, our focus has been on improving the shopping experience and tailoring stores to our customers and locations. The successful delivery of 60 new format trial stores, with great customer feedback and encouraging sales figures, has fed into our investment thinking for 2013. We have also standardised our trading hours, simplifying over 54 different trading patterns to just six core trading times, providing a more consistent service to our customers.

We launched 83 new stores across the UK in 2012, including the acquisition of Scottish convenience chain David Sands, increasing our presence by 28 stores; plus ten former Costcutter stores in London. All stores were trading as The Co-operative Food before Christmas.

Support for our store estate has been improved through investment in our distribution network, with the LIDIA transformation programme almost complete. In November, we opened our new distribution centre at Avonmouth which saw us invest £22m in the facility. We have also made excellent progress on our new Castlewood depot, with practical completion ahead of target and outbound deliveries scheduled from March 2013.



New stores across the UK

We launched 83 new stores across the UK in 2012, including the acquisition of convenience chain David Sands, **increasing our presence** in Scotland by 28 stores; plus ten former Costcutter stores in London.

Our award-winning Store Merchandising and Replenishment Transformation programme (SMART) is now complete. SMART delivers an end-to-end supply chain solution from supplier to store, transforming the way stock is replenished in our food stores. It has radically increased product availability to more than 97.5% and has won two prestigious awards; the coveted Grocer Gold award for Best Business Initiative and the BT Retail Week Programme Implementation of the Year award.

We are also rolling out an innovative recycling scheme to achieve zero waste to landfill for our Food stores. The project is on track to reduce waste to landfill by more than 34,000 tonnes a year by the middle of 2013.

One of the biggest challenges of the year has been the wet weather, not least for the farming industry. To help mitigate this, we relaxed our produce selection rules slightly, enabling stores to sell smaller or mis-shapen fruit and vegetables. This received strong support from our customers.

Our colleagues play a valuable role in their local communities at times like these. After weather disrupted Shetland's ferry schedules at Christmas, we airlifted festive supplies from Aberdeen to stores in Brae and Lerwick. The Stonehaven store funded 40 food hampers for customers, after the town was devastated by flooding, and many other stores across the UK also supported their communities during adverse weather, really showing our co-operative difference in action.

Our own farming operation was hugely impacted by flooding, with damaged crops, machinery and soil conditions. However, with our farming and food businesses now closely integrated, we have the structure in place to help ease industry challenges such as fluctuations in grain prices and wet weather, enabling us to focus on 21st century farming and quality British produce. Our new tenancy at Highland Court in Kent, which includes a pack-house operation, is performing well.

We also increased our premium on milk to farmers within the Co-operative Dairy Group (CDG) to help ensure a long term, sustainable future for British dairy farmers.

This year saw the launch of a new in-store magazine and we also supported the ITV Daybreak 'You Can Help' campaign, delivering food parcels to thousands of families in need last Christmas. Other innovations, including contactless payments and Amazon lockers, have been successfully piloted.

We have secured several awards this year, including the Environmental Sustainability Award at

the IGD Food Industry Awards and some fantastic coverage in the Which? consumer report 'A taste for change?', which cited us as "leading the way in helping consumers make healthier choices".

Our Fairtrade credentials continued to grow during the year. We switched all our bananas to Fairtrade and introduced a unique sourcing model, which commits to 50% of our fruit being sourced from small holder farmers. Going beyond Fairtrade in Kenya, the first of the tea leaves from the 15,000 strong smallholder co-operative we helped create, began to be packed into our 99 blend. In November we switched our fresh winter blueberries to 100% Fairtrade too, with the Apicoop co-operative in Chile another beneficiary of our beyond Fairtrade investment programme.

We also carry the red tractor standard on all our own label meat.

Continued investment in our own brand development resulted in numerous accolades from the industry press, as well as dozens of external awards, including eight Golds and two Silvers at the

International Cheese awards, three Quality Food Awards, and two Supermeat and Fish Awards.

The launch of our new brand idea – Here for You for Life – which first appeared across our 2012 Christmas campaign, gives us a great platform from which to evolve, putting our customer firmly at the heart of our brand.

Looking ahead

The year ahead looks positive, with new strategic and operational plans being developed, and the launch of an exciting new Vision for the business.

Structural changes at Food Executive level have included the appointment of our new Food Chief Executive Officer, Steve Murrells, as well as new roles focusing on customers and service delivery. These changes will enable us to centre more closely on our customers and increase efficiency, as we move through the next phase of our development.

We have **secured several awards this year**, including the **Environmental Sustainability Award** at the IGD Food Industry Awards



Improving availability in our stores

We have made **significant investments** in our distribution network, with the LIDIA transformation programme almost complete. In November, the business invested £22m in our new facility at Avonmouth.

Banking Group

During 2012, our banking business faced a series of **unique challenges** that adversely affected our **performance**.

	2012	2011
Core* operating result (excluding discontinued operations**)	£119.8m	£173.0m
Core Tier 1 capital ratio	8.8%	9.6%
Bank loans to deposit ratio	92% (2% improvement)	94%
2012 key facts		No.
Branches		342
Employees		10,341

* The 'Core' business represents activity consistent with our strategy and risk appetite. This includes the Retail, Corporate Core and Other segments. 'Non-Core' business lines include activities not congruent with our current strategy, which are managed for value and targeted for run down or exit. These non-core lines contain the majority of our impairment risk, and include Corporate non-core business, Optimum (the closed book of intermediary and acquired loan book assets) and Illius (the residential property company).

** Discontinued operations comprise the Life and Savings business (Co-operative Insurance Society), its subsidiaries, and The Co-operative Asset Management (TCAM), which is a subsidiary of The Co-operative Banking Group. The Co-operative Banking Group is in exclusive discussions with Royal London Mutual Insurance Society Limited regarding the sale of these operations and it is highly probable that this sale will take place in 2013.

Performance overview

During the last six months, forecasts for the UK economic outlook have deteriorated, with significant recovery now not expected until 2018. This prolonged economic downturn (the longest in a century) has been a major factor in 2012 being an extremely challenging year for The Co-operative Banking Group ('the Banking Group'), reflected in its statutory loss before taxation, distributions and discontinued operations of £661.8m (2011: profit of £138.0m). The outcome of an ongoing strategic review has seen the Bank, in line with the banking sector in general, segment some activities as non-core business and concentrate on managing them for value and targeted for run down or exit. The strategy is designed to both build on the strength of the Bank's core retail and business banking operations, where it can evidence a compelling co-operative alternative to its peer group, whilst at the same time de-risking the non-core assets in order to further strengthen the balance sheet.

The core business, reflecting the current strategy and risk appetite of the Banking Group, delivered an operating profit of £119.8m (2011: £173.0m), which, while lower than 2011, provides a solid platform for future growth. The non-core business, those activities not congruent with the current strategy, which are managed for value and targeted for run down or exit, generated an operating loss of £377.3m (2011: profit of £2.8m).

As a consequence of the financial performance noted above, the Core Tier 1 ratio for the Bank has reduced to 8.8% (2011: 9.6%).

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

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

- Credit impairment on non-core assets: the continued deterioration in the economic outlook has led to an impairment charge for The Co-operative Bank ('the Bank') of £351.1m, principally relating to the non-core Corporate business.
- Intangible asset impairment: the directors have re-evaluated the value stream from the investment made to date in developing our new banking platform in the light of the prolonged downturn, and concluded that a write down of £150.0m is required.
- PPI: in line with the rest of the Banking industry, the Bank saw a continued increase in the volume of PPI complaints in 2012. As a result, the



charge of £40m at the half year has been increased by a further £109.7m to cover the anticipated cost of customer redress.

- Insurance claims strengthening: some strengthening of reserves has been required in 2012 for motor claims that mainly relate to prior years. Despite this claims strengthening, the general insurance business generated an operating profit of £9.3m for 2012 (2011: £45.0m).
- Continued economic downturn: the reduction in operating profit within the core business from £173.0m in 2011 to £119.8m in 2012 was broadly attributable to the continued economic downturn. Margins remain under pressure as the result of prolonged low interest rates.

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

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

Looking ahead

The Banking Group's commitment to sustainability has again been recognised. For the third year running the Bank has been named 'Europe's most sustainable Bank' by the Financial Times.

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

We are not complacent about our financial strength and our strategic focus for the medium term is directed at implementing measures to enhance the strength of our capital ratios. In addition to a risk mitigation transaction executed since the year end, these include strengthening the management team and engaging a major investment bank to support on a range of balance sheet deleverage options. Further to the signing of the Sale and Purchase Agreement for the sale of the Co-operative Banking Group's life insurance business, which subject to regulatory approval is expected to generate a significant release of capital, the strategic review will encompass a review of the scope and composition of the financial services Group. Such measures recognise the ongoing uncertain economic environment and the steps required to bolster the balance sheet for the benefit of our customers and members.

In the meantime, as part of broadening our reach and appeal in the UK banking sector, the Banking Group continues to pursue the opportunity to acquire the Verde business from Lloyds Banking Group. The Banking Group remains confident

in its long term strategy to deliver a compelling co-operative alternative on the high street founded on strong relationships with its customers, the unified brand and the transformation of the branch network, which provide a solid platform for future growth.

We are working to **strengthen** our profitable core business, **enhance** our retail offer and **simplify** our high street presence under one **Co-operative brand**



Focusing on our customers

We were the **first high street bank** in the UK to **abolish sales related** targets for customer facing colleagues. Reflecting our commitment to providing **excellent service**, our incentives for staff are now based on customer **satisfaction scores**.

Specialist Businesses

Excellence, innovation, professionalism and dedication meant our Specialist Businesses delivered **strong performance** in sales and profit despite tough market conditions.

	Net revenue		Operating profit	
	2012 £m	+/- change	2012 £m	+/- change
Pharmacy	764	1.3%	28.2	(4.9%)
Funeralcare	348	6.4%	60.0	10.0%
Legal Services	33	12.8%	0.0	(99.4%)
Life Planning	10	5.9%	0.2	112.2%
Sunwin Services Group	37	23.4%	6.4	37.2%
Motors	225	(18.7%)	3.0	(5.7%)
Electrical	83	1.1%	0.6	(63.0%)
Clothing	6	(10.1%)	1.2	17.5%
Other central items	–	–	7.7	494.9%
Total	1,506	(0.6%)	107.3	8.7%

Market overview

For continuing specialist businesses, sales were up by £36.2m (3.0%) with operating profits higher by £7.2m (8.1%) year on year, which was a strong performance given tough trading conditions and competitive pressures, not least the continued impact of government funding pressures on the amount reimbursed for medical pricing. In addition, the amount invested in our Legal Services business year on year significantly increased as we seek to build the infrastructure to support our vision to be the leading provider of legal services in the country. This success was founded on maintaining our relentless attention to great customer service and value for money. As well as strong financial performance, this focus resulted in the record customer satisfaction scores in Funeralcare and Pharmacy.

Overall divisional sales, however, were marginally down by £10m (0.6%) compared to the previous period due to the disposal of our volume motor dealerships and the Clothing business during 2012.

Our workforce remains committed and engaged as demonstrated by high levels of colleague engagement scores as well as retaining IIP accreditation in Pharmacy and Funeralcare. We also took part in the Group's Apprentice Academy scheme and welcomed apprentices to Funeralcare and Legal Services.

Our ethical and environmental credentials remain as strong as ever; some of the highlights of our programme in 2012 were the seasonal vaccination programme for flu and the vaccination service we provided for Muslim customers undertaking the Hajj. We also introduced fairly-traded coffins, worked to promote our funeral service for the LGBT (Lesbian, Gay, Bisexual and Transgender) community, and in partnership with Mencap, Funeralcare has seen three adults with learning disabilities assisted into permanent jobs within the business.

Change programme

We undertook a programme of change in our specialist businesses during 2012 which was designed to deliver an even greater focus on professional services where we can be confident of commercial success. Our aim is to gain scale by driving solid returns in the interests of our customers and members, and provide a credible market alternative thereby improving choice and accessibility for customers.

During the year, we divested a number of our businesses including Clothing, Sunwin Fire and Security, and a number of our Motor dealerships. The drop in sales is due largely to the divestment of Motor dealerships which accounted for a drop in revenue of £52m. However, we also announced our ambitious plans for growth and began the process of expansion in the Legal Services business with the aim of employing 3,000 people in the future.

Performance review

Funeralcare



Key Headlines

Number of funeral homes	910
Number of staff	4,191

We have delivered a strong performance during 2012 with sales up 6% and an operating profit increase of 10%.

We continue to operate within a challenging market with competition continuing to grow as many new entrants join the market.

However, we are able to maintain our position as the UK's leading Funeral Director by staying focused on delivering the highest quality of care and personal service to each of our clients. One way in which we measure our service is through customer service questionnaires which are sent to every client. 2012 saw us achieve our highest result to date.

We continued to expand our business portfolio with 27 new funeral homes opening during the year to ensure our funeral home network remains local and accessible to clients. During the year we also completed the refurbishment of Emstrey Crematorium and invested over £11m in new vehicles.

We have invested in Resomation® and units are now operational in three states in the USA, so clients in the USA can now choose an alternative to burial or cremation. Funeralcare continues to work towards the legalisation and introduction of Resomation® in the UK.

Significant investment in client service, employees and our business portfolio are planned throughout 2013 which will be another exciting year for our business.

Pharmacy



Working in partnership with the NHS

We opened five Outpatient Dispensaries within hospitals in 2012. Working in **partnership** with the NHS allows us to bring our **Co-operative values** to life for NHS patients.

Key Headlines

Number of stores (including five outpatient dispensing sites)	781
Number of staff	7,163

We have achieved excellent results through our focus on patient care. Our success has been underpinned by market leading like-for-like prescription growth and maintaining our number one position for customer service. Our e-Pharmacy has grown and we have improved our Over-The-Counter (OTC) proposition within branch, again delivering sector-leading growth.

Despite these advances, operating profits decreased by £1.5m due to the continuing impact of government funding on medicine pricing which adversely impacted profits by an estimated £15m.

We have piloted our Branch Transformation Programme (BTP) in 21 branches. BTP is delivering completely remodelled branches and updated practices supported with training to provide customers with an even more improved experience.

We have refitted a further 38 branches, relocated eight others, opened three new branches and continue to diversify into new areas, opening five new Outpatient Dispensaries within hospitals.

We have also switched to Alliance Healthcare as our new wholesale distribution partner. Working with Alliance will bring the flexibility, service and value our patients expect.

Investment in improved patient services will see 100 refits, 16 relocations and four new branch openings in 2013. We also aim to deepen our relationship with the NHS and look for new ways to provide services to our customers.

Co-operative Legal Services



We began the process of **expansion** in the Legal Services business with the aim of employing **3,000 people** in the future.



Legal Services launches Family Law services

We launched our Family Law service to widespread acclaim. This has been a **great success**, with the securing of a **prestigious** Legal Services Commission contract for family law advice.

It was another exciting year for our Legal Services business, becoming the first national brand to be granted an Alternative Business Structure (ABS) licence. This allowed us to enter new markets, including Family Law.

Results for 2012 were achieved in line with expectations reflecting the investment in people, infrastructure and systems to support our ambitious expansion plans. Sales increased 12.8% to £33m, encompassing growth in Probate and Personal Injury (PI) and establishing a presence in Family Law with Operating profit of £26,000 reflecting the investments for future growth detailed above.

In line with our strategy “to make the law as accessible and unthreatening as possible” we continue to offer a broad range of consumer legal services that are easily accessible, high-quality and fairly priced. Our success is demonstrated through our consistently excellent customer service scores which continue to improve. Staff engagement scores also saw a significant four-point rise to an all-time high, demonstrating our commitment to our people. As part of our continued growth our executive team was strengthened with the addition of pre-eminent experts in Family Law.

We have put our principles into practice through a refinement of our Probate offering and a successful pilot scheme to offer Wills, Estate Planning, Probate, Bereavement Advice and Funeral Plans in 30 Co-operative Bank branches. We will roll this service out nationwide during 2013, with an improved service proposition that has been enhanced to further meet our customers’ and members’ needs.

Co-operative Electrical

The electrical retail sector continues to be affected by the persistent economic downturn, as consumers feel the pinch. While margins have been under pressure, sales have increased year on year by £1m (1.1%) with Christmas internet sales particularly impressive; up 15% on 2011. Peak season sales increased following the November launch of our market-leading delivery service, a free 60-minute delivery time slot on all our products. The business continues to receive impressive customer satisfaction results via the independent feedback forum FEEFO, with 98% of our customers rating our products and service as good or excellent.

Estates

We had another good year in 2012, providing key **support** for the trading businesses. We made **progress** with **unique leading edge projects** and delivered a solid performance despite a depressed property market.

	2012 £m	+/- change
Net revenue	36	–
Operating profit	19	(6%)

Market overview

The UK commercial property market fell in 2012 meaning that values remain well below the peak levels seen in 2007, and prices are predicted to continue to decline until 2014. Our investment property portfolio valuation fall of £25m in 2012 reflects this.

The volatility of the property market has seen commercial investors adopting mostly defensive strategies. However, food convenience retail property is an exception, where competition remains fierce for prime store locations, and planning applications are regularly contested by competitors.

Performance review

Despite the challenging market, we reported a good performance, with an operating profit of £19m for 2012.

The Trading Property team had a successful year in new acquisitions, particularly in food retail where there is a race for space for well located convenience stores. In total 83 new Food stores were launched during this year, with 125 stores being refurbished, including 60 new format trial stores. Within Pharmacy, three new branches were opened and a further 67 refitted, remodelled or relocated. The Estates team also supported the opening of 27 Funeral homes.

In 2012, the Estates Energy team bought nearly two terawatts of electricity for the Group and were able to save £6m against the energy budget by using a fully flexible, risk managed contract. This expertise in the purchase of energy saw our energy buying consortium expanded to other partners and organisations aligned with the Group's values, including the National Trust and Oxfam.

The extension to the Coldham Wind Farm on the Group's Cambridgeshire farming estate was completed during 2012, comprising seven additional wind turbines complementing the existing eight. This brings the total generation

at Coldham to 70 GW-hrs of electricity per year, equivalent to circa 7% of the electricity consumed by the Group. Construction of Biggleswade Wind Farm, Bedfordshire, comprising ten wind turbines has just commenced. The project will be fully operational by autumn 2013.

We help to enable the Group's trading businesses to deliver their sustainability targets. In 2012 we trialled the concept of returning waste from our stores back to our depots on delivery trucks. This initiative is now being rolled out to all Food stores around the UK and will halve our waste management bill whilst ensuring we hit our Ethical Operating Plan target to divert the majority of waste from landfill.

We also undertook a large scale trial to test the concept of installing doors on to our fridges and became the first retailer to commit to rolling this initiative out across our Food store estate.

These initiatives and others like them have delivered 40% carbon savings to the Group since 2006 and the Group is on track to deliver its target to generate 25% of its electricity from its own renewables projects by 2017.

1 Angel Square

The Co-operative Group's flagship new building in Manchester City Centre, 1 Angel Square, opened its doors to colleagues in February 2013, with migration into the building expected to complete by the middle of 2013.

1 Angel Square is the biggest single expression of our Co-operative brand and highlights why sustainability is often good for business. The building will reduce the Group's energy and water usage dramatically and reduce our carbon footprint to the point where 1 Angel Square is carbon negative. Meanwhile, the building's Combined Heat and Power generator is so efficient that it produces a power surplus which is sold back to the National Grid.

BREEAM (Building Research Establishment Environmental Assessment Method) is the



internationally recognised measurement of energy efficiency and sustainability and we have achieved the highest possible rating of Outstanding – the first building of this size ever to do so.

NOMA

The NOMA redevelopment of 20 acres of Manchester city centre continued at pace in 2012. The new public realm area directly in front of 1 Angel Square was completed, boasting a 300 square metre lawn and around 75 different species of plants, trees and shrubs, and creating a direct link between Angel Meadows – Manchester's only central green space – and the heart of the city.

Finally – and crucial to the success of NOMA – the inner city ring road was redirected, a move described by the Council as one of the catalysts to the inward investment vital to the success of NOMA.

In the winter 2012 edition of the Royal Institute of Chartered Surveyors' North West 'Surveyor' magazine, 1 Angel Square was described as "proof that in today's challenging economic climate it is possible for a built scheme to be visually striking, commercially viable and highly sustainable."

Looking ahead

2013 will see Estates support the new Food strategy by firmly embedding our acquisitions pipeline. This will see us continuing to fight for the best retail space and protect our current assets through robust defensive planning.

We will continue to reconfigure our Manchester presence to the three building campus solution of 1 Angel Square, Miller Street and Balloon Street. This will enable the Group to free up the other buildings in its Manchester estate for development as part of NOMA. Hanover building has been submitted for planning approval for redevelopment with a decision expected in early 2013.

Our people

Our **people strategies** are developed for all of our employees in all of our diverse businesses. We seek to ensure that working for The Co-operative Group is a **positive** and **rewarding** experience.

Developments in 2012

During 2012 we undertook a number of initiatives which unified departments and services to further enhance the employment experience for all employees across the Group.

The most notable of these projects has been changes to our pension offer, delivered under the Pensions Strategic Review programme which has aimed to ensure a fair, affordable and consistent approach to pension provision for all of our employees. In the final year of the three year programme we reached a significant milestone with the launch of a revised single pension offer through our main pension offer called 'Pace'. Pace was extended and now has two defined contribution sections (Pace Essential and Pace Extra) alongside the existing defined benefit section (renamed Pace Complete). This provides our colleagues with significant choice in their retirement planning options. The schemes acquired by the Group following merger and acquisition activity were closed to future accrual and all active members within those schemes were offered membership of Pace for future benefit build up.

Another significant change in the pension's arena was the introduction of the automatic enrolment legislation. The requirements under this new legislation meant that the Group would have to automatically enrol all qualifying employees into a pension scheme and Pace Essential was designed with this legislation in mind. Directly impacting around 40,000 employees, automatic enrolment means that pensions will become a more prominent aspect of our employee benefits.

All the changes delivered under the Pensions Strategic Review were supported by a comprehensive communications programme across the Group which has seen regular communication updates to colleagues including newsletters, videos, presentations, promotional materials and a managers' toolkit. We have also re-launched our pensions website and www.pensions.coop now contains updated and new information about the pensions offer at The Co-operative Group.

We are one of the few major UK employers still to offer a defined benefit scheme and Pace Complete is open to all colleagues with more than two years' service. Our Group Pensions Department has won many accolades and this year received recognition from the Professional Pension Awards for the communication around our defined benefit offer. We also won the Scheme Sponsor of the Year award at the Financial News Pension Awards.

Diversity

Promoting more equal representation between men and women at all levels of the business and across our democratic governance is an ongoing priority for the Group.

Women make up approximately 20% of our Group Management Executive and 25% of our Group Board. That puts us well ahead of the majority of plcs and in-line with the recommendations of Lord Davies' 2011 report on boardroom gender equality.

However, we are far from complacent about women's representation and recognise that there is still much to be done. We have made a commitment that by the end of 2016 we want to see women as 33% of our Group Board and by the same time, we want to see women making up 50% of our Area committee members.

As part of this wider work we have established a medium term plan to strengthen the pipeline of female management talent at a number of different management levels.

The Group was once again recognised for its commitment to supporting and embracing diversity, and at the start of 2013 was awarded 3rd place in Stonewall's top 100 Employers, again the only retailer to feature in the rankings. The Group's Respect Network, comprising employees who are passionate about LGBT issues and diversity, undertook a range of activities during 2012. These including supporting 18 UK Pride events, the implementation of a regional support structure to extend the reach of Respect and a significant presence at the International Year of Co-operatives Expo in Manchester. Respect was recognised by Stonewall as a star performer network group, for the third time, for its invaluable contribution to the experience of LGBT colleagues.

Inspiring Young People

Our commitment to apprenticeships continued during 2012 with all our businesses offering apprentice opportunities. Funeralcare launched an industry leading apprentice framework by working in partnership with the Sector Skills Council. Meanwhile, our Apprenticeships Academy grew, creating an additional 800 opportunities across the Group. Our commitment to this training and development approach continues throughout our businesses.

The Graduate Training Scheme continues to be recognised externally. In the JobCrowd 'Top Companies Graduates want to work for', The Co-operative Group was ranked 5th place, rising 24 places from last year, making us the highest ranking retailer. We have also moved from 75 to 58 in the Times 100 Top Graduate Employers.

In addition to our existing Graduate Business Management and Finance programmes, this year we launched two new specialist programmes in Human Resources and Retail Operations with an IT programme due to start in 2013. This will offer graduates more choices in their career development and creates a strong internal pipeline of talent.

Our aim is to increase the numbers of graduates recruited to these programmes over the next two years.

Together for the Future

As we continue our progress towards a unifying culture across The Co-operative Group our focus on how colleagues join us has resulted in a new single induction programme. A combination of face to face and online, the new welcome colleagues receive when they join us will give every new starter a more consistent and improved experience that gives an overview of the Group while at the same time recognising the diverse range of our businesses. Our new 'Co-operative Welcomes You' portal gives greater flexibility to induction while offering a high standard of information provision for all those beginning their career at the Group.

The move to the Group's new head office, 1 Angel Square is eagerly anticipated by many Manchester-based employees. Whilst it is a visible symbol of the Group's investment in the future, HR's focus, now and in the future, will always be all of our people across all of our businesses.

Social goals

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

In 2012, the United Nations International Year of Co-operatives, our co-operative and ethics-led approach continued to stand us apart. We were recognised with more than 25 awards and accolades centred around the Group's Ethical Plan, environmental management, community programmes and sustainability reporting, and including a Queen's Award for Enterprise in Sustainable Development and the Financial Times Award for the Most Sustainable Bank in Europe.

Our principles in practice

We are distinct from other major UK businesses in that we are owned by our members, and are held accountable to them through our democratic structure.

Our commitment to social responsibility and sustainability is articulated through Our Ethical Plan which sets out targets across eight priority areas and is reviewed annually with our democratically elected members through our Values and Principles Committees.

The latest update of the Plan was launched in February 2012. It sets out new targets on diversity, diet and health and the environment as well as maintaining existing commitments, including our goal to be recognised as the most socially responsible business in the UK.

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

Keeping communities thriving

With a presence in every UK postal area we provide access to products and services at the heart of the local community. Significantly, in 2012, our work led to an investment of £18.3m in UK communities. What's more, together with our members and colleagues, in 2012, we supported over 10,000 initiatives in our communities, that's the equivalent of one initiative every hour of every day, all year long.

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

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

Responsible retailing

Responsible retailing was at the heart of our founding principles and today we remain committed to making healthy and ethical offerings accessible to as many communities as possible.

We have made our Healthier Choice options no more expensive than our standard lines and we continue to reduce salt, saturated fat and sugar in our own-brand products.

We have long championed the view that consumers should be provided with open and honest labelling and have led the way on restricting the marketing of less healthy products to children. As such, it was pleasing that our work was

recognised in a 2012 study by Which? that concluded that our work on diet and health is leading the way amongst UK retailers.

Animal Welfare is a priority issue for our members, and we aim to deliver good baseline welfare standards across our entire own-brand range. In 2012, we converted all our fresh and smoked own-brand salmon to the Freedom Food standard.

Responsible banking

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

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

Our home and motor insurance products, where the underlying investments are screened against the Bank's Ethical Policy, continue to set the bar for ethical insurance in the UK.

In 2012, our reputation for responsible banking led to recognition from the general public as both the UK's most trusted bank¹ and as the leader amongst financial services businesses for social responsibility.²

Supporting co-operatives

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

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

Inspiring young people

Our Inspiring Young People programme aims to benefit one million young people by 2014, bringing about a cultural shift in the way that young people are viewed and treated in the UK.

Within this programme, the Green Schools Revolution, brings inspiring and engaging activities to primary and secondary school classrooms. With over 5,200 schools registered, we are well on our way to achieve our target to engage 6,000 schools by 2014.

The Co-operative StreetGames Young Volunteers supports young people from disadvantaged areas to develop sporting and community leadership skills, some 6,000 having volunteered since the programme's launch in 2007. In 2012, we funded the expansion of StreetGames into Scotland and Northern Ireland.

We are also working to progress our Co-operative Academy, delivering an innovative curriculum, with a values-led ethos. This forms part of our wider work supporting Co-operative Schools, of which there are 388.

Protecting the environment

Our longstanding commitment to the environment has seen our operational greenhouse gas emissions cut by 43% since 2006, saving 600,000 tonnes of greenhouse gases each year. We are on track to achieve our target of 50% emissions reduction by 2020.

We have reduced the volume of waste disposed by 38% since 2006 whilst increasing the proportion of waste that is reused or recycled by 6%.

Environmental efficiencies such as these, are contributing to annual cost savings of £65m.

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

In 2012 the Government announced that mandatory greenhouse gas reporting would become a reality for UK quoted FTSE companies in 2013. The Co-operative Group has long campaigned for the introduction of such regulation and will continue to lobby for such mandate to apply to all large businesses.

Our focus on sustainable product sourcing, has seen us maintain policies which have gained us recognition as one of the UK's most responsible retailers of fish, palm oil, wood and paper.

Direct Greenhouse Gas emissions (tonnes CO₂e)³

	Total net GHG emissions (tonnes CO ₂ e)	Total gross GHG emissions (tonnes CO ₂ e)
2006*	987,587	1,408,419
2009	583,097	1,088,730
2010	329,133	932,254
2011	301,481	853,575
2012	272,559	803,581 ⁴
Decrease 2006–2012	72%	43%
Decrease 2011–2012	10%	6%

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

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

³ Direct carbon footprint (CO₂e) is calculated using emission factors identified in the Department for Environment, Food and Rural Affairs 2012 guidance. Includes emissions from operations, including energy consumption, transport and refrigerant leakages from food stores, distribution centres and distribution fleet. Reporting period: January to December. The Co-operative is part of the CRC, however we have compiled this data on a voluntary basis.

	(tonnes CO ₂ e) 2012
Gas combustion	45,322
Transport*	129,421
Refrigeration	113,652
Electricity (gross)**	515,185
	803,581

⁵ See Sustainability Report for further detail on methodology and data completeness, www.co-operative.coop/sustainabilityreport.

* includes all business travel.

** counting electricity from renewables as grid average. In 2012, 'net' electricity emissions (counting electricity from renewables as zero carbon) were 9,058 tCO₂e.

Total waste arising (tonnes)⁵

	Disposed (tonnes)	Waste reused/recycled (tonnes)	Total waste (tonnes)
2006*	68,530	91,245	159,775
2009	50,786	72,038	122,824
2010	47,311	71,335	118,646
2011	44,297	69,771	114,068
2012	42,216	70,747	112,962
Decrease 2006–2012	38%		29%

* Baseline year

Tackling global poverty and human rights

We believe that, when undertaken fairly, trade and finance have an unparalleled capacity to improve quality of life.

We remain second to none in the UK for Fairtrade product availability. Further, our goal is that if a primary commodity from the developing world can be labelled Fairtrade, it will be achieving 90% of these conversions by the end of 2013. Uniquely, we are committed to going Beyond Fairtrade, by which we seek to deliver benefits for producer communities above and beyond what the Fairtrade premium alone can deliver.

Our Grow Co-operatives campaign, in partnership with Oxfam, focuses on the role that smallholder farmers and co-operatives can play in feeding the world's population. The campaign has seen 75,000 people join us in successfully calling on the Government to unlock greater resources from the UK's international development budget.

Since 2009, we have operated a Human Rights and Trade Policy, which establishes the exceptional circumstances under which we will withdraw all trade from a particular state, area or settlement. From 2012, this Policy meant that we would no longer engage with any supplier of produce known to be sourcing from illegal Israeli settlements.

In partnership with CARE International UK, we support lendwithcare.org, which allows people in the UK to lend directly to entrepreneurs in the developing world, helping them work their way out of poverty. As at the end of 2012 £1.6m had been lent, and our aim is to facilitate over 100,000 loans by the end of 2013.

2013 promises to be another challenging year commercially, but our commitment to social responsibility and sustainability remains stronger than ever as we continue to build on our world-class social goals programme.

Principal risks and uncertainties

Managing our risks

Taking and managing risks is an inevitable part of doing business and, like all businesses, The Co-operative Group faces potential threats and opportunities that could affect long term performance. The key challenge is to identify the principal risks and to develop and monitor appropriate and proportionate responses.

The Group is a complex mixture of retail trading and financial services businesses. Each business faces a variety of risks that could compromise its performance and ability to meet strategic objectives.

The Board is responsible for approving the Group's strategy, its principal markets and the level of acceptable risks. The Group operates a risk management process that identifies the key risks facing each business. Each business and division has a risk register that identifies the likelihood and impact of those risks occurring and the actions being taken to manage those risks.

Our risk management approach enables informed decision-making based on an assessment of the impact and likelihood of events, and seeks to balance risk and reward rather than eliminate risk entirely.

Group risks

The most significant risks faced by the Group and related mitigation actions are set out below.

Group risks	
Risk	Mitigation
<p>Adverse economic conditions</p> <p>The Group could be further impacted by the ongoing adverse UK economic conditions as well as market trends in the specific business markets we operate.</p> <p>The timing of the predicted economic recovery is constantly being pushed back. The Banking Group in particular is exposed to low base rates and uncertainty in financial markets.</p> <p>Similarly, a severe contraction in the housing and labour markets, coupled with a lack of credit availability and a dip in consumer confidence, leads to a decrease in consumer spending, a significant increase in bad debt risk and an increase in funding costs.</p>	<ul style="list-style-type: none"> • External uncertainties are stress tested when developing strategic plans including stress testing of economic indicators such as Interest Rates, House Price Index (HPI), Unemployment and Commercial Property Prices. • Economic indicators and impacts are monitored closely. • Our ranges of goods and services and their price positions are constantly reviewed and adapted to reflect changing customer demands and expectations. • Financial forecasts are frequently updated to reflect prevailing conditions, trends and outlook.
<p>Failure of major supplier</p> <p>As a result of the economic downturn there is a risk of key major suppliers or business partners going into administration, causing a serious interruption to our ongoing business.</p>	<ul style="list-style-type: none"> • Financial healthchecks of prospective new suppliers during tender process. • Regular monitoring of the financial position of our suppliers, especially those we suspect of having difficulties. • Identification of alternative sources of supply where we are aware of potential difficulties. • Restrictions on the levels of mutual dependency in key supplier relationships.
<p>Brand and reputation</p> <p>The Group's reputation could be damaged by a significant adverse event leading to a loss of trust and confidence amongst consumers. This could lead to financial loss, including direct cost of redress and reduced business levels. More significantly, a serious adverse reputational event could lead to significant withdrawals from the Bank. The widespread use of social media increases this risk.</p>	<ul style="list-style-type: none"> • Robust operational standards and regular compliance audits. • Continual monitoring of our corporate reputation and brand standards. • Commitment to our Social Goals Strategy, reported through the annual Sustainability Report. • Monitoring of social media sites and proactive response to any key issues arising. • Close monitoring by senior management, and proactive PR to manage the impact of key events. • Bank capital and liquidity buffers maintained as well as contingency action plans to support any immediate liquidity requirement arising from a significant reputation risk event. • Consideration of brand, ethics and reputation risks in decision-making processes.
<p>Pension costs</p> <p>The Group's pension arrangements are regarded as an important part of the rewards package for employees and a key element in the attraction and retention of our people. The pension funding position is highly sensitive to assumptions on life expectancy, inflation and discount rates. Therefore, any variation from these assumed values has the potential to introduce volatility to the Group's results. A new defined contribution scheme has been introduced in 2012 complying with new pension requirements.</p>	<ul style="list-style-type: none"> • The Group and the schemes' trustees continue to carefully monitor the pension risks, taking action where necessary to adjust contributions to the schemes and revising the schemes' investment strategy to mitigate the risks. • Engagement of external advisors and actuaries as appropriate. • Triennial valuation of all schemes. • Continuous engagement of employees on all relevant pension issues. • Close monitoring of the implementation of the new defined contribution scheme.

Group risks continued	
Risk	Mitigation
<p>Business disruption The Group could be exposed to any significant incident such as a terrorist attack, pandemic or information loss which would adversely affect business operations.</p>	<ul style="list-style-type: none"> • Robust disaster recovery plans and business continuity developed and tested on a regular basis. • Continuous improvement in the resilience of IT infrastructure. • Progressive premises strategy centred around more modern buildings and facilities.
<p>Energy prices We are exposed to the risk of rising energy prices.</p>	<ul style="list-style-type: none"> • The Group operates a buying policy under which an agreed proportion of forecast energy requirements is secured at fixed prices.
<p>Business integration and change The risk of failure to achieve anticipated benefits from various business transformation programmes being implemented across the Group. Failure to manage these change programmes adequately could put at risk our objectives and financial targets.</p>	<ul style="list-style-type: none"> • Adoption of disciplined project and programme management processes. • Processes to monitor capacity and prioritise projects at business unit and Group level. • Appropriate approval, monitoring and post investment appraisal processes in place. • Effective governance structures for all major programmes with close monitoring by Executive Management and, where appropriate, Board. • Regular reviews of each programme are undertaken considering resource requirements, progress, dependencies between projects, and risks. • Engagement of key stakeholders and colleagues involved in and affected by change.
<p>Data protection The Group holds a significant volume of confidential personal data and could be adversely affected if any of this data were to be lost or compromised. This could give rise to legal or regulatory penalties as well as commercial costs.</p>	<ul style="list-style-type: none"> • We have robust data protection policies and procedures in place. • We are undertaking an extensive programme of work across the Group to implement heightened controls against the risk of loss of data and card data compromise. • Continuous improvement in physical and IT security processes. • Thorough investigation of any incidents arising and implementation of corrective action.
<p>Financial capacity and financial risk management The Group must be able to generate and maintain sufficient funds to meet business needs while managing interest rate, forex and liquidity risks (more details of financial risk management are given in note 38).</p>	<ul style="list-style-type: none"> • We have rigorous Treasury policies and procedures to ensure that funding is in place at all times with appropriate covenants to meet the needs of the Group. • Short, medium and long term cash flow forecasts prepared and reviewed on a regular rolling basis. • Diversified sources and maturity of borrowings. • Continuous engagement with banks, bondholders and other finance providers to keep them up to date with business developments and future finance requirements. • Close monitoring of existing facility limits and covenant headroom. • Ongoing review and monitoring of interest-rate and other credit related risks are undertaken by Treasury.
<p>Ethical sourcing Ethical trading is at the heart of our business. A major incident could undermine this key point of difference; alienate customers and severely damage sales and profits. As our scale and profile grows this brings greater visibility to our brand.</p>	<ul style="list-style-type: none"> • We have clear sourcing policies in place, comprehensively reviewed and communicated. • Technical auditing of new suppliers and ongoing rigorous monitoring of compliance with standards. • Continuing training and development of all employees involved in purchasing. • General widespread communication and awareness of all of our values and principles including ethical sourcing.
<p>Regulatory compliance The Banking Group, Legal Services and a number of other Trading businesses operate in highly regulated environments. This brings a necessary cost of compliance and a risk that non-compliance could mean fines, reputational damage and, in extreme, inability to operate.</p>	<ul style="list-style-type: none"> • Employment of suitably qualified and experienced compliance and risk officers as appropriate to each business area. • Comprehensive risk and audit functions. • Full and continuous engagement with relevant authorities.
<p>Own label food scare We have successful and extensive own brand ranges of food products. We are at risk of a serious food scare or incident that results in public liability and damages public confidence in our brand.</p>	<ul style="list-style-type: none"> • We deploy robust technical quality assurance policies, procedures and audits.

Principal risks and uncertainties continued

Banking Group risks

Additional significant risks, specific to the Banking Group are as follows:

Risk	Mitigation
<p>Credit risk</p> <p>Credit risk is the current or prospective risk to earnings and capital arising from a borrower's failure to meet the terms of any contract with the Banking Group or their failure to perform as agreed.</p>	<ul style="list-style-type: none"> • All authority to take credit risk derives from the Banking Group's Board. This is delegated through authorities to individuals or committees via the Chief Executive. The level of credit risk authority delegated depends on seniority and experience, varying according to the quality of the counterparty or any associated security or collateral held. • The credit risk policy is approved by the Executive Risk Committee annually and is owned by the Chief Credit Officer. The policy determines the criteria for the management of retail, corporate and wholesale risk, including securitisation, market exposures and credit management standards, country, sector and counterparty limits, along with risk appetites and delegated authorities.
<p>Liquidity and Funding risk</p> <p>Liquidity risk is the risk that the Banking Group's resources will prove inadequate to meet its liabilities as they contractually fall due or as a result of any contingent or discretionary cash outflows that may occur in a stress. It arises from the mismatch of timings of cash flows generated from the Banking Group's assets and liabilities (including derivatives).</p>	<ul style="list-style-type: none"> • Asset & Liability Committee (ALCO) is primarily responsible for overseeing the management of market, liquidity and funding risks. Its responsibilities include: <ul style="list-style-type: none"> – Identifying, managing and controlling the Banking Group balance sheet risks in executing its chosen business strategy; – Overseeing and monitoring relevant risk control frameworks; and – Recommending to the CEO and Executive Risk Committee relevant Principal Risk Policies and detailed risk appetite limits for approval. • To assist in carrying out these responsibilities, ALCO is supported by a Treasury Market Risk Committee, Liquidity Management Committee and Capital Management Committee. • The Bank operates within a robust liquidity risk framework of stress testing combined with a number of strategic and tactical measures which feed into an overall liquidity status score. This is supported with detailed contingency funding plans which are tested and reviewed on a regular basis. The Bank's liquidity management framework is designed in line with FSA BIPRU regulations and industry guidelines, including Institute of International Finance and Bank for International Settlements recommendations. • The Bank monitors its liquidity position against the Board-approved liquidity risk appetite. It also closely monitors the adequacy of its controls to provide assurance that liquidity risk is being appropriately managed, and regularly assesses its funding position.

Banking risks continued	
Risk	Mitigation
<p>Market risk</p> <p>Market risk is the risk that the value of assets and liabilities, earnings and/or capital may change as a result of changes in market prices of financial instruments. The majority of the Banking Group's market risk arises from changes in interest rates.</p>	<ul style="list-style-type: none"> ALCO 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. All interest rate risk exposure is removed from the retail 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. ALCO monitors the non-trading interest rate risk which is split between certain wholesale portfolios, banking and investment books, and the rest of the Bank's balance sheet.
<p>General Insurance risk</p> <p>Insurance risk refers to fluctuations in the timing, frequency and severity of insured events relative to the expectations of the firm at the time of underwriting.</p> <p>Motor insurance claims costs have risen significantly in recent years, fuelled by the increase in personal injury claims costs. This trend has the potential to impact Profit and Capital of the General Insurance (GI) business.</p>	<ul style="list-style-type: none"> The objective in managing GI risk is to ensure that insurance risks are understood and accepted in accordance with detailed underwriting rules developed with regard to the documented insurance risk appetite and that pricing appropriately reflects the underlying risk. GI risk is managed through the underwriting strategy, reinsurance arrangements, proactive claims handling and the claims provisioning process. A number of actions are taken to understand and model the potential impact of personal injury claims. Assumptions are made as to the frequency of claims with a bodily injury element. Similarly the claims reserving process makes assumptions as to the cost of personal injury claims per policy.
<p>Conduct</p> <p>Conduct Risk is the risk that the Banking Group's past, present or future behaviours, offerings or interactions will result in unfair outcomes for customers, thereby risking redress, possible penalties and reputational damage.</p>	<ul style="list-style-type: none"> Conduct Risk may arise from any aspect of the way a business is conducted, the sole test being whether the outcome is an unfair one for customers. The Banking Group mitigates and prevents emerging Conduct Risk through established systems and controls including ongoing oversight and monitoring from risk functions. Significant conduct risks are reported through existing management structures and committees and challenged by the Board Risk Committee.

The Co-operative Group Board of Directors



Len Wardle (r)

Age 68. Group Chair. Joined the Board in 1992. Former University Fellow. Member of the South East Regional Board. Director of Co-operative Food Board and of Co-operative Specialist Businesses Board. Non-Executive Director of Co-operative Banking Group Ltd, The Co-operative Bank plc, Member of the Group Remuneration & Appointments Committee, the Governance Committee, the Political Strategy Committee, the Board Diversity Strategy Committee. Also, a Director of Communicate Mutuality Ltd.



Jenny Barnes (r)

Age 52. Joined the Board in 2009. Public Sector Worker. Member of the South & West Regional Board. Director of Co-operative Food Board and a Director of Co-operative Press Ltd. Member of the Group Values & Principles Committee and Chair of the Board Diversity Strategy Committee.



Steven Bayes (r)

Age 51. Joined the Board in 2009. Nurse. Member of the North Regional Board. Director of Co-operative Specialist Businesses Board and a Director of Co-operatives UK Ltd.



Duncan Bowdler (r)

Age 54. Joined the Board in 2007. Trade and Legislation Manager. Member of the North West & North Midlands Regional Board. Non-Executive Director of the Co-operative Banking Group Limited and The Co-operative Bank plc. Member of the Group Audit and Risk Committee and the Governance Committee.



John Brodie (i)

Age 48. Joined the Board on May 2012. Chief Executive, Scottish Midland Co-operative Society. Director of Co-operative Food Board.



Patrick Grange (r)

Age 70. Joined the Board in 2007. Farmer and Business Consultant. Member of the North West & North Midlands Regional Board. Director of Co-operative Food Board and a member of the Group Audit & Risk Committee.



Ray Henderson (r)

Age 66. Joined the Board in 2009. Retired Telecoms Engineer. Member of the North Regional Board. Director of Co-operative Food Board.



Chris Herries (r)

Age 66. Joined the Board in 2009. Trainer and Business Consultant. Member of the South & West Regional Board. Director of Co-operative Specialist Businesses Board. Member of the Group Remuneration & Appointments Committee, the Governance Committee and the Board Diversity Strategy Committee. Also a Director of Co-operatives UK Ltd.



Ursula Lidbetter (i)

Age 50. Group Deputy Chair. Joined the Board in 2009. Chief Executive, Lincolnshire Co-operative. Chair of Co-operative Food Board. Member of the Group Audit and Risk Committee and the Group Remuneration & Appointments Committee.



Liz Moyle (r)

Age 64. Joined the Board in 2011. Director of Co-operative Specialist Businesses Board and a member of the Board Diversity Strategy Committee.

(r) regional representative
(i) independent society
representative

Board compositions

Co-operative Food Board

Ursula Lidbetter
Group Deputy Chair &
Chair of Food Board

Len Wardle
Group Chair

Jenny Barnes
Group Director

John Brodie
Group Director

Eric Calderwood
Group Director

Martyn Cheatle
Group Director

Herbert Daybell
Group Director

Patrick Grange
Group Director

Ray Henderson
Group Director

John Longworth
Independent Professional
Non-Executive Director

Peter Marks
Group Chief Executive

Steve Murrells
Chief Executive, Food

Euan Sutherland
Independent Professional
Non-Executive Director

Martyn Wates
Chief Executive Specialist
Businesses & Group Deputy
Chief Executive

Co-operative Banking Group Board

Paul Flowers
Group Deputy Chair &
Chair of Banking Group Board

Len Wardle
Group Chair

Duncan Bowdler
Group Director

Richard Coates
Independent Professional
Non-Executive Director

David Davies
Independent Professional
Non-Executive Director &
Deputy Chair of Co-operative
Banking Group

Anne Gunther
Independent Professional
Non-Executive Director

Peter Harvey
Independent Professional
Non-Executive Director

Mertyn Lowther
Independent Professional
Non-Executive Director

Peter Marks
Group Chief Executive



Marilynne Burbage (r)
Age 70. Joined the Board in 2009. Horticultural and Medicinal Plants Consultant. Member of the South East Regional Board. Director of Co-operative Specialist Businesses Board. Member of the Group Values & Principles Committee, the Governance Committee and the Political Strategy Committee. Also, a Director of The Co-operative Foundation.



Eric Calderwood (r)
Age 60. Joined the Board in 2006. University Lecturer/Retail Consultant. Member of the Scotland & Northern Ireland Regional Board. Director of Co-operative Food Board and a member of the Group Remuneration & Appointments Committee. Also, Director of Co-operatives UK Ltd and Chair of The Manx Co-operative Society.



Martyn Cheatle (i)
Age 51. Joined the Board in 2010. Chief Executive, Midlands Co-operative Society. Director of Co-operative Food Board and Chair of the Group Audit and Risk Committee.



Herbert Daybell (r)
Age 65. Joined the Board in 2009. Retired Publisher. Member of the Central & Eastern Regional Board. Director of Co-operative Food Board. Chair of the Group Values & Principles Committee and a member of the Board Diversity Strategy Committee.



Paul Flowers (r)
Age 62. Group Deputy Chair. Joined the Board in 2008. Superintendent Methodist Minister. Member of the North Regional Board. Chair of Co-operative Banking Group Ltd and The Co-operative Bank plc. Director of Global Development Co-operative Limited. Chair of the Group Remuneration & Appointments Committee and Member of the Political Strategy Committee.



David Pownall (r)
Age 55. Joined the Board in 2007. Self Employed Plastering Contractor. Member of the North West & North Midlands Regional Board. Director of Co-operative Specialist Businesses Board. Director of Co-operative Action Ltd and Director of Co-operative Press Ltd.



Stuart Ramsay (r)
Age 55. Joined the Board in 2009. Computer Technician. Member of the Scotland & Northern Ireland Regional Board. Director of Co-operative Specialist Businesses Board. Member of the Group Values & Principles Committee, the Governance Committee and the Political Strategy Committee. Also, representative on the Co-operative Party NEC.



Ben Reid (i)
Age 58. Joined the Board in 2000. Chief Executive of The Midlands Co-operative. Non-Executive Director of Co-operative Banking Group Ltd and The Co-operative Bank plc. Member of the Co-operative Banking Group Audit Committee. Also a Member of the Group's Values and Principles Committee.



Mark Smith (i)
Age 53. Joined the Board in 2010. Chief Executive of the Southern Co-operative. Director of Co-operative Specialist Businesses Board and a member of the Group Audit and Risk Committee.



Steve Watts (r)
Age 61. Group Deputy Chair. Joined the Board in 2000. Open University tutor. Member of the Central & Eastern Regional Board. Chair of Co-operative Specialist Businesses Board. Non-Executive Director of Unity Trust Bank plc. Member of the Group Remuneration & Appointments Committee and Group Audit and Risk Committee.

Bob Newton
Independent Professional
Non-Executive Director

Ben Reid
Group Director

Barry Tootell
CBG Chief Executive

Martyn Wates
Chief Executive Specialist
Businesses & Group Deputy
Chief Executive

Co-operative Specialist Businesses Board

Steve Watts
Group Deputy Chair & Chair of
Specialist Businesses Board

Len Wardle
Group Chair

Steven Bayes
Group Director

Marilynne Burbage
Group Director

Penny Coates
Independent Professional
Non-Executive Director

Michael Cutt
Independent Professional
Non-Executive Director

Chris Herries
Group Director

Peter Marks
Group Chief Executive

Liz Moyle
Group Director

David Pownall
Group Director

Stuart Ramsay
Group Director

Mark Smith
Group Director

Martyn Wates
Chief Executive Specialist
Businesses & Group Deputy
Chief Executive

Management Executive



Peter Marks

Group Chief Executive

Age 63. Entire working life spent within the Co-operative Movement, having started with the Co-op in Bradford in 1967. Instrumental in bringing about a number of major co-operative mergers over the past decade, as well as the Group's acquisition of the Somerfield supermarket chain. Non-Executive Director of the Co-operative Banking Group, The Co-operative Bank plc, Co-operative Insurance Society Limited and CIS General Insurance Limited. A Non-Executive Director of Thomas Cook Group plc, Chairman of its Health, Safety and Environmental Committee. A member of Greater Manchester Local Enterprise Partnership.



Martyn Wates

Chief Executive, Specialist Businesses and Deputy Group Chief Executive

Age 46. Has held a number of senior roles within the Co-operative Movement over the past 16 years including Chief Financial Officer of The Co-operative Group and prior to that Chief Financial Officer of United Co-operatives where latterly he also had responsibility for the Funeral Division. A qualified chartered accountant and Director of various internal subsidiaries and Non-Executive Director of The Co-operative Bank plc, Co-operative Insurance Society Limited and CIS General Insurance Limited.



Barry Tootell

Chief Executive, Banking Group

Age 51. Qualified accountant with over 20 years of banking experience and was previously Chief Financial Officer. Executive Director of Co-operative Banking Group Limited, Co-operative Insurance Society Limited, The Co-operative Bank plc, CIS General Insurance Limited and Britannia Treasury Services.



Steve Murrells

Chief Executive, Food

Age 47. Joined as Chief Executive of The Co-operative Food in 2012. Previously CEO of Danish meat company, Tulip. Has a long history in fresh food retailing, having held a number of senior positions with Tesco, including CEO for One Stop Stores and Commercial Director of Fresh Foods. Has also worked within buying and trading for Sainsbury's.



Gill Barr

Group Marketing Director

Age 55. Joined the Group Executive in January 2011. Previous positions include Marketing Director of John Lewis, and Business Development Director at Woolworth, as well as a range of senior positions within Kingfisher, KPMG and Freemans. Gill is also a Non-Executive Director of Morgan Sindall plc.



Mark Craig

Director of Corporate Affairs

Age 57. Has spent his whole working life within the Co-operative Movement, having started with Co-operative Retail Services in 1982, before moving to Oxford & Swindon Co-operative Society and then United Norwest Co-operatives. Represents The Co-operative Group on the Board of the British Retail Consortium and the Prince's Trust Retail Leadership Group.



Andy Haywood

Chief Information Officer

Age 49. Joined The Group Executive in January 2012. Has held a wide range of senior IT leadership roles across several industries. Most notably as Chief Information Officer of Boots, Chief Information Officer of HBoS Retail Bank and Chief Information Officer of ASDA.



Martyn Hulme

Managing Director
Co-operative Estates

Age 51. Has worked for The Co-operative Group for over 20 years joining the Group Executive in 2010. Qualified accountant and MBA, has held a variety of senior management positions within Finance, Strategy and Change, playing a leading role in many of the recent transformational changes within the Group. Director of various internal subsidiaries.



Steve Humes

Group Chief Financial Officer

Age 47. Joined The Co-operative Group in 2000, ten years as Director of Finance for the Food business and Group CFO since the beginning of 2011. A qualified chartered accountant with extensive food retail and manufacturing experience prior to joining the Group.



Wayne Lee

Acting Group HR Director

Age 53. Joined The Co-operative Group in 2000 and has undertaken a number of senior HR roles, joining the Group Executive in October 2012. Prior to joining The Co-operative Group, developed extensive HR experience in roles with UK Co-operative and in the public and private sectors.



Moira Lees

Group Secretary

Age 54. Heads the Group's Secretariat, covering the Governance, Membership and Legal functions. Also Secretary of Co-operative Banking Group. Has been with the Group since 1981. Has held a number of positions in the Co-operative Movement. Currently Chair of The Co-operative Academy of Manchester.

Corporate Governance



Introduction from the Chair

The Board of The Co-operative Group is committed to the highest standards of corporate governance and recognises that good governance helps the business to deliver its strategy, strengthen member confidence and safeguard the long term interests of the Group. It believes that good governance is essential to the success of the Group and should be focused not only in the boardroom but across the entire business.

Our business model, which is described on pages 2 and 3 of this report, makes us unique in comparison to organisations of a similar size and our democratic nature ensures we have directors who are fully committed to our Co-operative Values and Principles and the long term success of the Group.

Good governance requires the active and committed engagement of all directors and management. During the year, individual peer evaluations of a third of the directors took place and these helped inform discussions between myself and individual directors on their performance. An externally facilitated Board Culture review was also undertaken with all of the Group Board and executives. This will help drive the effectiveness of the Board.

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

- the appointment of a new Group Chief Executive;
- the potential acquisition of 632 branches from Lloyds Banking Group (Verde);
- instigation of a Strategic Review of the Food Business;
- the construction of the new Head Office at 1 Angel Square and the development of the NOMA site in Manchester;
- the introduction of a revised Membership Proposition and Customer Strategy; and
- a review of the Board Diversity Policy.

Len Wardle
Group Chair

Governance structures

Our Governance structure

The diagram below shows our governance structure.

The Group has three principal subsidiaries, all of which are industrial and provident societies.

The Co-operative Banking Group (CBG) is responsible for the Group's banking and insurance arms. This has a number of subsidiaries which are regulated by the FSA. The other two subsidiaries of the Group have responsibilities set by the Group Board for specific areas – one for the Food business and one for the other customer facing businesses (Specialist Businesses) and have been designed to improve the Group's governance and to provide greater scrutiny of its large and diverse businesses.

Membership involvement

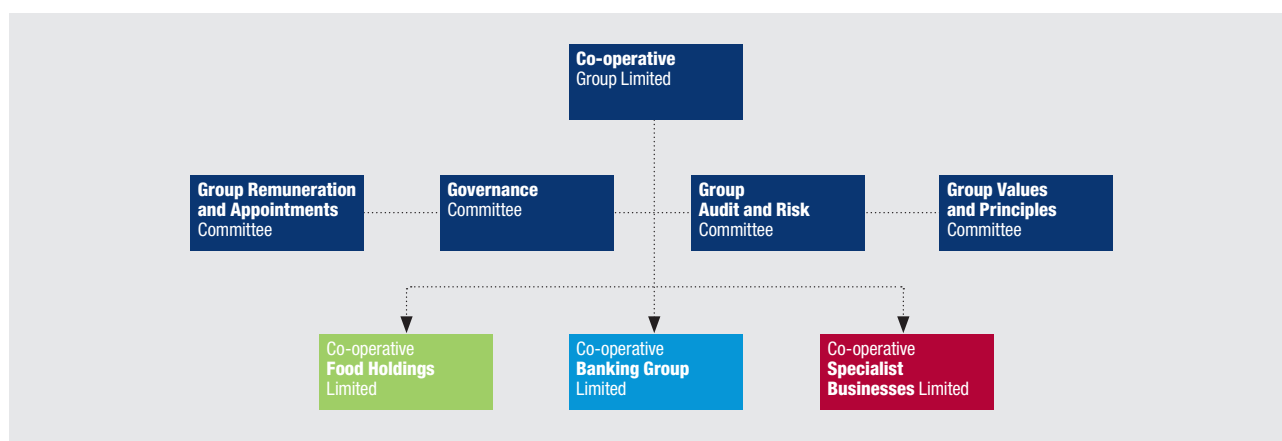
As a co-operative, the Group is jointly owned, and democratically controlled, by over 7.6 million individual members and approximately 80 Independent Society Members. Individual members of the Group exercise democratic control by serving as representatives on its 48 Area Committees and seven Regional Boards, or by voting in elections (222,221 individual members voted in 2011), attending twice yearly members' meetings held throughout the country or participating in other consultation initiatives.

The Group provides formal learning and development opportunities to ensure members have the necessary knowledge and skills to fulfil their role within the governance process. The Group regularly communicates with active members using magazines, mailings and the internet. Additionally, the Group encourages members to share their views and influence policies and standards through local area meetings and online members' meetings.

Compliance with the UK Corporate Governance Code

The Group is an Industrial and Provident Society. It is unusual amongst other UK consumer co-operatives in that it has both Independent Society Members and individual members. As a co-operative society, it is not mandatory for the Group to comply with the UK Corporate Governance Code (the Code); however, the Group aims to conform to the spirit of the Code, where this is appropriate.

The Group also adheres to a Corporate Governance Code of Best Practice, published by Co-operativesUK, which applies to consumer co-operatives within the UK. The Group will report on its compliance with this Code directly to Co-operativesUK, as appropriate, and full copies of this report are available on request from the Group Secretary.



Corporate Governance continued

Leadership

Role and responsibilities of the Group Board and Subsidiary Boards

The Group Board is responsible for setting the strategy of the Group and for maintaining the policy and decision making framework within which this strategy is implemented. It ensures that the necessary financial and human resources are in place to meet strategic aims, monitor performance against key financial and non-financial indicators, oversee the system of risk management and to set values and standards in governance matters, brand and membership.

The Group Board provides leadership of the Group and direction for management and is collectively responsible for the long term success of the Group. As such the Board directs the business in the following ways:

- ensuring that the Group's affairs are conducted and managed in accordance with its purpose and objects as set out in its Rules, and in accordance with the best interests of the Group and its individual and Independent Society Members;
- determining the vision and strategy of the Group in consultation with the Chief Executive and the Executive;
- overseeing the Group Chief Executive and the Executive in the day to day management of the business of the Group; and
- determining capital allocation to subsidiaries.

The role of the Subsidiary Boards is to lead and direct the respective businesses and to monitor performance.

Group Board Composition and Independence

The Group Board consists of 20 directors; 15 of which are elected from the Regional Members Constituency and five are elected from Independent Co-operative Societies. The number of directors is determined by Rule.

The names of the members of the Board at the end of 2012, their biographies and details of length of service are set out on pages 30 and 31.

The Code requires at least half of the Board, excluding the Chair, to be independent Non-Executive Directors. In accordance with the Code, it is for the Board to consider whether a director is independent in character and judgement and whether there are any relationships or circumstances which are likely to affect, or could be perceived to affect, the director's judgement.

Due to the democratic nature of the Group, all directors are Non-Executive. The Board has concluded that those directors elected from the Regional Members' Constituency (with the exception of Duncan Bowdler who is an employee of the Group) are defined as independent, while those directors elected from Independent Society Members are not independent. This is because the latter represent Independent Society Members which enter into material transactions with the Group and which may carry out similar trading activities to the Group. Whilst this is inherent in the federal role and constitution of the Group, conflicts of interest are declared, where appropriate, during Group Board business and necessary safeguards are put in place.

It is the Group Board's view that the role of senior independent director is not appropriate for the Board due to its democratic nature. The appointment of three Deputy Chairs, in addition to the Group Chair, meets the necessary governance requirement of senior leadership on the Board.

Directors are expected to exercise their judgement when making decisions in the best interests of the Group as a whole, mindful of their responsibilities to members and other stakeholders. The Group Board believes that all of its directors make valuable contributions to the operation of the Group. They constructively challenge and help to develop proposals on strategy and bring strong, independent judgement, knowledge and experience to the Board's deliberations.

Appointment of directors

Under the Rules of the Group, a third of directors are subject to re-election each year. Contested elections were held during the year and as a result the following sitting directors were re-elected to the Board in 2012 for a three year period:

- Jenny Barnes, Co-operative Group South West Region
- Herbert Daybell, Co-operative Group Central & Eastern Region
- Eric Calderwood, Co-operative Group Scotland & Northern Ireland Region
- David Pownall, Co-operative Group North West & North Midlands Region
- Ben Reid, Midcounties Co-operative
- Mark Smith, the Southern Co-operative was re-elected for a two year term

In addition, with effect from 26 May, 2012, John Brodie, Scottish Midlands Co-operative Society, was elected to the Board for the first time for a three year period.

The role of the Group Chair

The Group Chair, Len Wardle, is elected by and from the Group Board and is a Non-Executive Director. He leads the Group Board in the determination of its strategy and in the achievement of its objectives. The Group Chair is responsible for organising the business of the Group Board, ensuring its effectiveness and setting its agenda. The Chair has no involvement in the running of the day to day business of the Group. The Group Chair facilitates the effective contribution of directors, ensures constructive relations between the directors and the Group executive management, ensures directors receive accurate, timely and clear information and ensures that there is effective communication with members.

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

The Chair is supported by three Group Deputy Chairs who are Paul Flowers (Chair of Co-operative Banking Group), Ursula Lidbetter (Chair of Co-operative Food Board) and Steve Watts (Chair of Co-operative Specialist Businesses Board).

The Secretary to the Board

The Group Secretary, Moira Lees, is professionally qualified and is responsible for advising the Group Board and the Group Chair on all governance matters. The directors have access to the advice and services of the Group Secretary. Under the Group's Rules, the appointment and removal of the Group Secretary is a matter for the Group Board.

The role of the Chief Executive and the Executive

The Group Chief Executive, Peter Marks, is appointed by the Group Board and has direct responsibility for the Group on a day to day basis. He is accountable to the Group Board for the financial and operational performance of the Group.

It is the responsibility of the executive to implement the strategic objectives as agreed by the Group Board. The executive, under the leadership of the Group Chief Executive, is responsible for the management of the Group.

In August, 2012, Peter Marks announced his intention to retire as Group Chief Executive of the Group in May 2013. Following an extensive search using external recruitment advisers, and a robust selection process, the Board announced that Euan Sutherland would succeed Peter in this role in May 2013. Euan is currently the Group Chief Operating Officer of Kingfisher plc and is currently a Non-Executive Director on the Co-operative Food Board.

The Group Chief Executive and other members of the Group Executive team are not directors of the Group.

How the Board operates

Meetings

In addition to regular Board meetings, the Group Board meets separately, alongside senior executives, to consider performance and longer term planning, giving consideration both to the opportunities and risk of future strategy. The Subsidiary Boards generally meet once a month and they have the responsibility for their respective businesses. Joint Board meetings are arranged from time to time to consider wider Group strategic issues.

The number of meetings of the Group Board and main Board committees is set out below. This also details directors' attendance. Meetings are held at the Group's head office in Manchester, however, the annual strategy and planning event is generally held off site. In addition, the Board holds private sessions in the absence of senior management to discuss specific issues on a case by case basis.

Attendance

The table below sets out the frequency, and related attendance of the Board and Committee meetings for the period under review by directors.

In the case of a director being unable to attend a meeting, the Chair has received a satisfactory reason for their absence.

	Group Board	Group Audit & Risk Committee	Group Remuneration & Appointments Committee
Jenny Barnes	12 (12)		
Steven Bayes	12 (12)		
Duncan Bowdler	12 (12)	8 (8)	
John Brodie	6 (8)		
Marilynne Burbage	12 (12)	2*	
Eric Calderwood	11 (12)		5 (5)
Martyn Cheadle	10 (12)	7 (8)	
Herbert Daybell	12 (12)		
Paul Flowers	12 (12)		10 (10)
Patrick Grange	12 (12)	8 (8)	4 (4)
Ray Henderson	12 (12)		
Chris Herries	12 (12)		10 (10)
Ursula Lidbetter	11 (12)	8 (8)	9 (10)
Liz Moyle	12 (12)		
David Pownall	11 (12)		
Stuart Ramsay	12 (12)		
Ben Reid	12 (12)	7 (7)	
Mark Smith	9 (12)	1 (1)	
Len Wardle	12 (12)		10 (10)
Steve Watts	12 (12)	8 (8)	10 (10)

The number in brackets indicates the number of meetings a director was entitled to attend.

Directors' attendance at all the Group's Boards and Committees can be found on the members' website.

* Attended in the capacity as an observer.

Information to directors

Recognising the need for a more secure, cost effective alternative to paper board packs and in line with the Group's strong stance on environmental ethics, an electronic board paper solution was trialled with directors and key meeting attendees in 2011. Following a positive response from directors, the distribution of hard copy board packs was phased out completely by June 2012. In addition to board papers, the application is being used to provide access to supporting material, training and calendar management.

Board Committees

The Group Board governs through clearly identified Board Committees which are detailed in this report. Each of these Committees has a role in ensuring the effectiveness of the Group. A provision of the Code is that the terms of reference for the Group Remuneration and Appointments Committee and the Group Audit and Risk Committee are available on the Group website at www.co-operative.coop.

The Board ensures that the Committees are provided with sufficient resources to enable them to undertake their duties. The Board Committees formally report to the Board on their proceedings after each meeting and generally on all matters and activities for which they are responsible through the Committee Chairs and via access to Committee minutes.

Group Audit and Risk Committee – Information on the Group Audit and Risk Committee is given on pages 37 and 38.

Group Remuneration and Appointments Committee – Information on the Group Remuneration & Appointments Committee is in the Committee's report on pages 40 to 50.

Group Chair's Committee – The Group Chair's Committee has the authority to act between Group Board meetings if required. The remit of the Committee covers all areas reserved to the Group Board. The Committee comprises:

Len Wardle (Group Chair)
Paul Flowers (Group Deputy Chair)
Ursula Lidbetter (Group Deputy Chair)
Steve Watts (Group Deputy Chair)

Governance Committee – The Governance Committee's remit is to consider any matter that relates to the good governance of the Group that the Group Board request, in particular, constitutional matters, member development and learning, elections at Area, Regional and Board level and Boardroom governance practices. The composition of the Committee is:

Len Wardle (Group Chair)
Duncan Bowdler
Marilynne Burbage
Chris Herries
Stuart Ramsay

Values & Principles Committee – Although this Committee is not a formal Committee of the Board, it is monitored by and accountable to the Group Board and the Group Board receives regular reports as to its activities. Its membership currently includes:

Herbert Daybell (Chair of the Committee)
Jenny Barnes
Marilynne Burbage
Stuart Ramsay
Ben Reid

Corporate Governance continued

In addition, there are seven regional representatives, one from each of the Group's seven regions, one person appointed by the Membership Diversity Working Group and one representative appointed by Independent Society Members.

The Committee is responsible for monitoring the Group's Membership engagement and community strategies. It also scrutinises the Group's Sustainability Report on behalf of the Group Board and is responsible for maintaining relationships with the wider Co-operative Movement.

Political Strategy Committee – This Committee considers and makes recommendations to the Group Board, the Group Values & Principles Committee and/or Management on any matter that relates to the political engagement of the Society. It monitors the Group's overall approach to political engagement, in particular to its engagement with Government at all levels, including the European Union, Westminster, the devolved legislatures, regional structures within England and local government throughout the UK. This includes political parties, funding within the political environment, engagement at political conferences and other events, political consequences and the outcomes of our Social goals strategy, Engagement of members in public policy interventions and any other matters of political strategy development, which falls within its remit, as determined by the Committee or the Group Board. The composition of this Committee comprises:

Len Wardle (Group Chair)
Herbert Daybell (Chair of Values & Principles Committee)
Marilynne Burbage
Paul Flowers
Stuart Ramsay

Board effectiveness

Board Statement on Diversity

The Board takes the issue of diversity seriously and actively promotes a policy and practice of equality or opportunity in employment for all colleagues, regardless of age, disability, ethnicity, gender, religion or belief or sexual orientation.

Board Diversity Strategy Committee

The Board has established a Diversity Strategy Committee, whose role is not only to look at diversity issues amongst employees, but also within its membership population, including its elected Area Committees, Regional Boards and the Group Board. It also considers diversity issues in respect of the goods and services The Co-operative Group provides.

The Board Diversity Strategy Committee is responsible for consideration of the overall diversity strategy for the Group. Membership of the Board Diversity Strategy Committee comprises:

Paul Flowers (Co-operative Banking Group Board,
Chair of the Board Diversity Strategy Committee)
Len Wardle (Group Chair)
Herbert Daybell (Chair of the Values & Principles Committee)
Jenny Barnes (Co-operative Food Board)
Chris Herries (Co-operative Specialist Businesses Board)

In 2012, the Board approved a policy for Board Diversity applicable to the Group Board and its key Subsidiary Boards. This policy sets out the proposals as to how each Board will achieve its vision of being representative of the communities it serves.

The policy includes all aspects of diversity and in particular, responds to the Co-operative Women's Challenge 2020 which aims to ensure that women are fairly represented at all levels within co-operative businesses, and the revised UK Corporate Governance Code published in September 2012, which addresses the recommendations by Lord Davies in his 'Women on Boards' report published in February 2011. The policy aims to address the

representation of women on the Group Board by setting interim targets for the percentage of female directors serving on the Board. Targets have also been set for the Group's Area Committees and Regional Boards, as through such democratic processes, appointments to the Group Board are made. The policy also aims for the composition of the Group Board to reflect the diverse composition of the UK population based on the most recent UK Census results.

For the Group Board, targets have been set to comprise a minimum of 33% of female directors by 2016, and a minimum of 40% of females by 2018.

The Board is comprised of entirely Non-Executive, elected directors. Of the 20 directors on the Group Board, five of these are women, which represents 25% of the total. Of these, one is the Deputy Chair of the Group and also Chair of the Co-operative Food Board.

Performance evaluation

The Code requires the Board to undertake a formal and rigorous annual evaluation of its own performance and of its Committees and individuals.

A three year programme of assessment of Board and Committee effectiveness exercises and peer evaluations was introduced in 2011. Each year, one third of the Board of Directors are subject to a peer evaluation, selected on length of service from first appointment to the Board, subject to having served at least one year on the Board as at 30 June. Such an exercise took place in 2012. The responses to the peer evaluation questionnaires provided the basis of one to one discussions between the Chair of the Board and each Non-Executive Director.

An internal exercise to assess the effectiveness of the Group Board also took place during the year and the conclusions have been fed back to the Board. As a result earlier in the summer of 2012, a Board Culture consultation was undertaken with the Group Board directors, externally facilitated by Circus Communications Limited. The outcome of the consultation exercise has been discussed with the Board of Directors and further facilitated discussions will take place during 2013.

Induction and Continuing professional development

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

A Board Learning and Development Policy supports all directors. Following meetings with directors to review individual and collective training and development, thematic learning and development sessions for the whole Board have taken place.

In addition, directors receive information on the operation of the Group Board's Committees, including the powers delegated to the Committees, corporate governance practices and procedures and the powers reserved to the executive, together with the latest financial information. All directors have the opportunity to attend a meeting of a subsidiary Board or any of the Committees as observers.

This is supplemented by regular visits to key trading outlets and meetings with key senior executives where appropriate, together with in depth training and round table sessions on specific areas.

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

The Chair addresses the development needs of the Board as a whole, with a view to developing its effectiveness. He ensures that the directors' professional development needs are identified and that they are adequately informed about the Group and their responsibilities as directors. Individual learning and development records are issued to all Non-Executive Directors summarising activity undertaken through the year.

Succession planning

The term of office of one third of the Board expires each year, giving the opportunity for new directors with different skills and experience to be elected to the Group Board. To ensure that newly appointed directors have the skills and knowledge required to effectively undertake their duties, all candidates must have completed the Group Board Development Centre in advance of being nominated. The Development Centre requires the submission of 'a portfolio of evidence' in respect of eight competencies, followed by a 'professional discussion' with an independent assessor. The eight competencies being: Strategic; Financial; Co-operative Group Knowledge; Values & Principles; Stakeholder; Legal Responsibilities; Business and Analytical.

The Group Board makes the appointments to Subsidiary Boards and Committees, and in doing so, ensures that the persons appointed have the relevant skills and experience for the role.

Conflicts of interests

The Board has adopted a Conflicts of Interests Policy, which is contained within the Code of Conduct for Directors.

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

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

Directors and their interests

Due to the nature of the Group, directors are elected through the democratic process by both individual and Independent Society Members. Directors elected by individual members hold shares directly in the Group, whilst those directors elected by the Independent Society Members have an interest in the Group by virtue of their respective Independent Society Members' shareholdings. It is not considered appropriate to detail the interests of each director in this report as they are not material. As a key role of the Group is to provide a federal service to its Independent Society Members, material transactions are conducted with these members, some of whom are represented on the Board. Other than this, no director had a material interest at any time during the year in any contract of significance, with the Group or any of its subsidiary undertakings.

Insurance and indemnities

The Group maintains appropriate directors' and officers' liability insurance cover in respect of legal action against its directors and officers. The insurance cover was reviewed and renewed in 2012.

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

Professional advice and Board support

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

Group Audit and Risk Committee

Committee overview

Composition

The Committee is appointed by the Board and comprises six members as follows:

Martyn Cheatle (appointed Chair on 4 November 2012)
Duncan Bowdler
Patrick Grange
Ursula Lidbetter
Mark Smith (appointed on 4 November 2012)
Steve Watts

Ben Reid served as a member and Chair of the Committee until 4 November 2012, when he stepped down.

In addition, the Chair of the Co-operative Banking Group Audit Committee together with the Chair of the Co-operative Banking Group Risk Committee, attend meetings for agenda items relating to the Co-operative Banking Group.

At the invitation of the Chair, the Chief Financial Officer, Director of Group Internal Audit, Group Financial Controller, Head of Accounting and other representatives of senior management regularly attend Committee meetings. The Committee as a whole also meets separately with the Director of Group Internal Audit and the external Auditors prior to each meeting.

Full details of attendance at Committee meetings are shown on page 35.

All Committee members are considered by the Board to have the necessary ability and experience to understand financial statements. At the time of considering its annual Board appointments, the Board reviewed the requirement that at least one member of the Committee should have recent and relevant financial experience and concluded that up until the time of his stepping down from the Committee, Ben Reid, fulfilled this requirement. Martyn Cheatle and Mark Smith currently fulfil this requirement. Biographical details of each member of the Committee are contained on pages 30 to 32.

The role of the Committee

The Committee works to an annual schedule of regular standing items, as required under its terms of reference. Additional meetings are arranged as required. Items on the agenda are focused to coincide with the annual financial reporting cycle. The Committee regularly reports its findings to the Group Board and where appropriate, the Food, Specialist Businesses and Co-operative Banking Group Subsidiary Boards.

The main responsibilities of the Committee are set out in its terms of reference which are available on the Group's website: www.co-operative.coop. These include to:

- Monitor the integrity of the Group's published financial statements and financial information;
- Review the quality and effectiveness of the external audit and the procedures and controls to ensure auditor independence;
- Review and monitor the effectiveness of the internal audit function;
- Ensure that an appropriate relationship between the Group and the external auditor is maintained, including reviewing non-audit services and fees, taking into account relevant ethical guidance on the provision of non-audit services by the external audit firm and report to the Group Board, identifying any matters in respect of which it considers that action or improvement is needed;
- Review the effectiveness of the Group's systems of internal controls and the processes for monitoring and evaluating the risks facing the Group;
- Review the Group's systems and controls in relation to employee and stakeholder whistleblowing procedures;
- Review the minutes and receive reports of the Co-operative Banking Group Audit Committee and the Co-operative Banking Group Risk Committee.

Corporate Governance continued

Committee focus during 2012

During the year, the Committee met eight times. Additional meetings to the scheduled four were held to focus on the scope and findings of the due diligence surrounding the proposed transaction by the Group's subsidiary, The Co-operative Bank, of the acquisition of 632 bank branches of Lloyds Banking Group.

In addition the Committee focused on the following key issues during the year:

- Review of the published financial information, including the Annual and Interim reports. To assist with consideration of these, reports were received from management and the external auditor;
- Process for risk management in the Group continued to be monitored by the Committee with detailed reports on: Banking Group Integration; the 'Unity' Programme; the accounting for lump sum funeral plans in the Life Planning business; Internal Audit Red Flag report and Litigation issues;
- The Committee received regular reports during the year from KPMG Audit Plc and representatives from KPMG Audit Plc were consulted throughout the debates during meetings;
- Reports are received on the Group's Pension Schemes; Whistleblowing (including anti-bribery report) and the Grocery Supply Code of Practice (including the report from the Code Compliance Officer);
- The Committee met with each of the Director of Group Internal Audit and representatives from the External Auditors without management present at least four times during the year.

Annual review of effectiveness

During 2012, the Committee conducted a review of its performance as part of the annual Group Board evaluation process.

This review concluded that the Committee was effective and had sufficient resources to enable it to carry out its duties.

Training for Committee members

A training programme for the Committee was delivered during the year. The training schedule is designed to ensure sufficient time is dedicated to regulatory updates and changes in best practice. The topics covered during the year included Corporate Governance and Risk Management responsibilities. In addition, Committee members have access to KPMG Audit Plc's Audit Committee Institute for background information and guidance on the role and responsibilities of Audit Committee members. New Committee members are also provided with a structured induction session.

In addition, the Committee took the opportunity of visiting the dealing room in the Bank's Treasury function.

A presentation was also provided by KPMG Audit Plc on the role of the external auditors to members who attended the Regional Board Conference in May 2012.

External auditor

The Group's auditor is KPMG Audit Plc.

One of the duties of the Audit and Risk Committee is to make recommendations to the Board in relation to the appointment of the external auditors. In line with good corporate governance an external audit exercise took place in 2011. Subsequently, at the Annual General Meeting held on 26 May 2012, members agreed to re-appoint KPMG Audit Plc as auditor of the Group. A resolution to re-appoint KPMG Audit Plc as auditor will be proposed at the next Annual General Meeting on 18 May 2013.

Independence, objectivity and fees

The Committee regularly reviews the other services being provided to the Group by the external auditor and has in place a formal policy to ensure that this does not impair their independence or objectivity.

During the year, the Committee reviewed and updated its policy on the provision of non-audit services and the employment of external auditors.

Details of the amounts paid to the external auditors during the year for audit and other services are set out in the notes to the financial statements in note 3.

The external auditors are permitted to provide some non-audit services that are not in conflict with their independence and at each meeting the Committee receives a report providing details of assignments and related fees carried out by the external auditors, in addition to their statutory audit work. An additional comparison is provided through an analysis of cumulative fees paid to other major accounting firms for non-audit assignments.

Recognising the substantial changes in management and improvements in systems, processes and controls currently being implemented across the Group, the Audit Committee has requested KPMG to extend the mandate of the audit partner by a year to cover the financial statements for the period ended 4 January 2013, to maintain and enhance audit quality.

Pre-approval of the Committee is required for external auditor's services above certain thresholds determined by the Committee. In addition, the following are prohibited from being performed by the external auditors:

- Bookkeeping or other services related to the accounting records or financial statements
- Financial information systems design and implementation
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resources
- Any other services that the Audit and Risk Committee may determine

Performance

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

Internal Audit

Internal Audit is an independent appraisal function that derives its authority from the Group Board through the Group Audit and Risk Committee. Its primary role is to provide reasonable and objective assurance about the adequacy and effectiveness of the Group's financial control framework and its risk management.

Internal Audit seeks to discharge the responsibilities set out in its charter by reviewing the processes that ensure business risks are effectively managed; reviewing the financial and operational controls that help to ensure compliance with corporate objectives, policies and procedures and external legislation (other than those relating to safety, health and the environment and product regulatory compliance, which are the responsibility of other assurance functions) and, on an ad hoc basis, reviewing that value for money is obtained.

Internal Audit also acts as and is a source of constructive advice and best practice, assisting senior management with its responsibility to improve the process by which business risks are identified and managed.

Internal Audit reports are submitted to the Group Audit and Risk Committee on a regular basis, with significant issues being discussed by the Committee.

Internal control

The Group Board has overall responsibility for the Group's system of internal controls, which aims to safeguard the Group's assets and to ensure that proper accounting records are maintained and that the financial information used within the business and for publication is accurate, reliable and fairly presents the financial position of the Group and the results of its business operations.

The Group Board is also responsible for reviewing the effectiveness of its system of internal controls. The review has been in place for the year under review and is regularly reviewed by the Group Board. The system is designed to provide reasonable assurance of effective operations and compliance with laws and regulations, although any system of internal controls can only provide reasonable, not absolute, assurance against material mis-statement or loss, and can only mitigate rather than eliminate the risk of failure to achieve business objectives.

Assisted by the Group Audit and Risk Committee, the Group Board has reviewed the effectiveness of the Group's non-financial as well as financial controls, including operational controls, risk management and the Group's high-level internal control arrangements. The Group has adopted an internal control framework that contains the following key elements:

Control environment

The Group's control environment is designed to create an attitude of taking acceptable business risk within clearly defined limits. The control environment includes:

- An organisational structure with clear lines for responsibility, delegation of authority and reporting requirements;
- Co-ordinated activity across the whole Group through executive management meetings;
- Clearly defined policies for capital and revenue expenditure. Larger capital and revenue expenditure requires Group Board authorisation;
- Comprehensive systems of financial reporting. The annual budget and long term plans of the Group and of each Division are reviewed and approved by the Group Board. Results are reported against budget and previous year and action taken where appropriate; and
- A Code of Business Conduct covering relations with customers, members, employees, suppliers, community and competitors. The Code provides procedures to allow any employee to report, in confidence, suspected serious malpractice. An anti-fraud policy with guidance further supports the Code.

Internal audit, compliance and operational functions that review the system of internal control, including a financial control self-assessment process.

Risk management

The Group Board and executive management teams have the primary responsibility for identifying the key business risks facing the Group. Management is responsible for identifying the risks facing the business and for establishing controls and procedures to monitor and mitigate those risks. The Board is responsible for ensuring there is a robust risk management process and for regularly reviewing the identified key risks. The Group Audit and Risk Committee keep the effectiveness of the process under regular review. Details on the Society key risks can be found on pages 26 to 29.

Each business has a risk register that identifies the likelihood and impact of risks within their area and the actions being taken to manage them. Risk assessments are updated on a quarterly basis and reported to the appropriate Risk Management Committee and Audit and Risk Committee. The information is consolidated for the Group Risk Management Committee, which provides reports on how these risks are being managed to the Group Audit and Risk Committee.

The Group's Risk Management Committee has responsibility for establishing a coherent framework for the Group to manage risks. The objective of the Committee is to assist the Group Board in carrying out its responsibility to ensure effective risk management and a system of control.

Members of the Group Risk Management Committee are:

- Group Chief Executive (Chair)
- Deputy Chief Executive
- Chief Financial Officer
- Group Secretary
- Director of Corporate Affairs
- Co-operative Banking Group Chief Risk Officer
- Pensions Finance and Risk Controller
- Head of Financial Planning and Reporting
- Director of Group Internal Audit

Control procedures

The Group's control procedures are designed to ensure complete and accurate accounting for financial transactions and to limit the potential exposure to loss of assets or fraud. Procedures and reference information are maintained in relation to the Group's Rules, accounting policies and procedures, insurance, employees and Code of Business Conduct. These are issued to appropriate management who are trained in the procedures.

Information and communication

Communication takes place with all key stakeholders through a variety of media including the Group's Sustainability Report. Employees receive and provide information on strategy and objectives through their reporting lines and a formal performance measurement process. Newsletters, magazines, bulletins, events and electronic media communicate other information.

Assurance

The operation of the system of internal control is the responsibility of line management. It is subject to independent internal audit review and, where appropriate, review, by the Group's external auditors and external regulators.

The Group Audit and Risk Committee, on behalf of the Group Board, reviews the reports of the Group on internal control.

A key part of the process of assessing internal control, by the Group Audit and Risk Committee, is an annual 'confirmation of assurance' process. In this executive management confirm they have assessed the effectiveness of their systems of internal financial and non-financial controls, their compliance with Group policies (including those relating to safety, health and the environment), local laws and regulations (including the industry's regulatory requirements) and have reported any key control improvements required. The outcome of these is reported to the Group Audit and Risk Committee. The directors are then able to review the system of internal controls and ensure it complies with relevant regulatory guidance.

The Audit and Risk Committee considers that there have been no weaknesses that have resulted in any material losses or contingencies that have not been disclosed.

Remuneration report

Committee Chairman's summary

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

Key principles which make the Group remuneration policy distinctive from public companies include:

- Balanced scorecard linked to Co-operative values and principles;
- Levels of variable pay (annual and long term bonus) opportunity are consistently set at levels lower than in comparably sized public companies;
- The construct of both the annual and long term bonus plans is based on a balanced scorecard that includes significant non-financial measures which ensure that there is no encouragement of inappropriate risk taking.

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

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

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

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

Paul Flowers

Chair

Group Remuneration and Appointments Committee

As a co-operative, the Group is required to produce its accounts in accordance with the Industrial and Provident Societies Act 1965 to 2003, the Industrial and Provident Societies (Group Accounts) Regulations 1969 and applicable accounting standards. In the interests of best governance practice, as a guideline for its disclosure in relation to remuneration, the Group uses the disclosure requirements applicable to listed companies, as set out in the *Large and Medium Sized Companies and Groups (Accounts and Reports) Regulations 2008 (incorporated into the Companies Act 2006)*, and takes account of the requirements of the UK Corporate Governance Code.

The Group Board is entirely non-executive, the directors being elected from its membership. It has three principal subsidiary boards which comprise Group Board directors, Executives and Independent Professional Non-Executive Directors (IPNEDs). The day to day management of the Group falls to the Executives. For completeness, this report provides details of both Executives' and directors' remuneration.

This report will be put to an advisory vote of the Group's members at the Annual General Meeting on 18 May 2013.

Introduction

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

The Remuneration Report is presented by the Group Board and contains the following information.

Policy section:

- A description of the role of the Remuneration and Appointments Committee;
- A summary of the Group's remuneration policy, including statements of policy in relation to Executives' and directors' remuneration;
- A policy table with supporting notes showing each element of Executives' and directors' remuneration;
- Details of the terms of the service contracts and exit payment policy;
- Considerations elsewhere in the Group.

Implementation section:

- Details of the current terms of office and total remuneration of each Executive and director for the 2012 financial year;
- Remuneration governance.

Policy section

Role of the Remuneration and Appointments Committee (the Committee)

The Committee's terms of reference were last revised and approved by the Group Board on 15 September 2010. The principal terms of reference are to:

- Determine policy on remuneration and other main terms and conditions of employment in respect of all Group employees who are members of the Group Executive, including, amongst others, the Group Chief Executive and the Chief Executive, Banking Group (together 'Executives');
- Oversee contractual arrangements for Executives and approve the principal terms and conditions of their employment;
- Review remuneration using comparisons against the agreed market benchmarks for the Executive roles;
- Make recommendations on Executive appointments and the terms and conditions relating to these;
- Approve any relevant variable pay schemes and ensure that they support the Group's strategy, values and objectives, and authorise payments under any variable pay schemes in line with their rules; and
- Receive, review and decide on issues raised in relation to retirement benefit schemes across the Group and advise the Board on these issues as appropriate.

In respect of the directors, including IPNEDs, on the Group Subsidiary Boards, the Committee's responsibilities include:

- Ensuring there is a timely review of the remuneration and expenses policy for directors and agreeing the process and resource for an independent review;
- Ensuring that in the event of any compensation payments being made to the directors, an independent process is in place to ensure the policy and the interpretation of the policy is fair, reasonable and transparent, avoids conflicts of interest and that such payments are in the wider interests of the Group and membership as a whole;
- Considering and recommending to the Group Board the appropriate recruitment process for the appointment of IPNEDs to the Group's subsidiary boards;
- Overseeing contractual arrangements including remuneration in respect of IPNEDs; and
- Ensuring there is a succession plan in place in respect of the position of Group Chair and Chair, Banking Group.

The terms of reference of the Committee are available on the Group's website.

The Committee members are all non-executive. They have no personal financial interests in the Committee's decisions and they have no involvement in the day to day management of the Group.

To ensure that it receives independent advice on remuneration matters, the Committee retained New Bridge Street (an Aon Hewitt company) as its independent adviser during the year. New Bridge Street supplied the survey data and advised on market trends and other general remuneration issues. Other than specialist advice in relation to the Group's remuneration issues, New Bridge Street does not provide other services to the Group.

Policy on Executives' remuneration

In determining the remuneration policy for Executives, the Committee has considered a number of factors including:

- The importance of attracting, retaining and motivating senior Executives of the appropriate calibre to further the success of the Group;
- The linking of reward to individual and business performance and the strengthening of co-operative values, which include a strong belief in stewardship of all of the Group's resources and, therefore, ensures that Executives are not rewarded for the assumption of undue risk;
- The alignment of the interests of Executives with those of the wider Group and its members;
- Pay practices and conditions of all employees throughout the Group; and
- The coherence of pay practices across the Group as a whole in conjunction with the Banking Group Remuneration Committee.

The current policy is to pay base salaries at a level around the market median, when compared with other organisations of comparable size and complexity in the same or similar business sectors. The Committee supports the principle of performance-related pay and operates both an annual incentive plan and a long term incentive plan ('LTIP'). However, the Committee does not consider it appropriate to adhere to the size of incentive pay typically available in public companies and accordingly the amounts payable under these plans are lower than in comparable public companies. These are based on performance metrics linked to the Group's Key Performance Indicators. Furthermore, the Committee carefully considers the motivational impact of its variable pay arrangements to ensure that they are effective and do not adversely impact areas such as governance, environment and social issues, or encourage inappropriate risk-taking.

Policy table

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

Element	Overview	How each element supports the strategic objectives of business	High level details	Clawback provision	Change in approach since last disclosure
Base salary ¹	To provide a competitive base salary to attract and retain talented leaders.	Payment for day to day role and responsibilities, individual performance objectives aligned to overarching business strategy.	Reviewed annually. Targeted around market median. Future increases based on performance results.	N	N
Benefits ²	To provide benefits in line with normal market practice.	Competitive benefits proposition ensures talent is attracted/retained and able to undertake duties.	Car or car allowance, fuel card, medical, phone and life insurance.	N	N
Pension ³	To provide competitive pension and protection benefits to attract and retain talented leaders.	Retains skills and experiences within the business.	The Co-operative Group provides either a Defined Benefit or a Defined Contribution pension plan (on the same basis as applies to all other employees in the Group) and/or an allowance designed so that the total value of the pension element is broadly the same as the value of the Defined Benefit pension plan.	N	Y – Group-wide change in pension policy, applicable to all colleagues including Executives.
Annual Incentive Plan ⁴	To incentivise and reward for the delivery of superior annual performance, based on the Group's annual business objectives and co-operative values.	Motivates delivery of business results aligned to the Board agreed balanced scorecard. Inclusion of financial and non-financial targets.	Up to 60% of salary based on annual Group financial and non-financial targets (and Divisional, if applicable). Incentive opportunity is below the market norm in comparable public companies. (See page 44.)	Y	Y
Long Term Incentive Plan ⁵	To incentivise and reward the delivery of superior long term performance, based on the Group's objectives and values, and to retain talent.	Encourages long term, sustained performance; motivates delivery of long term business results aligned to the Board agreed balanced scorecard. Inclusion of financial and non-financial targets.	Awards up to 100% of salary for the Group Chief Executive and 75% to 100% for other Group Executives based on stretching three year Group financial and non-financial targets. Incentive opportunity is below the market norm in comparable public companies. (See page 44.)	Y	N

Remuneration report continued

Policy notes to the policy table:

1 Base salary

It is the Committee's policy to ensure that the base salary for each Executive is appropriate and competitive for the responsibilities involved. Base salaries for Executives are reviewed by the Committee, usually annually, having regard to competitive market practice (in particular salary levels for similar positions in comparable companies), the level of salaries elsewhere in the Group and the individual's performance for the financial year. Comparative pay data is used carefully, recognising the potential for an upward ratchet in remuneration caused by over-reliance on such data. The normal month for salary review is January.

2 Benefits

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

3 Pensions

The Group offers every employee the opportunity to join a pension scheme.

Prior to 6 October 2012 employees may have built up pension benefits in any one of a number of pension arrangements, determined by their original employer within the Group (or other business prior to merger with, or acquisition by, the Group).

For current Executives, these were provided through The Co-operative Pension Scheme ('Pace') and the United Norwest Co-operatives Employees' Pension Fund ('the United Scheme'). Both of these schemes are registered occupational pension schemes, providing defined benefit pensions. The United Scheme broadly provides defined benefit pensions based on 1/60th of final pensionable salary for each year of pensionable service. Pace provides defined benefit pensions based on 1/60th of average pensionable earnings, revalued by inflation for each year of pensionable service (benefits accrued as at 5 April 2006, in respect of membership of the scheme preceding Pace, continue to be linked to final pensionable salary at a member's date of leaving or retirement, whichever is earlier). Both schemes also provide pensions to dependants on death and a lump sum is payable if death occurs in service.

The Group introduced significant pension changes for all employees from 6 October 2012 following completion of a major strategic review. As a result the following changes were implemented:

- All schemes, other than Pace, were closed to future pension accrual from 6 October 2012. Defined benefits built up to this date continue to be linked to final pensionable salary at a member's date of leaving or retirement, whichever is earlier.
- Pace remains open for future pension accrual. Two new defined contribution sections were introduced called Pace Essential and Pace Extra and the defined benefit section was renamed Pace Complete.
- Members of Pace Essential, into which all eligible employees will be automatically enrolled, currently pay 1% of pay and the Group pays 2%. Members of Pace Extra, which is available to all employees, currently pay 4% of pay and the Group pays 8%. Under both sections a lump sum is payable if death occurs in service.
- From 6 October 2012 all employees can choose to join Pace Complete once they have completed two or more consecutive years' service.

Executives who are members of Pace Complete currently contribute 8% of their pensionable salary or 7% of pensionable salary (until October 2013) if they were a contributing member of Pace at 31 December 2011. Prior to 6 October 2012 Executives who are members of Pace contributed 6% of their pensionable salary, whilst Executives who are members of the United Scheme contributed 8% of their pensionable salary. The Group pays the balance of the cost of providing defined benefits.

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

Furthermore, in the light of the pension tax changes applying to registered schemes from 6 April 2011, Group executive pension policy was revised. Where an Executive may be impacted by the Annual Allowance or the Lifetime Allowance they have the facility of opting out of future pension accrual in favour of a pension allowance or opting for restricted pension accrual based on a capped pensionable salary of £187,500 and receiving a restricted pension allowance in lieu of pension provision based on salary above £187,500. Where paid, the rate of pension allowance is based on the employer contribution rate to Pace Complete. This is currently 16% of pensionable salary (16.7% prior to October 2012).

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

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

4 Annual incentive plan

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

Each Executive is eligible to participate in an annual incentive plan. The Committee reviews and sets bonus targets and levels of eligibility annually. Each Executive is eligible to receive a payment of up to 60% of base salary. Bonus is only payable for achieving or exceeding Board agreed performance targets.

The annual incentive is based on a mixture of financial and non-financial measures. For Executives with solely Group responsibilities the incentive is based on Group measures only. For the majority of Executives with Divisional responsibilities, their incentives are based one-third on Group measures and two-thirds on Divisional measures (except the MD, Estates where the apportionment is 50:50). The table below sets out the measures used in 2012 for different roles and the weighting of each measure.

Performance metrics and weightings

Role	Group measures	Divisional measures
Group Chief Executive	Group profit (70%)	n/a
Group CFO	Group corporate responsibility (10%)	
Group Secretary	Colleague engagement (10%)	
Group HR Director	Customer satisfaction (10%)	
Director of Marketing		
Director of Communications		
Group CIO		
Chief Executive, Specialist Businesses/ Deputy Group Chief Executive, Chief Executive, Food	Group profit (23.33%) Group corporate responsibility (3.33%) Colleague engagement (3.33%) Customer satisfaction (3.33%)	Divisional profit (46.67%) Divisional colleague engagement (10%) Divisional customer satisfaction (10%)
MD, Estates	Group profit (35%) Group corporate responsibility (5%) Colleague engagement (5%) Customer satisfaction (5%)	Divisional profit (35%) Divisional colleague engagement (7.5%) Group customer satisfaction (7.5%)
Chief Executive, Banking Group	Group profit (23.33%) Group corporate responsibility (3.33%) Colleague engagement (3.33%) Customer satisfaction (3.33%)	Banking Group profit (33.33%) Return on Risk Weighted exposure amount (13.33%) Divisional colleague engagement (6.67%) Divisional customer advocacy (6.67%) Divisional risk (6.67%)

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

Targets are set for each metric, with 50% of the maximum opportunity (ie 30% of salary) payable for on-target performance (with nothing payable below this level), increasing on a straight-line basis to 100% of the opportunity (ie 60% of salary) payable at a stretch level of performance. The amount payable for on-target performance for 2012 was 25% of the maximum opportunity; however, as this was a substantially lower percentage of maximum opportunity compared to other organisations, this presented difficulties in recruiting Executives for The Co-operative Group. The Committee changed this policy on a forward looking basis for the 2013 performance year.

Clawback

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

⁵Long term incentive plan (LTIP)

The purpose of this plan is to focus senior managers on the achievement and delivery of the medium to long term strategic goals for The Co-operative Group whilst protecting long term firm wide sustainability.

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

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

Executives participate in the long term incentive plan, using cumulative targets over a three year period, as the Committee believes this arrangement aligns Executives with the long term interests of members and aids retention of talent. The maximum payment is 100% of base salary for the Group Chief Executive and between 75% and 100% for other Group Executives.

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

Metric	Weighting
Cumulative Group profit, subject to a minimum level of average Return on Net Operating Assets (RONOA), over the three year performance period	70%
Group corporate responsibility	10%
Colleague engagement	10%
Customer satisfaction	10%

A performance range is set for each metric, with 25% of the maximum payable for threshold performance, 50% of the maximum payable for target performance and 100% payable at a stretch level of performance, with a sliding scale between these points.

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

Service contracts and exit payment policy

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

FSA Remuneration Code (the Code)

FSA remuneration code principles fully apply to The Co-operative Banking Group (CBG) CEO and all remuneration arrangements and practices in place are compliant with the Code.

Share plans

As a Co-operative, the Group does not operate a share plan or a share option plan.

Non-executive directorships

The Committee has determined that, subject to the Committee's approval, Executives may accept one non-executive directorship, or similar, with an external organisation. This represents an important opportunity to further develop individuals' skills and experience, which is beneficial to the Group. Any fees received for such a role are normally paid to the Group.

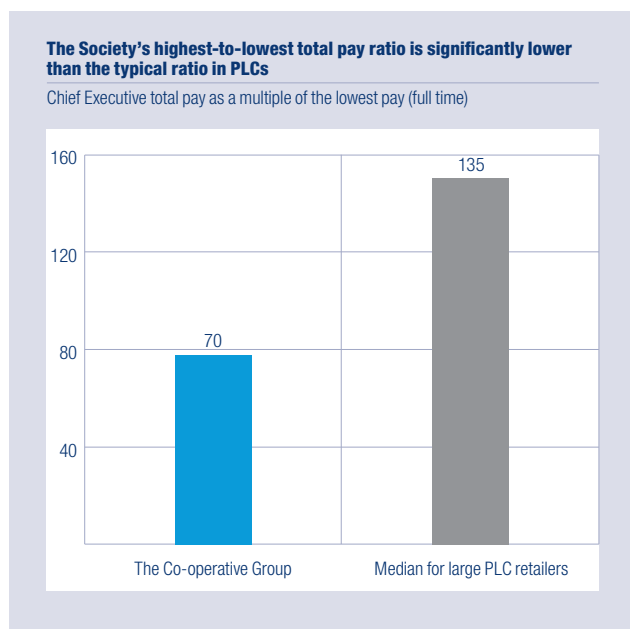
Remuneration report continued

Considerations elsewhere in the Group

The Committee takes account of the pay and conditions of other employees in the Group when reviewing Executive pay. The Committee also considers Executive pay within the wider context of the UK market in which the Group competes for talent.

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

The chart below shows the multiple of pay (net of tax) between the lowest paid employee and the Group Chief Executive of The Co-operative Group, and the typical ratio in large plc retailers in the UK. As the chart indicates, the multiple for total pay in The Co-operative Group is significantly lower than the norm for plc retailers. This is a consequence of the Committee's policy of setting maximum incentive pay at around half of the market level in comparable plcs.



Data taken from 2011/12 being the most up-to-date market data available at time of publication.

Highest total pay = 2011/12 salary, bonus paid in relation to 2011/12, expected value of long term incentives at grant, pension and benefits, net of income tax and employees' national insurance (based on 2011/12 rates), sourced from Report & Accounts.

Lowest total pay = 2011/12 salary (based on the over 18 hourly rate and standard full-time working week) and bonus paid in relation to 2011/12 (salary and bonus data sourced from IDS' 'Pay and Conditions in Retail'), assumed combined pension and benefits worth 10% of base salary, net of income tax and employees' national insurance (based on 2011/12 rates).

The information in the chart is not subject to audit.

On 16 July 2012, Steve Murrells was appointed as Chief Executive, Food.
Andy Haywood was appointed as Chief Information Officer on 4 January 2012.

Implementation Section

Total Remuneration received by Executives in respect of 2012 are set out in Table 1(a) (on page 46).

Total emoluments include:

- annual bonus payments in respect of 2012;
- long term incentive plan (LTIP) payments in respect of the 2010–12 plan;
- dates of appointment for Executives.

2012 AIP Out-turn

For 2012 AIP, zero award is payable in respect of Group performance due to the Group profit target level not being achieved. However in respect of Specialist Businesses and Property the divisional measures were met and so AIP was payable for this proportion for the Divisional Heads.

Role	Group measures	Divisional measures
Group Chief Executive	Group profit (70%)	n/a
Group CFO	Group corporate responsibility (10%)	
Group Secretary	Colleague engagement (10%)	
Group HR Director	Customer satisfaction (10%)	
Director of Marketing		
Director of Communications		
Group CIO		
Chief Executive, Specialist Businesses/Deputy Group Chief Executive	Group profit (23.33%) Group corporate responsibility (3.33%) Colleague engagement (3.33%)	Divisional profit (46.67%) Divisional colleague engagement (10%) Divisional customer satisfaction (10%)
Chief Executive, Food	Customer satisfaction (3.33%)	
MD, Estates	Group profit (35%) Group corporate responsibility (5%) Colleague engagement (5%) Customer satisfaction (5%)	Divisional profit (35%) Divisional colleague engagement (7.5%) Group customer satisfaction (7.5%)
Chief Executive, Banking Group	Group profit (23.33%) Group corporate responsibility (3.33%) Colleague engagement (3.33%) Customer satisfaction (3.33%)	Banking Group profit (33.33%) Return on Risk Weighted exposure amount (13.33%) Divisional colleague engagement (6.67%) Divisional customer advocacy (6.67%) Divisional risk (6.67%)

LTIP Out-turn

Under the plan cycle 2010–12, 11.46% of maximum opportunity is payable due to colleague engagement and corporate responsibility measures being achieved. Cumulative group profit and customer satisfaction targets were however not met and therefore no payment was made in respect of these.

Metric	Weighting
Cumulative Group profit, subject to a minimum level of average Return on Net Operating Assets (RONOA), over the three year performance period	70%
Group corporate responsibility	10%
Colleague engagement	10%
Customer satisfaction	10%

The plan cycle 2010–12 was completed in December 2012. The plan cycle 2011–13 remains outstanding, and grants were made in 2012 covering the 2012–14 cycle. Executives participating in the schemes are detailed in Table 1(b) (on page 47).

Pensions

The Group Chief Executive, the Group Secretary, the Chief Executive, Specialist Businesses and the Chief Executive, Food were paid a pension allowance in lieu of pension provision.

The Managing Director, Estates opted out of future pension accrual from 6 April 2012 and was paid a pension allowance. Prior to that date he had opted for restricted pension accrual in Pace Complete and was paid a restricted pension allowance.

The Group Chief Financial Officer, the Group Marketing Director and the Acting Chief Executive, Banking Group have restricted pension accrual in Pace Complete and were paid a restricted pension allowance.

The Acting Chief Executive, Food opted for restricted pension accrual in the United Scheme and Pace Complete from 1 February 2012 and was paid a restricted pension allowance from that date.

All other Executives accrued full pension benefits in Pace Complete and/or the United Scheme during the year.

Additional pension details are available in Tables 1 and 2 (on pages 46 and 48).

Directors

The Group directors do not have service contracts. The years of their first election are shown in Table 3 (on page 49). All Group directors are subject to a three year term of office, (unless they are filling a casual vacancy), following which they can be re-elected if eligible.

Group directors' fees are determined by the Group's members. At the Annual General Meeting on 26 May 2012, members agreed that with effect from 2013 onwards, the fee increases of Group directors and other elected members be aligned to that the most recently implemented The Co-operative Group managerial salary increase.

The basic remuneration for a Group director is £11,291 per annum. Those Group directors appointed to serve on the Board of The Co-operative Banking Group receive an additional annual fee of £16,937. The Chair and the three Deputy Chairs of the Group receive further fees to reflect their additional responsibilities and supplementary fees are also paid to directors serving on various other boards and committees.

None of the Group directors, by virtue of their Board position, participate in any of the Group's incentive plans or pension schemes, nor do they include share options or other performance related elements.

The total fees received by each director are set out in Table 3 (on page 49).

Separate fees are not received by any member of the Executive who serves as a director on the subsidiary boards.

The Group Board has appointed two IPNEDs to the Boards of Co-operative Food and Co-operative Specialist Businesses, each receiving an annual fee of £51,950. The term of office of two of these – Penny Coates and Mike Cutt – are due to expire in 2013. In addition, the Group Board appoints the Board of The Co-operative Banking Group, which includes six IPNEDS.

Governance

Members of the Committee during 2012 comprised Paul Flowers (Group Deputy Chair and Chair, Banking Group, who also chairs the Committee), Eric Calderwood (appointed 20 June 2012), Patrick Grange (resigned 20 June 2012), Chris Herries, Ursula Lidbetter (Group Deputy Chair), Len Wardle (Group Chair) and Steve Watts (Group Deputy Chair). The Group Board believes that all members of the Committee are independent for the purpose of reviewing remuneration matters. The Group Chief Executive (Peter Marks), the Group Secretary (Maira Lees) and the Group's Interim HR Director (Wayne Lee) are also invited to attend the meetings of the Committee, but are not present when their own remuneration or terms and conditions are being considered. Other individuals are invited to attend for specific agenda items when necessary.

The Committee met seven times in the period under review.

By the Order of the Board

Paul Flowers, Chair

Group Remuneration and Appointments Committee

20 March 2013

Remuneration report continued

Table 1(a) – Executives' emoluments

	Notes	Date of appointment (Note 1)	Adjusted basic salary (Note 2) £000	Other supplements (Note 3) £000	Performance related bonus – annual (Note 4) £000	Benefits in kind (Note 5) £000	Total related to 2012 (Note 6) £000	Performance related bonus – long term (Note 7) £000	2012 Total emoluments £000	2011 Total emoluments £000
Peter Marks		29 July 2007	1,014	172	–	43	1,229	103	1,332	1,661
Gill Barr		31 January 2011	313	37	–	1	351	–	351	445
Richard Bide	8	15 September 2003	265	5	–	8	278	25	303	528
Mark Craig		1 September 2010	188	3	–	22	213	–	213	291
Martyn Hulme		1 September 2010	265	54	50	1	370	6	376	374
Stephen Humes		1 January 2011	499	58	–	11	568	9	577	645
Moira Lees		28 November 2007	302	68	–	–	370	23	393	490
Martyn Wates		24 September 2007	591	104	197	19	911	59	970	968
Andy Haywood	9	4 January 2012	303	16	–	1	320	–	320	–
Sean Toal	10	19 September 2011	215	1	–	11	227	10	237	167
Barry Tootell		22 July 2011	522	72	–	1	595	–	595	510
Wayne Lee	11	1 October 2012	63	1	–	1	65	5	70	–
Steve Murrells	12	16 July 2012	296	48	–	16	360	–	360	–

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

Note 2 Basic salary has been adjusted to incorporate the extended year end, see note 6.

Note 3 Other supplements include full or partial pension allowances in lieu of a pension provision, car allowance, fuel, phone and healthcare supplements (ie non-P11D items).

Note 4 Performance related bonus – annual refers to bonus amounts earned in respect of the whole of 2012.

Note 5 Benefits in kind include car and healthcare cover (ie P11D items). In addition to the above the Executives also receive life insurance.

Note 6 2012 total emoluments represent 53 weeks to the period 5 January 2013, this equates to 1 week's additional earnings comparative to 2011 total emoluments.

Note 7 Performance related bonus – long term refers to bonus amounts in respect of the 2010–12 plan.

Note 8 Richard Bide stepped down as Group HR Director on 28 September 2012.

Note 9 Andy Haywood was appointed as Group Chief Information Officer on 4 January 2012. The emoluments shown represent earnings from that date. In addition a taxable payment of £76,665 was awarded to cover forfeiture of bonus from his former employer. This is not included in the table.

Note 10 Sean Toal ceased to be an Executive Committee member on 15 July 2012.

Note 11 Wayne Lee was appointed as acting HR Director on 1 October 2012. The emoluments shown represent earnings from that date.

Note 12 Steve Murrells was appointed as Chief Executive Food on 16 July 2012. The emoluments shown represent earnings from that date. In addition a taxable sum of £48,077 was paid to cover relocation expenses and is not included in the above table.

Table 1(b) – Maximum potential LTIP awards

Name of Executive	Award	Notes	Maximum award opportunity at start of year	Maximum award opportunity granted in year	Awards vested in year	Awards lapsed in year (Note 5)	Maximum award opportunity at end of year
Peter Marks	2012–2014		–	£994,000	–	–	£994,000
	2011–2013		£970,000	–	–	–	£970,000
	2010–2012		£900,000	–	£103,140	£796,860	–
Gill Barr	2012–2014		–	£230,625	–	–	£230,625
	2011–2013		£225,000	–	–	–	£225,000
Richard Bide	2012–2014	1	–	£259,500	–	£194,625	£64,875
	2011–2013	1	£253,500	–	–	£105,625	£147,875
	2010–2012		£238,500	–	£25,054	£213,446	–
Mark Craig	2012–2014		–	£138,375	–	–	£138,375
	2011–2013		£135,000	–	–	–	£135,000
Martyn Hulme	2012–2014		–	£195,000	–	–	£195,000
	2011–2013		£172,500	–	–	–	£172,500
	2010–2012		£52,339	–	£5,998	£46,341	–
Stephen Humes	2012–2014		–	£490,000	–	–	£490,000
	2011–2013		£400,000	–	–	–	£400,000
	2010–2012		£82,823	–	£9,492	£73,331	–
Moirra Lees	2012–2014		–	£222,000	–	–	£222,000
	2011–2013		£216,750	–	–	–	£216,750
	2010–2012		£202,500	–	£23,207	£179,293	–
Barry Tootell	2012–2014	2	–	£512,500	–	–	£512,500
	2011–2013	2	£305,250	–	–	–	£305,250
	2010–2012	2, 3	£288,750	–	–	£288,750	–
Martyn Wates	2012–2014		–	£579,000	–	–	£579,000
	2011–2013		£565,000	–	–	–	£565,000
	2010–2012		£515,000	–	£59,019	£455,981	–
Sean Toal	2012–2014	4	–	£200,000	–	–	£200,000
	2011–2013		£92,250	–	–	–	£92,250
	2010–2012		£90,000	–	£10,314	£79,686	–
Steve Murrells	2012–2014		–	£615,000	–	–	£615,000
Andy Haywood	2012–2014		–	£225,000	–	–	£225,000
Wayne Lee	2012–2014		–	£48,000	–	–	£48,000
	2011–2013		£46,845	–	–	–	£46,845
	2010–2012		£42,900	–	£4,916	£37,984	–

Note: table sets out the potential maximum LTIP payment: actual payments will be subject to meeting specified performance conditions.

Note 1 Richard Bide stepped down as Group HR Director on 28 September 2012. Awards lapse under both 2011–13 & 2012–14 LTIP during the year as a result of stepping down.

Note 2 Additional conditions apply to these LTIP awards to comply with the FSA Remuneration Code which must be met to enable the award to vest. On vesting 50% of the award is payable and 50% retained within an Alternative Instrument for an additional six months subject to additional requirements.

Note 3 2010 grants relate to Banking Group LTIP awards with performance solely relating to Banking Group over a three year period, together with additional conditions to comply with the FSA Code. Zero award is payable as the three year aggregate operating profit threshold target was not met.

Note 4 Sean Toal ceased to be an Executive Committee member on 15 July 2012.

Note 5 The majority of entitlement to award under terms of the 2010–2012 Trading Group LTIP has lapsed during the year as a result of the aggregate financial measures not being achieved, only the non-financial elements of colleague engagement and Group Corporate Responsibility paid out.

Remuneration report continued

Table 2 – Pension details of the Executive

	Notes	Years of service	Total accrued pension at 5 January 2013 £000	Increase in accrued pension during the year £000	Increase in accrued pension during the year (net of inflation) £000	Transfer value of previous column at 5 January 2013 net of members' contributions £000	Transfer value of total accrued pension at 31 December 2011 £000	Transfer value of total accrued pension at 5 January 2013 £000	Increase in transfer values net of members' contributions £000
Peter Marks	4	45	–	–	–	–	–	–	–
Gill Barr	5	1	3	3	3	35	–	47	35
Richard Bide	6	9	42	7	6	110	659	889	209
Mark Craig		18	76	5	3	44	1,711	1,748	22
Andy Haywood	7	1	4	4	4	28	–	43	28
Martyn Hulme	8	22	88	3	–	1	1,561	1,753	190
Stephen Humes	9	12	55	5	3	28	668	757	76
Wayne Lee	10	13	32	5	4	58	469	595	115
Moira Lees	11	31	135	5	–	–	2,487	2,972	486
Steve Murrells	12	–	–	–	–	–	–	–	–
Sean Toal	13	11	61	3	2	2	717	643	-89
Barry Tootell	14	4	25	4	3	34	274	340	55
Martyn Wates	15	17	164	6	–	–	2,261	2,017	-244

General Notes

- Note 1 The total accrued pension is that which would be paid annually on retirement at normal retirement age based on service to 5 January 2013 and includes any transferred-in benefits as appropriate. Under the terms of their contracts, existing Group Executives at 17 January 2007 may take these benefits from age 60 and new Executives after 17 January 2007 may take these benefits from age 65. The transfer values in the table above have been calculated on this basis. Years of service include, where appropriate, pre-merger service with United Co-operatives. Mark Craig joined United Co-operatives on 24 January 1994 and transferred-in benefits built up in other Co-operative schemes in respect of service from 4 October 1982.
- Note 2 All transfer values have been calculated in accordance with the current transfer value method and basis in force for the scheme applicable to the Executive. This is set by the Trustee(s), after taking actuarial advice, to be consistent with the requirements of legislation and the rules of the scheme.
- Note 3 Pension scheme members have the option of paying additional voluntary contributions to their respective pension scheme. Neither any contributions paid nor any benefits arising from them are shown in the above table.

Individual Notes

- Note 4 Peter Marks was paid a pension allowance in lieu of pension provision.
- Note 5 Gill Barr has restricted pension accrual and was paid a restricted pension allowance.
- Note 6 Richard Bide stepped down as Group HR Director on 28 September 2012.
- Note 7 Andy Haywood became a member of the Executive on 4 January 2012.
- Note 8 Martyn Hulme opted out of Pace from 6 April 2012 and became entitled to a deferred pension from Pace when he left the scheme. He was paid a pension allowance in lieu of pension provision. Prior to 6 April 2012 he had restricted pension accrual and was paid a restricted pension allowance.
- Note 9 Stephen Humes has restricted pension accrual and was paid a restricted pension allowance. The increase in accrued pension during the year is based on a restated (lower) accrued pension at 31 December 2011 of £49,746.
- Note 10 Wayne Lee became an acting member of the Executive on 1 October 2012.
- Note 11 Moira Lees opted out of the Pace Scheme from 6 April 2011 and became entitled to a deferred pension from Pace when she left the scheme. She was paid a pension allowance in lieu of pension provision. Deferred pensions are revalued under the Pace Scheme rules and account has been taken of this in the above table.
- Note 12 Steve Murrells became a member of the Executive on 16 July 2012. He was paid a pension allowance in lieu of pension provision.
- Note 13 Sean Toal left the Executive on 13 July 2012. He opted for restricted pension accrual from 1 February 2012 and was paid a restricted pension allowance.
- Note 14 Barry Tootell is an acting member of the Executive. He has restricted pension accrual and was paid a restricted pension allowance.
- Note 15 Martyn Wates opted out of the United Scheme from 27 May 2011 and became entitled to a deferred pension from the United Scheme when he left the scheme. He was paid a pension allowance in lieu of pension provision. Deferred pensions are revalued under the United Scheme rules and account has been taken of this in the above table.

Table 3 – Directors' remuneration 2012

	Notes	Year first elected	Term expires	2012 Remuneration £000	2011 Remuneration £000
Jenny Barnes		2009	2015	32	31
Steven Bayes		2009	2014	34	33
Duncan Bowdler		2007	2013	42	37
John Brodie	1, 2	2012	2015	13	–
Marilynne Burbage		2009	2013	31	31
Eric Calderwood	3	2006	2015	38	36
Martyn Cheatle	1, 7	2010	2013	27	23
Herbert Daybell		2009	2015	40	36
Paul Flowers	4, 5	2008	2013	132	128
Patrick Grange		2007	2014	41	38
Ray Henderson		2009	2015	32	32
Chris Herries		2009	2013	42	39
Ursula Lidbetter	1	2009	2014	40	38
Liz Moyle		2011	2014	29	19
David Pownall		2007	2015	36	33
Stuart Ramsay		2009	2014	34	33
Ben Reid	1, 8	2000	2015	38	40
Mark Smith	1, 9	2010	2014	23	22
Len Wardle	5	1992	2015	145	139
Steve Watts	6, 10	2000	2013	52	54

Note 1 The remuneration of some directors is paid, at their request, direct to their employers who release them to act as directors of the Group.

Note 2 John Brodie was appointed as director of the Group on 26 May 2012.

Note 3 Eric Calderwood was appointed as member of the Group Remuneration and Appointments Committee on 20 June 2012.

Note 4 Paul Flowers' fee covers his role as Chair of the Banking Group Board and Group Deputy Chair.

Note 5 Includes Group car.

Note 6 Includes a fee of £5,000 per annum in respect of Steve Watts' appointment as director of Unity Trust Bank plc.

Note 7 Martyn Cheatle was appointed as Chair of the Group Audit and Risk Committee on 4 November 2012.

Note 8 Ben Reid stepped down as Chair and a member of the Group Audit and Risk Committee on 4 November 2012.

Note 9 Mark Smith was appointed as member of the Group Audit and Risk Committee on 4 November 2012.

Note 10 The fee paid to Steve Watts in 2011 reflects a back payment for his appointment to the Group Audit and Risk Committee on 14 September 2011.

Remuneration report continued

Table 4 – Independent Professional Non-Executive Directors (IPNEDs) Remuneration

	Notes	Subsidiary Board	Year appointed	2012 Fees £000	2011 Fees £000
Penny Coates		Specialist Businesses	2010	52	50
Mike Cutt		Specialist Businesses	2010	52	50
John Longworth		Food	2010	52	50
Euan Sutherland		Food	2010	52	50
David Davies	1, 5, 7	The Co-operative Banking Group	2003	90	85
Anne Gunther	4	The Co-operative Banking Group	2011	60	19
Peter Harvey	1, 2, 3	The Co-operative Banking Group	2009	69	68
Merlyn Lowther	3	The Co-operative Banking Group	2011	71	16
Bob Newton	6, 7, 8	The Co-operative Banking Group	2007	97	88
Former directors who resigned during the year					
Rodney Baker-Bates (to 31 July 2012)	1	The Co-operative Banking Group	2009	44	75
Paul Hewitt (to 21 September 2012)	3	The Co-operative Banking Group	2003	53	68

All fees were pro rata if a position was held for part of the year.

Note 1 As Deputy Chairs of the Banking Group, David Davies, Peter Harvey and Rodney-Baker Bates received an additional fee of £15,720 per annum.

Note 2 As Chair of the CBG Exposures Committee, Peter Harvey received an additional fee of £5,240 per annum.

Note 3 The Chair of the CBG Board Risk Committee and the Chair of the CBG Audit Committee each received an additional fee of £11,004 per annum.

Note 4 The Chair of the CBG Remuneration and Appointments Committee received an additional fee of £9,000 per annum.

Note 5 David Davies received an additional fee of £11,004 per annum as the Chair of Pace.

Note 6 Bob Newton received an additional fee of £25,000 per annum for serving on the Board of the Reclaim Fund Limited.

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

Note 8 The Chair of the Integration and Change Committee received an additional fee of £7,336 per annum.

Corporate Governance continued

Other statutory disclosures

Principal activities

The major activities of the Group include food retailing, funerals, pharmacies, legal services, farming and e-stores. It is the parent organisation of Co-operative Banking Group Limited, whose operating subsidiaries – The Co-operative Bank Plc, Co-operative Insurance Society Limited and CIS General Insurance Limited – provide an extensive range of banking and insurance products and services.

Results and distributions

The loss before taxation was £703m (2011: profit of £231m).

The directors recommended a final dividend of £64.3m in respect of 2012 comprising £33.8m to individual members, £10.2m to Corporate members at a rate of 64p per £100 qualifying purchases, £12.6m to employee members and a £7.7m Community dividend.

An interim individual dividend of £8.2m was approved at the Half Year Meeting on 3 November 2012 to give total individuals dividends of £42m at rate of 1 pence per point and total overall distributions of £72.5m.

Post Balance Sheet Events

The Group signed the sale and purchase agreement of its Life business on 18 March 2013 with Royal London subject to regulatory approval. Given the timing of this agreement, it is not possible to estimate the full financial effect of this transaction. For more details, refer to page 71.

Supplier payment policy and practice

In many cases, the Group does not impose standard payment terms on its suppliers but agrees terms separately with each of them, whilst in others the use of standardised terms is regarded as consistent with much of the market. Every effort is made to pay suppliers in accordance with the terms that have been agreed. At 5 January 2013, trade creditors expressed as number of days outstanding was 39 days (2011: 44 days) for the Group.

Significant contracts

The Group maintains a number of significant contracts with IT providers, cash-handling entities and mailing-service companies.

Going concern

The financial statements are prepared on a going concern basis as the directors are satisfied that the Group has the resources to continue in business for the foreseeable future. In making this assessment, the directors have considered a wide range of information relating to present and future conditions including future projections of profitability, cash flows and capital resources. Further information relevant to the assessment is provided within the basis of preparation section of the financial statements on page 62.

Employees

The Group and its subsidiary undertakings, including the Banking Group, employed 99,201 persons at 5 January 2013 (1 January 2012: 99,268) and their aggregate remuneration for the year was £1,711m (2011: £1,674m).

More information on the provision of information and consultation with, and involvement of, employees, developing and engaging people, managing and rewarding performance and diversity is contained in the 'Our People' pages of the Business review.

Corporate responsibility and the environment

The sustainable development section can be found within the Business review on pages 24 and 25. In addition, the Group's new Sustainability Report, which will be published in summer 2013, will describe how the Group manages its social, ethical and environmental impact.

Political donations

The Group is a significant supporter of The Co-operative Party, which was created in 1917 by the UK Co-operative Movement in order to promote its values and principles. The Co-operative Party works to raise awareness of the benefits of co-operative and mutual models, and to influence governments towards support for more co-operative action. The Co-operative Party has representation in both Houses of Parliament, the Scottish Parliament, the national Assembly of Wales and the Greater London Assembly, and additionally, has over 350 local Councillors.

A motion was approved by members at the half yearly Meeting on 5 November 2011 to permit political expenditure, including donations to political parties, up to a maximum ceiling of £1.15m for 2012. During the course of 2012, actual donations have come to just over £880,000.

During the year, an annual donation of £563,000 (2011: £533,000) was made to The Co-operative Party. In addition, £242,000 (2011: £234,000) was paid in grants to Co-operative Party Councils. The Group Board also authorised a donation of £10,000 as a contribution to The Co-operative Party's campaigning activities in advance of the May 2012 Greater London Authority and London Mayoral elections. In addition, a number of donations totalling £28,500 (2011: £28,500) (including in-kind contributions) were made to The Co-operative Party to support a range of activity including party conferences. The Co-operative Party reports donations to the Electoral Commission in accordance with its reporting obligations as a registered political party under the Political Parties, Elections and Referendums Act 2000.

The Group Board also approved the donation of £50,000 through the Labour Party to support the Shadow Chancellor's office.

Furthermore, during the course of 2012, a number of donations were made to support various Labour Party events, including at a national and local level with a value of no more than £11,550. With 2012 designated by the United Nations as the International Year of Co-operatives, the Group has also supported a number of Parliamentarians who have undertaken study tours about the global co-operative sector, and these donations have been recorded in relevant Registers of Financial Interests.

Like many other businesses of a comparable size, the Group undertakes a programme of activity designed to showcase its corporate credentials to a wide audience of political opinion formers. This work includes a range of activities at political party conferences and, in 2012, the Group was represented at the conferences of the Green Party, The Co-operative Party, Liberal Democrats Party, Labour Party, the Conservative Party and the Scottish National Party.

Compliance with Grocery Supplier Code of Practice ('the Code')

The Code was introduced on 4 February 2010 following a Competition Commission investigation of the market for the supply of groceries in the UK. The Code applies to all grocery retailers with a turnover greater than £1bn and aims to address a number of findings of the investigation by placing those retailers under specific obligations regarding their supplier relationships, including a requirement to deliver an annual compliance report (of which this is a summary) to the Office of Fair Trading.

We expect to work purposefully and collaboratively with our suppliers in the long term interests of our customers and members, and believe this approach has served us well in the past and will continue to do so in the future. Naturally, we take our responsibilities under the Code seriously.

Consequently, a significant investment has continued to be made in robust compliance processes and systems (both within our Food business and, to the extent it retails grocery items, our Pharmacy operation). This includes work commissioned by our appointed Code Compliance Officer, a rolling programme of internal audits to test compliance, a comprehensive training programme for all employees involved in dealings with our suppliers, an online supplier portal, and the provision of regular reports to the Group's Audit and Risk Committee to ensure that the Committee retains effective oversight of Code compliance generally.

Corporate Governance continued

A modest number of alleged breaches of the Code has been asserted by suppliers, but all but two of these have been found, on examination, not to engage the provisions of the Code in fact. Of the two which did mature into formal Disputes under the Code, we are pleased to be able to report that the Group was able to resolve these with the suppliers in question without recourse to the prescribed arbitration procedures.

Statement of directors' responsibilities in respect of the Annual Report and Financial Statements

The directors are responsible for preparing the Annual Report and Group financial statements in accordance with applicable law and regulations.

Industrial and Provident Society law requires the directors to prepare financial statements for each financial year. Under that law they have elected to prepare the financial statements in accordance with IFRSs as adopted by the EU.

The Group's financial statements are required by law to give a true and fair view of the state of affairs of the Group and of the profit or loss of the Group for that period.

In preparing the Group's financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable IFRSs as adopted by the EU have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group will continue in business.

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Group and enable them to ensure that its financial statements comply with the Industrial and Provident Societies Acts 1965 to 2003. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

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

Financial Statements

So far as the directors are aware, there is no relevant information that has not been disclosed to the Group's auditor, and the directors believe that all steps have been taken that ought to have been taken to make them aware of any relevant audit information and to establish that the Group's auditor has been made aware of that information. A statement by the directors as to their responsibilities for preparing the financial statements is included in the Statement of directors' responsibilities set out above.

Audit

As recommended by the Group Audit and Risk Committee, a resolution to appoint KPMG Audit Plc as auditor of the Group and to authorise the directors to fix their remuneration will be proposed at the 2013 Annual General Meeting on 18 May 2013.

By Order of the Board

Moira Lees, Group Secretary
20 March 2013

Independent auditor's report to the members of Co-operative Group Limited

We have audited the financial statements of Co-operative Group Limited (the Society) for the period ended 5 January 2013 set out on pages 54 to 184. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU.

This report is made solely to the society members, as a body, in accordance with section 9 of the Friendly and Industrial and Provident Societies Act 1968. Our audit work has been undertaken so that we might state to the Society's members those matters we are required to state to them in an auditor's 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 society and the society's members, as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement set out on page 52, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate.

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the society's affairs as at 5 January 2013 and of the society's loss for the period then ended;
- have been properly prepared in accordance with IFRSs as adopted by the EU;
- have been properly prepared in accordance with the Industrial and Provident Societies Acts 1965 to 2003 and the Industrial and Provident Societies (Group Accounts) Regulations 1969.

Matters on which we are required to report by exception

We have nothing to report in respects to the following:

Under the Industrial and Provident Societies Acts 1965 to 2003 we are required to report to you if, in our opinion:

- a satisfactory system of control over transactions has not been maintained; or
- the association has not kept proper accounting records; or
- the financial statements are not in agreement with the books of account; or
- we have not received all the information and explanations we need for our audit.

In addition to our audit of the financial statements, the directors have engaged us to review their Corporate Governance Statement on pages 33 to 52 as regards the society's compliance with paragraphs D1.1 (paragraph 5), D2.1, D2.4, D3.1 (paragraph 3) and D3.2 of the Co-operatives UK Limited's Corporate Governance Code of Best Practice issued in May 2005 ('the Code'). Under the terms of our engagement, we are required to review whether the Corporate Governance Statement reflects the society's compliance with the five provisions of the Code specified for our review.

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

20 March 2013

Consolidated income statement

For the period ended 5 January 2013

	Notes	Period ended 5 January 2013			Period ended 31 December 2011 (restated*)		
		Before significant items £m	Significant items £m	Total £m	Before significant items £m	Significant items £m	Total £m
Revenue	2	12,598	(150)	12,448	12,403	(90)	12,313
Operating expenses	3	(12,729)	(408)	(13,137)	(12,066)	(200)	(12,266)
Other income	4	154	–	154	248	80	328
Operating profit/(loss)	1	23	(558)	(535)	585	(210)	375
Finance income	5	47	–	47	75	–	75
Finance costs	6	(116)	–	(116)	(66)	–	(66)
Share of profit/(loss) of associates and joint ventures	13	5	–	5	(11)	–	(11)
(Loss)/profit before member payments		(41)	(558)	(599)	583	(210)	373
Member payments	7			(104)			(142)
(Loss)/profit before tax	1			(703)			231
Taxation	8			174			(49)
(Loss)/profit after tax but before profit on discontinued operations				(529)			182
Profit on discontinued operations, net of tax	9			10			26
(Loss)/profit for the period				(519)			208
Attributable to:							
Equity holders of the parent				(521)			205
Non-controlling interests				2			3
(Loss)/profit for the period				(519)			208

Additional profit analysis

	Period ended 5 January 2013			Period ended 31 December 2011		
	Trading Group	Banking Group	Total	Trading Group	Banking Group	Total
Underlying operating profit** (note 1)	311	(257)	54	350	176	526
Operating profit/(loss) before significant items	291	(268)	23	340	245	585
Profit/(loss) before member payments	63	(662)	(599)	235	138	373

* See general accounting policies on page 62 for more details of the restatement.

** Non GAAP measure is defined and reconciled to profit before tax in note 1.

Consolidated statement of comprehensive income

For the period ended 5 January 2013

	Notes	2012 £m	2011 £m
(Loss)/profit for the period		(519)	208
Other comprehensive (losses)/income:			
Changes in available for sale assets		50	(7)
Foreign exchange surplus transferred to the income statement		(2)	–
Actuarial losses on employee pension schemes	15	(30)	–
Restriction of pension surplus under IFRIC 14	15	(16)	–
Changes in cash flow hedges		(15)	24
Tax on items taken directly to consolidated statement of comprehensive income	8	3	(4)
Other comprehensive (losses)/income for the period net of tax		(10)	13
Total comprehensive (losses)/income for the period		(529)	221
Total comprehensive (losses)/income attributable to:			
Equity holders of the parent		(530)	218
Non-controlling interests		1	3
		(529)	221

Consolidated balance sheet

as at 5 January 2013

	Notes	2012 £m	2011 £m
Assets			
Trading Group assets			
Property, plant and equipment	10	2,440	2,511
Goodwill and intangible assets	11	1,518	1,520
Investment property	12	273	340
Investments in associates and joint ventures	13	59	67
Derivatives	14	82	79
Pension assets	15	426	431
Trade and other receivables	18	36	29
Deferred tax assets	16	133	133
Total Trading Group non-current assets		4,967	5,110
Inventories and biological assets	17	528	610
Income tax receivable		–	13
Trade and other receivables	18	666	478
Cash and cash equivalents		180	267
Assets held for sale	19	–	1
Total Trading Group current assets		1,374	1,369
Total Trading Group assets		6,341	6,479
Banking Group assets			
Cash and balances at central banks		5,429	6,696
Reclaim fund assets	42	435	315
Derivatives	14	819	981
Loans and advances to banks	20	1,904	2,007
Loans and advances to customers	21	33,406	33,782
Fair value adjustments for hedged risk	21	354	366
Investments	22	8,184	5,949
Investments in associates and joint ventures	13	4	3
Reinsurance contracts	23	67	71
Income tax		93	45
Intangible assets	11	303	401
Property, plant and equipment	10	163	202
Deferred tax assets	16	72	55
Prepayments and other receivables	18	412	332
Assets held for sale	19	24,013	24,266
Total Banking Group assets		75,658	75,471
Total assets		81,999	81,950

	Notes	2012 £m	2011 £m
Liabilities			
Trading Group liabilities			
Interest-bearing loans and borrowings	25	1,501	1,534
Trade and other payables	26	601	558
Derivatives	14	122	141
Provisions	27	290	303
Pension liabilities	15	228	253
Deferred tax liabilities	16	219	299
Total Trading Group non-current liabilities		2,961	3,088
Interest-bearing loans and borrowings	25	313	163
Income tax payable		86	–
Trade and other payables	26	1,356	1,444
Provisions	27	124	118
Total Trading Group current liabilities		1,879	1,725
Total Trading Group liabilities		4,840	4,813
Banking Group liabilities			
Amounts owed to credit institutions	28	3,625	3,328
Customer accounts	29	35,960	35,073
Capital bonds	30	888	1,430
Derivatives	14	968	1,091
Insurance and participation contracts	23	1,051	1,064
Debt securities in issue	31	4,714	4,165
Other borrowed funds	32	1,259	1,259
Income tax payable		–	30
Trade and other payables	26	255	428
Deferred tax liabilities	16	6	40
Pension liabilities	15	7	46
Provisions	27	187	111
Reclaim fund liabilities	42	361	241
Liabilities held for sale	19	23,353	23,775
Total Banking Group liabilities		72,634	72,081
Total liabilities		77,474	76,894
Equity			
Members' share capital	24	70	70
Retained earnings		4,145	4,703
Other reserves		275	248
Total equity attributable to equity holders of the parent		4,490	5,021
Non-controlling interests		35	35
Total equity		4,525	5,056
Total equity and liabilities		81,999	81,950

Board's certification

The financial statements on pages 54 to 184 are hereby signed on behalf of the Board pursuant to Section 3(a)(1) of the Friendly and Industrial Provident Societies Act 1968.

Len Wardle, Chair
Stephen Watts, Deputy Chair
Moirá Lees, Group Secretary

20 March 2013

Consolidated statement of changes in equity

For the period ended 5 January 2013

	Notes	Members' share capital £m	Retained earnings £m	Other reserves £m	Total shareholder interest £m	Non-controlling interests £m	Total equity £m
Balance at 31 December 2011		70	4,703	248	5,021	35	5,056
Loss for the period		–	(521)	–	(521)	2	(519)
Other comprehensive income:							
Gains less losses on available for sale assets		–	–	168	168	–	168
Available for sale cumulative gains transferred to the income statement		–	–	(118)	(118)	–	(118)
Net changes in fair value of cash flow hedges		–	–	17	17	(1)	16
Net cashflow hedge gains transferred to the income statement		–	–	(31)	(31)	–	(31)
Foreign exchange surplus transferred to the income statement		–	–	(2)	(2)	–	(2)
Actuarial losses on employee pension schemes	15	–	(30)	–	(30)	–	(30)
Restriction of pension surplus under IFRIC 14	15	–	(16)	–	(16)	–	(16)
Tax on items taken directly to other comprehensive income	8	–	10	(7)	3	–	3
Total other comprehensive (expense)/income		–	(36)	27	(9)	(1)	(10)
Distributions to members:							
Members' share interest		–	(1)	–	(1)	–	(1)
Dividend – non-controlling interests		–	–	–	–	(1)	(1)
Distributions to members		–	(1)	–	(1)	(1)	(2)
Balance at 5 January 2013		70	4,145	275	4,490	35	4,525

Other reserves

Other reserves comprises the following:

Reclaim fund capital reserve

This reserve comprises the surplus from the Reclaim fund. The surplus has not been transferred to retained earnings because the profits are ultimately payable to the Big Lottery Fund and are therefore not available for distribution by the Group. The period end balance is £74m (2011: £74m) following the surplus created in other income in the prior period (see note 4). Further details of the balance sheet items can be found in note 41.

Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of the Chinese joint venture investment (see note 13). The year end balance is £nil (2011: £2m). The Group's share of the entity was sold during the period and the surplus transferred into the income statement.

Hedging reserve

The hedging reserve comprises the effective portion of the cumulative net change in fair value of cash flow hedging instruments. The period end balance is £63m (2011: £72m). There was a £14m debit (2011: £24m credit) movement during the period offset by a £5m tax credit (2011: £5m debit) relating to this movement.

Revaluation reserve – property, plant and equipment

This reserve relates to the surplus created following the revaluation of certain assets in previous periods. There have been no movements during the period (2011: £nil). The balance in 2012 and 2011 was £95m.

Available for sale investments reserve

Co-operative Bank and CISGIL mainly hold debt securities as available for sale investments. Subsequent valuation is at fair value with differences between fair value and carrying value recognised in equity as they arise. The period end balance is £43m (2011: £5m). There has been a £168m gain (2011: £64m) following the revaluation of available for sale assets during the period. £118m of gains (2011: £71m) were transferred to the income statement during the period. A tax debit of £12m (2011: £2m credit) has also affected this reserve.

	Notes	Members' share capital £m	Retained earnings £m	Other reserves £m	Total shareholder interest £m	Non-controlling interests £m	Total equity £m
Balance at 2 January 2011		70	4,576	160	4,806	33	4,839
Profit for the period		–	131	74	205	3	208
Other comprehensive income:							
Gains less losses on available for sale assets		–	–	64	64	–	64
Available for sale cumulative gains transferred to the income statement		–	–	(71)	(71)	–	(71)
Net changes in fair value of cash flow hedges		–	–	73	73	–	73
Net cashflow hedge gains transferred to the income statement		–	–	(49)	(49)	–	(49)
Actuarial gains and losses on employee pension schemes	15	–	–	–	–	–	–
Tax on items taken directly to other comprehensive income	8	–	(1)	(3)	(4)	–	(4)
Total other comprehensive income		–	(1)	14	13	–	13
Distributions to members:							
Members' share interest		–	(1)	–	(1)	–	(1)
Dividend – non-controlling interests		–	–	–	–	(1)	(1)
Distributions to members		–	(1)	–	(1)	(1)	(2)
Changes in ownership interests in subsidiaries							
Acquisition of non-controlling interest		–	(2)	–	(2)	–	(2)
Balance at 31 December 2011		70	4,703	248	5,021	35	5,056

Consolidated statement of cash flows

For the period ended 5 January 2013

	Notes	2012 Trading Group £m	2011 Trading Group £m	2012 Banking Group £m	2011 Banking Group £m	2012 Total £m	2011 Total £m
Net cash from operating activities	33	442	562	1,105	4,161	1,547	4,723
Cash flows from investing activities							
Acquisition of property, plant and equipment		(378)	(375)	(33)	(54)	(411)	(429)
Proceeds from sale of property, plant and equipment		41	29	1	–	42	29
Purchase of intangible assets		(7)	–	(85)	(165)	(92)	(165)
Proceeds from sale/(acquisition) of investments		11	(4)	1	1	12	(3)
Internal dividends received/(paid)		–	72	–	(72)	–	–
Disposal of businesses, net of cash acquired		5	(51)	–	–	5	(51)
Acquisition of businesses, net of cash acquired		(25)	–	–	–	(25)	–
Proceeds from sale and maturity of investment securities		–	–	2,617	4,514	2,617	4,514
Purchase of investment securities		–	–	(4,961)	(3,668)	(4,961)	(3,668)
Net cash (used in)/from investing activities		(353)	(329)	(2,460)	556	(2,813)	227
Cash flows from financing activities							
Interest paid on borrowings		(112)	(77)	(87)	(67)	(199)	(144)
(Decrease)/increase in corporate investor shares	25	(5)	5	–	–	(5)	5
Preference dividends paid		–	–	(6)	(5)	(6)	(5)
Dividends paid to non-controlling shareholders in subsidiary undertaking		(1)	(1)	(1)	–	(2)	(1)
Member payments		(104)	(135)	–	–	(104)	(135)
Additional payments into pension schemes		(57)	(47)	–	–	(57)	(47)
Issue/(repayment) of borrowings, net of derivatives	25	109	(106)	(21)	171	88	65
Finance leases repaid		(6)	(5)	–	–	(6)	(5)
Net cash (used in)/from financing activities		(176)	(366)	(115)	99	(291)	(267)
Net (decrease)/increase in cash and cash equivalents		(87)	(133)	(1,470)	4,816	(1,557)	4,683
Cash and cash equivalents at beginning of period		267	400	8,218	3,402	8,485	3,802
Cash and cash equivalents at end of period		180	267	6,748	8,218	6,928	8,485
Analysis of cash and cash equivalents							
Cash and balances with central banks		–	–	5,429	6,696	5,429	6,696
Less mandatory deposits with the Bank of England		–	–	(39)	(38)	(39)	(38)
Loans and advances to banks	20	–	–	851	1,020	851	1,020
Short term investments		–	–	85	241	85	241
Cash held in Reclaim fund	42	–	–	435	315	435	315
Cash and cash equivalents per balance sheet		180	267	–	–	180	267
Amounts due to credit institutions		–	–	(13)	(16)	(13)	(16)
		180	267	6,748	8,218	6,928	8,485

Cash and cash equivalents include deposits of £52m (2011: £58m) held in trustee-administered bank accounts of the Society, which can only be utilised to meet liabilities in respect of funeral bonds issued. These liabilities are included in trade and other payables (see note 26). Also included within cash and cash equivalents is £8m (2011: £nil) of cash proceeds relating to property sales which are within the Group's solicitors' bank facilities, but are accessible to the Group to exclusively repay debt facilities. The cash held in the Reclaim fund of £435m (2011: £315m) is not distributable to the Group.

Included in the above are cash flows from discontinued operations. An analysis of these can be found in note 9.

General accounting policies

This section sets out details of the general Group accounting policies that relate to the financial statements as a whole. Details of other accounting policies are included within the notes to the financial statements to which they relate. This allows readers quick and easy access to the relevant policy. This section also sets out new accounting standards, amendments and interpretations endorsed by the EU and their potential future impact on the Group financial statements.

General information

The Co-operative Group Limited is an Industrial and Provident Society domiciled in England and Wales. The address of the Society's registered office is 1 Angel Square, Manchester M60 0AG.

Basis of preparation

The Group accounts have been prepared in accordance with the Industrial and Provident Societies Acts 1965 to 2003, the Industrial and Provident Societies (Group Accounts) Regulations 1969, and applicable International Financial Reporting Standards as endorsed by the EU (IFRS) for the period ended 5 January 2013. As permitted by statute and IAS 1, the financial statement formats have been adapted as necessary to give a fair presentation of the state of affairs and result of the Group. As permitted by Industrial and Provident Society statute, a separate set of financial statements for the Society are not included.

The financial statements follow the provisions of the Revised Statement of Recommended Practice on Accounting for Insurance Business (SORP) issued by the Association of British Insurers in 2005 (as amended in December 2006), insofar as these are compatible with the requirements of IFRS.

The accounts are presented in pounds sterling and are principally prepared on the basis of historical cost. Areas where other bases are applied are identified in the relevant accounting policy in the notes.

The accounting policies set out in the notes have been applied consistently to all periods presented in these financial statements, except where stated otherwise.

Basis of consolidation

The financial statements consolidate the Society and its subsidiary undertakings. Subsidiaries are those entities controlled by the Group. Control exists when the Society has the power, directly or indirectly, to govern the financial and operating policies of an entity, so as to obtain benefits from its activities. In assessing control, potential voting rights that are presently exercisable or convertible are taken into account. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

Associates are those entities in which the Group has significant influence, but not control, over the financial and operating policies. The consolidated financial statements include the Group's share of the total comprehensive income of associates on an equity accounted basis, from the date that significant influence commences until the date that significant influence ceases. When the Group's share of losses exceeds its interest in an associate, the Group's carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of an associate.

A joint venture is a contractual arrangement whereby the Group and one or more other parties undertake an economic activity that is subject to joint control. Joint control exists when the strategic, financial and operating policy decisions relating to the activity require the unanimous consent of the parties sharing control. The Group conducts its joint venture arrangements through jointly controlled entities and accounts for them using the equity method of accounting. Where the Group transacts with its jointly controlled entities, unrealised profits and losses are eliminated to the extent of the Group's interest in the joint venture.

Special purpose entities (SPEs) are entities that are created to accomplish a narrow and well defined objective.

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

The assessment of whether the Group has control over an SPE is carried out at inception. No further assessment of control is carried out unless changes in the structure or terms of the SPE or additional transactions between the Group and the SPE occur.

Mixed presentation and definition of Trading Group and Banking Group

As permitted by IAS 1 in the case of diverse groups such as The Co-operative Group, a mixed presentation has been applied to the balance sheet to separate the Banking Group from the Trading Group. The Banking Group comprises The Co-operative Bank plc and its subsidiaries as well as the Group's general insurance business, mainly Co-operative Insurance Society General Insurance Ltd (CISGIL) and life insurance business, mainly Co-operative Insurance Society Ltd (CISL). The Trading Group includes Food, Specialist Businesses, Estates, Federal and the Group's corporate function. As the Banking Group's operations differ from those of the rest of the Group, the assets and liabilities of the Banking Group are separated from the rest of the Group and analysed in order of liquidity. The assets and liabilities of the Trading Group are analysed as current or non-current. The Group does not eliminate interest payable and cash between Trading Group and the Banking Group as eliminating it would mislead the reader when understanding the financial performance of the Trading Group. Additionally, in order to reflect the performance of the Group as a single economic entity, the gross interest revenue of the Banking Group has been included as revenue in the consolidated income statement.

Accounting dates

The financial statements are made up for the 53 weeks ending 5 January 2013. Comparatives are for the 52 weeks ending 31 December 2011. Since the financial periods are virtually co-terminus with the calendar years, the financial period figures are headed 2012 and the comparatives are headed 2011. The comparative amounts are not entirely comparable with the results of 2012, which are based on a longer period.

General accounting policies continued

The Banking Group subsidiaries of the Group have prepared accounts with accounting periods ending 31 December. This differs from the parent of the Group and other Trading Group subsidiaries which have accounting periods ending on the first Saturday of each new year (unless 31 December). For the period ending 5 January 2013, there are no significant transactions or events which need to be adjusted for to reflect the difference in reporting dates.

Offsetting

Financial assets and financial liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to do so and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

Going concern

The Director's have assessed the Group's business activities, together with the factors likely to affect its future development, performance and position (set out in the Business Review on pages 16 to 22). The Directors have also assessed the financial risks facing the Group, its liquidity position and borrowing facilities. These are described principally in note 38 to the accounts. In addition, notes 38 and 41 also include the Group's objectives, policies and processes for managing its capital, its financial risk management objectives and its financial instruments and hedging activities. In assessing the appropriateness of the going concern basis, the Directors consider the position and outlook of the Trading and Banking Groups separately as they are separately funded.

The Trading Group meets its working capital needs through a number of facilities which are discussed in more detail in note 38. As shown in note 38, the 2013 £200m Eurobond is due for repayment in December 2013. Under current forecasts, the Trading Group has sufficient resources to repay this debt at the due date. In addition, management has assessed the Trading Group's ability to operate within the level of its other current facilities, including compliance with all financial covenants and concluded that the going concern assumption remains appropriate.

The Banking Group made a loss before member payments, tax and discontinued operations of £662m. This was heavily influenced by a number of exceptional charges including, a substantial impairment provision against non-core assets (£351m), a write-down of intangible assets (£150m) and an increased PPI provision (£150m) in common with the industry. Nevertheless, given the overall reported statutory loss, the going concern assumption adopted for the Banking Group has been carefully considered. The Bank's capital position remains acceptable with a period end core tier one position of 8.8% (31 December 2011: 9.6%). The Board recognises the need to build the capitalisation of the Bank to provide increased resilience and capacity for future growth. Actions taken early in 2013 improved this position to 9.2%. Current forecasts indicate that the Bank's capital will remain above regulatory requirements over the period of the Plan. However, in response to the impact of new Basel III regulations and the expectation of a prolonged economic downturn, we are reviewing our business with the intent of improving our profitability and capital position. Without management action, compliance with regulatory capital requirements would come under pressure.

Bank liquidity has been reviewed by considering the latest liquidity forecast for 2013–2015, as well as the stress testing results from period end for internal liquidity assessment, together with the Bank's compliance with its regulatory required levels. The evidence from stress testing as at period end shows that sufficient liquidity levels can be maintained under the most severe scenarios. This is also documented in the Individual Liquidity Adequacy Assessment (ILAA).

The going concern assessment does not take account of the potential benefits of the purchase of the Lloyds branches. This deal would provide opportunity to enhance the reach of the Bank, grow our customer base, and become a truly compelling alternative for the UK consumer. The deal will only be pursued if it is in the best interests of our customers and members. Overall, the directors are satisfied that the Bank is a going concern, has sufficient profit, capital and liquidity in place and forecast, and has plans in place to strengthen that position going forward. The Banking Group's Insurance business is required to maintain a sufficient buffer over regulatory capital requirements in order to continue to be authorised to carry on its business. The forecasts and objectives, taking into account a number of potential changes in trading performance, insurance and investment risk, show that the Insurance business should be able to operate at an adequate level of regulatory capital for the foreseeable future. The Insurance business has also considered a number of stress tests on capital and these provide assurance that it is sufficiently capitalised.

Therefore, after making all appropriate enquiries, the directors have reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the Group's financial statements.

Critical accounting estimates and judgments in applying accounting policies

The preparation of financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgments about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period or in the period of the revision and future periods if the revision affects both current and future periods.

Judgments and estimates made by management in the application of IFRS that have a significant effect on the financial statements and estimates with a significant risk of material adjustment in the next year are described in the following notes stated below:

- Disposal groups and held for sale IFRS 5 criteria (notes 9 & 19)
- Pensions (note 15)
- Provisions (note 27)
- Non-current asset impairment (notes 10 & 11)
- Banking Group impairment provision on loans and advances and timing of recognition of impairments (note 20 & 21)
- General Insurance claims and reserves (note 23)

The Group has applied all endorsed IFRSs that are effective for the Group's financial statements for the period ended 5 January 2013 and the comparative period.

Restatement and changes in accounting policies

Following a number of restructuring initiatives in 2012, certain costs that were incurred by the divisions are now held at the Corporate centre. Therefore, in the operating segments note, the 2011 segmental figures have been restated to show these now central costs on a comparable basis. In addition, the treatment of fuel card sales in Food changed in 2012. Therefore, the 2011 revenue comparative has been restated to show revenue on a comparable basis.

The Group adoption of the following amendments and interpretations in 2012 has not had a significant impact on the Group's results:

- IFRS 7 (Disclosures: Transfers of Financial Assets (2010))
- Amended IAS 12 (Income Taxes: Deferred Tax – Recovery of Underlying Assets (2010))
- IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments (2009)

Standards, amendments and interpretations issued but not yet effective

The Group has not early adopted the following standards and statements which are not yet effective. The adoption of these standards is not expected to have a material impact on the Group's accounts when adopted, except where stated:

- IFRS 10 Consolidated financial statements (2011)
- IFRS 11 Joint Arrangements (2011)
- IFRS 12 Disclosure of Interests in Other Entities (2011)
- IFRS 13 Fair value measurement (2011)
- Amended IAS 12 Income taxes: Deferred Tax – Recovery of underlying assets (2010)
- Amended IAS 1 Presentation of items of other comprehensive income (2010)

- Revised IAS 19 Employee Benefits (2011) This revision covers the standard's recognition, measurement and presentation criteria with regard to a pension scheme's expense contained within IAS 19's 'defined benefit' scope. The 'corridor approach' will be removed from IAS 19. This will have no impact on the Group's financial statements. However, the revision eliminates the 'expected return on assets' from the measurement of a pension's expense and directs entities to instead charge a cost of finance against its net unfunded liability or surplus position. This is performed by determining a discount rate in reference to market yields from high quality corporate bonds ahead of any previously assumed government bond yield reference point. This is expected to decrease the net pension finance income included in finance income by £40m per annum based on current bond yields
- Amended IAS 27 Consolidated and Separate Financial Statements (2011)
- Amended IAS 28 Investments in associates and joint ventures (2011)
- IFRS 9 (Financial Instruments: Classification and Measurement (2010))* This new standard replaces IAS 39 (Financial Instruments: Recognition and Measurement (2009)). Phase one requires financial assets to be classified as at amortised cost or at fair value. Further phases of IFRS 9 are scheduled to cover impairment and hedge accounting. It becomes effective for accounting periods beginning on or after 1 January 2015. Early adoption is permitted, once endorsed by the EU. The impact of IFRS 9 is likely to be material to the Group, due to the value of financial instruments held on the Group's balance sheet. The standard is currently being drafted and so a detailed assessment of its impact is not currently possible
- Amendments to IFRS 7 Disclosures Offsetting Financial Assets and Liabilities
- Amendments to IAS 32 Offsetting financial assets and financial liabilities

* Not yet endorsed by the European Union.

Notes to the financial statements

1. Operating segments

The segmental information presented below reflects the key components of the Group, the operating results of which are regularly reviewed by the Group's Chief Executive Officer.

A summary of the operations of the businesses and further financial information on all segments can be found in the business reviews on pages 16 to 22.

	2012				
	Revenue from external customers £m	Underlying segment operating profit £m	Significant items (net) £m	Additions to non-current assets £m	Depreciation and amortisation £m
Food	7,442	288	(105)	194	(225)
Specialist Businesses (see below)	1,506	107	(8)	41	(61)
Estates	36	19	–	14	(2)
Federal	1,421	–	–	–	–
Corporate, Group costs and other adjustments	(18)	(103)	(50)	136	(5)
Trading Group	10,387	311	(163)	385	(293)
Banking Group – core		120			
Banking Group – non-core		(377)			
Banking Group – total	2,211	(257)	(395)	118	(123)
Total	12,598	54	(558)	503	(416)

Banking Group – core relates to the primary retail banking and insurance operations and corporate lines of business that are consistent with current strategy and risk appetite. Banking Group – non-core includes Optimum (the closed book of intermediary and acquired loan book assets) and certain other corporate lines of business targeted for run down or exit. The Group's Life and Savings (CISL) and the Asset Management (TCAM) business are classified as discontinued operations and, as such, are not included in the segmental analysis above.

	2011 (restated)				
	Revenue from external customers £m	Underlying segment operating profit £m	Significant items (net) £m	Additions to non-current assets £m	Depreciation and amortisation £m
Food	7,344	318	(70)	249	(219)
Specialist Businesses (see below)	1,516	99	(9)	35	(58)
Estates	36	20	–	80	(2)
Federal	1,314	–	–	–	–
Corporate, Group costs and other adjustments	(21)	(87)	(24)	11	(7)
Trading Group	10,189	350	(103)	375	(286)
Banking Group – core		173			
Banking Group – non-core		3			
Banking Group – total	2,214	176	(107)	219	(135)
Total	12,403	526	(210)	594	(421)

As discussed in the general accounting policies section, the apportionment of costs between the Corporate centre and other operating segments has changed in 2012. Underlying segment operating profit has been restated in the prior period comparative to present costs on a comparable basis.

A breakdown of the Group's Specialist Businesses division is as follows:

	2012					2011 (restated)				
	Revenue from external customers £m	Underlying segment operating profit £m	Significant items (net) £m	Additions to non-current assets £m	Depreciation and amortisation £m	Revenue from external customers £m	Underlying segment operating profit £m	Significant items (net) £m	Additions to non-current assets £m	Depreciation and amortisation £m
Funeralcare	348	60	–	27	(19)	328	55	–	22	(17)
Pharmacy	764	28	6	9	(35)	754	30	(9)	7	(35)
Other specialist businesses	394	19	(14)	5	(7)	434	14	–	6	(6)
Specialist Businesses	1,506	107	(8)	41	(61)	1,516	99	(9)	35	(58)

- a) Underlying segment operating profit is segment operating profit before significant items, property disposals, the Financial Services Compensation Scheme levy, fair value amortisation and change in value of investment properties.
- b) Each segment derives its revenue and profits from the sale of goods and provision of services, mainly from retail. The Banking Group derives its revenue and profits from a range of financial services including banking and insurance.
- c) Additions to non-current assets excludes additions to financial instruments, deferred tax assets, post employment benefit assets and rights arising under insurance contracts.
- d) The Group's external revenue and non-current assets arise primarily within the United Kingdom. The Group does not have a major customer who accounts for 10% or more of revenue.
- e) In addition to the revenue above, Banking Group revenue with other Group operating segments was £5m (2011: £7m). Specialist Businesses revenue with the Banking Group was £15m (2011: £17m), mainly through its Sunwin Services business and was £32m (2011: £42m) with Food, through its Sunwin Services and Electricals online business. All transactions between reportable segments are undertaken at arm's length.
- f) The Funeralcare segment results were aggregated into the Specialist Businesses segment in 2011. As Funeralcare's profits have increased relative to the Group, IFRS 8 requires additional disclosure of this segment. The Pharmacy segment results have also been disclosed in addition for the benefit of the reader.
- g) Federal relates to the activities of a joint buying group that is operated by the Group for other independent co-operative societies. This is run on a cost recovery basis and therefore no profit is derived from its activities.

A reconciliation between underlying segment operating profit and (loss)/profit before tax is provided below:

	Note	Trading Group		Banking Group		Total	
		2012 £m	2011 £m	2012 £m	2011 £m	2012 £m	2011 £m
Underlying segment operating profit		311	350	(257)	176	54	526
Change in value of investment properties	3, 4	(25)	9	–	–	(25)	9
Property disposal gains/(losses)	3, 4	5	(19)	–	–	5	(19)
Financial Services Compensation Scheme levy	27	–	–	(26)	(17)	(26)	(17)
Fair value amortisation	4	–	–	15	86	15	86
Operating profit/(loss) before significant items		291	340	(268)	245	23	585
Significant items (net)	2, 3, 4	(163)	(103)	(395)	(107)	(558)	(210)
Underlying interest payable	6	(106)	(81)	–	–	(106)	(81)
Finance income	5	47	75	–	–	47	75
Non-cash finance (costs)/income	6	(10)	15	–	–	(10)	15
Share of profit/(loss) of associates and joint ventures	13	4	(11)	1	–	5	(11)
Profit/(loss) before member payments		63	235	(662)	138	(599)	373
Member payments	7					(104)	(142)
(Loss)/profit before tax						(703)	231

2. Revenue

	2012 £m	2011 £m
Trading Group:		
– Sale of goods	8,556	8,500
– Provision of services	428	396
– Federal sales	1,421	1,314
Banking Group:		
– Interest and similar income	1,380	1,369
– Fee and commission income	251	240
– Gross earned premiums	611	641
– Premiums ceded to reinsurers	(31)	(36)
Intercompany eliminations	(18)	(21)
Net revenue	12,598	12,403
Value Added Tax	877	864
Gross sales	13,475	13,267
Significant items excluded from the above analysis are as follows:		
Provision for customer compensation relating to Payment Protection Insurance (see note 27)	(150)	(90)

Notes to the financial statements continued

2. Revenue continued**Accounting policies****Gross sales**

A non-GAAP measure representing the amounts receivable by the Group for goods and services supplied to customers, net of discounts but including VAT.

Trading Group**Sale of goods**

Revenue is recognised to the extent that it is probable that the economic benefits will flow to the Group and the revenue can be reliably measured. Revenue is measured at the fair value of the consideration received, excluding customer non-member discounts, rebates, VAT and other sales tax or duty. For the sale of goods, revenue is recognised at the point of sale. The revenue recognition accounting policy for funeral bonds is discussed in more detail on note 26.

Provision of services

Provision of services relates to activities in Funeralcare, Legal Services, Life Planning and Sunwin Services Group. Revenue is recognised when the service is rendered and the revenue can be reliably measured.

Banking Group

Income derived directly from customers is treated as revenue. Income derived from investments and third party business is treated as other income (see note 4).

Interest and similar income

Interest income is recognised on an effective interest rate (EIR) basis, inclusive of directly attributable incremental transaction costs and fees including arrangement and broker fees, valuation and solicitor costs, discounts and premiums where appropriate and early redemption fees. The EIR basis spreads the interest income and expense over the expected life of each instrument. The EIR is the rate that, at the inception of the instrument, exactly discounts expected future cash payments and receipts through the expected life of the instrument back to the initial carrying amount. When calculating the EIR, the Group estimates cash flows considering all contractual terms of the instrument (for example, prepayment options) but does not consider assets' future credit losses except for assets acquired at a deep discount. On applying this approach to the mortgage portfolio, judgments are made in relation to estimating the average life of that portfolio. These judgments are made based on specific factors including product terms and historical repayment data. The estimates are updated in each reporting period to reflect actual performance. A key judgment area is the average life of the mortgage portfolio. A change in the average life by one year would result in an increase of 0.2% in gross interest income.

For assets acquired at a value significantly below the carrying value in the acquiree's financial statements because they have incurred losses, expectations of future losses are higher than at origination, and interest spreads have widened because of deteriorating market conditions, the calculation of EIR is the same as shown above with the exception that the estimates of future cash flows include credit losses.

Fee and commission income

Predominantly made up of arrangement and other fees relating to loans and advances to customers that are included in the effective interest calculation. Commitment fees received are deferred and included in the EIR calculation upon completion or taken in full at the date the commitment period expires and completion does not occur.

All other fee and commission income, such as a loan closure fee or an arrears fee, that is not included in the effective interest calculation, is recognised on an accruals basis as the service is provided.

Gross earned premiums

Gross written premiums comprise receivables on those contracts which were incepted during the period, irrespective of whether they relate in whole or in part to a later accounting period, together with any necessary adjustments to amounts reported in prior periods.

Gross written premiums:

- are stated gross of commission and exclude any taxes or levies based on premiums; and
- include an estimate of the premiums receivable on those contracts which were incepted prior to the period end but which have not been notified by the balance sheet date ('pipeline premium'). When calculating pipeline premiums it is assumed, where appropriate, that options to renew contracts automatically will be exercised.

Written premiums (whether paid in advance or by instalments) are earned evenly over the period of the contract (usually 12 months). The treatment of outward reinsurance premiums is similar to gross premiums written.

3. Operating expenses

Operating profit/(loss) is stated after (charging)/crediting the following:

	2012 £m	2011 £m
Cost of sales:		
– Trading activities	(7,373)	(7,380)
– Banking activities – Interest expense and similar charges	(922)	(948)
– Banking activities – Claims incurred, net of claims recovered from reinsurers	(502)	(494)
– Banking activities – Fee and commission expense	(96)	(81)
Employee benefits expense (see below)	(1,711)	(1,674)
Net loss on disposal of property, plant and equipment	–	(19)
Change in value of investment property	(25)	–
Operating lease rentals	(226)	(226)
Impairment losses on loans and advances and investments	(469)	(115)
Contributions to defined contribution plans	(6)	(6)
Subscriptions and donations	(2)	(2)
Significant items within operating expenses are as follows:		
– Integration and transformation costs	(57)	(90)
– Restructuring and reorganisation costs	(76)	(93)
– Impairment of non-current assets	(163)	(8)
– Acquisition costs	(53)	(5)
– Net loss on disposal of property, plant and equipment and other businesses	(56)	–
– Other costs	(3)	(4)
	(408)	(200)

Integration and transformation costs relate to the investment in Banking Group, following the merger with Britannia to integrate and develop the enlarged business. Restructuring costs comprise costs incurred modernising our food distribution network and significant reorganisations in our Food and Corporate central teams.

Impairment of non-current assets consists mainly of a £150m write down of Banking Group costs previously capitalised as part of its strategic transformation programme.

Acquisition costs of £53m relate primarily to the Group's bid for the Lloyds Banking Group's Verde business. The net loss on disposal of property, plant and equipment of £56m relates to strategic one-off disposals in our family of businesses.

Employee benefits expense

	2012 £m	2011 £m
Wages and salaries	(1,530)	(1,492)
Social security costs	(93)	(97)
Pension costs	(88)	(85)
	(1,711)	(1,674)

The average number of people employed by the Group in the UK (excluding discontinued businesses) was:

	2012	2011
Full-time	37,620	40,146
Part-time	63,662	66,251
	101,282	106,397

Remuneration of key management

For details regarding remuneration of the Group Board and the Executive refer to pages 40 to 50.

Notes to the financial statements continued

3. Operating expenses continued
Auditors' remuneration and expenses

	2012 £m	2011 (restated) £m
Audit of these financial statements	1.0	1.0
Amounts receivable by Society's auditor in respect of:		
Audit of financial statements of subsidiaries in respect of the Society	0.5	0.5
Other services pursuant to such legislation	0.1	0.1
Services relating to:		
– Audit related assurance services	–	–
– Taxation compliance services	–	–
– Other tax advisory services	0.2	1.4
– Corporate finance services	3.3	0.7
– Information technology services	1.0	0.5
– Pensions services	0.3	0.3
– Other assurance services	–	–
– All other services	1.0	1.1
Total	7.4	5.6

No costs in relation to services performed by the auditors were capitalised by the Group in 2012. Not included in the above analysis for 2011 were £1.3m of capitalised costs.

Accounting policies**Operating expenses**

Operating expenses are analysed by nature, as defined by IAS 1.

Fees and commissions payable to introducers in respect of obtaining lending business, where these are direct and incremental costs related to the issue of a financial instrument, are included in interest income as part of the effective interest rate.

Significant items

Non-recurring items outside the normal operating activities of the Group that are material by both size and nature are treated as significant items and disclosed separately on the face of the income statement.

The separate reporting of significant items helps provide an indication of the Group's underlying business performance. Events which may give rise to the classification of items as significant include individually significant restructuring and integration costs.

4. Other income

Income from activities outside the normal trading activities of the Group include:

	2012 £m	2011 £m
Other investment income	52	58
Net gains on remeasurement of financial and other assets available for sale	23	15
Net gains on sale of investment securities – loans and receivables	16	37
Fair value amortisation	15	86
Net gain on disposal of property, plant and equipment	5	–
Change in value of investment property	–	9
Rental income from investment property	27	27
Other fee and commission income	16	16
	154	248
Significant items within other income are as follows:		
Reclaim fund surplus	–	74
Pension curtailment	–	6
	–	80

Fair value amortisation

When Britannia Building Society transferred its engagements to The Co-operative Bank plc in 2009, net assets were restated to fair value on merger. Fair value amortisation includes adjustments to reflect the interest rates charged and received on both assets and liabilities where a different rate may be prevalent in today's market. These adjustments unwind over future periods and in 2012 represent a net credit to the income statement of £15m (2011: credit of £86m).

Reclaim fund surplus

In 2011 the Group established a wholly owned subsidiary, Reclaim Fund Limited to administer the collection of funds from dormant savings accounts in UK financial institutions and pass them to the Big Lottery Fund for distribution. £74m was recognised in 2011 in other income as principally being the net difference between the amount received in respect of dormant accounts and the provisions and distributions back to dormant account holders and the Big Lottery Fund respectively. This income related to the creation of capital through earnings to meet FSA capital requirements. The Group derives no financial benefit from the fund and the surplus created in 2011 is for provision of regulatory capital to the Fund and is held in a separate reserve. More details of the Reclaim Fund and its balance sheet can be found in note 42.

Accounting policies

Investment income

Interest income on financial assets designated as available for sale and loans and receivables are recognised within investment income on an effective interest rate (EIR) basis, inclusive of directly attributable incremental transaction costs and fees, and discounts and premiums where appropriate.

The EIR basis spreads the interest income over the expected life of the instrument. The EIR is the rate that, at inception of the instrument, exactly discounts expected future cash payments and receipts through the expected life of the instrument back to the initial carrying amount. When calculating EIR, General Insurance estimates cash flows considering all contractual terms of the instrument (for example prepayment options) but does not consider future credit losses.

Interest income on assets designated as fair value through income and expense is recognised within investment income in the income statement as it accrues on an effective interest basis.

Gains less losses arising from financial instruments and other assets

Investments in the General Insurance business, other than those in debt securities, are classified as financial assets at fair value through the income statement and they are included within operating income rather than financial expenses. This is because they are not part of the normal funding arrangements of the Group.

Rental income

Rental income arising from operating leases on investment properties is accounted for on a straight-line basis over the lease term. For accounting policies relating to investment property, refer to note 12.

5. Finance income

	2012 £m	2011 £m
Net pension finance income	47	75

For more information on pension interest and expected return on planned assets, refer to note 15.

6. Finance costs

	2012 £m	2011 £m
Loans repayable within five years	(91)	(60)
Loans repayable wholly or in part after five years	(14)	(20)
Corporate investor share interest	(1)	(1)
Underlying interest payable	(106)	(81)
Fair value movement on quoted debt	(21)	(16)
Fair value movement on interest rate swaps	23	42
Discount unwind of provisions	(12)	(11)
Non-cash finance costs	(10)	15
Total finance costs	(116)	(66)

Finance costs exclude interest in respect of Banking activities, which is shown within operating expenses. Fair value movements on forward currency transactions were immaterial in the current and prior period.

7. Member payments

	2012 £m	2011 £m
To individual members	(53)	(78)
To employees who are members	(24)	(32)
To corporate members	(17)	(22)
Community distribution	(10)	(10)
	(104)	(142)

Further details of member payments are shown in the Finance Review on page 15.

Notes to the financial statements continued

7. Member payments continued

Accounting policies

Shares issued by the Society are classified as debt or equity in accordance with the substance of the contractual rights and obligations conferred. All payments to holders of shares ('members') that are classified as debt, such as corporate investor shares (see note 25), are charged to the income statement when the Society incurs the obligation to make such payments, and classified as financial costs.

Payments to members in their capacity as equity shareholders of the Parent Society, such as share interest, are treated as dividends, recognised as a liability when approved by the members in a general meeting and accounted for as an appropriation of profit.

Payments to members in their capacity as customers or employees are treated as charges in the income statement. Additionally members are allocated funds to distribute to charitable and co-operative organisations which are also treated as charges to the income statement. Where payments are non-contractual and distinguishable from the operating activities of the business, and payment is dependent on, and subject to, member approval in a general meeting, these payments are termed 'Member payments', charged below operating profit (where material) and recognised when such payments are approved by the membership.

8. Taxation

	2012 £m	2011 £m
Current tax – current period	18	(7)
Current tax – adjustments in respect of prior periods	27	19
Deferred tax credit/(charge) – current period	131	(24)
Deferred tax charge – adjustments in respect of prior periods	(5)	(21)
Total tax	171	(33)
Deduct tax (charge)/credit on discontinued businesses	3	(16)
Total tax on continuing businesses	174	(49)

The tax on the Group's net (loss)/profit before tax differs from the theoretical amount that would arise using the above standard rate of corporation tax of 24.5% (2011: 26.5%) as follows:

	2012 £m	2011 £m
(Loss)/profit before tax	(703)	231
Current tax at 24.5% (2011: 26.5%)	172	(61)
Expenses not deductible for tax (including significant items)	(16)	(18)
Depreciation and amortisation on non-qualifying assets	(13)	(12)
Non-taxable investment income	–	21
Adjustment in respect of previous periods	23	8
Losses taxed at lower rate/utilisation of losses	–	2
Restatement of deferred tax to 23% (2011: 25%)	8	11
Tax credit/(charge) on continuing business	174	(49)

Tax benefit/(expense) items taken directly to consolidated statement of comprehensive income

	2012 £m	2011 £m
Changes in available for sale assets	(12)	1
Actuarial gains and losses on employee pension scheme	10	(1)
Effective portion of cash flow hedges transferred to the cash flow hedging reserve	5	(5)
Revaluation of equity instruments	–	1
	3	(4)

Of the tax taken directly to the consolidated statement of comprehensive income, £6m (2011: £28m) relates to deferred taxation. See note 16 on deferred tax.

The 2012 Autumn Statement on 5 December 2012 announced that the UK corporation tax rate will reduce to 21% by 2014. A reduction in the rate from 26% to 25% (effective from 1 April 2012) was substantively enacted on 5 July 2011, and further reductions to 24% (effective from 1 April 2012) and 23% (effective from 1 April 2013) were substantively enacted on 26 March 2012 and 3 July 2012 respectively. This will reduce the Group's future current tax charge accordingly. For 2012, this increased the Group's tax credit by £4m (2011: £11m). The deferred tax liability at 5 January 2013 has been calculated based on the rate of 23% substantively enacted at the balance sheet date. It has not yet been possible to quantify the full anticipated effect of the announced further 2% rate reduction, although this will further reduce the company's future current tax charge and reduce the Group's deferred tax assets and liabilities.

Accounting policies

Income tax on the profit or loss for the period comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in reserves, in which case it is recognised in other comprehensive income. Current tax is the expected tax payable on the taxable income for the period, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

An element of tax attributable to Co-operative Insurance Society Ltd (CIS) comprises tax attributable to both policyholders' returns and shareholders' profit or loss. The returns and associated tax of the life business and its subsidiaries are attributable to the life policyholders. The profit or loss of the other than life insurance business is attributable to the shareholder. For the deferred tax accounting policy see note 16.

9. Profit on discontinued operations, net of tax

Following a strategic review of the Life and Savings business, the decision was taken to close the Financial Adviser sales channel and in July 2011 the Group announced that it was entering into exclusive discussions with Royal London Group for the sale of CIS Limited (the entity responsible for Life and Savings business), including a number of its wholly owned subsidiaries, and TCAM Limited (whose principal activity is the management of the Life fund investment portfolio). Although the sale has not completed during 2012, the Group is still in negotiations with Royal London Group and remains of the view that the sale is highly probable in accordance with IFRS 5. Therefore the results of the current and prior period have been included in discontinued operations and assets and liabilities remain held for sale (see note 19). Subsequent to the period end, as a post balance sheet event, the sale and purchase agreement was subsequently signed on 18 March 2013 with Royal London subject to regulatory approval. Given the timing of this agreement, it is not possible to estimate the full financial effect of this transaction.

The 2011 discontinued profit includes the Group's former travel business which was transferred to TCCT Holdings UK Limited (see note 13) in October 2011. A small number of former Somerfield foodstores and former Department and Home Stores are also included within prior period discontinued figures.

In 2012, the Group sold its clothing business and parts of its motor and cash in transit businesses. As these businesses are not considered to be separate, major operating lines of the Group, they have not been disclosed as discontinued operations as defined by IFRS 5.

Results of discontinued operations	2012 £m	2011 £m
Revenue	312	643
Expenses	(1,504)	(2,341)
Other income	1,254	1,766
Results from operating activities before significant items	62	68
Significant items	–	(2)
Results from operating activities	62	66
Profit on sale of discontinued operations	–	5
Income tax excluding tax attributable to policyholder returns	(3)	16
Income tax relating to tax attributable to policyholder returns	(56)	(61)
Minority interest	7	–
Profit for the period	10	26

Notes to the financial statements continued

9. Profit on discontinued operations, net of tax continued

Included within the above are the following in relation to the Life and Savings business:

	2012 £m	2011 £m
Gross earned premiums	327	408
Less premiums ceded to reinsurers	(15)	(15)
Net premiums	312	393
Expenses:		
Claims paid	(1,075)	(997)
Technical charges	42	(832)
Change in unallocated divisible surplus	(233)	(16)
Investment expenses and charges	(107)	(98)
Fee and commission expenses	(21)	(30)
Other operating expenses	(108)	(111)
Other income:		
Fee and commission income and income from service activities	75	75
Investment income	594	636
Gains less losses arising from financial instruments and other assets	585	1,055
Results from operating activities	64	75
Income tax excluding tax attributable to policyholder returns	(4)	(4)
Income tax relating to tax attributable to policyholder returns	(56)	(61)
Minority interest	7	–
Result for the period, net of income tax	11	10

Further details of income and expenses relating to the Life and Savings business and TCAM can be found in note 39.

	2012 £m	2011 £m
Cash flows used in discontinued operations:		
Net cash from operating activities	24	61

Net cash from investing activities and financing activities in discontinued operations were both £nil in the period (2011: £nil). Net consideration received by the Group on discontinued items sold in 2012 was £nil (2011: £19m). The prior year figure relates largely to former Somerfield foodstore disposals as mentioned above.

Accounting policies

Discontinued operations are those operations that can be clearly distinguished from the rest of the Group, both operationally and for financial reporting purposes, that have either been disposed of or classified as held for sale and which represent a separate major line of business or geographical area or a subsidiary purchased exclusively with a view to resale.

10. Property, plant and equipment

	2012 £m	2011 £m
Trading Group	2,440	2,511
Banking Group	163	202
Total	2,603	2,713

For the period ended 5 January 2013

	Property £m	Plant £m	Total £m
Cost or valuation:			
At 31 December 2011	1,761	2,311	4,072
Additions	220	288	508
Acquisition of subsidiaries (see note 34)	5	1	6
Transfers from Banking Group investments (see note 22)	11	–	11
Disposals	(308)	(111)	(419)
At 5 January 2013	1,689	2,489	4,178
Depreciation:			
At 31 December 2011	256	1,103	1,359
Charge for the period	32	266	298
Impairment	3	18	21
Disposals	(10)	(93)	(103)
At 5 January 2013	281	1,294	1,575
Net book value:			
At 5 January 2013	1,408	1,195	2,603
At 31 December 2011	1,505	1,208	2,713
Capital work in progress included above	4	50	54

Disposals of £316m (net book value) include £136m relating to the sale and leaseback of 1 Angel Square. This had unconditionally exchanged on 21 December 2012 and so was accounted for as a disposal. The sale was completed and the cash received on 8 February 2013. The lease will be accounted for as an operating lease under IAS 17 in future years.

Within property, land of £49m is held at valuation (2011: £49m). The historical cost equivalent is £1m (2011: £1m). This relates to agricultural land held for development purposes, but farmed by the Group whilst the development potential is explored. The carrying amount of £49m is tested annually for impairment in line with the Group's approach to all property, plant and equipment. Valuations are based on rental yields in an active market at similar sites. The impairment charge of £21m (2011: £13m) primarily relates to loss making stores in Food. The prior period figure related to the impairment of former distribution depots. No impairment charge went through the statement of other comprehensive income in the period (2011: £nil) as the charge relates to assets held at original cost which have not previously been revalued.

Notes to the financial statements continued

10. Property, plant and equipment continued
For the period ended 31 December 2011

	Property £m	Plant £m	Total £m
Cost or valuation:			
At 1 January 2011	1,717	2,093	3,810
Additions	94	296	390
Acquisition of subsidiaries	8	–	8
Transfers to Banking Group investments	(4)	–	(4)
Transfers from intangible assets	–	32	32
Disposals	(54)	(110)	(164)
At 31 December 2011	1,761	2,311	4,072
Depreciation:			
At 1 January 2011	239	939	1,178
Charge for the period	31	263	294
Impairment	11	2	13
Disposals	(25)	(101)	(126)
At 31 December 2011	256	1,103	1,359
Net book value:			
At 31 December 2011	1,505	1,208	2,713
At 1 January 2011	1,478	1,154	2,632
Capital work in progress included above	80	35	115
		2012 £m	2011 £m
Plant includes assets held under finance leases as follows:			
Cost		53	59
Accumulated depreciation		(23)	(24)
Net book value		30	35

Critical accounting estimates and judgments**Impairment**

The carrying amount of property, plant and equipment is reviewed at each balance sheet date and whenever there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated. An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognised in the income statement. Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of any associated goodwill allocated to cash-generating units, and then to reduce the carrying value of other fixed assets.

An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent of the asset's carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

The recoverable amount is the greater of the fair value less costs to sell and value in use. Estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessment of the time value of money and risks specific to the asset.

Accounting policies

Where parts of an item of property, plant and equipment have materially different useful lives, they are accounted for as separate items of property, plant and equipment.

Cost includes purchase price plus any costs directly attributable to bringing the assets to the location and condition necessary for it to be capable of operating in the manner intended by management.

Depreciation is provided on the cost or valuation less estimated residual value (excluding freehold land) on a straight-line basis over the anticipated working lives of the assets except for Funeralcare vehicles which are depreciated on a reducing balance basis of between 20% and 35%.

Useful lives are, generally:

Property

Freehold buildings – 50 years

Leasehold property – period of lease or 50 years

Plant

Plant and machinery – 3 to 13 years

Vehicles – 3 to 6 years

The residual value, if significant, is reassessed annually.

Freehold land that is subject to potential development is carried at fair value. Movements in fair value are recognised in the statement of comprehensive income.

The derecognition of property, plant and equipment occurs when the entity loses the future economic benefits associated with the asset. For a property disposal, this usually relates to when the property is unconditionally exchanged.

Leased assets

Leases where the Group assumes substantially all the risks and rewards of ownership are classified as finance leases. Plant and vehicles acquired under finance leases are stated at an amount equal to the lower of fair value and the present value of the minimum lease payments at inception of the lease, less accumulated depreciation and any impairment losses.

Depreciation is provided on the same basis as for owned assets. Minimum finance lease payments are apportioned between the finance charge and the redemption of the outstanding liability. The finance charge is allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.

Property held under operating leases that would otherwise meet the definition of investment property may be classified as investment property on a property by property basis. Where such leases are treated as investment properties, the assets are held at fair value and the leases are accounted for as finance leases.

Lease payments in respect of operating leases are charged to the profit and loss account on a straight-line basis over the period of the lease. Lease incentives received are recognised in the income statement as an integral part of the total lease expense and the aggregate benefit is recognised as a reduction of rental expense over the lease term on a straight-line basis.

For any leases where the Group is the lessor, the aggregate cost of incentives is recognised as a reduction of rental income over the lease term on a straight-line basis.

Sale and leaseback

A sale and leaseback transaction is one where a vendor sells an asset and immediately reacquires the use of that asset by entering into a lease with the buyer. The accounting treatment of the sale and leaseback depends upon the substance of the transaction and whether or not the sale was made at the asset's fair value. For sale and finance leasebacks, any apparent profit or loss from the sale is deferred and amortised over the lease term. For sale and operating leasebacks, generally the assets are sold at fair value, and accordingly the profit or loss from the sale is recognised immediately in the income statement. Following initial recognition, the lease treatment is consistent with those principles described above.

Notes to the financial statements continued

11. Goodwill and intangible assets

	2012 £m	2011 £m
Trading Group	1,518	1,520
Banking Group	303	401
Total	1,821	1,921

For period ended 5 January 2013

	Goodwill £m	Licences £m	Computer software £m	Deferred acquisition costs £m	Other £m	Assets in course of construction £m	Total £m
Cost:							
At 31 December 2011	1,274	503	183	177	46	220	2,403
Additions – acquired separately	25	–	1	–	–	–	26
Additions – internally developed	–	–	1	61	–	85	147
Transfers	–	–	21	–	–	(21)	–
Disposals	(3)	–	(4)	–	–	–	(7)
At 5 January 2013	1,296	503	202	238	46	284	2,569
Amortisation:							
At 31 December 2011	131	125	72	142	12	–	482
Charge for the period	–	25	24	64	5	–	118
Impairment	3	–	–	–	–	150	153
Disposals	(2)	–	(3)	–	–	–	(5)
At 5 January 2013	132	150	93	206	17	150	748
Net book value:							
At 5 January 2013	1,164	353	109	32	29	134	1,821
At 31 December 2011	1,143	378	111	35	34	220	1,921

For period ended 31 December 2011

	Goodwill £m	Licences £m	Computer software £m	Deferred acquisition costs £m	Other £m	Assets in course of construction £m	Total £m
Cost:							
At 1 January 2011	1,271	503	139	135	46	150	2,244
Additions – acquired separately	5	–	2	–	–	–	7
Additions – internally developed	–	–	–	74	–	165	239
Disposals	(2)	–	(21)	–	–	–	(23)
Transfers to assets held for sale	–	–	–	(32)	–	–	(32)
Transfers from/(to) property, plant and equipment	–	–	63	–	–	(95)	(32)
At 31 December 2011	1,274	503	183	177	46	220	2,403
Amortisation:							
At 1 January 2011	129	100	70	77	7	–	383
Charge for the period	–	25	20	77	5	–	127
Impairment	2	–	–	–	–	–	2
Disposals	–	–	(18)	–	–	–	(18)
Transfers to assets held for sale	–	–	–	(12)	–	–	(12)
At 31 December 2011	131	125	72	142	12	–	482
Net book value:							
At 31 December 2011	1,143	378	111	35	34	220	1,921
At 1 January 2011	1,142	403	69	58	39	150	1,861

Goodwill

The components of goodwill are as follows:

	2012 £m	2011 £m
Somerfield (Food)	868	868
Alldays (Food)	86	86
Other Food	148	126
Other businesses	62	63
	1,164	1,143

Within other businesses is goodwill relating to Funeralcare, Pharmacy and Legal Services.

Additions in the year include £18m in relation to the purchase of David Sands Limited on 24 April 2012 and £6m in relation to the acquisition of ten Costcutter stores (for further details see note 34).

Impairment

The components of the impairment charge are as follows:

	2012 £m	2011 £m
Assets in the course of construction in Banking Group	150	–
Goodwill in Food	2	2
Goodwill in Banking Group	1	–
	153	2

Critical accounting estimates and judgments**Goodwill**

A cash-generating unit (CGU) is the smallest identifiable group of assets that generates cash inflows which are largely independent of the cash inflows from other assets of the Group.

In the Trading businesses, the CGUs' recoverable amounts are based on value in use estimates, using projections of the Group's performance based on the three year plans approved by the Board. The discount rate is based on the cost of capital for each business and calculations range from 7 – 11% (2011: 7.5 – 2%). Business-specific growth rates are used to extrapolate cash flows beyond the three-year plan. The cash flows for each business are risk adjusted as appropriate to their respective industry. For large acquisitions, buying benefits and synergies are included in cash flows when performing impairment testing at acquisition level. Corporate costs have been allocated as appropriate to each CGU.

For Food, the key assumption used in the review for potential impairment of goodwill arising on the acquisition of Somerfield is that future EBITDA growth is projected as 2% from 2013 taken into perpetuity and discounted to present value. For other individual stores/smaller groups, annual cashflows have been inflated for growth by between 1% and 3% per annum (dependent on the size of the acquisition group) taken into perpetuity and discounted to present value. The majority of loss making stores are assumed to close within two years. Sensitivity analysis has been performed on all goodwill testing and for both a 1% increase in the discount rate and a decrease in EBITDA growth to 1%, the cash flows remain well in excess of the current carrying value.

For Funeralcare, average selling price increases and wage and cost inflation have been applied as per the assumptions in the three year plan. Cash flows have been projected for ten years and into perpetuity from year 11 and discounted back to present value. Sensitivity analysis has been performed with both the growth rate and discount rate adjusted by +/- 1%, and under these sensitivities significant headroom is maintained.

For Legal Services, average selling price increases and wage and cost inflation have been applied as per the assumptions in the three year plan. The prudent assumption of no growth beyond year three has been applied. Sensitivity analysis has been performed with both the growth rate and discount rate adjusted by +/- 1%, and under these sensitivities significant headroom is maintained.

The Bank's goodwill relating to the transfer of engagements of Britannia Building Society was written down to nil during the period (2011: £1m).

Licences and goodwill – Pharmacy

For the purposes of impairment testing of Pharmacy licences and goodwill, the recoverable amounts were determined by discounting future cash flows, assuming growth in profits of 3% per annum for 20 years. Sensitivity analysis has been performed with both the growth rate and discount rate adjusted by +/- 1%, and under these sensitivities significant headroom is maintained and the impact on impairment is immaterial.

Notes to the financial statements continued

11. Goodwill and intangible assets continued**Assets in the course of construction and computer software**

Assets in the course of construction includes an amount of £86m (2011: £193m) relating to the implementation of Finacle; a project to design and install a new core banking system. These assets have not yet been commissioned for use and no amortisation has been charged to date. The anticipated amortisation period for these assets is ten years from commission date. In addition, computer software includes £45m (2011: £50m) of assets relating to the Finacle Implementation project which have been commissioned and which are being amortised over a period of ten years.

A further £18m of assets relating to this project are held within property, plant and equipment as computer equipment and assets in course of construction (2011: £23m).

During the period, impairment losses of £150m were recognised relating to the Finacle Implementation asset (2011: £2m relating to assets utilised by the Field Sales Force channel of the Life and Savings business. These are included within disposals).

Impairment testing for assets in course of construction

Assets in the course of construction are reviewed annually to determine if there is any indication of impairment. If impairment is indicated, the asset's recoverable amount (being the greater of fair value less cost to sell and value in use) is estimated. Value in use is calculated by discounting the future cash flows (both costs to complete and benefits post completion) generated from the continuing use of the asset. If the carrying value of the asset is less than the greater of the value in use and the fair value less costs to sell, an impairment charge is recognised to this value.

The cash flows relating to this project have been reviewed and revised in the light of the prolonged economic downturn and a greater understanding of the costs and timescales to complete. The value in use of assets in the course of construction has been computed using the pre tax discount rate of 12.5% p.a. for the Finacle Implementation assets (2011: £12.5%) and 12.0% for other assets (2011: 12.0%).

This analysis resulted in a £150m impairment being recorded against the asset. This value in use calculation, and therefore the size of the impairment, is highly judgmental. All the elements of the calculation – costs to complete, benefits, timings of cash flows and the discount rate used, require judgments to be made around the likely outcome. A 1% change in the discount rate would change the value in use by £28m. A six month delay in completion (and therefore realisation of benefits), would reduce the value in use by £35m.

Management believes the impairment to be a fair reflection of the asset's value to the organisation. Were the Banking Group's acquisition of the Lloyds Banking Group branches (Project Verde) to be successfully completed, the Finacle implementation would not proceed and the remaining asset would be written off. If that acquisition does not go ahead, it is the current intention to complete the implementation in line with the current strategy.

Accounting policies**Goodwill**

Goodwill represents amounts arising on acquisition of subsidiaries, associates and joint ventures. In respect of business acquisitions that have occurred since 11 January 2004, goodwill represents the difference between the cost of the acquisition and the fair value of the identifiable assets, liabilities and contingent liabilities acquired. In respect of acquisitions prior to 11 January 2004, goodwill is included on the basis of its deemed cost, which represents the amount recorded under previous UK GAAP.

Assets and liabilities accepted under a transfer of engagements are restated at fair value, including any adjustments necessary to comply with the accounting policies of the Group.

Goodwill is stated at cost less any accumulated impairment losses. Goodwill is allocated to cash-generating units and is not amortised but is tested annually for impairment. In respect of associates, the carrying value of goodwill is included in the carrying amount of the investment in the associate. Where impairment is required the amount is recognised in the income statement and cannot be written back.

Negative goodwill arising on an acquisition is recognised directly in the income statement.

For transfers of engagements on or after 3 January 2010, considerations transferred have been valued by reference to the fair value of the Group's interest in the acquiree using a valuation technique. The technique involves assessing the future net profit of the acquiree and then discounting to perpetuity using a discount rate that reflects current market assessment of the time value of money and risks specific to the acquiree.

Acquisition costs since 3 January 2010 are now expensed to the income statement when incurred.

Acquisitions of non-controlling interests on or after 3 January 2010 are accounted for as transactions with owners in their capacity as owners and therefore no goodwill is recognised as a result of such transactions. The adjustments to non-controlling interests are based on a proportionate amount of the net assets of the subsidiary. Previously, goodwill was recognised on the acquisition of non-controlling interests in a subsidiary, which represented the excess of the cost of the additional investment over the carrying amount of the interest in the net assets acquired at the date of the transaction.

Computer software

Stated at cost less cumulative amortisation and impairment. In the Banking Group, all costs directly attributable in the development of computer software for internal use are capitalised and classified as intangible assets where they are not an integral part of the related hardware and amortised over their useful life up to a maximum of ten years.

Other intangible assets

These include pharmacy licences and Deferred Acquisition Cost (DAC) assets that are acquired by the Group and are stated at cost less accumulated amortisation (see below) and impairment losses. Expenditure on internally generated goodwill and brands (except the brand generated as a result of Britannia Building Society transfer of engagement) is recognised in the income statement as an expense as incurred. The Britannia brand was deemed to have a fair value on transfer of engagement and is subject to an annual impairment review.

Customer lists represent the intrinsic value of the retail savings book in the Britannia Bank which was recognised on the transfer of engagement. The asset is being amortised over the estimated useful life of three years.

Assets in the course of construction

Include directly attributable software development costs and purchased software that are not an integral part of the related hardware, as part of strategic projects that meet the capitalisation requirements under IAS 38 but have not been brought into use. The costs are held within assets in the course of construction until the project has gone live or the related asset is brought into use. At that point it will be transferred out of this classification and will be amortised based on the useful economic life as defined by the intangible asset accounting policy specified above.

Subsequent expenditure

Subsequent expenditure on capitalised intangible assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

Amortisation

This is charged to the income statement on a straight-line basis over the estimated useful lives of intangible assets. Goodwill with an indefinite useful life is systematically tested for impairment at each balance sheet date. Other intangible assets are amortised from the date they are available for use. The estimated useful lives are as follows:

- Software development costs: three to seven years (Core systems – maximum of ten years)
- Pharmacy licences: 20 years
- General Insurance DAC assets: Up to one year
- Long term business DAC assets (being the estimated life of a unit trust contract): Up to six years

Impairment

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount (the greater of the fair value less costs to sell and value in use). Impairment losses are recognised in the income statement. Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to cash-generating units, and then to reduce the carrying value of other fixed assets.

The carrying amounts of the Group's intangibles are reviewed at each balance sheet date and whenever there is any indication of impairment. For goodwill, and for assets that have an indefinite useful life and intangible assets that are not yet available for use, the recoverable amount is estimated at each balance sheet date. If any such indication of impairment exists, the assets' recoverable amount is estimated.

For the purposes of impairment testing of goodwill, the Group is regarded as several cash-generating units. Components of goodwill range from individual cash generating units, where stores were acquired individually, to groups of cash generating units, where groups of stores/branches were acquired as part of one transaction. Impairment testing is carried out at the level at which management monitor these components of goodwill.

Deferred acquisition costs

Within the general insurance business, costs directly associated with the acquisition of new business, including commission, are capitalised and amortised in accordance with the rate at which the gross premiums written associated with the underlying contract are earned.

Long term insurance business deferred acquisition costs are not represented as an explicit asset under the realistic basis of reporting actuarial liabilities. Acquisition costs relating to unit-linked investment contracts are recognised when incurred as the Directors do not consider these costs to be recoverable from future income. Deferred acquisition costs in relation to unit trust management are expected to be realised over a period of up to 5.5 years (2011: 6.8 years), being the expected term of a unit trust contract. Of the total value £8m (2011: £15m) is expected to be recovered after more than one year.

Notes to the financial statements continued

12. Investment properties

	2012 £m	2011 £m
Valuation at beginning of period	340	339
Additions	3	13
Transfers to other investments (note 13)	–	(3)
Disposals	(45)	(18)
Revaluation (deficit)/surplus recognised in income statement	(25)	9
Valuation at end of period	273	340

Investment properties have been valued as at 5 January 2013. The valuation was carried out by a number of external chartered surveyors: Colliers Conrad Rittblat Erdman, Strutt & Parker and Smiths Gore; as well as in-house valuers, on the basis of open market value in accordance with the RICS Appraisal and Valuation Manual.

The mean ERV (Estimated Rental Value) yield over the whole estate at the period end is 6.5% (2011: 6.4%).

In the case of investment properties, it is assumed that uplifts on valuation principally reflect future rentals. Investment properties do not include those within Banking and Insurance activities which are disclosed in note 22 and 40 respectively.

The transfer to other investments in the prior year represents the transfer of White Mill Windfarm which was transferred into investments from investment properties when the company was incorporated and the build of the windfarm commenced (see note 13 for more information).

Direct operating expenses of investment property are not considered material to the Group in either the current or prior year. Rental income is disclosed in note 4.

Accounting policies

Properties held for long term rental yields that are not occupied by the Group or property held for capital appreciation are classified as investment property. Investment property comprises freehold land and buildings and are carried at fair value. Fair value is based on current prices in an active market for similar properties in the same location and condition, using the work of independent valuers. No depreciation is provided on these properties. Any gain or loss arising from a change in fair value is recognised in the income statement. ERV is the Group's external valuers' opinion as to the open market rent, which on the date of valuation, could reasonably be expected to be obtained on a new letting or rent review.

On disposal of an investment property, the gain or loss on the disposal is recognised within the change in value of investment property line within the income statement.

Properties are valued individually, and yields therefore vary on a property-by-property basis. If an investment property becomes owner-occupied, it is reclassified as property, plant and equipment, and its fair value at the date of reclassification becomes its cost for subsequent accounting purposes. Similarly, transfers to the investment property portfolio are made when owner-occupancy ceases and the property meets the criteria of an investment property under IAS 40. Prior to such a transfer the property is measured at fair value with any uplift recognised in the income statement.

13. Investments in associates and joint ventures

The Group's share of profits in relation to associates and joint ventures for the year was £5m (2011: losses of £11m). The split of investments, including movements in investments in associates, joint ventures and other investments are as follows:

	2012 £m	2011 £m
Trading Group	59	67
Banking Group	4	3
Total	63	70

	2012			2011		
	Associates and joint ventures £m	Other investments £m	Total £m	Associates and joint ventures £m	Other investments £m	Total £m
At beginning of period	65	5	70	28	5	33
Acquisition of associates	–	–	–	53	–	53
Transfer from investment properties (note 12)	–	–	–	3	–	3
Share of profits/(losses)	5	–	5	(11)	–	(11)
Impairment	–	–	–	(8)	–	(8)
Disposal	(12)	–	(12)	–	–	–
At end of period	58	5	63	65	5	70

The £58m of investments in associates and joint ventures (2011: £65m) comprises £46m in TCCT Holdings UK Limited (2011: £44m), £nil in Grangefern Properties Limited (2011: £12m), £4m in White Mill Windfarm (2011: £3m), £3m in Coldham Windfarm (2011: £2m), £4m in Britannia Personal Lending Limited (2011: £3m) and £1m of other (2011: £1m). The table below shows the aggregated financial information of the Group's joint ventures and associates if they were not adjusted for percentage owned:

	2012	2011
	£m	£m
Current assets	303	109
Non-current assets	394	184
Total assets	696	293
Current liabilities	596	391
Non-current liabilities	37	34
Total liabilities	632	425
Income	338	76
Expenditure	328	109

The Group owns 50% of the ordinary share capital of White Mill Windfarm Limited, incorporated in England and Wales. The entity's principal activity is to build and operate a windfarm. The entity has a year end date of 31 December.

The Group owns 49% of the ordinary shares in Britannia Personal Lending Limited, incorporated in England and Wales. Its principal activity is unsecured personal lending. The entity has a year end date of 31 December.

The above entities are jointly managed and controlled by the Group and a third party. They are accounted for as joint ventures under the equity method.

The Group owns 30% of the ordinary shares in TCCT Holdings UK Limited, incorporated in England and Wales. Its principal activity is as a travel agency and tour operator. The entity has a year end date of 30 September.

The Group owns 20% of the ordinary share capital of Coldham Windfarm Limited, incorporated in England and Wales. The entity's principal activity is the operation of a windfarm. The entity has a year end date of 31 December.

The Group does not have the power to control the Board of the above two entities, accordingly they are not fully consolidated in the Group accounts but are accounted for as associates under IAS 28.

The Group sold its 60% of the ordinary share capital of Tiajin Tasly Sants Pharmaceutical Distributors Ltd in 2012. This investment was written down to nil in 2011 based on management's assessment of its recoverable value.

The Group sold its 50% share of the ordinary share capital of Grangefern Properties Limited, incorporated in England and Wales.

There were no contingent liabilities in respect of the Group's joint ventures or associates as at 5 January 2013 (2011: £nil).

Accounting policies

The Group conducts its joint venture arrangements through jointly controlled entities and accounts for them using the equity method of accounting. Where the Group transacts with its jointly controlled entities, unrealised profits and losses are eliminated to the extent of the Group's interest in the joint venture. The Group's associates are also accounted for under the equity method. The Group records its share of the associate's post tax profit or loss within the income statement and its share of the net assets within investments.

Other investments include investments where the Group does not have significant influence over the respective business. The investments are accounted for at cost.

Notes to the financial statements continued

14. Derivatives

	Assets		Liabilities	
	2012 £m	2011 £m	2012 £m	2011 £m
Trading Group	82	79	(122)	(141)
Banking Group	819	981	(968)	(1,091)

Trading Group

Derivatives held for non-trading purposes for which hedge accounting has not been applied are as follows:

	2012			2011		
	Contractual/ notional amount £m	Fair value assets £m	Fair value liabilities £m	Contractual/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Interest rate swaps	1,605	82	(122)	1,733	79	(141)
Forward currency transactions	7	–	–	8	–	–
Total recognised derivative assets/(liabilities)	1,612	82	(122)	1,741	79	(141)

Interest rate swaps and forward currency transactions are measured at fair value through the income statement (see note 6).

The objectives and policies for financial instruments are included within note 38 on risk management.

Banking Group**Derivative financial instruments**

The analysis of derivatives in the current period is for Banking and General Insurance activities only. Details of derivatives held by the Life and Savings business can be found in note 40 for the current and previous period.

The Bank, as principal, has entered into various derivatives either as a trading activity, which includes proprietary transactions and customer facilitation, or as a hedging activity for the management of interest rate risk, equity risk and foreign exchange rate risk. Positive and negative fair values have not been netted as the Group does not have a legal right of offset.

Derivatives held for trading purposes:

Trading transactions are wholly interest rate related contracts including swaps, caps and floors, forward rate agreements and exchange traded futures. Trading transactions include derivatives where the Bank enters into a transaction to accommodate a customer together with the corresponding hedge transaction.

CIS uses interest rate swaps, swaptions and total return swaps to manage interest rate risk in the fund and specifically as an economic hedge against part of its exposure to guaranteed annuity options. The market value represents the initial margin and the daily variation margin.

Non-trading derivatives:

Non-trading transactions comprise derivatives held for hedging purposes to manage the asset and liability positions of the Group. Derivatives used to manage interest rate related positions include swaps, caps and floors, forward rate agreements and exchange traded futures. The foreign exchange rate positions are managed using forward currency transactions and swaps. Equity risk is managed using equity swaps.

	Fair value assets		Fair value liabilities	
	2012 £m	2011 £m	2012 £m	2011 £m
Derivatives held for trading:				
Interest rate swaps	196	167	(167)	(142)
Interest rate options	1	2	(1)	(4)
Total derivative assets/(liabilities) held for trading	197	169	(168)	(146)
Derivatives held for hedging:				
Interest rate swaps designated as cashflow hedges	120	218	(52)	(106)
Interest rate swaps designated as fair value hedges	111	137	(630)	(731)
Interest rate swaps held for non-trading purposes for which hedge accounting has not been applied	45	14	(63)	(51)
Embedded derivatives – options	61	29	–	(1)
OTC interest rate options	–	–	(3)	(4)
Equity swaps	63	113	–	–
Forward currency transactions	222	301	(52)	(52)
Total derivative assets/(liabilities) held for non-trading	622	812	(800)	(945)
Total recognised derivative assets/(liabilities)	819	981	(968)	(1,091)

Accounting policies

Information in respect of derivatives and other financial instruments has for clarity been presented separately for the Trading Group, Banking and General Insurance divisions. The policies applied are consistent across the Group.

The Trading Group uses derivative financial instruments to provide an economic hedge to its exposure to foreign exchange and interest rate risks arising from operational, financing and investment activities. In accordance with its treasury policy, the Trading Group does not hold or issue derivative financial instruments for trading purposes.

Derivatives entered into include swaps and forward rate agreements. Derivative financial instruments are measured at fair value and any gains or losses are included in the income statement.

Fair values are based on quoted market prices in active markets, and where these are not available, using valuation techniques such as discounted cashflow models. For further details refer to note 38.

Interest payments or receipts arising from interest rate swaps are recognised within net financial income/(expenses) in the period in which the interest is incurred or earned.

Derivatives used for asset and liability management purposes

Derivatives are used to hedge interest and exchange rate exposures related to non-trading positions. Instruments used for hedging purposes include swaps, forward rate agreements, futures, options and combinations of these instruments. The Bank also uses equity derivatives to hedge the equity risks within its capital bonds.

Derivative financial instruments are stated at fair value based on quoted market prices in active markets, and where these are not available, using valuation techniques such as discounted cashflow models. All derivatives are carried as assets when the fair value is positive and liabilities when the fair value is negative. The gain or loss on re-measurement to fair value is recognised immediately in the income statement except where derivatives qualify for cashflow hedge accounting.

On initial designation of derivatives and qualifying hedged items as a hedge, the Bank formally documents the relationship between the hedging instrument(s) and hedged item(s) including the risk management objective and strategy in undertaking the hedge transaction together with the method used to assess effectiveness of the hedging relationship.

The Bank makes an assessment, both at the inception of the hedge relationship as well as on an ongoing basis as to whether the hedging instruments are expected to be 'highly effective' on offsetting the changes in fair value or cashflows of the respective hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within a range of 80%–125%.

Notes to the financial statements continued

14. Derivatives continued**Cashflow hedges**

Where derivatives are designated as hedges of the exposure to variability in cash flows of a recognised asset or liability, or a highly probable forecast transaction, the portion of the fair value gain or loss on the derivative that is determined to be an effective hedge is recognised directly in equity. The ineffective part of any gain or loss is recognised in the income statement immediately. The accumulated gains and losses recognised in equity are reclassified to the income statement in the periods in which the hedged item will affect profit or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss recognised at that time remains in equity until the forecast transaction is eventually recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was recognised in equity is immediately reclassified to the income statement.

Fair value hedges

Where a derivative is designated as the hedging instrument to hedge the change in fair value of a recognised asset or liability or a firm commitment that could affect income or expense, changes in the value of the derivative are recognised immediately in the income statement together with changes in the fair value of the hedged item that are attributable to the hedged risk. Fair values are based on quoted market prices in active markets, or where these are not available, using valuation techniques such as discounted cashflow models.

If the derivative expires or is sold, terminated, or exercised, or no longer meets the criteria for fair value hedge accounting, or the designation is revoked, then hedge accounting is prospectively discontinued. Any adjustment up to that point, to a hedged item for which the effective interest method is used, is amortised to income or expense as part of the recalculated effective interest rate of the item over its remaining life.

Fair value hedge accounting for a portfolio hedge of interest rate risk

As part of its risk management process the Bank identifies portfolios whose interest rate risk it wishes to hedge. The portfolios may comprise only assets, only liabilities or both assets and liabilities. The Bank analyses each portfolio into repricing time periods based on expected repricing dates, by scheduling cash flows into the periods in which they are expected to occur. Using this analysis, the Bank decides the amount it wishes to hedge and designates as the hedged item an amount of assets or liabilities from each portfolio equal to this.

On a monthly basis, the Bank measures the change in fair value of the portfolio relating to the risk that is being hedged. Provided that the hedge has been highly effective the Bank recognises the change in fair value of each hedged item in the income statement with the cumulative movement in its value being shown on the balance sheet as a separate item, fair value adjustment for hedged risk, either within assets or liabilities as appropriate. If the hedge no longer meets the criteria for hedge accounting, this amount is amortised to the income statement over the remaining average useful life of the hedge relationship.

The Bank measures the fair value of each hedging instrument monthly. The value is included in derivative financial instruments in either assets or liabilities as appropriate, with the change in value recorded in the income statement.

Any hedge ineffectiveness is recognised in the income statement as the difference between the change in fair value of the hedged item and the change in fair value of the hedging instrument.

Embedded derivatives

A derivative may be embedded in another instrument, known as the host contract. Where the economic characteristics and risks of an embedded derivative are not closely related to those of the host contract (and the host contract is not carried at fair value through income or expense), the embedded derivative is separated from the host and held on balance sheet at fair value. Movements in fair value are posted to the income statement, whilst the host contract is accounted for according to the relevant accounting policy for that particular asset or liability.

Derivatives used for trading purposes

Derivatives entered into for trading purposes include swaps, forward rate agreements, futures, options and combinations of these instruments. Derivatives used for trading purposes are measured at fair value and any gains or losses are included in the income statement. The use of derivatives and their sale to customers as risk management products is an integral part of the Bank's trading activities.

15. Pensions

The pension assets and liabilities in the balance sheet comprise:

	Assets 2012 £m	Assets 2011 £m	Liabilities 2012 £m	Liabilities 2011 £m	Net 2012 £m	Net 2011 £m
Trading Group schemes in surplus						
The Co-operative Group Pension (Average Career Earnings) Scheme (Pace)	6,919	6,611	(6,532)	(6,242)	387	369
Somerfield Pension Scheme	766	763	(732)	(701)	34	62
Lothian Borders & Angus Co-operative Society Limited Employees' Pension Fund	60	–	(55)	–	5	–
	7,745	7,374	(7,319)	(6,943)	426	431
Trading Group schemes in deficit						
United Norwest Co-operatives Employees' Pension Fund	430	384	(563)	(532)	(133)	(148)
Other former United Co-operatives Funds	144	132	(182)	(177)	(38)	(45)
Plymouth and South West and Brixham Funds	76	70	(133)	(129)	(57)	(59)
Lothian Borders & Angus Co-operative Society Limited Employees' Pension Fund	–	57	–	(58)	–	(1)
	650	643	(878)	(896)	(228)	(253)
Banking Group schemes in deficit:						
Britannia Pension Scheme	603	569	(587)	(608)	16	(39)
Less asset limitation (IFRIC 14)	(16)	–	–	–	(16)	–
	587	569	(587)	(608)	–	(39)
Britannia unfunded obligations	–	–	(3)	(3)	(3)	(3)
EFRBS liabilities from the Pace scheme (unfunded)	–	–	(4)	(4)	(4)	(4)
	587	569	(594)	(615)	(7)	(46)

The Group operates a number of defined benefit pension schemes, the assets of which are held in separate trustee-administered funds. As the Banking Group does not have right to a refund on any surplus in the Britannia Pension Scheme, the net asset of £16m (excluding unfunded obligations) has been restricted to zero.

The Group pension schemes are set out below. All pension schemes, apart from Pace were closed to new accrual in 2012. In addition, the United Norwest Co-operatives Limited 1989 Discretionary Early Retirement Benefits Scheme (closed to new entrants from 5 November 1995) and the Leeds Co-operative Society Limited Managerial Staff Pensions Scheme provide additional benefits for long-serving employees who commenced employment prior to scheme closure. The pension costs are assessed in accordance with actuarial advice using the projected unit method. The most recent valuation of the schemes was carried out by a qualified actuary. The date of the last full valuations of the schemes are shown below. The assumptions used by the actuary are the best estimates chosen from a range of possible actuarial assumptions which may not necessarily be borne out in practice. The Group is currently performing a scheme valuation for the Lothian Borders & Angus Fund which will be concluded in 2013.

Date of last actuarial valuation

The Co-operative Group Pension (Average Career Earnings) Scheme (Pace)	April 2010
United Norwest Co-operatives Employees' Pension Fund	January 2011
Somerfield Pension Scheme	March 2010
Britannia Pension Scheme	April 2011
Yorkshire Co-operatives Limited Employees' Superannuation Fund	January 2011
Sheffield Co-operative Society Limited Employees' Superannuation Fund	January 2011
Leeds Co-operative Society Limited Employee Pension Fund	January 2011
Lothian Borders & Angus Co-operative Society Limited Employees' Pension Fund	January 2012
Plymouth and South West Co-operative Society Limited Employees' Superannuation Fund	March 2010
Brixham Co-operative Society Limited Employees' Superannuation Fund	March 2011

Notes to the financial statements continued

15. Pensions continued**Critical accounting estimates and judgments**

The actuarial valuations of the schemes have been updated to 5 January 2013 in accordance with IAS 19.

	2012	2011
The principal assumptions used to determine the liabilities of the Group's pension schemes were:		
Discount rate	4.60%	4.60%
Rate of increase in salaries	4.80%	4.80%
Future pension increases where capped at 5.0% pa – Retail Price Index	3.30%	3.30%
Future pension increases where capped at 5.0% pa – Consumer Price Index	2.80%	2.80%
Future pension increases where capped at 2.5% pa – Retail Price Index	2.50%	2.50%
Future pension increases where capped at 2.5% pa – Consumer Price Index	2.50%	2.00%
Expected return on plan assets	5.10%	6.10%

The average life expectancy (in years) for mortality tables used to determine scheme liabilities for the largest schemes at 5 January 2013 are as follows:

	Member currently aged 65 (current life expectancy)		Member currently aged 45 (life expectancy at age 65)	
	Male	Female	Male	Female
Pace Scheme	22.4	24.0	24.2	25.9
United Norwest Fund	22.0	24.0	23.8	26.0
Britannia Scheme	22.4	24.6	24.2	26.5
Somerfield Scheme	22.4	23.7	24.3	25.7

The weighted-average asset allocations at the year end were as follows:

	2012	2011
Equities	27%	26%
Liability-driven instruments	29%	32%
Alternative growth	12%	12%
Property	4%	4%
Bonds	21%	21%
Diversified growth	5%	4%
Other ⁽ⁱ⁾	2%	1%

Notes

(i) The other category includes cash and current assets.

As all the above pension schemes are not subject to materially different risks, the following disclosures are made in total across all pension schemes:

	2012 £m	2011 £m
The amounts recognised in the balance sheet are as follows:		
Present value of funded obligations	(8,772)	(8,434)
Present value of unfunded liabilities	(19)	(20)
Asset limitation (IFRIC14)	(16)	–
Fair value of plan assets	8,998	8,586
Net retirement benefit asset	191	132

A movement in the discount rate of 0.1% would impact the liabilities by £172m. An adjustment to price and salary inflation of 0.1% would impact liabilities by £156m. An increase in the assumed long term rate of improvement in mortality from 1.25% p.a. to 1.5% p.a. would increase liabilities by £127m.

	2012 £m	2011 £m
The amounts recognised in the income statement are as follows:		
Current service cost	(88)	(85)
Interest on liabilities	(385)	(403)
Expected return on scheme assets	432	480
Gains on settlement and curtailments:		
– Significant items	–	6
– Non-significant items	–	1
	(41)	(1)
Actual return on scheme assets	528	859

Net pension finance income of £47.2m in the Income Statement includes £49.8m net pension finance income in respect of the Pace Scheme, £0.4m net pension finance income in respect of the Britannia Pension Scheme, £0.1m net pension finance cost in respect of the four defined benefit schemes operated by the former United Co-operatives, £0.7m net pension finance cost in respect of Somerfield and a net pension finance cost of £2.2m for all remaining schemes. For all schemes including Britannia, there is £385.3m of interest on liabilities and £432.5m of expected return on scheme assets.

	2012 £m	2011 £m
Changes in the present value of the scheme liabilities are as follows:		
Opening defined benefit liabilities	8,454	7,831
Current service cost	88	85
Interest on liabilities	385	403
Contributions by members	28	29
Actuarial losses recognised in equity	126	379
Benefits paid	(290)	(266)
Gains on settlements and curtailments	–	(7)
Closing defined benefit liabilities	8,791	8,454

	2012 £m	2011 £m
Changes in the fair value of the scheme assets are as follows:		
Opening fair value of scheme assets	8,586	7,827
Expected return on scheme assets	432	480
Actuarial gains recognised in equity	96	379
Contributions by the employer	146	134
Contributions by members	28	29
Benefits paid	(290)	(263)
Closing fair value of scheme assets	8,998	8,586

In 2011, actuarial losses recognised in equity include a gain of £50m arising from a change in the deferred pension rights of a small number of members from RPI to CPI. This follows the completion of the detailed legal review of all pension schemes rules during 2011 following the change to statutory pension increases announced by the Government in July 2010.

Notes to the financial statements continued

15. Pensions continued

The Group expects to contribute £162m to its pension schemes in 2013.

To develop the expected long term rate of return on assets assumption, the Group considered the current level of expected returns on risk-free investments (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolios invest and the expectations for future returns of each asset class. The expected return for each asset class was then weighted based on the target asset allocation to develop the expected long term rate of return on assets assumption for the portfolios. This resulted in the selection of a range between 4.1% to 6.13 % (2011: 4.4% to 7.1%) assumption for the period ended 5 January 2013.

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Amounts recognised in the balance sheet:					
Defined benefit liabilities	(8,791)	(8,454)	(7,831)	(7,319)	(5,335)
Asset limitation (IFRIC 14)	(16)	–	–	–	–
Scheme assets	8,998	8,586	7,827	7,035	5,592
Surplus/(deficit)	191	132	(4)	(284)	257
History of experience gains and losses:					
Experience adjustment on scheme liabilities	(50)	(17)	(377)	1	10
% of scheme liabilities	1%	0%	5%	0%	0%
Experience adjustment on scheme assets	(146)	(174)	452	227	(609)
% of scheme assets	-2%	-2%	6%	3%	-11%

The above two tables only include four years history for the Somerfield, Britannia, Plymouth & South West and Brixham schemes – this being the period that has elapsed since they became part of the Group.

16. Deferred taxation

Deferred income taxes are calculated on all temporary differences under the liability method using an effective tax rate of 23% (2011: 25%).

	2012 £m	2011 £m
Net deferred tax comprises:		
Deferred tax asset		
Trading Group	133	133
Banking Group	73	55
	206	188
Deferred tax liability		
Trading Group	(219)	(299)
Banking Group	(6)	(40)
	(225)	(339)
Net deferred tax (liabilities)/assets		
Trading Group	(86)	(166)
Banking Group	67	15
	(19)	(151)
Comprised of:		
Other temporary differences	68	76
Temporary differences arising on derivatives and interest	(17)	(8)
Other temporary differences arising on fair value and merger with Britannia Building Society	(56)	(3)
Retirement benefit obligations	(43)	(33)
Capital allowances on fixed assets	87	(55)
Capital allowances on assets leased to customers	1	(3)
Unrealised gains on investments, investment properties and rolled-over gains	(154)	(188)
Claims equalisation reserve	(7)	(7)
Tax losses	102	70
	(19)	(151)

The main components of the deferred tax liability are the potential liability on rolled over gains of £154m (2011: £188m), net retirement obligations of £43m (2011: £33m), timing differences arising on derivatives and interest of £17m (2011: £8m), plus £56m arising on fair value differences on the acquisition of Britannia (2011: £3m).

These liabilities are offset by deferred tax assets arising in respect of tax allowances on property plant and equipment and intangible assets of £88m (2011: £58m liability), carried forward tax losses of £102m (2011: £70m), taxation of special purpose vehicles under securitisation regime of £29m (2011: £26m) and deferred tax relief on other accounts provisions including holiday pay and onerous lease provisions of £39m (2011: £49m). The Group has recognised a gross deferred tax asset of £205m following a review of the future financial performance forecasts of the Group, which demonstrate these assets will be able to be utilised against future taxable profits.

Deferred income taxes are calculated on all temporary differences under the liability method using an effective tax rate of 23% (2011: 25%).

	2012 £m	2011 £m
At beginning of period	(151)	(138)
Income statement credit/(charge):		
– Group	126	(45)
– CIS Life Business	–	43
Transfer of CIS Life business to liabilities held for sale	–	16
Charged to equity:		
– Retirement benefit obligations	9	1
– Other	(3)	(28)
At end of period	(19)	(151)

Accounting policies

Deferred tax is provided for, with no discounting, using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following temporary differences are not provided for: the initial recognition of assets or liabilities that affect neither accounting nor taxable profits, and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available for utilisation. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

17. Inventories and biological assets

	2012 £m	2011 £m
Inventories	523	605
Biological assets	5	5
	528	610

Inventories are comprised of the following:

	2012 £m	2011 £m
Raw materials, consumables and work in progress	11	10
Finished goods and goods for resale	512	595
	523	605

The period end inventories provision is £20m (2011: £19m) and largely relates to Food in both years. A charge of £2m (2011: charge of £8m) has been made to the income statement in the period also largely relating to Food. There was no inventory pledged as security for liabilities in the current or prior period.

Accounting policies

Inventories are stated at the lower of cost, including attributable overheads and net realisable value.

Biological assets are stated at fair value less estimated point of sale costs, with any resultant gain or loss recognised in the income statement. Point of sale costs include all costs that would be necessary to sell the assets, excluding costs necessary to get the assets to market.

Notes to the financial statements continued

18. Trade and other receivables

	2012 £m	2011 £m
Non-current	36	29
Current	666	478
Trading Group	702	507
Banking Group	412	332
	1,114	839

	2012 £m	2011 £m
Trade receivables	374	315
Receivables arising from insurance	200	207
Prepayments and accrued income	225	153
Other receivables	315	164
	1,114	839

Trade receivables are stated net of an impairment provision of £7.6m (2011: £7.2m). £0.5m (2011: £0.2m credit) has been charged to the income statement offset by £0.1m payments received in the year.

Further details on the ageing of trade and other receivables of the Trading Group can be found in note 38.

Trade receivables include amounts totalling £33m (2011: £25m), which are overdue but not considered to be impaired, age analysed as follows:

	2012 £m	2011 £m
Amounts overdue:		
Less than three months	28	21
Three to six months	3	2
More than six months	2	2
	33	25

Amounts overdue but not impaired typically comprise high volume/low value balances for which the individual trading businesses do not seek collateral but continue to work with counterparties to secure settlement. No other receivables are overdue.

Accounting policies**Bad and doubtful debts**

The amount charged against operating profit comprises collective provisions against identifiable losses and, in the Banking Group's activities, a collective provision to cover latent but unidentifiable losses due to doubtful debts. Both provisions are based on a year end appraisal of debtors, loans and advances on the basis of objective evidence that a loss has been incurred. Receivables, loans and advances are shown in the balance sheet after deducting these provisions. Debts are written off when there is no realistic prospect of further recovery of the amounts owing.

Impairment

The carrying amounts of the Group's receivables are reviewed at each balance sheet date and whenever there is any indication of impairment. If any such indication exists, the assets' recoverable amount is estimated. Any adjustment to the level of impairment provision is recognised within the income statement in operating profit.

19. Assets and liabilities held for sale

As per note 9, the Life and Saving business' assets and liabilities are held for sale.

	Assets held for sale		Liabilities held for sale	
	2012 £m	2011 £m	2012 £m	2011 £m
Trading Group	–	1	–	–
Banking Group	24,013	24,266	(23,353)	(23,775)
Total	24,013	24,267	(23,353)	(23,775)

Assets classified as held for sale

	2012 £m	2011 £m
Property, plant and equipment	–	1
Intangible assets	13	20
Trade and other receivables	208	221
Loans and advances to customers	1	2
Derivatives	1,244	1,487
Investments	18,931	19,049
Reinsurers' share of technical provisions	3,616	3,487
	24,013	24,267

Liabilities classified as held for sale

	2012 £m	2011 £m
Derivatives	(1,168)	(1,197)
Deferred tax	(36)	(16)
Amounts owed to credit institutions	(27)	(722)
Insurance contracts	(17,702)	(17,679)
Investment contracts	(360)	(314)
Unallocated divisible surplus	(1,286)	(1,052)
Net assets attributable to unit holders	(56)	–
Trade and other payables	(2,683)	(2,706)
Income tax payable	(24)	(81)
Provisions	(11)	(8)
	(23,353)	(23,775)

Further details of assets and liabilities held for sale relating to the Life and Savings business and TCAM can be found in note 40.

Accounting policies

Non-current assets (or disposal groups comprising assets and liabilities) that are expected to be recovered primarily through sale rather than through continuing use are classified as held for sale. Immediately before classification as held for sale, the assets (or components of a disposal group) are remeasured in accordance with the Group's accounting policies. Thereafter, generally the assets (or disposal group) are measured at the lower of their carrying amount and fair value less cost to sell. Any impairment loss on a disposal group is first allocated to goodwill, and then to remaining assets and liabilities on a pro rata basis, except that no loss is allocated to inventories, financial assets, deferred tax assets, employee benefit assets, investment property and biological assets, which continue to be measured in accordance with the Group's accounting policies. Impairment losses on initial classification as held for sale and subsequent gains or losses on remeasurement are recognised in profit or loss. Gains are not recognised in excess of any cumulative impairment loss.

20. Loans and advances to banks

	2012 £m	2011 £m
Items in the course of collection from other banks	104	123
Placements with other banks	747	897
Included in cash and cash equivalents	851	1,020
Other loans and advances to banks	1,053	987
	1,904	2,007

Accounting policies**Sale and repurchase agreements**

Securities sold subject to repurchase agreements (repos) are reclassified on the balance sheet as pledged assets when the transferee has the right by contract or custom to sell or repledge the assets. The liability to the transferee is also included on the balance sheet, in deposits by banks. The difference between sale and repurchase price is accrued over the life of the agreements using the EIR method.

Securities purchased under agreements to re-sell (reverse repos) are classified as loans and advances to banks on the balance sheet, as appropriate.

Notes to the financial statements continued

21. Loans and advances to customers

	2012 £m	2011 £m
Gross loans and advances	34,403	34,440
Less allowance for losses on loans and advances	(643)	(292)
Less fair value adjustments for hedged risk	(354)	(366)
	33,406	33,782

Fair value adjustments for hedged risk

The Group has entered into interest rate swaps that protect it from changes in interest rates on the floating rate liabilities that fund its portfolio of fixed rate mortgages. Changes in the fair values of these swaps are offset by changes in the fair values of the fixed rate mortgages.

Securitisation

Loans and advances to customers include £10,997m (2011: £9,100m) securitised under the Group's securitisation and covered bond programmes. The Group remains exposed to substantially all of the risks and rewards of ownership of these assets. Included within Group deposits by banks are £58m (2011: £62m) of loans from external third parties and within Group debt securities in issue are £4,145m (2011: £3,989m) of fixed and floating rate notes, all secured on these mortgage assets.

Concentration of exposure

The Group's exposure is virtually all within the United Kingdom. There is a detailed analysis of the concentration of exposure within the risk management disclosures (note 38).

Allowance for losses on loans and advances

	2012					2011				
	Individual mortgage £m	Individual corporate £m	Collective retail £m	Collective corporate £m	Total £m	Individual mortgage £m	Individual corporate £m	Collective retail £m	Collective corporate £m	Total £m
At beginning of the year	9	105	166	12	292	9	56	158	–	223
Charge against profits	9	380	43	11	443	5	77	37	13	132
Amounts written off	(7)	(47)	(30)	(1)	(85)	(5)	(27)	(27)	(1)	(60)
Unwind of discount of allowance	–	(4)	(3)	–	(7)	–	(1)	(2)	–	(3)
Interest charged on impaired loans	–	–	–	–	–	–	–	–	–	–
At end of the period	11	434	176	22	643	9	105	166	12	292

The largest charge against profits in the above table is in individual corporate which relates to the Banking Group – non-core business (see note 1). Loans and advances to customers include £154m (2011: £114m) 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 £49m (2011: £37m) are secured by real estate collateral.

Loans and advances to customers include finance lease receivables:

	2012 £m	2011 £m
Gross investment in finance leases, receivable:		
– No later than one year	22	26
– Later than one year and no later than five years	69	63
– Later than five years	73	82
	164	171
Unearned future finance income on finance leases	(44)	(48)
Net investment in finance leases	120	123
The net investment in finance leases may be analysed as follows:		
– No later than one year	16	19
– Later than one year and no later than five years	48	41
– Later than five years	57	63
	121	123

There are no unguaranteed residual values for any of the finance leases. The Bank enters into finance lease and hire purchase arrangements with customers in a wide range of sectors including transport, retail and utilities. The accumulated allowance for uncollectible minimum lease payments receivable is £nil (2011: £nil).

Critical accounting estimates and judgments

Loans and advances impairment

Overview

The loan portfolios are reviewed on a continual basis to assess impairment. In determining whether an impairment provision should be recorded, judgments are made as to whether there is objective evidence that a financial asset or portfolio of financial assets is impaired as a result of loss events that occurred after recognition of the asset and by the balance sheet date. The calculation of impairment loss includes expectations of levels of future cash flows, and is based on both the likelihood of a loan or advance being written off and the estimated loss on such a write off. Where loans are subject to forbearance, they may be treated as impaired. Further explanation of the treatment of forborne balances is included in note 38.

Collective provisions

Personal advances are identified as impaired by taking account of the age of the debt's delinquency, the product type and the regularity of payments made whilst in arrears. The provision is calculated by applying a percentage rate to different categories and ages of impairment debt. The provision rates reflect the likelihood that the debt in that category/age will be written off or charged off at some point in the future. The rates are based on historical experience and current trends, incorporate the effects of discounting at the customer interest rate and are subject to regular review. The provision is the product of the rate and the balance for the relevant arrears band. The majority of provisions are made against unsecured loans. A key estimate within this provisioning model is the percentage of accounts that will be charged off. A 1% change would change the collective provision by £1m.

The Group's corporate collective provision has increased to £22m (2011: £12m), reflecting the continuing difficulties and uncertainties currently being experienced in this sector. This is a consequence of applying increasing levels of prudence to the pool of accounts which are identified as having higher levels of risk.

Following a review of the loan loss provisioning for the 2012 year end, the collective unimpaired provision methodology has been refined for Corporate Banking. The methodology has been based on risk parameters defined by the Group. It is a risk based approach, covering accounts with exposures less than £0.5m, not individually reviewed and where a trigger event could have occurred but has not yet been observed. The formula underpinning this methodology applied to the unimpaired portfolio is:

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

A key estimate within the corporate collective model is the loss emergence period. A movement of one month in this estimate would change the provision by £6m.

Individual provisions

i. Secured residential

Mortgage accounts are identified as impaired and provided for on an individual basis by taking account of the age of the debt's delinquency on a case by case basis. Due to continuing difficulties and uncertainties currently being experienced in this sector, the Group now classifies all accounts with arrears outstanding equivalent to 30 days or more as individually impaired. Previously, the trigger for recognition of individual impairment was 90 days or more.

A total of £5.3bn of impaired Britannia loans and advances to customers were acquired at a deep discount due to estimated future credit losses. This £121m discount (2011: £145m), is realised on the actual redemptions of the associated mortgages (mainly in Optimum). A key assumption in the judgment of estimated future credit losses is our estimate of future HPI movements. If future HPI movements were to differ from expectations by 5%, the impact on the estimate would be £4m. Following a review of the parameters of the model, the Group maintains its view that no further write backs of the deep discount (2011: £20m) will be made due to the remaining uncertainties in the exact timing of economic recovery.

ii. Corporate Banking

The Group's corporate individual provision has increased to £434m (2011: £105m). It reflects both the impact to the Group of having exhausted its associated fair value adjustment for credit risk within the year, and a deterioration of expected future recoveries against impaired loans. Given the continuing and persistent weakness in economic recovery and the increasing levels of risk associated with refinancing and interest payment cover currently being experienced in this sector, a significantly higher number of cases meet the definition of corporate loans identified as being individually impaired. Each corporate account is assessed and allocated a 'risk grade' to enable the Group to monitor the overall quality of its lending assets. Those of lesser quality, where the lending is potentially at risk and provisions for loss may be required, are centrally monitored with specific management actions taken at each stage within laid down procedures and specific provisioning criteria. Provisions represent the likely net loss after realisation of any security. A key estimate within the corporate individual model is collateral valuation. A 10% movement in this estimate would change the provision by £106m.

For further information on credit risk and impairment, see note 38.

Notes to the financial statements continued

21. Loans and advances to customers continued**Accounting policies****Financial instruments (excluding derivatives)****Recognition**

The Group initially recognises loans and advances, deposits, debt securities issued and other borrowed funds on the date at which they are originated.

Financial assets are recognised on the trade date which is the date the Group commits to purchase the instruments. All other financial assets and liabilities are initially recognised on the trade date at which the Group becomes a party to the contractual provisions of the instrument.

Financial assets

The Bank classifies its financial assets (excluding derivatives) as either:

- Loans and receivables
- Available for sale
- Financial assets at fair value through the income statement

1) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and the Group does not intend to sell immediately or in the near term. These are initially measured at fair value plus transaction costs that are directly attributable to the financial asset. Subsequently, these are measured at amortised cost using the effective interest method. The amortised cost is the amount advanced less principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the amount advanced and the maturity amount less impairment provisions for incurred losses.

Loans and receivables mainly comprise loans and advances to banks and customers except where the Group has elected to carry the loans and advances to customers at fair value through income or expense as described in 3) below and assets reclassified from available for sale in 2) below.

2) Available for sale

Available for sale financial assets are debt securities that are not held for trading and are intended to be held for an indefinite period of time. These are measured at fair value based on current bid prices where quoted in an active market. Where the securities are unlisted the fair values are based on valuation techniques including discounted cashflow analysis, with reference to relevant market rates, and other commonly used valuation techniques. Movements in fair value are recorded in equity as they occur. On disposal, gains and losses recognised previously in equity are transferred to the income statement. In exceptional circumstances, for instance where the market in the securities has become inactive, the Group has reclassified such assets as loans and receivables. Any transfer back from loans and receivables, upon reclassification, would be measured at fair value based on current bid prices where quoted in an active market. Where there is no active market or the securities are unlisted the fair values are based on valuation techniques including discounted cashflow analysis, with reference to relevant market rates, and other commonly used valuation techniques.

CISGIL classifies the holdings in debt securities as available for sale. Initial measurement is at fair value, being purchase price upon the date on which CISGIL commits to purchase plus directly attributable transaction costs. Subsequent valuation is at fair value with movements recognised in other comprehensive income as they arise. Where there is evidence of impairment, the extent of any impairment loss is immediately recognised in the income statement and a corresponding reduction in the value of the asset is recognised through the use of an allowance account. On disposal, gains or losses previously recognised in other comprehensive income are transferred to the income statement.

3) Financial assets at fair value through income or expense

These are either:

- acquired or incurred principally for the purpose of selling or repurchasing in the near term;
- part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short term profit taking; or
- upon initial recognition designated at fair value through income or expense to eliminate or significantly reduce a measurement and recognition inconsistency or where management specifically manages an asset or liability on that basis, ie capital bonds.

These are measured at fair value based on current bid prices where quoted in an active market. Where there is no active market or the securities are unlisted the fair values are based on valuation techniques including discounted cashflow analysis, with reference to relevant market rates, and other commonly used valuation techniques. Gains and losses arising from changes in the fair value are brought into the income statement within trading income as they arise.

21. Loans and advances to customers continued

4) Impairment provision

At the balance sheet date, the Bank assesses its financial assets not at fair value through income or expense for objective evidence that an impairment loss has been incurred.

Objective evidence that financial assets are impaired can include significant financial difficulty of the borrower, a breach of contract, such as default or delinquency in interest of principal payments, the granting by the Bank to the borrower, for economic and legal reasons relating to the borrower's financial difficulty, a concession that the Bank would otherwise not consider, indications that a borrower or issuer will enter bankruptcy or other financial reorganisation, or the disappearance of an active market for security.

The Group considers evidence for impairment for loans and advances at both a specific asset and collective level. All secured loans and advances are assessed for impairment using a range of criteria graded for levels of risk. Accounts at risk of impairment are monitored and impaired where they display clear indications of underperformance. Loans and advances that do not meet the criteria for individual impairment are collectively assessed for impairment by grouping together loans and advances of similar risk characteristics.

When assessing collective impairment for secured retail loans, the Bank estimates incurred losses on those mortgages where there has been a material deterioration in the borrower's external credit score in the last 12 months or where the loan is identified as being subject to forbearance. When assessing collective impairment for unsecured retail loans, the Bank estimates losses on loans with delinquency greater than a pre-determined trigger point. In addition the Bank makes provision on all loans arising from fraud and loans transferred to Debt Collection Agencies. In respect of unsecured loans the Bank uses statistical modelling of historical trends of probability of default, timing of recoveries and the amount of loss incurred. The model's results are adjusted for management's judgment as to whether current economic and credit conditions are such that actual losses are likely to differ from those suggested by historical modelling. Once impaired, accounts are subjected to higher levels of impairment according to both their relevant stage of delinquency, that is the number of days in arrears, and their consequent likelihood of ultimately being charged off. Default rates, loss rates and future recoveries are regularly benchmarked against actual outcomes to ensure that they remain appropriate.

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

The amount of the loss is the difference between:

- the asset's carrying amount; and
- the present value of estimated future cash flows (discounted at the asset's original or variable effective interest rate for amortised cost assets and at the current market rate for available for sale assets).

Where the debt is secured, the assessment reflects the expected cash flows from the realisation of the security, net of cost to realise, whether or not foreclosure or realisation of the collateral is probable.

Impairment of financial assets carried at amortised cost

The amount of the impairment loss on assets carried at amortised cost is recognised immediately through the income statement and a corresponding reduction in the value of the financial asset is recognised through the use of an allowance account.

A write off is made when all or part of a claim is deemed uncollectible or forgiven after all the possible collection procedures have been completed and the amount of loss has been determined. Write offs are charged against previously established provisions for impairment or directly to the income statement. Any additional recoveries from borrowers, counterparties or other third parties made in future periods are offset against the write off charge in the income statement once they are received.

Provisions are released at the point when it is deemed that following a subsequent event the risk of loss has reduced to the extent that a provision is no longer required.

Impairment of financial assets classified as available for sale

Available for sale assets are assessed at each balance sheet date to see whether there is objective evidence of impairment. In such cases, any impairment losses are recognised by transferring the cumulative loss that has been recognised directly in equity to income or expense.

When a subsequent event causes the amount of impaired loss on available for sale investment securities to decrease and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed through the income statement. However any further recovery in fair value of an impaired available for sale equity security is recognised directly in equity.

5) Derecognition of financial assets

Financial assets are derecognised when they are qualifying transfers and:

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

When available for sale financial assets are derecognised the cumulative gain or loss, including that previously recognised in reserves, is recognised in the income statement.

Notes to the financial statements continued

22. Investment – Banking Group

	2012 £m	2011 £m
Fair value through profit or loss:		
– Listed equities	1,845	343
Held-for-trading:		
– Listed debt securities	960	–
Available for sale:		
– Unlisted equities	10	9
– Listed debt securities	4,322	4,065
– Unlisted debt securities	237	324
	4,569	4,398
Total fair value through profit or loss and available for sale investments	7,374	4,741
Loans at amortised cost	295	805
Deposits with credit institutions	342	219
Investment properties	173	184
	8,184	5,949

The Banking Group investments are held by CIS General Insurance Limited and The Co-operative Bank plc. In the Co-operative Bank, repossessed properties are maintained off balance sheet against the mortgage portfolio as collateral. The investments of CISL were moved to assets held for sale in the prior year.

All investment properties are held to generate rental income until such time that the Group considers it appropriate to realise its investment. Investment properties are carried at fair value. During 2012, £11m was transferred to property, plant and equipment from investment properties.

23. Insurance contracts liabilities and reinsurance assets**a) Analysis of insurance and participating contract liabilities**

This analysis of insurance and participating contract liabilities relates to General Insurance activities only. Liabilities in relation to Life and General Insurance activities are classified as held for sale. Further analysis is included in note 40.

	2012 £m	2011 £m
General insurance contracts:		
– Claims reported	574	602
– Claims incurred but not reported	186	118
– Claims settlement expenses	18	17
– Unearned premiums	273	327
Total gross insurance liabilities	1,051	1,064
Recoverable from reinsurers:		
– Claims reported	(32)	(31)
– Claims incurred but not reported	(33)	(36)
– Unearned premiums	(2)	(4)
Total reinsurers' share of insurance liabilities	(67)	(71)
General insurance contracts:		
– Claims reported	542	571
– Claims incurred but not reported	153	82
– Claims settlement expenses	18	17
– Unearned premiums	271	323
Total net insurance liabilities	984	993

Liabilities are stated positive in the above analysis.

Critical accounting estimates and judgments

b) General insurance contracts – assumptions, changes in assumptions and sensitivity

CISGIL uses a combination of recognised actuarial and statistical techniques to assess the ultimate cost of claims. These include:

- Projecting historic claims payment and recoveries data
- Projecting numbers of claims
- Adjusting case estimates for future inflation and on to a provisioning basis
- Deriving average costs per claim to apply to claim numbers
- Projecting historic claims incurred data (payment plus estimates) – statistical actuarial techniques including chain ladder, Bornhuetter-Ferguson and Cape Cod

Detailed claims data, including individual case estimates, are used to derive patterns in average claims costs and timings between occurrence and estimate/payment of claims. The most common method used is the chain ladder method. This technique involves the analysis of historical claims development trends and the selection of estimated development factors based on this historical pattern. The selected development factors are then applied to cumulative claims data for each accident year which is not yet fully developed to produce an estimated ultimate claims cost for each accident year. A degree of judgment is required in selecting the most appropriate development factors.

The chain ladder method can be quite volatile for relatively undeveloped origin periods so a Bornhuetter-Ferguson/Cape Cod method is often used in such cases. This method uses some prior expectation of the ultimate claims, and stabilises the projected ultimate by weighting between the prior expected ultimate and the projected based on the assumed development factors. The Cape Cod method differs from the Bornhuetter-Ferguson method in that it uses a trending of ratios (such as the average cost) to arrive at a prior expected ultimate for use in the projections.

The work is undertaken and supervised by suitably qualified personnel. Claims provisions are separately computed for each claim type such as bodily injury, accidental damage, storm, flood and subsidence. All provisions are calculated with explicit allowance for reinsurance and subrogation recoveries. Provisions are not discounted for investment return other than any required additional provision for unexpired risks, periodic payment settlements and provisions relating to asbestos exposure within the electric industry ('EIROS' claims).

The EIROS reserve was based on a report produced for the industry by Towers Watson (an actuarial consultancy) at the end of 2011, which gave Towers Watson's estimate of both the undiscounted and discounted incurred but not reported (IBNR) reserves as at the end of the second quarter 2011. This was the most recent report available when we calculated our 2012 period end reserves.

The average period to settlement of such claims is:

- 10.8 years for Employers' liability (2011: 10.7 years)
- 13.9 years for Public and Product's liability (2011: 14.0 years)
- 11.1 years in total (2011: 11.0 years)

In both cases, the discount rate is 4.0%. The current EIROS reserve amounts to £3m (2011: £2m).

The criteria adopted for estimating the period that will elapse before the claims are settled, used the run off pattern from previous experience.

As outlined within the risk management section, there is significant uncertainty in the assessment of liabilities, and provisions are set to be adequate to cover the eventual cost. Sensitivity analysis is performed to assist the selection of key parameters and, hence, the provisions adopted. Provisions are subject to detailed review regarding the appropriateness of key assumptions and the quantum of the provisions established.

The overall objective of CISGIL's reserving policy is to produce reliable and accurate estimates. Assumptions underlying the reserving calculations are agreed by a Reserving Committee and the Audit Committee, methodologies are peer reviewed throughout the calculation process. Provisions are approved and signed off by the quarterly reserving forum Executive Committee.

Periodic reports are produced by the actuarial team and presented to the Reserving Committee (RC) in order to advise management of the performance of the business. More detailed reports are produced on a quarterly basis providing information on the performance of the business against plan. These reports are presented to the Reserving Committee (RC) and form the basis of reporting the performance to the Board.

Key assumptions

Principal assumptions underlying the claims provisions include:

- Explicit allowance for future inflation at rates varying from 0.00% to 8.25% pa according to the claim type. The range of future inflation rates is largely unchanged from that used at the previous year end; and
- For bodily injury claims, allowance has been made for:
 - i) Use of the appropriate Ogden Tables;
 - ii) Increased awards for general damages in accordance with the 10th edition of the JSB guidelines;
 - iii) A small proportion of large claims being settled by periodic payments; and
 - iv) Improvements in the case estimation techniques resulting in earlier recognition of the size of the claims.

Notes to the financial statements continued

23. Insurance contracts liabilities and reinsurance assets continued

The gross insurance provision for claims and loss adjustment expenses arising in respect of prior years of £440m (2011: £401m) includes a movement of £44m (2011: £40m) arising from an increase of reserves, as follows:

	2012 £m	2011 £m
Fire and Accident release/(increase) of reserves	3	(6)
Motor increase of reserves	(43)	(31)
Movement on claims handling reserves	(4)	(3)
Movement in gross insurance liabilities	(44)	(40)

Sensitivity analysis

There is greater uncertainty over motor claims provisions than other provisions as they often involve claims for bodily injury and associated legal costs which typically have a longer period to settlement. Motor provisions represent the most significant proportion of the total general insurance outstanding claims liabilities (gross of salvage and subrogation). Sensitivity information is given for motor claims provisions together with limited information for all other classes. The following table indicates the effect on gross claims provisions (gross of reinsurance and salvage and subrogation) of changes in key assumptions. The impact of the increased uncertainty on the income statement risk is mitigated through holding management margin on the best estimate reserves that is proportional to the level of uncertainty.

Assumption

	Changes in parameter	2012		2011	
		Effect on gross provision £m	% Effect	Effect on gross provision £m	% Effect
Motor					
Average cost of claims for last three years – bodily injury and legal	10%	67	13.7%	53	9.6%
Mean term to settlement – bodily injury and legal	+ ½ year	11	1.9%	14	2.5%
Rate of future inflation – bodily injury and legal	1%	19	3.2%	15	2.8%
Ogden discount rate – bodily injury	- ¼ %	5	0.8%	4	0.6%
Other classes					
Mean term to settlement (liability)	+ ½ year	–	2.1%	–	2.1%
Mean term to settlement (non-liability)	+ ½ year	1	1.3%	1	1.3%
Rate of future inflation (liability)	1%	1	5.2%	1	4.2%
Rate of future inflation (non-liability)	1%	1	1.3%	1	1.4%

c) Changes in General Insurance liabilities and reinsurance assets**i) Change in insurance contract liabilities (net of salvage and subrogation)**

	Gross £m	Salvage and subrogation £m	Net £m
At beginning of period	737	(47)	690
Movement in period	41	(15)	26
At end of period	778	(62)	716

ii) General insurance – claims and loss adjustment expenses

	2012			2011		
	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
Claims reported	602	(31)	571	517	(25)	492
Claims incurred but not reported	118	(36)	82	130	(25)	105
Claims settlement expenses	17	–	17	17	–	17
At beginning of period	737	(67)	670	664	(50)	614
Claims paid during period	(525)	9	(516)	(484)	6	(478)
Increase in liabilities:						
– arising from current and previous period claims	566	(7)	559	557	(23)	534
Total movement	41	2	43	73	(17)	56
Claims reported	574	(32)	542	602	(31)	571
Claims incurred but not reported	186	(33)	153	118	(36)	82
Claims settlement expenses	18	–	18	17	–	17
At end of the period	778	(65)	713	737	(67)	670

iii) General Insurance – provisions for unearned premiums

	2012			2011		
	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
Unearned premium provision						
At beginning of period	327	(4)	323	299	(4)	295
Increase in period	556	(30)	526	669	(36)	633
Release in period	(610)	31	(579)	(641)	36	(605)
Movement in period	(54)	1	(53)	28	–	28
At end of the period	273	(3)	270	327	(4)	323

v) Analysis of claims development – net of reinsurance

	Accident year										Total £m
	2003 £m	2004 £m	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	
At end of accident year:	570	547	478	417	373	335	313	398	481	490	4,402
– One year later	541	525	466	409	378	306	321	434	515	–	3,895
– Two years later	525	493	437	401	370	296	325	459	–	–	3,306
– Three years later	506	465	411	393	358	292	317	–	–	–	2,742
– Four years later	498	448	420	386	359	290	–	–	–	–	2,401
– Five years later	495	452	414	385	359	–	–	–	–	–	2,105
– Six years later	492	451	415	380	–	–	–	–	–	–	1,738
– Seven years later	493	451	420	–	–	–	–	–	–	–	1,364
– Eight years later	490	450	–	–	–	–	–	–	–	–	940
– Nine years later	488	–	–	–	–	–	–	–	–	–	488
Estimate of cumulative claims	488	450	420	380	359	290	317	459	515	490	4,168
Cumulative payments to date	(483)	(445)	(398)	(361)	(337)	(276)	(279)	(371)	(359)	(191)	(3,500)
Provision before discounting	5	5	22	19	22	14	38	88	156	299	668
Provision for prior years before discounting											28
Discounting											(1)
Net outstanding claims liabilities											695

	£m
Net claims reported	542
Net claims incurred but not reported	153
Net outstanding claims liabilities	695

Notes to the financial statements continued

23. Insurance contracts liabilities and reinsurance assets continued**Accounting policies****i) Unearned premium provision**

For general insurance business, the proportion of written premiums relating to periods of risk beyond the period end is carried forward to future accounting periods. The relevant proportion is calculated using the daily pro rata basis.

Outward reinsurance premiums are treated as earned in accordance with the profile of the reinsured contracts.

ii) Claims incurred

Insurance claims incurred comprises claims paid during the period together with related handling costs and the movement in the gross liability for claims in the period net of related recoveries including salvage and subrogation.

iii) Claims outstanding

Claims outstanding comprise provisions representing the estimated ultimate cost of settling:

- estimates on claims reported by the balance sheet date ('claims reported'); and
- expected additional cost in excess of 'claims reported' for all claims occurring by the balance sheet date ('claims incurred but not reported').

Aggregate claims provisions include attributable claims handling expenses and are set at a level such that no adverse run-off deviations are envisaged. Adverse run off deviations, which are material in the context of the business as a whole, would be separately disclosed in the notes to the financial statements including the claims development tables. Anticipated reinsurance recoveries and estimates of salvage and subrogation recoveries are disclosed separately within assets under the headings of 'reinsurance assets' and 'insurance receivables and other assets' respectively. In accordance with Accounting Regulations, discounting of outstanding claims is permitted in certain circumstances. For statutory accounts the outstanding reserves are discounted in respect of periodical payments and a portion of liability type claims from the electric industry ('EIROS') for which separate assets are held of appropriate term and nature.

iv) Unexpired risk provision

Additional provision is made for unexpired risks where the claims and expenses, likely to arise after the end of the financial year in respect of contracts concluded before that date, are expected to exceed the unearned premiums carried forward for those contracts. Provision for unexpired risks is calculated separately for categories of business managed together, offsetting surpluses and deficits within each category, and is determined after taking account of future investment return arising on investments supporting the unearned premium provision and unexpired risk provision. No post balance sheet events are taken into account. Such provisions ensure that the carrying amount of unearned premiums provision less related deferred acquisition costs is sufficient to cover the current estimated future cash flows including claims handling expenses and therefore meets the minimum requirements of the liability adequacy test as set out in IFRS 4 (Insurance Contracts).

v) Acquisition costs

Costs directly associated with the acquisition of new business, including commission, are capitalised and amortised in accordance with the rate at which the gross written premiums associated with the underlying contract are earned.

vi) Reinsurance

Contracts with reinsurers that give rise to a significant transfer of insurance risk are accounted for as reinsurance contracts. Amounts recoverable under such contracts are recognised in the same period as the related claim. Premiums, claims and receivables are presented on a gross basis in the income statement and balance sheet.

Amounts recoverable under reinsurance contracts are assessed for impairment at each balance sheet date. If objective evidence of impairment exists, reinsurance assets are reduced to the level at which they are considered to be recoverable and an impairment loss is recognised in the income statement.

24. Share capital

	Nominal and paid-up value Members' share capital	
	2012 £m	2011 £m
Representing:		
– Corporate shares of £5 each	9	9
– Individual shares of £1 and 10p each	61	61
	70	70

IFRIC 2 determines the features that allow shares to be classified as equity capital.

Members' share capital

Members' share capital comprises corporate and individual shares. The rights attached to shares are set out in the Society's rules. Shares held by corporate members (corporate shares) are not withdrawable and are transferable only between corporate members with the consent of the Society's Board. Shares held by individual members (individual shares) are withdrawable on such period of notice as the Society's Board may from time to time specify.

As the Board has an unconditional right to refuse redemption of both classes of shares, both corporate and individual shares are treated as equity shares.

Both classes of share maintain a fixed nominal value, attract a limited rate of interest and do not carry voting rights per se. Voting for corporate members is in proportion to trade with the Society. Each individual member has one vote in the appropriate region of the Society and each region has voting rights calculated on the same basis as a corporate member.

Corporate members receive a payment on trade transacted with the Society.

Distribution of reserves in the event of a winding-up

The Society's rules state that any surplus in the event of a winding-up shall be transferred to one or more societies registered under the Industrial and Provident Societies Acts 1965 to 2003. Such societies must be in membership of Co-operatives^{UK} Limited and have the same or similar rule provisions as regards surplus distribution on a dissolution or winding-up as the Society. If not so transferred, the surplus shall be paid or transferred to Co-operatives^{UK} Limited to be used and applied in accordance with co-operative principles.

Notes to the financial statements continued

25. Interest-bearing loans and borrowings

This note provides information about the contractual terms of the Trading Group's interest-bearing loans and borrowings. For more information about the Group's exposure to interest rate and foreign currency risk, see note 38.

	2012 £m	2011 £m
Non-current liabilities:		
– Secured bank loan	149	187
– Unsecured bank loans	450	254
– 5 7/8% Eurobond Notes due 2013*	–	207
– 5 5/8% Eurobond Notes due 2020*	471	455
– 6 1/4% Eurobond Notes due 2026*	368	356
– 7 5/8% First Mortgage Debenture Stock 2018*	55	62
– Corporate investor shares	1	–
– Other loans	4	4
– Non-current portion of finance lease liabilities	3	9
	1,501	1,534
Current liabilities:		
– Current portion of secured bank loan	4	3
– Current portion of unsecured bank loans	–	100
– 5 7/8% Eurobond Notes due 2013*	206	–
– Corporate investor shares	45	51
– Current portion of finance lease liabilities	5	5
– Other secured loans	50	–
– Other unsecured loans	3	4
	313	163

* These drawn down loan commitments are designated as financial liabilities at fair value through the income statement. All of the other liabilities, except the finance lease liability, are classified as loans and receivables in accordance with IAS 39.

Corporate investor shares

Corporate investor shares may be issued to existing corporate members who hold fully paid corporate shares and are registered Industrial and Provident Societies. The rate of interest payable is determined by the London Interbank Offered Rate (LIBOR).

Terms and repayment schedule

The 7.625% First Mortgage Debenture Stock 2018, which is secured over freehold and leasehold properties with an original value of £50m (carrying amount of £55m) to be paid to holders upon maturity.

The 5.875% Eurobond Issue 2013 (due to be repaid in December 2013) has an original value of £200m (carrying amount of £206m), the 5.625% Eurobond Issue 2020 has an original value of £450m (carrying amount of £471m) and the 6.25% Eurobond Issue 2026 has an original value of £350m (carrying amount of £368m). All of which are to be paid to holders upon maturity.

The unsecured bank loans consist of a £450m term loan which is fully drawn as at 5 January 2013. The Group also holds a £500m revolving credit facility which is drawn at £5m as at 5 January 2013. Both of these facilities terminate in full on 26 July 2017.

The Group also holds uncommitted facilities and a Bi-Lateral facility of £50m which expires in March 2015.

Reconciliation of movement in net debt

Net debt is a measure that shows the Trading Group's net indebtedness to banks and other external financial institutions and comprises the total of cash and short term deposits less deposits held in trustee-administered bank accounts and current and non-current interest-bearing loans and borrowings.

For period ended 5 January 2013

	Start of period £m	Non-cash movements £m	Cash flow £m	Movement in corporate investor shares £m	Transfer from non-current to current £m	End of period £m
Cash and cash equivalents	267	–	(87)	–	–	180
Less:						
– Deposits held in trustee-administered bank accounts	(58)	–	6	–	–	(52)
– Interest-bearing loans and borrowings – non-current	(1,534)	(13)	(159)	(1)	206	(1,501)
– Interest-bearing loans and borrowings – current	(163)	–	50	6	(206)	(313)
Net debt	(1,488)	(13)	(190)	5	–	(1,686)

For period ended 31 December 2011

	Start of period £m	Non-cash movements £m	Cash flow £m	Movement in corporate investor shares £m	Transfer from non-current to current £m	End of period £m
Cash and cash equivalents	400	–	(133)	–	–	267
Less:						
– Deposits held in trustee-administered bank accounts	(61)	–	3	–	–	(58)
– Interest-bearing loans and borrowings – non-current	(1,620)	(20)	106	–	–	(1,534)
– Interest-bearing loans and borrowings – current	(159)	1	–	(5)	–	(163)
Net debt	(1,440)	(19)	(24)	(5)	–	(1,488)

Finance lease liabilities

Finance leases have the following maturities in the Trading Group:

	2012 £m	2011 £m
Less than one year	5	5
Greater than one year but less than five years	3	9
Greater than five years	–	–
	8	14

Under the terms of the lease agreements, no contingent rents are payable.

Notes to the financial statements continued

25. Interest-bearing loans and borrowings continued**Accounting policies****Financial instruments (excluding derivatives)**

The Trading Group classifies its financial assets and liabilities (excluding derivatives) as either:

1. Loans and receivables

Loans and receivables are initially recognised at fair value, being cost inclusive of attributable transaction costs; and are subsequently carried at amortised cost using the effective interest method.

2. Available for sale

Available for sale financial assets are equity investments, intended to be held for an indefinite period of time. These are measured at fair value with movements in the carrying value brought into other comprehensive income as they arise, except for changes in value arising from impairment, which are recognised in the income statement. On disposal, gains and losses recognised previously in other comprehensive income are transferred to the income statement. The fair value of equity investments is their quoted market price (bid value) at the balance sheet date.

3. Financial assets and liabilities at fair value through profit or loss

These are:

- acquired or incurred principally for the purpose of selling or repurchasing in the near term;
- part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short term profit taking; or
- upon initial recognition designated at fair value through profit or loss to eliminate or significantly reduce a measurement of recognition inconsistency.

These are measured at fair value with movements in the carrying value brought into the income statement as they arise. No assets are classified as held to maturity.

The Trading Group measures all of its financial liabilities (excluding derivatives) at amortised cost, except quoted debt, which is measured at fair value through profit or loss.

The quoted debt is designated at fair value through profit or loss because this significantly reduces a measurement inconsistency (accounting mismatch) that would arise from measuring interest rate swaps or recognising gains and losses on them on different bases. There are a number of interest rate swaps whose execution and maturity dates link into the quoted debt.

Also, this group of financial assets and/or liabilities is managed and its performance is evaluated on a fair value basis in accordance with the risk management strategy.

26. Trade and other payables

	2012 £m	2011 £m
Current	1,356	1,444
Non-current	601	558
Trading Group	1,957	2,002
Banking Group	255	428
	2,212	2,430
	2012 £m	2011 £m
Trade payables	900	1,140
Value added tax, PAYE and social security	39	27
Accruals and deferred income	348	419
Other reinsurance liabilities	2	9
Member payments payable	34	34
Funeral bonds	561	508
Other payables	328	293
	2,212	2,430

Further details on the maturity profile of trade and other payables of the Trading Group can be found in note 38.

Other payables in the Banking Group include finance lease obligations as follows:

	Present value of lease payments		Future minimum lease payments	
	2012 £m	2011 £m	2012 £m	2011 £m
Due after five years	1	1	2	2

The future minimum lease payments have been discounted at LIBOR over the term of the lease to give the present value of these payments.

Accounting policies

Funeral Bonds are accounted for under IAS 18. The Group recognises a small proportion of revenue on the sale of each bond, equivalent to the upfront marketing and administration costs incurred in the initial sale.

The proportion of the bond value that is recognised ranges from 10% to 16% depending on the type of bond and the sales channel through which it is sold. For one particular type of bond sold, where the Group is less certain to conduct the ultimate funeral, no revenue is recognised and instead an element of upfront costs incurred are deferred over the expected bond life.

A liability for the funeral delivery is charged at the date of bond sale. Both the initial bond investment and the liability for the funeral delivery are recorded at the bond value less the revenue recognised on sale. A liability adequacy test is performed at least annually on the funeral bond liability to ensure it at least reflects the anticipated cost of delivering the funeral in the future.

The value of the financial liability was linked to the value of the debt security and accordingly both the asset and liability were designated in the measurement category of fair value through income or expense at inception. All of the change in the fair value of the liability is attributable to changes in the fair value of the debt security and does not reflect changes in the credit risk of the liability.

Notes to the financial statements continued

27. Provisions

	2012 £m	2011 £m
Non-current	290	303
Current	124	118
Trading Group	414	421
Banking Group	187	111
	601	532

	Self Insurance £m	Onerous leases £m	Restructuring and integration £m	Litigation £m	FSCS levy £m	PPI £m	Regulatory/ other £m	2012 Total £m	2011 Total £m
At beginning of the period	79	234	65	12	27	62	53	532	504
Credit to income statement	–	(4)	(7)	(3)	–	–	(4)	(18)	(36)
Charge to income statement	38	27	48	4	26	150	10	303	241
Discounting	–	12	–	–	–	–	–	12	11
Payments	(35)	(37)	(36)	–	(13)	(96)	(11)	(228)	(180)
Transfer to liabilities held for sale	–	–	–	–	–	–	–	–	(8)
At end of the period	82	232	70	13	40	116	48	601	532

Critical accounting estimates and judgments**Self Insurance**

This relates to potential liabilities arising from past events. The provision includes an assessment, based on historical experience, of claims incurred but not reported at the period end. The claims are expected to be settled substantially over the next three years. Discounting does not materially impact the level of the provision.

Onerous leases

This primarily relates to properties that are no longer used for trading. The provision is net of estimated rental income from sub-letting the properties. The provision is calculated on a property by property basis by reference to the headlease term and includes property holding costs such as business rates. Rental streams are assumed to terminate at the next most likely break point. The leases expire at dates ranging over many years and payments under lease commitments, net of amounts receivable under sub-lettings, will be approximately £82m (2011: £72m) payable in the next five years. The vast majority of costs have been discounted at a rate of 2.96% (2011: 3.5%). 8% (2011: 8%) has been used on costs relating to the former Somerfield head office where the provision was fair valued at this rate upon acquisition in 2009.

Restructuring and integration

This relates principally to costs associated with the rationalisation of corporate head office, divisional central support functions and distribution network. Costs are expected to be incurred over the period 2013–2014 with the majority being incurred in 2013.

Litigation

The provision represents management's prudent estimate of costs arising from potential litigation. The majority of these costs are expected to be incurred within the next one to three years.

Financial Services Compensation Scheme (FSCS) Levy

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

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

The Group has provided £40m (2011: £27m) 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 £28m in respect of the interest levy (2011: £25m). The Group's interest levy provision calculation includes estimates of the total FSCS levy in each levy year and estimates of the Group's market participation in each levy year. During 2012, the FSCS indicated that it expected to raise a capital levy to cover an estimated shortfall in excess of £800m in the amounts recovered from the failed banks to repay HM Treasury loans made to the FSCS. The Group's share of such a levy is estimated at £24m and the Group has provided £11m in the current year in respect of this.

PPI (Payment Protection Insurance)

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

The FSA issued a policy statement in August 2010 which amended the 'Disputes Resolution: Complaints' section of the FSA Handbook, setting out new rules for handling complaints, including complaints of PPI mis-selling. The Bank must comply with the policy statement which requires complainants to receive adequate redress and the Bank to complete a proactive review of all past business to identify mis-sold policies where no complaint has been made. An additional provision of £150m (2011: £90m) has been recognised in the period (note 2), in respect of the expected cost to the Bank of carrying out this work and paying compensation, making total provisions raised of £244m (2011: £94m).

Regulatory/other

Provisions have been made in respect of various potential customer compensation claims. Claims are investigated on an individual basis and, where appropriate, compensation payments are made. Other provisions also include the cost of rectifying potential asbestos in properties and potential contract termination costs. The expected timing of payment varies across these provisions and may be incurred after two to three years.

Accounting policies

A provision is recognised in the balance sheet when the Group has a legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

28. Amounts owed to credit institutions

	2012 £m	2011 £m
Items in course of collection	49	49
Deposits from other banks	3,563	3,254
Other	13	25
	3,625	3,328

Included within deposits from other banks are liabilities of £1,881m (2011: £1,703m) secured on investment securities with a carrying value of £1,984m (2011: £2,114m) which have been sold under sale and repurchase agreements.

Accounting policies

Financial liabilities are contractual obligations to deliver cash or another financial asset. Financial liabilities are recognised initially at fair value, net of directly attributable transaction costs. Financial liabilities, other than derivatives and capital bonds, are subsequently measured at amortised cost.

A financial liability is derecognised when the obligation is discharged, cancelled or expires. Any difference between the carrying amount of a financial liability derecognised and the consideration paid is recognised through the income statement.

29. Customer accounts

	2012 £m	2011 £m
Customer accounts	35,960	35,073

The Group has entered into interest rate swaps that protect it from changes in interest rates on the floating rate assets that are funded by its fixed rate customer accounts.

Notes to the financial statements continued

30. Capital Bonds

	2012 £m	2011 £m
Retail	888	1,430

Capital bonds are fixed term customer accounts with returns based on the movement in an index (eg FTSE 100). The capital bonds have been designated on initial recognition at fair value through income and expense and are carried at fair value. The fair values for the capital bonds are obtained on a monthly basis from the swap counterparties. These external valuations are reviewed independently using valuation software to ensure the fair values are priced on a consistent basis. None of the change in the fair value of the capital bonds is attributable to changes in the liability's credit risk. The maximum amount the Group would contractually be required to pay at maturity for all the capital bonds is £889m (2011: £1,430m). The Group uses swaps to create economic hedges against all of its capital bonds. The gain on capital bonds in the income statement for the year is £33m (2011: £25m). However, taking into account changes in fair value of the associated swaps, the net impact to the income statement for the year is a gain of £nil (2011: gain of £1m).

Accounting policies

Capital bonds within customer accounts have been designated at fair value upon initial recognition in the balance sheet. Changes in fair value are recognised through the income statement. The capital bonds are economically matched using equity linked derivatives, which do not meet the requirements for hedge accounting. Recording changes in fair value of both the derivatives and the related liabilities through the income statement most closely reflects the economic reality of the transactions. In doing so this accounting treatment eliminates a measurement inconsistency that would otherwise arise from valuing the capital bonds at amortised cost and the derivatives at fair value.

31. Debt securities in issue

	2012 £m	2011 £m
Certificates of deposits	158	252
Commercial papers	8	–
Fixed and floating notes	4,548	3,913
Debt securities in issue	4,714	4,165

The Group has entered into cross currency interest rate swaps that protect it from changes in exchange rates and interest rates on its debt securities in issue. Changes in the fair values of these swaps are largely offset by changes in the sterling equivalent carrying value of the debt securities in issue.

Debt securities in issue include fixed and floating rate notes, the majority of which are secured on portfolios of variable and fixed rate mortgages. The notes are redeemable in part from time to time, such redemptions being limited to the net capital received from mortgagors in respect of the underlying assets. There is no requirement for the Group to make good any shortfall out of general funds. The maturity date of the notes matches the maturity date of the underlying assets.

32. Other borrowed funds

	2012 £m	2011 £m
£150,000,000 Step up callable subordinated notes 2019	38	150
£60,000,000 9.25% non-cumulative irredeemable preference shares of £1 each	60	60
Floating rate subordinated notes 2016	22	21
5.625% Subordinated notes 2021	9	150
9.25% Subordinated notes 2021	275	275
7.875% fixed rate subordinated notes 2022	235	–
Fixed rate subordinated notes 2024	174	167
Fixed rate subordinated notes 2033	125	122
Perpetual subordinated bonds	292	283
Issue costs, discounts and accrued interest	29	31
	1,259	1,259

£150m Step up callable subordinated notes 2019

The notes were issued on 1 April 2004 at a discount of 0.946%. The notes are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders will be subordinated in right of payment to the claims of depositors and other creditors of the Bank. The notes carry an interest rate of 5.875% per annum to (but excluding) 2 April 2014, and thereafter the interest rate will be determined by reference to the gross redemption yield on the five year benchmark gilt, and a margin of 2.25%. Interest is payable annually in arrears on 2 April. The Bank may redeem all, but not less than all, of the notes at their principal amount on 2 April 2014. On 19 December 2012 the Bank invited investors to exchange their holdings in the above instrument for a new subordinated note, which resulted in the redemption of £112m of the notes (representing 74.8% of the amount outstanding), leaving £38m outstanding.

£60m 9.25% Non-cumulative irredeemable preference shares of £1 each

The preference shares carry the right to a fixed non-cumulative preferential dividend on the capital for the time being paid up, at the rate of 9.25% per annum exclusive of any associated tax credit. The dividends are payable on 31 May and 30 November each year and take priority over dividends to any other class of share in the capital of the Bank.

On a return of capital on winding up, the assets of the Bank shall be applied in repaying the preference share capital in priority to any payments to the holders of any other class of shares in the capital of the Bank. The amount receivable by the holders of the preference shares shall be the greater of the capital paid up or the average quoted price during the three months immediately preceding the date of the notice convening the meeting to consider the resolution to wind up.

The holders of the preference shares shall have the right to vote at a general meeting of the Bank only if and when, at the date of the notice convening the meeting, the dividend due to them has been in arrears for six months or more or if a resolution is to be proposed at the meeting abrogating or varying their rights or privileges or for the winding up of the Bank or other return of capital and then only on that resolution.

Floating rate subordinated notes 2016

The notes were issued on 18 May 2006 at a discount of 0.14%. The notes are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders will be subordinated in right of payment to the claims of depositors and other creditors of the Bank. The notes are denominated in Euros and interest is calculated at three months EURIBOR plus a margin of 0.28%. From 18 May 2011 interest has been calculated at three months EURIBOR plus a margin of 0.78%. The first interest coupon was paid in August 2006. The notes were hedged with a cross currency swap converting the exposure into sterling which paid a floating rate at three months LIBOR with a margin on interest coupon of 0.34125% and received floating rate of three months EURIBOR plus a margin on interest coupon of 0.28%. The cross currency swap matured on 18 May 2011.

On 28 April 2011 the Bank redeemed €149m of the notes (representing 81% of the amount outstanding) leaving €35m outstanding. The Bank had the option to call the outstanding notes in whole but not in part on the interest payment date falling on or nearest to May 2011, and now at any interest payment date thereafter subject to prior consent of the Financial Services Authority.

5.625% fixed rate subordinated notes 2021

The notes were issued on 16 November 2006 at a discount of 0.189%. The notes are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders will be subordinated in right of payment to the claims of depositors and other creditors of the Bank. The notes carry an annual interest rate of 5.625% up to and including the interest payment date on 16 November 2016, when the interest basis changes to floating rate. During the fixed rate period, interest is payable semi-annually in arrears on 16 May and 16 November.

From 17 November 2016, the notes carry a floating interest rate of three months LIBOR plus a margin of 1.75%. Interest is payable quarterly in arrears on 16 February, 16 May, 16 August and 16 November, commencing on the interest payment date falling in February 2017 up to and including the maturity date.

The Bank may redeem all, but not less than all, of the notes at the principal amount on 16 November 2016, and on any quarterly interest payment date thereafter. On 19 December 2012 the Bank invited investors to exchange their holdings in the above instrument for a new subordinated note, which resulted in the redemption of £141m of the notes (representing 94.2% of the amount outstanding), leaving £9m outstanding.

9.25% fixed rate subordinated notes 2021

On 28 April 2011 the Bank issued £275m fixed rate subordinated notes due 2021, issued at par. The notes are an unsecured obligation of the Bank and in the event of winding up of the Bank, the claims of noteholders will be subordinated in right of payment to the claims of depositors and other creditors of the Bank. The notes carry an annual interest rate of 9.25% up to (but excluding) 28 April 2021. Interest is payable annually in April. There is no option to redeem the notes early.

7.875% fixed rate subordinated notes 2022

On 19 December 2012 the Bank issued £235m fixed rate subordinated notes due 2022, issued at par. The notes are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders will be subordinated in right of payment to the claims of depositors and other creditors of the Bank. The notes carry an annual interest rate of 7.875% up to 18 December 2022. Interest is payable annually in arrears in December. There is no option to redeem the notes early.

Notes to the financial statements continued

32. Other borrowed funds continued**Fixed rate subordinated notes 2024**

The notes were issued on 17 March 2004 at a discount rate of 1.148%. The notes are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders will be subordinated in right of payment to the claims of depositors and other creditors of the Bank.

The notes carry an annual interest rate of 5.75% to 2 December 2019 (reset date). During this period the notes are hedged with interest rate swaps that convert the interest rate payable into floating rates at six months LIBOR plus a margin of 0.72%. The fixed receipt leg of the swap is received annually to match the payment to the noteholders. The floating payment leg of the swap is payable semi-annually in June and December. The interest rate swaps mature on 2 December 2019.

From the reset date the interest rate will be calculated based on the Five Year Benchmark Gilt rate plus a margin of 1.94%. The Five Year Benchmark Gilt rate being the Gross Redemption Yield determined by the UK government security having a maturity date falling on or nearest the fifth anniversary of the determination date (the determination date being two days prior to the reset date), converted to an annualised yield. The Gross Redemption Yield being calculated on the basis set out by the UK Debt Management Office in the publication 'Formulae for Calculating Gilt Prices from Yields'. From the reset date the interest will be paid annually in arrears until maturity or redemption.

The notes are callable in whole but not in part, at the principal amount, on 2 December 2019, subject to the prior consent of the Financial Services Authority.

Fixed rate subordinated notes 2033

The notes were issued on 28 March 2002 at a discount rate of 0.93%. The notes are an unsecured obligation of the Bank and in the event of the winding up of the bank, the claims of note holders will be subordinated in right of payment to the claims of depositors and other creditors of the Bank. The notes carry an annual interest rate of 5.875% to maturity. Interest is payable semi-annually in March and September.

Of the notes, £100m are hedged with interest rate swaps that have a floating payment leg at six months LIBOR payable in March and September. The fixed interest rate receivable leg on the swaps are £25m at 5.405% and £75m at 5.225%. The semi-annual interest receivable leg on the swap is matched to the dates on the notes.

Perpetual subordinated bonds

Perpetual Subordinated Bonds (PSBs) with a par value of £110m were issued in 1992 at a discount of 0%. PSBs with a par value of £200m were issued in 2005 at a discount rate of 0%. Both the £110m and £200m PSBs are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of the bondholders will be subordinated in right of payment of all creditors (including subordinated creditors) of the Bank.

The PSBs with a par value of £110m carry an annual interest rate of 13%. Interest is payable semi-annually in January and July.

The PSBs with a par value of £200m carry an annual interest rate of 5.5555% up until the reset date. This coupon is payable semi-annually in June and December. From the reset date of 14 December 2015 the interest rate will be amended to the rate for three month deposits in sterling plus a margin of 2.05% per annum. The interest payments will then be made quarterly in arrears in March, June, September and December, with the interest resetting at each interest payment date.

During the period up until the reset date the PSBs are hedged with an interest rate swap that converts the interest rate payable into floating rates at six months LIBOR plus a margin of 1.175%. The semi-annual interest receivable and payable on the swap is aligned to the interest payment dates of the notes. The interest rate swap matures on 14 December 2015.

Given prior relevant supervisory consent, the Bank may elect to repay all, but not less than all, of these PSBs on 14 December 2015 or on any interest payment date thereafter at their principal amount.

Accounting policies**Borrowed funds**

Borrowings are recognised initially at fair value, which equates to issue proceeds net of transaction costs incurred. Borrowings are subsequently stated at amortised cost; any difference between proceeds net of transaction costs and the redemption value is recognised in the income statement over the period of the borrowings using the effective interest method.

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

Perpetual subordinated bonds

Perpetual subordinated bonds are carried at their nominal value plus any premium and a fair value adjustment for hedged risk where items are designated as part of a fair value hedge relationship. Interest payable on perpetual subordinated bonds is recognised in the income statement using the EIR method.

33. Reconciliation of operating profit to net cash inflow from operating activities

	Trading Group		Banking Group		Total	
	2012 £m	2011 (restated) £m	2012 £m	2011 (restated) £m	2012 £m	2011 £m
Operating profit/(loss) after significant items	128	237	(663)	138	(535)	375
(Losses)/profits on discontinued operations before interest and tax	(1)	(4)	14	15	13	11
Depreciation and amortisation	285	287	59	60	344	347
Non-current asset impairments	24	23	150	–	174	23
(Profit)/loss on disposal of non-current assets	(5)	15	–	4	(5)	19
Change in value of investment properties	25	(9)	–	–	25	(9)
Effect of exchange rate movements	–	–	10	16	10	16
Effect of non-cash pension costs	–	(12)	2	2	2	(10)
Decrease/(increase) in inventories	82	(20)	–	–	82	(20)
(Increase)/decrease in receivables	(43)	(2)	43	(69)	–	(71)
(Decrease)/increase in provisions and payables	(96)	66	(182)	445	(278)	511
Decrease in funeral bonds	(10)	(3)	–	–	(10)	(3)
Interest payable on subordinated liabilities	–	–	81	85	81	85
Impairment losses on loans and advances	–	–	480	131	480	131
Impairment losses on investments	–	–	(5)	(40)	(5)	(40)
Interest amortisation	–	–	(6)	(16)	(6)	(16)
Amortisation on investments	–	–	(65)	(339)	(65)	(339)
Fair value amortisation	–	–	(15)	(86)	(15)	(86)
Preference dividend	–	–	6	6	6	6
Tax received/(paid)	53	(16)	(86)	(44)	(33)	(60)
Net cash flow from trading activities	442	562	(177)	308	265	870
Decrease in deposits by banks	–	–	309	364	309	364
Increase in customer accounts	–	–	353	2,307	353	2,307
Decrease/(increase) in debt securities in issue	–	–	480	(141)	480	(141)
Increase in loans and advances to banks	–	–	(68)	(73)	(68)	(73)
Increase in loans and advances to customers	–	–	54	1,034	54	1,034
Investment property movement	–	–	107	(93)	107	(93)
Fair value through profit and loss movement	–	–	(125)	(988)	(125)	(988)
Derivative financial instruments movement	–	–	210	400	210	400
Assets available for sale movement	–	–	226	(72)	226	(72)
Reinsurance assets	–	–	(108)	(406)	(108)	(406)
Insurance and participation contract provisions	–	–	56	1,322	56	1,322
Unallocated divisible surplus	–	–	233	15	233	15
Investment contracts	–	–	46	(2)	46	(2)
Amounts owed to credit institutions	–	–	(730)	(115)	(730)	(115)
Other provisions	–	–	138	243	138	243
Net asset value attributable to unit holders	–	–	56	(30)	56	(30)
Increase/(decrease) in intangible assets	–	–	2	(7)	2	(7)
Other cashflow movements	–	–	43	95	43	95
Asset and liability movements in Banking Group	–	–	1,282	3,853	1,282	3,939
Net cash flow from operating activities	442	562	1,105	4,161	1,547	4,723

The cash flows above and in the cash flow statement include discontinued operations and reclaim fund cash flows.

Funeral bond movements above are the net movements in funeral bond receivables and payables.

Accounting policies

Cash and cash equivalents comprise cash balances, call deposits and balances with an original maturity of three months or less. Bank overdrafts that are repayable on demand and form an integral part of the Group's cash management are included as a component of cash and cash equivalents for the purpose of the statement of cash flows.

Notes to the financial statements continued

34. Acquisitions**Acquisition of David Sands Limited**

On 24 April 2012, the Group completed its acquisition of a 100% equity interest in the convenience store retailer, David Sands Limited including its 28 food stores, distribution depot and head office.

David Sands Limited has contributed £26m to the Group's revenue and £1m to the Trading Group's operating profit in the period since acquisition.

A summary of the acquired balance sheet is shown below:

	Book values on acquisition £m	Adjustments £m	Fair values recognised £m
Property, plant and equipment ^(a)	8	(2)	6
Goodwill ^(b)	1	(1)	–
Inventories	2	–	2
Trade receivables	1	–	1
Cash and cash equivalents	1	–	1
Other payables	(2)	–	(2)
Net identifiable assets	11	(3)	8
Goodwill			18
Purchase consideration ^(c)			26

(a) Property fair values are based on external valuations in April 2012.

(b) The goodwill on the acquiree's balance sheet has been de-recognised in line with IFRS.

(c) Purchase consideration was solely in the form of cash.

Differences in accounting policies and all other acquisition adjustments were immaterial to the Group.

The fair value of assets and liabilities arising on the acquisition have been based on factors and circumstances available at the time of the business combination and at period end. While the fair values are considered accurate, IFRS 3 allows for hindsight adjustments to be made up to one year after the acquisition date, should additional facts or information regarding circumstances existing at the time of acquisition cause our assessment of the fair values on acquisition to change. The hindsight period comes to an end on 23 April 2013.

The goodwill created is largely attributable to location, footfall and synergies on integration across the stores acquired. No other intangibles have been identified as part of the fair value exercise.

Other acquisitions also included ten food stores acquired in London on 19 November 2012 with a purchase consideration of £6m. No net assets were recognised upon acquisition and therefore goodwill of £6m was created.

If these acquisitions had occurred on 1 January 2012, then there would not have been a material impact on the Group's revenue and operating profit before significant items for the period.

35. Commitments and contingent liabilities

a) Capital expenditure committed by the Group at period end was £78m (2011: £99m). This all related to property, plant and equipment.

b) Commitments under operating leases:

The Group's operating leases include stores, warehouses, vehicles and farming equipment. These have varying terms, restrictions and renewal rights. At 5 January 2013, the future minimum lease payments under non-cancellable operating leases were:

	2012		2011	
	Land and buildings £m	Other £m	Land and buildings £m	Other £m
Within one year	200	17	182	23
In two to five years	703	22	637	20
In over five years	2,374	–	2,380	–
	3,277	39	3,199	43

The total of future minimum sublease payments expected to be received under non-cancellable subleases less than 50 years is £426m (2011: £438m).

c) Banking activities

The table below gives the contract amounts and risk weighted amounts of contingent liabilities and commitments. The contract amounts indicate the volume of business outstanding at the balance sheet date and do not represent amounts at risk. The risk weighted amounts have been calculated in accordance with the FSA rules.

The contingent liabilities of the Bank as detailed below arise in the normal course of banking business and it is not practical to quantify their future financial effect.

	2012		2011	
	Contract amount £m	Risk-weighted amount £m	Contract amount £m	Risk-weighted amount £m
i) Contingent liabilities				
Guarantees and irrevocable letters of credit	169	121	168	132
	169	121	168	132
ii) Other commitments:				
Documentary credits and short term trade related transactions	4	1	8	2
Forward assets purchases and forward deposit placed	53	–	45	1
Undrawn formal standby facilities, credit lines and other commitments to lend (includes revocable and irrevocable commitments) ^(a)	4,713	1,065	4,700	1,148
	4,770	1,066	4,753	1,151

Notes

(a) Undrawn loan commitments include revocable commitments which are unused credit card limits of £2,048m (2011: £2,182m).

Assets pledged

Assets are pledged as collateral under repurchase agreements with other banks. These deposits are not available to finance the Group's day-to-day operations. Mandatory reserve deposits are also held with the Bank of England in accordance with statutory requirements.

See note 38 for further details of assets pledged.

Notes to the financial statements continued

36. Related party transactions and balances**a) Trading Group**

The nature of the relationship of related parties and the extent of material transactions and balances with them are set out below or are disclosed elsewhere within the financial statements.

	Relationship	2012 £m	2011 £m
Sales to associated undertakings and joint ventures on normal trading terms	(i)	1.2	0.5
Subscription to Co-operatives ^{UK} Limited	(ii)	1.0	1.0

i) Details of the Society's associates and joint ventures are set out in note 13.

ii) The Society is a member of Co-operatives^{UK} Limited.

The Society's corporate members include consumer co-operative societies which, in aggregate, own the majority of the corporate shares with rights attaching as described in note 24. The sales to corporate members, on normal trading terms, were £1,455m (2011: £1,355m) and the amount due from corporate members in respect of such sales was £75m at 5 January 2013 (2011: £79m).

Transactions with directors and key management personnel

Disclosure of key management compensation is set out in the Remuneration Report on pages 40 to 50. A number of trading transactions are entered into with key management in the normal course of business. Key management are considered to be members of the management executive and directors of The Co-operative Group. The average value of all transactions greater than £1,000 with the Trading Group was £13,360 (2011: £9,886).

In 2012, the Group purchased the residential home of a key member of management for £900,000. Relocation costs of £198,000 were also reimbursed. The transaction was carried out on equivalent terms to those that would prevail on an arm's length transaction. As at 5 January 2013, the Group still owned the property and are in the process of selling the property in the open market.

b) Banking Group

A number of banking transactions are entered into with key management in the normal course of business. These include loans and deposits. Key management are considered to be Board Executive members of the Group. The volume of related party transactions, outstanding balances at the period end and related income and expense for the period are as follows:

	2012 £m	2011 £m
Loans, credit card and mortgage balances outstanding	1.0	0.4
Deposits at beginning of period	1.0	0.8
Net movement	0.1	0.2
Deposits at end of period	1.1	1.0

c) Insurance activities

The Society enters into transactions with key management personnel in the normal course of business. Details of the transactions carried out during the period and balances are as follows:

	2012 £m	2011 £m
At beginning of period	0.5	0.4
Net movement	(0.3)	0.1
At end of period	0.2	0.5

37. Principal subsidiary undertakings

The principal subsidiary undertakings of the Society, which are registered in England and Wales, are:

	Society holding %	Nature of business
Co-operative Banking Group Ltd:	100	Holding society
CIS General Insurance Ltd	100	General insurance
CFS Management Services Ltd	100	Service company
CIS Finance Ltd	100	Financial services
Reclaim Fund Ltd	100	Reclaim Fund
The Co-operative Asset Management Company Ltd	100	Asset management
Co-operative Insurance Society Ltd:	100	Life assurance
Hornby Road Investments Ltd ^(iv)	100	Investment holding
CIS Unit Managers Ltd ^(iv)	100	Investment holding and management
CIS Policyholder Services Ltd ^(iv)	100	Provision of financial services
The Co-operative Bank plc:	100	Banking
Britannia Treasury Services Ltd	100	Holding company
Britannia Development and Management Company Ltd	100	Property investment
Britannia Asset Management Ltd	100	Holding company
Illius Properties Ltd	100	Property investment
Unity Trust Bank plc ^{(iii) (iv)}	27	Banking
Trading:		
Co-operative Group Healthcare Ltd	100	Pharmaceutical retailing
Co-operative Brands Ltd	100	Holds intellectual property
Co-operative Legal Services Ltd	100	Legal services
Co-operative Life Planning Ltd	100	Life Planning
Co-operatives E-Store Ltd	100	Electricals online
Co-operative Group Holdings (2011) Ltd	100	Property management
Farmcare Ltd	100	Farming
Funeral Services Ltd	100	Funeral directors
Millgate Insurance Brokers Ltd	100	Insurance broking
National Co-operative Chemists Ltd	99	Pharmaceutical retailing
Rochpion Properties (4) LLP	100	Holds property
The Fairways Partnership Ltd	100	Funeral directors
Fairways Funeral Partnership Ltd	100	Funeral directors
The Co-operative Trust Corporation Ltd	100	Charity
The Co-operative Pharmacy National Distribution Centre Ltd	100	Pharmacy distribution
Donald Wardle & Son Ltd	100	Pharmacy
Somerfield Stores Ltd	100	Food retailing
Sunwin Services Group (2010) Ltd	100	Cash in transit, security services
Co-operative Group Motors Ltd	100	Motors retailing
Co-operative Group Food Ltd	100	Food retailing
David Sands Ltd	100	Food retailing

All of the above have been fully consolidated into the Group's accounts. For further information on the Group's principal associated undertakings, refer to note 13.

Notes

i) All the principal subsidiaries are audited by KPMG Audit Plc.

ii) All of the Group's financial services subsidiaries have a year end of 31 December 2012.

iii) Unity Trust Bank plc is a subsidiary of the Group because The Co-operative Bank plc elects a majority of directors and appoints the chair and managing director of Unity Trust Bank plc.

iv) Indirectly held subsidiaries.

v) All transactions between entities are in the usual course of business and are at arm's length.

vi) During the period the Group sold its 100% holding in The Co-operative Clothing Ltd.

Notes to the financial statements continued

38. Financial risk management

The principal financial risks facing the Group are set out below in the context of: a) Trading Group financial risk; b) Banking Group financial risk (which includes General Insurance financial risk and Life Insurance financial risk). Overall group risks and the strategy used by the Group to mitigate these risks are discussed in the Principal Risks and Uncertainties section on pages 26 to 29.

a) Trading Group financial risk**Introduction**

The Trading Group meets its working capital needs through a number of facilities totalling £2,253m. During 2012, the Group refinanced £950m of these facilities through Syndicated Bank Debt comprising a fully drawn Term Loan of £450m and a Revolving Credit Facility of £500m. Under the current facilities, repayment of the £200m Eurobond is due in December 2013 and this will be funded by drawing on the Revolving Credit Facility. The remaining facilities of £2,053m are predominantly due for repayment between 2017 and 2026 demonstrating the establishment of core medium and long term funding for the Trading Group.

Credit risk

Credit risk arises from the possibility of customers and counterparties failing to meet their obligations to the Trading Group. Management has a credit policy in place and the exposure to credit risk is monitored on an ongoing basis. Credit evaluations are performed for all customers requiring credit over a certain amount. The Trading Group does not require collateral in respect of financial assets. The majority of businesses in the Trading Group have cash-based rather than credit-based sales hence customer credit risk is relatively small.

Investments are allowed only in liquid securities and only with counterparties that have a credit rating equal to or better than the Trading Group. Transactions involving derivative financial instruments are with counterparties with whom the Trading Group has a signed netting agreement as well as sound credit ratings. Given their high credit ratings, management has no current reason to expect that any counterparty will fail to meet its obligations.

At the balance sheet date there were no significant concentrations of credit risk. Further information regarding the age profile of trade receivables is shown in note 18. The carrying value of all balances that attract a credit risk, which represents the maximum exposure, is set out below:

	Carrying amount 2012 £m	Carrying amount 2011 £m
Trade and other receivables (excluding prepayments and accrued income)	587	401
Interest rate swaps	82	79
Cash deposits	180	267

Interest rate risk**Hedging**

Interest rate risk arises from movements in interest rates that impact on the fair value of the assets and liabilities and related finance flows. The Trading Group adopts a policy of ensuring that between 40 – 80% of its exposure to changes in interest rates on borrowings is on a fixed-rate basis. The fixed proportion as at 5 January 2013 was 60%. Interest rate swaps, denominated exclusively in sterling, have been entered into to achieve an appropriate mix of fixed and floating rate exposure within the Trading Group's policy. The swaps mature over the next fifteen years following the maturity of the related loans (see the following table) and have fixed swap rates ranging from 1.98% to 5.68%. At 5 January 2013, the Trading Group had interest rate swaps with a notional contract amount of £1,605m (2011: £1,733m).

The Trading Group does not designate interest rate swaps or forward foreign exchange contracts as hedging instruments. Derivative financial instruments that are not hedging instruments are classified as held for trading by default and thus fall into the category of financial assets at fair value through the income statement. Derivatives are subsequently stated at fair value, with any gains and losses being recognised in the income statement.

The net fair value of swaps at 5 January 2013 was a net liability of £40m (2011: £62m) comprising assets of £82m (2011: £79m) and liabilities of £122m (2011: £141m). These amounts are recognised as fair value derivatives.

Effective interest rates and repricing analysis

In respect of income-earning financial assets and interest-bearing financial liabilities, the following table indicates their effective interest rates at the balance sheet date and the periods in which they reprice.

	Effective interest rate	Total £m	6 months or less £m	2012 6-12 months £m	1-2 years £m	2-5 years £m	More than 5 years £m
Cash and cash equivalents	0.563%	180	180	–	–	–	–
Secured debt:							
First mortgage debenture 2018	7.625%	(50)	–	–	–	–	(50)
Investment Properties Loan	1.829%	(153)	(2)	(2)	(4)	(145)	–
Effect of interest rate swap	4.716%	–	–	–	–	–	–
Unsecured bond issues:							
5 7/8% Fixed-rate sterling Eurobond	5.875%	(200)	–	(200)	–	–	–
5 7/8% Effect of interest rate swaps	–3.773%	–	(200)	200	–	–	–
5 5/8% Fixed-rate sterling Eurobond	5.625%	(450)	–	–	–	–	(450)
5 5/8% Effect of interest rate swaps	–2.213%	–	(450)	–	–	–	450
6 1/4% Fixed-rate sterling Eurobond	6.250%	(350)	–	–	–	–	(350)
6 1/4% Effect of interest rate swaps	–1.137%	–	(150)	–	–	–	150
Other unsecured loans	2.785%	(457)	(2)	(1)	(4)	(450)	–
Effect of interest rate swaps	2.623%	–	652	(50)	–	(568)	(34)
Corporate investor shares	2.000%	(46)	(34)	(11)	(1)	–	–
Finance lease liabilities		(8)	(3)	(2)	(2)	(1)	–
		(1,534)	(9)	(66)	(11)	(1,164)	(284)

	Effective interest rate	Total £m	6 months or less £m	2011 6-12 months £m	1-2 years £m	2-5 years £m	More than 5 years £m
Cash and cash equivalents	0.563%	267	267	–	–	–	–
Secured debt:							
First mortgage debenture 2018	7.625%	(50)	–	–	–	–	(50)
Investment Properties Loan	2.344%	(190)	(2)	(1)	(3)	(184)	–
Effect of interest rate swap	4.201%	–	–	–	–	–	–
Unsecured bond issues:							
5 7/8% Fixed-rate sterling Eurobond	5.875%	(200)	–	–	(200)	–	–
5 7/8% Effect of interest rate swaps	–3.083%	–	(200)	–	200	–	–
5 5/8% Fixed-rate sterling Eurobond	5.625%	(450)	–	–	–	–	(450)
5 5/8% Effect of interest rate swaps	–2.136%	–	(450)	–	–	–	450
6 1/4% Fixed-rate sterling Eurobond	6.250%	(350)	–	–	–	–	(350)
6 1/4% Effect of interest rate swaps	–1.106%	–	(150)	–	–	–	150
Other unsecured loans	2.743%	(358)	(354)	–	–	(4)	–
Effect of interest rate swaps	3.867%	–	618	–	(50)	(568)	–
Corporate investor shares	1.450%	(51)	(42)	(9)	–	–	–
Finance lease liabilities		(14)	(3)	(2)	(5)	(4)	–
		(1,396)	(316)	(12)	(58)	(760)	(250)

Notes to the financial statements continued

38. Financial risk management continued

Foreign currency risk

The Trading Group is exposed to foreign currency risk on purchases that are denominated in a currency other than sterling. The currencies giving rise to this risk are primarily Euro and US Dollars.

The Trading Group hedges at least 90% of all trade payables denominated in a foreign currency. At any point in time the Trading Group also hedges 90% of its estimated foreign currency exposure in respect of orders placed and not invoiced over the following four months. The Trading Group uses forward exchange contracts to hedge its foreign currency risk. The forward exchange contracts have maturities of less than one period after the balance sheet date. Where necessary, the forward exchange contracts are rolled over at maturity.

In respect of other monetary assets and liabilities held in currencies other than sterling, the Trading Group ensures that the net exposure is kept to an acceptable level, by buying or selling foreign currencies at spot rates where necessary to address short term imbalances.

At 5 January 2013, the Trading Group had forward currency transactions in Euro and US Dollars with a notional contract amount of £7m (2011: £8m).

Liquidity risk

As at 5 January 2013, the Trading Group had available borrowing facilities totalling £2,253m (2011: £1,994m), which comprised uncommitted facilities of £50m (2011: £50m) and committed facilities of £2,203m (2011: £1,944m). These are detailed below:

Bank facilities as at 5 January 2013

	Expiry	£m
Uncommitted facilities	July 2013/August 2013	50
Syndicate Term Loan	July 2017	450
Syndicate Revolving Credit Facility	July 2017	500
Bilateral Facility	March 2015	50
Secured Investment Property Bilateral	September 2015	153
		1,203
Debenture	December 2018	50
Eurobond issue – 2013	December 2013	200
Eurobond issue – 2020	July 2020	450
Eurobond issue – 2026	July 2026	350
		2,253

The following are the maturities of financial liabilities as at 5 January 2013:

	Carrying amount £m	Contractual cash flows £m	6 months or less £m	6–12 months £m	1–2 years £m	2–5 years £m	More than 5 years £m
Non-derivative financial liabilities							
Secured bank loans	(153)	(153)	(2)	(2)	(4)	(145)	–
Secured debenture	(55)	(50)	–	–	–	–	(50)
Unsecured bank facility	(457)	(457)	(2)	(1)	(4)	(450)	–
Sterling Eurobond 2013	(206)	(200)	–	(200)	–	–	–
Sterling Eurobond 2020	(471)	(450)	–	–	–	–	(450)
Sterling Eurobond 2026	(368)	(350)	–	–	–	–	(350)
Finance lease liabilities	(8)	(8)	(3)	(2)	(2)	(1)	–
Trade and other payables	(1,957)	(1,957)	(1,296)	(50)	(46)	(67)	(498)
Derivative financial liabilities							
Interest rate swaps used for hedging	(122)	(122)	–	(2)	–	(80)	(40)

The following are the maturities of financial liabilities as at 31 December 2011:

	Carrying amount £m	Contractual cash flows £m	6 months or less £m	6–12 months £m	1–2 years £m	2–5 years £m	More than 5 years £m
Non-derivative financial liabilities							
Secured bank loans	(190)	(190)	(2)	(1)	(3)	(184)	–
Secured debenture	(62)	(50)	–	–	–	–	(50)
Unsecured bank facility	(354)	(354)	–	(100)	(254)	–	–
Sterling Eurobond 2013	(207)	(200)	–	–	(200)	–	–
Sterling Eurobond 2020	(455)	(450)	–	–	–	–	(450)
Sterling Eurobond 2026	(356)	(350)	–	–	–	–	(350)
Finance lease liabilities	(14)	(14)	(3)	(2)	(5)	(4)	–
Trade and other payables	(2,002)	(2,002)	(1,213)	(228)	(16)	(43)	(502)
Derivative financial liabilities							
Interest rate swaps used for hedging	(141)	(141)	–	–	(3)	(97)	(41)

Sensitivity analysis

Interest rate risk

At 5 January 2013 if sterling (GBP) market interest rates had been 1% higher/lower with all other variables held constant, the post-tax result for the period would have been GBP £68m (2011: GBP £74m) higher and GBP £109m (2011: GBP £116m) lower respectively, mainly arising from the revaluation of the Society's £1,050m quoted debt marked to market through the consolidated income statement. Profit is relatively less sensitive to movements in GBP interest rates due to the level of borrowings' fixed-interest cover in place as disclosed under 'hedging'.

Foreign exchange risk

At 5 January 2013, if the Euro, US Dollar, Australian Dollar and New Zealand Dollar had all strengthened or weakened by 10% against sterling (GBP) with all variables held constant, there would have been no material impact to post-tax profit in either the current or prior period.

Guarantees

In the course of conducting its operations, the Trading Group is required to issue bank guarantees and bonds in favour of various counterparties. These facilities are provided by the Trading Group's banking syndicate and as at 5 January 2013 the total amount of guarantees/bonds outstanding is £56m (2011: £83m).

Notes to the financial statements continued

38. Financial risk management continued

Fair values of the Trading Group

The fair value of financial assets and liabilities together with the carrying amounts shown in the balance sheet at 5 January 2013 and 31 December 2011 respectively are as follows:

	2012			2011		
	Quoted market prices in active market Level 1 £m	Valuation techniques using observable inputs Level 2 £m	Valuation techniques using unobservable inputs Level 3 £m	Quoted market prices in active market Level 1 £m	Valuation techniques using observable inputs Level 2 £m	Valuation techniques using unobservable inputs Level 3 £m
Financial assets						
Trade and other receivables	–	702	–	–	507	–
Cash and cash equivalents	–	180	–	–	267	–
Derivative financial assets and liabilities						
Interest rate swaps:						
Assets	–	82	–	–	79	–
Liabilities	–	(122)	–	–	(141)	–
Non-derivative financial liabilities						
Secured debt:						
First mortgage debenture 2018	(55)	–	–	(62)	–	–
Other secured loans	–	(153)	–	–	(190)	–
Unsecured bond issue:						
Fixed-rate sterling Eurobond	(1,045)	–	–	(1,018)	–	–
Funeral bonds	–	–	(561)	–	–	(508)
Unsecured bank facilities:						
Other unsecured loans	–	(457)	–	–	(358)	–
Corporate investor shares	–	(46)	–	–	(51)	–
Finance lease liabilities	–	–	(8)	–	–	(14)
Trade and other payables (excluding accruals, deferred income and funeral bonds)	–	(1,153)	–	–	(1,283)	–

Estimation of fair values

The following summarises the major methods and assumptions used in estimating the fair values of financial instruments reflected in the table.

Securities

Fair value is based on quoted market prices at the balance sheet date without any deduction for transaction costs.

Derivatives

Forward exchange contracts are either marked to market using listed market prices or by discounting the contractual forward price and deducting the current spot rate. For interest rate swaps, broker quotes are used. Those quotes are back-tested using pricing models or discounted cash flow techniques.

Where discounted cash flow techniques are used, estimated future cash flows are based on management's best estimates and the discount rate is a market-related rate for a similar instrument at the balance sheet date. Where other pricing models are used, inputs are based on market-related data at the balance sheet date.

Interest bearing loans and borrowings

These are shown at amortised cost or are determined in whole by using quoted market prices.

Trade and other receivables/payables

For receivables/payables, the notional amount is deemed to reflect the fair value.

Hierarchy of fair values

The fixed rate sterling Eurobond and the first mortgage debenture values are determined in whole by using quoted market prices. The interest rate swap values are determined in whole by counterparties who use quoted market prices. The forward exchange contracts are valued using an internal valuation technique. All other assets and liabilities stated in the table above are held at par value.

Interest rates used for determining fair value

The Trading Group uses the government yield curve as of the period end plus an adequate constant credit spread to discount financial instruments.

The interest rates used are as follows:

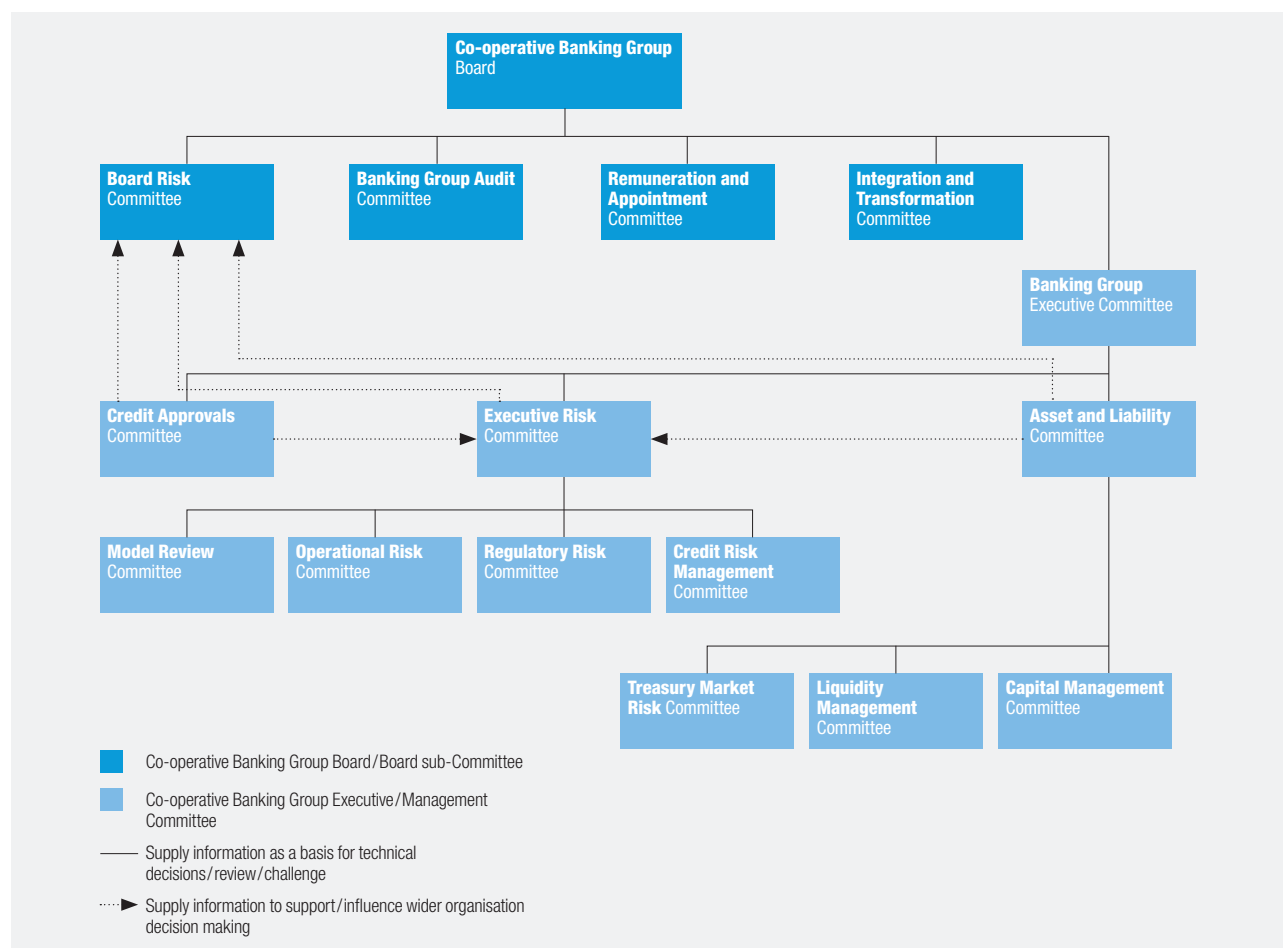
	2012	2011
Derivatives	0.58%–2.73%	1.10%–2.70%
Loans and borrowings	4.33%– 6.15%	4.85%–6.45%

Notes to the financial statements continued

38. Financial risk management continued

b) Banking Group Financial Risk

The Co-operative Group governance structure is detailed on page 33. The following is that part of the governance structure applicable to the Banking Group.



Board delegation

The Banking Group Board has established senior management committees whose responsibilities include:

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

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

This includes:

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

Integration and Transformation Committee

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

Credit Approvals Committee

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

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

Executive Risk Committee (ERC)

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

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

Asset and Liability Committee (ALCO)

ALCO is chaired by the CEO, Banking Group. It is primarily responsible for overseeing the management of market, liquidity and funding risks. Its responsibilities include:

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

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

Risk and capital management sub-committees

Model Review Committee (MRC)

The MRC provides oversight and challenge of model governance across the Banking Group in support of the Enterprise Risk Director.

Operational Risk Committee (ORC)

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

Regulatory Risk Committee (RRC)

The RRC supports the Regulatory Risk Director in oversight of:

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

Credit Risk Management Committee (CRMC)

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

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

Treasury Market Risk Committee (TMRC)

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

Liquidity Management Committee (LMC)

The role of the LMC is to enable more detailed discussion on all aspects of Banking Group liquidity risk management, monitoring and control including operational issues in respect of covered bond and residential mortgage backed security funding activities. It also recommends actions to ensure the Banking Group's liquidity position remains in line with agreed levels.

Capital Management Committee (CMC)

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

Risk Management Forums

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

Roles and Responsibilities

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

Business management act as the first line of defence. They are responsible for identifying where the business area is exposed to risks, including from the development of new products, processes or other business change. They also manage the risks that reside within their business areas on a day to day basis, implementing effective monitoring and control processes to ensure that the business' risk profile is understood and maintained within the Banking Group Board defined risk appetite.

Notes to the financial statements continued

38. Financial risk management continued

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

Internal Audit act as the third line of defence. They are responsible for independently verifying that the principal risk control framework have been implemented as intended across the business and independently challenge the overall management of the framework to provide assurance to the Banking Group Audit Committee and senior management on the adequacy of both the first and second lines.

Recovery and resolution planning (RRP)

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

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

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

- Banking Group Executive Team
- ERC
- BRC
- the Banking Group Board

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

Significant risks

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

Risk type	Definition	Bank (note 38)	CISGIL (note 38)	CISL (note 40)
Credit risk	Credit risk is the current or prospective risk to earnings and capital arising from a borrower's/counterparty's failure to meet the terms of any contract with the respective division or their failure to perform as agreed.	127	153	174
Liquidity and funding risk	Liquidity and funding risk is the risk that the division's resources will prove inadequate to meet its liabilities as they contractually fall due or as a result of any contingent or discretionary cash outflows that may occur in a stress. It arises from the mismatch of timings of cash flows generated from the division's assets and liabilities (including derivatives).	145	154	177
Market risk	Bank – The risk that the value of assets and liabilities, earnings and/or capital may change as a result of changes in market prices of financial instruments. The majority of the Bank's market risk arises from changes in interest rates. CISGIL – The risk that arises from fluctuations in values of, or income from assets, or in interest rates to the extent that there is a mismatch between assets and liabilities. CISL – The risk that the fair value and/or cash flows of a financial instrument will fluctuate due to changes in market prices. Market risk is of particular importance to the long term business fund in relation to asset portfolios that contain a significant proportion of equity, property and alternative investments such as hedge funds.	148	152	174
Insurance risk	Insurance risk refers to fluctuations in the timing, frequency and severity of insured events relative to the expectations of the firm at the time of underwriting. The principal risk that CISGIL faces under its insurance contracts is that actual claims exceed the carrying amount of the insurance liabilities.	–	151	172

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

Bank Credit risk Overview

Credit risk is one of the principal risks identified in the risk management framework and is an integral part of our business activities. It is inherent in both traditional banking products (loans, commitments to lend, and contingent liabilities such as letters of credit) and in 'traded products' (derivative contracts such as forwards, swaps and options, repurchase agreements, securities borrowing and lending transactions).

All authority to take credit risk derives from the Banking Group's Board. This authority is delegated to the Chief Executive Officer, Banking Group 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.

Credit risk policy

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

The key principles of the policy are:

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

Credit exposure

Definitions

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

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

Analysis of credit exposure

The following analysis of credit exposure shows:

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

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

	Loans and advances to banks £m	Loans and advances to customers £m	Investment securities £m	Derivative financial instruments £m	Total £m
2012					
Gross balance	1,904	33,983	6,929	819	43,635
Less: allowance for losses	–	(643)	(39)	–	(682)
	1,904	33,340	6,890	819	42,953
Analysis of credit risk exposure					
Not impaired:					
– Neither past due nor impaired	1,904	30,633	6,901	819	40,257
– Impaired	–	3,687	39	–	3,726
	1,904	34,320	6,940	819	43,983
Credit commitments	54	4,885	–	–	4,939
Gross credit risk exposure	1,958	39,205	6,940	819	48,922
Less:					
– Fair value adjustments	–	(337)	(11)	–	(348)
– Allowance for losses	–	(643)	(39)	–	(682)
Net credit risk exposure	1,958	38,225	6,890	819	47,892

Notes to the financial statements continued

38. Financial risk management continued

	Loans and advances to banks £m	Loans and advances to customers £m	Investment securities £m	Derivative financial instruments £m	Total £m
2011					
Gross balance	2,007	34,058	4,616	976	41,657
Less: allowance for losses	–	(292)	(45)	–	(337)
	2,007	33,766	4,571	976	41,320
Analysis of credit risk exposure					
Not impaired:					
– Neither past due nor impaired	2,002	31,681	4,590	975	39,248
– Impaired	21	2,772	46	–	2,839
	2,023	34,453	4,636	975	42,087
Credit commitments	41	4,859	–	–	4,900
Gross credit risk exposure	2,064	39,312	4,636	975	46,987
Less:					
– Fair value adjustments	(16)	(396)	(20)	–	(432)
– Allowance for losses	–	(292)	(45)	–	(337)
Net credit risk exposure	2,048	38,624	4,571	975	46,218

The comparative table has been updated to include the changes made to impairment criteria.

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
- loans and advances to banks

Loans and advances to customers**How we oversee and control credit risk**

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

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

The management of credit risk by portfolio is described covering:

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

Assessment for impairment

The loan portfolios are periodically reviewed to assess impairment. A loan is deemed to be impaired when there is objective evidence that a loss event has occurred after recognition of an asset and by period end.

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

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

	Retail		CABB			Total £m
	Secured £m	Unsecured £m	Corporate		Optimum £m	
2012			Core £m	Non-core £m		
Gross balance	15,987	1,393	6,097	3,167	7,339	33,983
Less: allowance for losses	(3)	(173)	(136)	(320)	(11)	(643)
	15,984	1,220	5,961	2,847	7,328	33,340
Analysis of credit risk exposure						
Not impaired:						
– Neither past due nor impaired	15,836	1,179	5,828	1,618	6,172	30,633
– Impaired	156	214	269	1,765	1,283	3,687
	15,992	1,393	6,097	3,383	7,455	34,320
Credit commitments	390	2,333	2,114	48	–	4,885
Gross credit risk exposure	16,382	3,726	8,211	3,431	7,455	39,205
Less:						
– Fair value adjustments	(5)	–	–	(216)	(116)	(337)
– Allowance for losses	(3)	(173)	(136)	(320)	(11)	(643)
Net credit risk exposure	16,374	3,553	8,075	2,895	7,328	38,225
Reconciliation of accounting to customer balances						
Gross balance	15,987	1,393	6,097	3,167	7,339	33,983
Fair value adjustments	5	–	–	216	116	337
Other accounting adjustments	(61)	95	32	(65)	38	39
Gross customer balances	15,931	1,488	6,129	3,318	7,493	34,359

Notes to the financial statements continued

38. Financial risk management continued

	Retail		CABB			
	Secured £m	Unsecured £m	Corporate		Optimum £m	Total £m
			Core £m	Non-core £m		
2011						
Gross balance	15,802	1,518	5,539	3,453	7,746	34,058
Less: allowance for losses	(3)	(164)	(83)	(34)	(8)	(292)
	15,799	1,354	5,456	3,419	7,738	33,766

Analysis of credit risk exposure

Not impaired:						
– Neither past due nor impaired	15,665	1,299	5,354	2,927	6,436	31,681
– Impaired	144	219	185	776	1,448	2,772
	15,809	1,518	5,539	3,703	7,884	34,453
Credit commitments	312	2,423	2,048	75	1	4,859
Gross credit risk exposure	16,121	3,941	7,587	3,778	7,885	39,312
Less:						
– Fair value adjustments	(7)	–	–	(251)	(138)	(396)
– Allowance for losses	(3)	(164)	(83)	(34)	(8)	(292)
Net credit risk exposure	16,111	3,777	7,504	3,493	7,739	38,624

Reconciliation of accounting to customer balances

Gross balance	15,802	1,518	5,539	3,453	7,746	34,058
Fair value adjustments	7	–	–	251	138	396
Other accounting adjustments	(16)	18	(35)	(64)	50	(47)
Gross customer balances	15,793	1,536	5,504	3,640	7,934	34,407

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

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

Secured residential credit risk

Acquisition and account management

Mortgages are loans to customers secured by a first charge over a residential property. Mortgages are originated directly to customers via branches, telephone and the internet under the Britannia and Co-operative Bank brands, and via intermediaries under the Platform brand. In 2012, 70% (2011: 55%) of mortgages were originated directly and 30% (2011: 45%) through intermediaries.

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

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

	2012			2011		
	Amount advanced £m	Average LTV %	Interest only %	Amount advanced £m	Average LTV %	Interest only %
Retail prime	1,855	60	8	791	58	12
Platform prime	248	62	18	182	66	22
Total prime	2,103	61	9	973	59	13
Buy to let	539	63	84	446	63	83
Almost prime	8	57	1	10	53	13
Total completions	2,650	61	25	1,429	60	30

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

Loans may have been advanced on a capital and interest repayment basis, where the loan is repaid over the term of the loan, or interest only, where the capital element of the loan is repayable at the end of the term.

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

	2012			2011		
	Retail secured £m	Optimum £m	Total £m	Retail secured £m	Optimum £m	Total £m
Less than 50%	5,459	461	5,920	5,706	484	6,190
50% to 60%	2,233	359	2,592	2,158	373	2,531
60% to 70%	2,622	657	3,279	2,418	673	3,091
70% to 80%	2,698	1,014	3,712	2,563	1,068	3,631
80% to 90%	1,915	1,470	3,385	1,875	1,605	3,480
90% to 100%	621	1,538	2,159	652	1,696	2,348
Greater than 100%	383	1,994	2,377	421	2,035	2,456
	15,931	7,493	23,424	15,793	7,934	23,727

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

	2012			2011		
	Exposure £m	Average LTV %	Interest only %	Exposure £m	Average LTV %	Interest only %
Prime residential	15,377	45	22	15,746	44	25
Buy to let	3,256	75	91	2,881	76	91
Self-certified	2,092	77	78	2,229	77	77
Almost prime	941	90	67	997	90	67
Non-conforming	1,758	78	67	1,874	77	66
	23,424	54	42	23,727	53	43

Collateral

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

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

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

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

	2012			2011		
	Exposure £m	Collateral £m	Cover %	Exposure £m	Collateral £m	Cover %
Impaired	1,445	1,386	96	1,604	1,541	96
Not impaired	21,979	21,832	99	22,123	21,991	99
	23,424	23,218	99	23,727	23,532	99

Impairment

A loan is considered to be individually impaired when:

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

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

Notes to the financial statements continued

38. Financial risk management continued

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

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

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

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

The table below shows:

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

	2012			2011		
	Retail secured £m	Optimum £m	Total £m	Retail secured £m	Optimum £m	Total £m
Gross customer balances	15,931	7,493	23,424	15,793	7,934	23,727
Impaired customer balances	156	1,289	1,445	145	1,459	1,604
Impaired as a % of gross customer balances	1%	17%	6%	1%	18%	7%
Credit protection						
Impairment provisions	3	11	14	3	8	11
Fair value adjustments	5	116	121	7	138	145
	8	127	135	10	146	156
Credit protection as a % of impaired customer balances	5%	10%	9%	7%	10%	10%

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

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

	2012			2011		
	Retail secured £m	Optimum £m	Total £m	Retail secured £m	Optimum £m	Total £m
Low to medium risk	14,932	5,901	20,833	14,797	6,218	21,015
Medium to high risk	843	302	1,145	852	257	1,109
	15,775	6,203	21,978	15,649	6,475	22,124

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

Forbearance

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

- arrangements to repay outstanding arrears over a period of time, by making payments above the contractual amount. The loan is deemed to be impaired, until the arrears have been cleared in full;
- short term concessions, where the borrower is allowed to make reduced repayments (or, in exceptional circumstances, no repayments) on a temporary basis to assist with a short term financial hardship. In these cases the shortfall on the repayments will accrue as arrears and the loan is deemed to be impaired;
- payment holidays are allowed as part of a customer's flexible mortgage contract. Payment holidays are not knowingly allowed for customers experiencing financial hardship. However, in the absence of evidence to the contrary, loans that have had a payment holiday in the last two years are treated as being subject to forbearance;
- temporary conversion of a mortgage to interest only repayments. The capital repayments due in this period are spread over the remaining term on conversion back to capital repayment as part of an instalment recalculation exercise;
- a permanent switch from capital and interest repayments to interest only repayments, provided the borrower declares they have an alternative means of repaying the capital at the end of the term;
- an extension to the mortgage term to reduce the borrower's repayments. Loans that have had a term extension in the last two years (or since 2008 in the case of the Optimum portfolio) are considered to be subject to forbearance;
- capitalisation, where outstanding arrears are added to the capital value of the loan to be repaid over the remaining term. This is only considered where it is appropriate for the borrower's circumstances, and where the borrower has been performing for at least six months. During 2012, 20 loans (2011: 90) had arrears capitalised of £0.03m (2011: £0.3m). These loans are not treated as impaired unless the borrower meets another impairment trigger (eg misses a mortgage payment); and
- where applicable we will work with the customer as part of a government support scheme. Unmet loan payments will continue to accrue as arrears until such time as the loan is cleared, or the outstanding payments are brought up to date.

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

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

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

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

	Neither past due nor impaired £m	Impaired £m	Loans subject to forbearance £m	Impairment coverage £m
2012				
Arrangements	52	449	501	(22)
Concessions	1	4	5	–
Payment holidays	160	–	160	–
Interest only switches	582	–	582	(1)
Term extensions	314	–	314	–
Capitalisations	1	–	1	–
	1,110	453	1,563	(23)
	Neither past due nor impaired £m	Impaired £m	Loans subject to forbearance £m	Impairment coverage £m
2011				
Arrangements	59	487	546	(26)
Concessions	2	5	7	–
Payment holidays	176	–	176	–
Interest only switches	564	1	565	(1)
Term extensions	147	–	147	–
Capitalisations	10	–	10	–
	958	493	1,451	(27)

Notes to the financial statements continued

38. Financial risk management continued

Unsecured retail credit risk

Acquisition and account management

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

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

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

	2012 £m	2011 £m
Loans	734	751
Credit cards	2,704	2,841
Overdrafts	383	377
	3,821	3,969

Impairment

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

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

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

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

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

The table below shows:

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

	2012 £m	2011 £m
Gross customer balances	1,488	1,536
Impaired customer balances	301	310
Impaired as a % of gross customer balances	20%	20%
Credit protection		
Impairment provisions	173	163
DCA balances written off	87	90
	260	253
Credit protection as a % of impaired customer balances	86%	82%

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

Forbearance

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

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

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

Corporate credit risk

Acquisition and account management

The Bank is managed through two distinct classifications. 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 include activities not congruent with the current strategy of the Bank, which are 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 by experienced staff within the centrally based credit underwriting team, independent from income generation. Lending discretions are based on the risk profile of the customer and the amount of exposure. The lending discretions of the Credit Risk Director, the Chief Executive, Banking Group and the Credit Approvals Committee are operated to sanction the largest credit applications.

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

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

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

Notes to the financial statements continued

38. Financial risk management continued

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

2012	Standardised £m	Strong £m	Good £m	Satisfactory £m	Weak £m	Default £m	Total £m
Core							
Accommodation, food and licensed services	278	119	152	22	18	9	598
Care	249	36	73	31	1	2	392
Education	67	61	3	1	–	–	132
Financial services	84	79	30	4	–	5	202
Football clubs	–	34	–	–	–	1	35
Housing associations	8	257	1	–	–	–	266
Manufacturing	88	20	45	13	15	9	190
Motor trade and garages	25	57	26	10	1	4	123
PFI	–	1	1,250	35	–	11	1,297
Professional services	71	72	21	13	1	3	181
Property and construction:							
– Commercial investment	50	92	1,158	178	25	87	1,590
– Residential investment	13	6	116	15	8	7	165
– Commercial development	3	10	155	75	15	36	294
– Residential development	1	5	61	14	8	7	96
Public sector entities	180	1	–	–	–	–	181
Renewable energy	606	–	–	–	–	9	615
Retail and wholesale trade	108	397	56	13	5	18	597
Services	466	120	59	31	18	24	718
Transport, storage and communication	106	58	5	16	–	15	200
Utilities	94	1	2	1	–	1	99
Business banking	1	35	6	3	–	1	46
Other	7	2	2	5	–	2	18
	2,505	1,463	3,221	480	115	251	8,035
Non-Core							
Accommodation, food and licensed services	38	–	1	–	–	270	309
Care	–	–	–	–	–	–	–
Education	–	–	–	–	–	–	–
Financial services	–	–	–	–	–	–	–
Football clubs	–	–	–	–	–	18	18
Housing associations	–	834	45	–	–	–	879
Manufacturing	–	–	–	–	–	–	–
Motor trade and garages	–	–	–	–	–	–	–
PFI	–	–	–	–	–	–	–
Professional services	–	–	–	–	–	–	–
Property and construction:							
– Commercial investment	16	2	274	94	101	1,337	1,824
– Residential investment	–	–	100	47	43	113	303
– Commercial development	–	–	–	–	–	6	6
– Residential development	–	–	–	–	–	–	–
Public sector entities	–	–	–	–	–	–	–
Renewable energy	28	–	–	–	–	–	28
Retail and wholesale trade	–	–	–	–	–	–	–
Services	–	–	–	–	–	–	–
Transport, storage and communication	–	–	–	–	–	–	–
Utilities	–	–	–	–	–	–	–
Business banking	–	–	–	–	–	–	–
Other	–	–	–	–	–	–	–
	82	836	420	141	144	1,744	3,367
Total exposure	2,587	2,299	3,641	621	259	1,995	11,402

2011	Standardised £m	Strong £m	Good £m	Satisfactory £m	Weak £m	Default £m	Total £m
Core							
Accommodation, food and licensed services	256	61	52	31	2	11	413
Care	177	29	19	27	3	–	255
Education	69	46	11	1	–	–	127
Financial services	82	54	40	5	–	4	185
Football clubs	–	42	–	1	–	2	45
Housing associations	213	–	–	–	–	–	213
Manufacturing	92	16	41	21	24	2	196
Motor trade and garages	34	40	23	2	9	4	112
PFI	1	–	1,261	–	15	–	1,277
Professional services	62	27	27	8	3	4	131
Property and construction:							
– Commercial investment	17	93	1,131	211	39	50	1,541
– Residential investment	9	10	113	5	1	11	149
– Commercial development	7	9	113	123	24	11	287
– Residential development	2	2	65	35	13	4	121
Public sector entities	198	–	–	–	–	–	198
Renewable energy	407	–	–	–	–	10	417
Retail and wholesale trade	107	335	70	20	1	–	533
Services	460	103	51	61	8	22	705
Transport, storage and communication	169	53	11	7	15	24	279
Utilities	74	1	2	11	–	–	88
Business banking	1	33	7	3	1	1	46
Other	12	1	2	4	–	2	21
	2,449	955	3,039	576	158	162	7,339
Non-Core							
Accommodation, food and licensed services	63	–	1	–	–	100	164
Football clubs	–	–	–	–	15	4	19
Housing associations	920	–	–	–	–	–	920
Professional services	–	–	–	–	–	–	–
Property and construction:							
– Commercial investment	106	81	336	556	546	512	2,137
– Residential investment	2	49	116	111	23	144	445
– Commercial development	–	–	–	–	–	–	–
Renewable energy	30	–	–	–	–	–	30
	1,121	130	453	667	584	760	3,715
Total exposure	3,570	1,085	3,492	1,243	742	922	11,054

The Standardised category relates to customers who have not defaulted and, for the purposes of capital calculations, are not rated with a regulatory approved rating model. These typically belong to the public sector entities and renewable energy sectors, and to the following customer types within other sectors: other energy efficiency schemes, leveraged, newly established companies with an insufficient number of published financial accounts, project finance and charities. During 2012 the Bank was granted regulatory approval to rate housing associations with a PD model; hence a significant amount of exposure has migrated from Standardised to the Strong category.

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

Notes to the financial statements continued

38. Financial risk management continued

Collateral

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

Property collateral for corporate lending is categorised as security for property development or investment customers (ie 'property' lending) or owner occupied premises to secure mainstream loan and overdraft facilities. For general lending, in addition to taking charges over property assets owned by the customer, other security is taken in modest proportion to the total portfolio. This includes debentures or floating charges (supported by tangible security, where appropriate, including property, life policies and stocks and shares) and cash cover.

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

- the security is legally enforceable and is of a tangible nature and type
- an appropriate, recent and reliable valuation is held
- 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:

Core	2012			2011		
	Exposure £m	Collateral £m	Impairment provision £m	Exposure £m	Collateral £m	Impairment provision £m
Non-default loans with <= 1 year and all defaulted exposures regardless of term						
Less than 50%	69	69	–	51	51	–
50% to 60%	86	85	–	53	53	–
60% to 70%	107	107	–	54	54	–
70% to 80%	114	114	–	89	89	–
80% to 90%	27	26	1	63	60	2
90% to 100%	31	31	–	19	18	1
Greater than 100%	156	97	36	145	88	12
Unsecured	35	–	8	33	–	6
	625	529	45	507	413	21
Non-default loans with > 1 year						
Less than 50%	246	246	–	221	221	–
50% to 60%	293	293	–	231	231	–
60% to 70%	402	402	–	277	277	–
70% to 80%	309	309	–	293	293	–
80% to 90%	61	61	–	132	132	–
90% to 100%	33	33	–	88	88	–
Greater than 100%	106	78	–	263	216	–
Unsecured	70	–	–	86	–	–
	1,520	1,422	–	1,591	1,458	–
	2,145	1,951	45	2,098	1,871	21

Non-Core	2012			2011		
	Exposure £m	Collateral £m	Impairment provision £m	Exposure £m	Collateral £m	Impairment provision £m
Non-default loans with <= 1 year and all defaulted exposures regardless of term						
Less than 50%	1	1	–	3	3	–
50% to 60%	2	2	–	7	–	7
60% to 70%	37	34	3	1	1	–
70% to 80%	2	2	–	117	116	1
80% to 90%	46	45	1	55	55	–
90% to 100%	72	48	24	53	50	4
Greater than 100%	1,185	815	301	780	488	182
Unsecured	178	–	60	32	–	2
	1,523	947	389	1,048	713	196
Non-default loans with > 1 year						
Less than 50%	30	30	–	59	59	–
50% to 60%	64	64	–	76	76	–
60% to 70%	185	185	–	147	147	–
70% to 80%	31	31	–	126	126	–
80% to 90%	91	91	–	211	211	–
90% to 100%	68	68	–	98	98	–
Greater than 100%	123	92	–	692	598	9
Unsecured	18	–	–	125	–	–
	610	561	–	1,534	1,315	9
	2,133	1,508	389	2,582	2,028	205

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

Impairment

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

- unsatisfactory account operation – both lending facility and current accounts
- considerable reduction in value of collateral
- deteriorating balance sheet position and/or material losses/cashflow pressures
- breach of covenants
- application of forbearance strategies

Dependent on the Bank's satisfaction that the triggers leading to inclusion on the watchlist no longer apply, customers who stop exhibiting higher risk traits are removed from the watchlist. Removal from the watchlist usually requires the customer's management information to show that trading is achieving the revised plan with objective evidence that this will continue. The Bank also reviews all higher risk loans monthly (including those accounts subject to forbearance) and considers the potential loss which might arise were the borrowers to fail (notwithstanding that continued trading remains the expectation).

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

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

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

Notes to the financial statements continued

38. Financial risk management continued

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

Provisioning adjustments are also recorded, as appropriate, against loans whose interest terms have changed such that revised future cashflows discounted at the original interest rate are less than the current carrying amount. Collective impairment provisions are based on the remaining portfolio where a trigger event could have occurred but has not yet been observed.

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

The table below shows:

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

	2012		2011	
	Core £m	Non-core £m	Core £m	Non-core £m
Gross customer balances	6,129	3,318	5,504	3,640
Impaired customer balances	243	1,739	185	776
Impaired as a % of gross customer balances	4%	52%	3%	21%
Credit protection				
Impairment provisions	136	320	83	34
Fair value adjustments	–	216	–	251
	136	536	83	285
Credit protection as a % of impaired customer balances	56%	31%	45%	37%

Despite a substantial increase in provisions for corporate non-core loans, the impairment cover as a percentage of impaired customer balances has fallen from 37% to 31% since the prior period. The newly impaired balances have a low credit protection rate reflecting the high average value of collateral held.

Core impaired balances have increased by £58m with an increase in the credit protection rate of 11 percentage points. This reflects the nature of the core portfolio which would generally have lower value security.

Forbearance

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

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

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

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

The table below analyses the exposures subject to forbearance:

	2012			2011		
	Forborne £m	Non-forborne £m	Total £m	Forborne £m	Non-forborne £m	Total £m
Core						
Default	139	112	251	60	102	162
On watchlist	205	67	272	198	79	277
Neither default nor on watchlist	198	7,314	7,512	333	6,566	6,899
	542	7,493	8,035	591	6,747	7,338
Non-core						
Default	1,119	625	1,744	309	450	759
On watchlist	159	64	223	840	330	1,170
Neither default nor on watchlist	95	1,305	1,400	113	1,674	1,787
	1,373	1,994	3,367	1,262	2,454	3,716
	1,915	9,487	11,402	1,853	9,201	11,054

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

For those customers that benefit from ongoing concessions (such as postponement of principal payments), the Bank retains the forbearance status for as long as the concession remains in place. In the event of one off concessions (such as capitalisation of interest payments), the Bank removes the forbearance status 12 months after their occurrence.

Investment securities

Policies are in place with regard to the management and valuation of collateral. Repos and secured lending positions are revalued daily. Margin calls on collateralised swaps are predominantly made daily, save for several arrangements which permit calls on a weekly basis. Eligible financial collateral for Basel II reporting purposes includes gilts held under reverse repo agreements and cash held under both repo agreements and collateralised swap arrangements. The guarantees relied upon are either parental guarantees held against subsidiary exposures within bank groups or sovereign guarantees.

At the balance sheet date, the Bank has a total investment securities portfolio of £6,929m (2011: £4,617m) of which £39m (2011: £47m) is considered impaired and against which £39m (2011: £46m) of provisions are held.

Notes to the financial statements continued

38. Financial risk management continued

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

2012	Loans and receivables £m	Available for sale £m	Fair value through income or expense £m	Held for trading £m	Total £m
Gross balance	295	3,829	1,845	960	6,929
Less: allowance for losses	–	(39)	–	–	(39)
	295	3,790	1,845	960	6,890
Analysis of credit risk exposure					
Not impaired:					
– Neither past due nor impaired	306	3,790	1,845	960	6,901
– Past due up to 90 days but not impaired	–	–	–	–	–
– Impaired	–	39	–	–	39
Gross credit risk exposure	306	3,829	1,845	960	6,940
Less:					
– Fair value adjustments	(11)	–	–	–	(11)
– Allowance for losses	–	(39)	–	–	(39)
Net credit risk exposure	295	3,790	1,845	960	6,890

2011	Loans and receivables £m	Available for sale £m	Fair value through income or expense £m	Held for trading £m	Total £m
Gross balance	808	3,466	343	–	4,617
Less: allowance for losses	(3)	(43)	–	–	(46)
	805	3,423	343	–	4,571
Analysis of credit risk exposure					
Not impaired:					
– Neither past due nor impaired	824	3,423	343	–	4,590
– Past due up to 90 days but not impaired	–	–	–	–	–
– Impaired	4	43	–	–	47
Gross credit risk exposure	828	3,466	343	–	4,637
Less:					
– Fair value adjustments	(20)	–	–	–	(20)
– Allowance for losses	(3)	(43)	–	–	(46)
Net credit risk exposure	805	3,423	343	–	4,571

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, for example this may be indicated by the disappearance of an active market. For available for sale securities particular consideration is given to evidence of any significant difficulty of the issuer or measurable decrease in the estimated cash flows from the investments.

Not impaired

The Bank only invests in treasury assets which comply with the Bank's treasury credit risk policy. Within the Bank's treasury investment security portfolio 99% (2011: 89%) of exposures have an external credit rating equivalent to Fitch A or above.

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.

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 2012 the Bank had a £307m (2011: £90m) gross exposure to the Government of Finland, £90m (2011: £nil) to the Swedish Export Credit Corporation and £12m (2011: £nil) to the Government of the Netherlands, repayable in over one year. It held no other non-UK sovereign debt.

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

Direct exposures

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

2012	Repayable within 30 days £m	Repayable within 1 year but more than 30 days £m	Repayable in over 1 year £m	Total gross exposure £m	Credit risk mitigation £m	Total net exposure £m
Austria	-	-	-	-	-	-
Belgium	-	-	-	-	-	-
Denmark	8	-	-	8	-	8
Finland	-	-	25	25	-	25
France	164	54	125	343	(34)	309
Germany	32	48	664	744	(690)	54
Ireland	-	-	-	-	-	-
Italy	-	-	-	-	-	-
Luxembourg	-	-	-	-	-	-
Netherlands	-	60	413	473	-	473
Norway	-	-	72	72	(72)	-
Portugal	-	-	-	-	-	-
Spain	-	-	-	-	-	-
Sweden	-	-	64	64	-	64
Switzerland	59	608	57	724	(521)	203
	263	770	1,420	2,453	(1,317)	1,136

	Repayable within 30 days £m	Repayable within 1 year but more than 30 days £m	Repayable in over 1 year £m	Total gross exposure £m	Credit risk mitigation £m	Total net exposure £m
2011						
Austria	-	44	-	44	(4)	40
Belgium	-	20	34	54	(34)	20
Denmark	8	-	-	8	-	8
Finland	-	-	-	-	-	-
France	175	5	135	315	-	315
Germany	39	105	38	182	(16)	166
Ireland	5	25	-	30	-	30
Italy	-	-	-	-	-	-
Luxembourg	-	-	-	-	-	-
Netherlands	-	40	211	251	-	251
Norway	-	-	-	-	-	-
Portugal	-	34	-	34	-	34
Spain	59	84	34	177	(32)	145
Sweden	10	10	7	27	-	27
Switzerland	73	10	414	497	(263)	234
	369	377	873	1,619	(349)	1,270

Notes to the financial statements continued

38. Financial risk management continued

For the purposes of the above table, exposures to counterparties which comprise subsidiaries of larger banking groups within which the Bank's Treasury team maintains additional counterparty relationships are aggregated at the Banking Group level with the associated risk country being that of the ultimate parent entity. As at period end an exposure of £13m to an Irish subsidiary of a major American bank group was accordingly reported as exposure to the American based parent and it 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.

2012	Bank and money market balances £m	Bonds £m	Derivatives £m	Other £m	Total exposure £m
Austria	–	–	–	–	–
Belgium	–	–	–	–	–
Denmark	–	–	–	8	8
Finland	–	25	–	–	25
France	–	100	17	192	309
Germany	–	–	22	32	54
Ireland	–	–	–	–	–
Italy	–	–	–	–	–
Netherlands	–	473	–	–	473
Norway	–	–	–	–	–
Portugal	–	–	–	–	–
Spain	–	–	–	–	–
Sweden	–	64	–	–	64
Switzerland	–	–	52	151	203
	–	662	91	383	1,136

2011	Bank and money market balances £m	Bonds £m	Derivatives £m	Other £m	Total exposure £m
Austria	–	40	–	–	40
Belgium	–	20	–	–	20
Denmark	1	–	–	7	8
Finland	–	–	–	–	–
France	–	63	24	228	315
Germany	–	103	24	39	166
Ireland	–	30	–	–	30
Italy	–	–	–	–	–
Netherlands	–	251	–	–	251
Norway	–	–	–	–	–
Portugal	–	34	–	–	34
Spain	–	126	19	–	145
Sweden	20	7	–	–	27
Switzerland	21	–	54	159	234
	42	674	121	433	1,270

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 period end totalled £171m (2011: £184m). 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 £1,444m (2011: £529m) before credit risk mitigation (£998m post credit risk mitigation (2011: £458m)) of which £544m matures within a year (2011: £82m); and
- ABS/MBS exposures of £11m and £3m to Spanish and Belgian special purpose entities respectively were outstanding as at period end.

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

The Bank's Treasury operates a risk based approach which monitors counterparty limits and exposure via a credit risk register. The counterparties or the assets held are monitored against a Banking Group 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 Bank's Treasury risk team reviews the entire portfolio and watchlists monthly for appropriate risk status bandings and any associated management actions.

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

Indirect exposures

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

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

Bank liquidity and funding risk

Capital and liquidity framework

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

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

Liquidity risk

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

The strategic measures approved by the Banking Group Board include:

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

Notes to the financial statements continued

38. Financial risk management continued**Liquidity risk management overview**

Liquidity risk arising from the structure of the balance sheet (structural liquidity) is managed in line with policies developed by LMC and ALCO. The Banking Group's liquidity management policies are reviewed and approved annually by the BRC (on behalf of the Banking Group Board) and compliance reviewed by LMC and monthly by ALCO. The Banking Group's policy is to ensure that sufficient funds are available at all times to meet demands from depositors, to fund agreed advances, to meet other commitments as and when they fall due, and to ensure the Banking Group Board risk appetite is met.

The Bank monitors its liquidity position on a daily basis and has weekly LMC meetings which operate to oversee the operational liquidity management. A range of indicators to detect early signs of liquidity risk either in the market or specific to the Bank are also monitored. LMC discuss the actual liquidity position and projected position incorporating business plans. More frequent meetings are held if necessary, ie when the markets have a heightened period of stress or liquidity shortage. The meetings ensure that the business plans are accurate and can be flexed as required.

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

Liquid asset portfolios

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

- the liquid asset buffer (LAB), the highest quality debt. This comprises cash at the Bank of England, gilts and central government and multilateral development bank bonds. The liquid asset ratio was 15% at period end (2011: 16%). The table below shows the market value and composition of the liquid asset buffer:

	2012 £m	2011 £m
Qualifying stock		
Operational balances with central banks	5,121	6,378
Gilts	665	1,086
Multilateral development banks	1,455	162
	7,241	7,626

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

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

Wholesale funding

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

The Bank also has access to a variety of long term wholesale funding sources including securitisations, covered bonds and Euro Medium Term Notes. In 2012 it raised £1,290m through these sources. The Bank will continue to issue from the programmes as funding requirements and market conditions permit. The Bank has a smaller presence in the shorter term wholesale liability markets, which it uses to manage short term cashflow requirements.

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 cash flow profiles over a period of ten years.

2012							
Contractual cash flows	Carrying value	Gross nominal outflow	Less than 1 month	1-3 months	3-12 months	1-5 years	Over 5 years
Non-derivative liabilities	£m	£m	£m	£m	£m	£m	£m
Deposits by banks	3,612	3,888	2,416	412	551	509	–
Customer accounts	35,884	36,168	24,147	1,861	6,393	3,767	–
Customer accounts – capital bonds	888	887	26	64	256	541	–
Debt securities in issue	4,714	5,860	67	127	214	4,738	714
Other borrowed funds	1,259	2,293	6	5	87	749	1,446
Amounts owed to other Co-operative Group undertakings	112	112	112	–	–	–	–
	46,469	49,208	26,774	2,469	7,501	10,304	2,160
Derivative liabilities							
Net outflow	967	1,650	20	48	180	588	814
	47,436	50,858	26,794	2,517	7,681	10,892	2,974
Other liabilities	287	–	–	–	–	–	–
Total recognised liabilities	47,723	50,858	26,794	2,517	7,681	10,892	2,974
Unrecognised loan commitments	4,770	4,770	4,751	19	–	–	–
Total liabilities	52,493	55,628	31,545	2,536	7,681	10,892	2,974
Behavioural adjustments							
Customer accounts	–	–	(21,219)	571	2,410	18,238	–
Total liabilities – behavioural	52,493	55,628	10,326	3,107	10,091	29,130	2,974
2011							
Contractual cash flows	Carrying value	Gross nominal outflow	Less than 1 month	1-3 months	3-12 months	1-5 years	Over 5 years
Non-derivative liabilities	£m	£m	£m	£m	£m	£m	£m
Deposits by banks	3,303	3,397	1,591	584	323	899	–
Customer accounts	34,991	35,110	23,458	2,540	7,127	1,985	–
Customer accounts – capital bonds	1,430	1,420	–	98	425	892	5
Debt securities in issue	4,164	5,188	148	139	187	3,265	1,449
Other borrowed funds	1,259	2,306	7	5	77	879	1,338
Amounts owed to other Co-operative Group undertakings	132	132	132	–	–	–	–
	45,279	47,553	25,336	3,366	8,139	7,920	2,792
Derivative liabilities							
Net outflow	1,088	2,137	285	31	205	559	1,057
	46,367	49,690	25,621	3,397	8,344	8,479	3,849
Other liabilities	316	–	–	–	–	–	–
Total recognised liabilities	46,683	49,690	25,621	3,397	8,344	8,479	3,849
Unrecognised loan commitments	4,752	4,752	4,571	160	21	–	–
Total liabilities	51,435	54,442	30,192	3,557	8,365	8,479	3,849
Behavioural adjustments							
Customer accounts	–	–	(20,527)	465	1,230	18,832	–
Total liabilities – behavioural	51,435	54,442	9,665	4,022	9,595	27,311	3,849

Encumbrance

The Banking Group ensures that sufficient eligible and unencumbered assets are available at all times to meet the needs of its secured funding programmes.

Notes to the financial statements continued

38. Financial risk management continued

Bank 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. The Bank's Treasury team also create market risk through its various portfolio management and trading activities along with currency risk.

Interest rate risk

Interest rate risk policy statements, approved by the ERC on behalf of the Banking Group Board, specify the scope of the Bank's wholesale market activity, market risk limits and delegated authorities. The policy is managed by the TMRC and ALCO. Their prime task is to assess the interest rate risk inherent in the maturity and repricing characteristics of the 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. The Bank's Treasury team 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 Banking Group Board receives reports on the management of balance sheet risk. TMRC and ALCO review the balance sheet risk positions and the utilisation of wholesale market risk limits.

Non-treasury interest rate risk

The Bank (excluding wholesale) uses a gap report and earnings approach for managing interest rate risk, focusing in detail on the sensitivity of assumed changes in interest rates on net interest income for one year. Higher level analysis is performed for subsequent years.

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

Gap reports are based on defined time periods. ALCO set guidance limits around the gap, principally that the sum of positions maturing in greater than 12 months and non-sensitive balances (includes non-maturity deposits) is no more than a set limit.

Non-maturity deposits which are non-interest bearing are separated into a stable 'core' element, based on a long run average, and the residual balance, which can fluctuate. In the gap report, the residual balance (along with interest bearing non-maturity deposits) are deemed to re-price or mature within one month. The 'core' non-maturity deposits are within the non-sensitive balance on the gap report, along with non-dated capital and other non-sensitive balances. ALCO sets guidance around the treatment of non-sensitive balances to re-invest 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 Bank's Treasury markets team to external wholesale markets, and loans and deposits which are executed internally with the Bank's Treasury markets team.

Basis risk is the risk that different assets and liabilities re-price with reference to different indices and at different times. This exposes the Bank to income volatility if indices do not move in a ratio of one to one. The overall exposure to basis risk has remained a net base rate asset throughout 2012 as customers continue to favour variable rate mortgages (where the introductory rate is linked to Bank of England base rate) and administered and fixed rate savings. Basis risk is monitored by TRMC 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. A £100m positive gap position would equate to the Bank's income increasing by £1m per annum if rates increased by 1%. The maximum sensitivity for the period shown below equates to approximately a £11m decrease in income if rates increased by 1%.

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

Treasury interest rate risk

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

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

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 (£3m) (2011: £15m) and a 1% decrease £15m (2011: (£16m)).

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.

Notes to the financial statements continued

38. Financial risk management continued

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

	2012					2011				
	£ m	\$ m	€ m	Other m	Total m	£ m	\$ m	€ m	Other m	Total m
Assets										
Cash and balances at central banks	5,433	–	–	–	5,433	6,696	–	–	–	6,696
Loans and advances to banks	1,738	39	125	2	1,904	1,569	60	373	5	2,007
Loans and advances to customers	33,121	40	154	25	33,340	33,513	55	157	41	33,766
Fair value adjustments for hedged risk	354	–	–	–	354	366	–	–	–	366
Loans and receivables	238	13	44	–	295	657	16	132	–	805
– Available for sale	3,669	71	49	–	3,789	3,127	125	171	–	3,423
– At FV through income or expense	1,822	12	11	–	1,845	336	–	7	–	343
– Held for trading	870	17	73	–	960	–	–	–	–	–
Derivative financial instruments	819	–	–	–	819	975	–	–	–	975
Equity shares	6	–	–	–	6	6	–	–	–	6
Investments in joint ventures	4	–	–	–	4	3	–	–	–	3
Goodwill	–	–	–	–	–	1	–	–	–	1
Intangible fixed assets	35	–	–	–	35	41	–	–	–	41
Investment properties	173	–	–	–	173	173	–	–	–	173
Property, plant and equipment	64	–	–	–	64	80	–	–	–	80
Amounts owed by other Co-operative Group undertakings	256	–	–	–	256	179	–	–	–	179
Other assets	70	–	–	–	70	31	–	2	–	33
Prepayments and accrued income	15	–	–	–	15	19	–	–	–	19
Current tax assets	173	–	–	–	173	14	–	–	–	14
Deferred tax assets	38	–	–	–	38	26	–	–	–	26
Total assets	48,898	192	456	27	49,573	47,812	256	842	46	48,956
Liabilities										
Deposits by banks	2,995	174	443	–	3,612	2,567	261	475	–	3,303
Customer accounts	35,784	7	50	3	35,884	34,899	36	52	4	34,991
Customer accounts – capital bonds	888	–	–	–	888	1,430	–	–	–	1,430
Debt securities in issue	4,706	–	8	–	4,714	4,039	–	125	–	4,164
Derivative financial instruments	967	–	–	–	967	1,084	1	3	–	1,088
Other borrowed funds	1,230	–	29	–	1,259	1,230	–	29	–	1,259
Amounts owed to other Co-operative Group undertakings	112	–	–	–	112	132	–	–	–	132
Other liabilities	104	–	–	–	104	173	–	1	–	174
Accruals and deferred income	20	–	–	–	20	40	–	–	–	40
Provisions for liabilities and charges	163	–	–	–	163	102	–	–	–	102
Deferred tax liabilities	–	–	–	–	–	–	–	–	–	–
Total liabilities	46,969	221	530	3	47,723	45,696	298	685	4	46,683
Net on balance sheet position	1,929	(29)	(74)	24	1,850	2,116	(42)	157	42	2,273

At period end, the Group's open position was £3m (2011: £nil) representing a potential loss of £nil given a 3% depreciation in sterling (2011: £nil). The open position is monitored against limits in addition to limits in place on individual currencies. All figures are in £ sterling equivalent.

CISGIL financial risk

CISGIL issues contracts that transfer insurance risk and is exposed to financial risk through its holdings of financial assets and liabilities. This section summarises these risks and the way CISGIL manages them.

Risk management structure

During 2012, CISGIL (as part of the Co-operative Banking Group) undertook a wide ranging review of its risk management framework, delivering significant change in organisational design, committee structures, management information and reporting.

The CISGIL Board is responsible for approving the general insurance strategy, its principal markets and the level of acceptable risks articulated through its statement of risk appetite. It is also responsible for overall corporate governance which includes ensuring that there is an adequate system of risk management in place.

CISGIL has developed and implemented a governance and organisation structure, which supports the CISGIL Board. This Board has established sub committees and senior management committees to:

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

Specific authority has been delegated to these sub-committees and the Chief Executive Officer, Banking Group who may in turn, delegate elements of these discretions to appropriate executive directors and their senior line managers.

CISGIL insurance risk

Insurance risk comprises risks that arise in respect of claims that have already occurred and for which reserves are already held (reserving risk) and of claims that are yet to occur (underwriting risk).

The major classes of general insurance business written are motor and property, together with some liability, pecuniary loss, pet insurance and personal accident risks. Almost all risks under general insurance policies cover a 12 month duration and all risks directly underwritten are confined to the UK market.

Motor cover is principally in respect of private vehicles or to small businesses, with limited underwriting of fleet business. Principal risks under motor policies are bodily injury to third parties, accidental damage to property including policyholders' and third parties' vehicles, and theft of or from policyholders' vehicles.

The most significant factors affecting the frequency and severity of motor claims are judicial, legislative and inflationary changes and the frequency and severity of large bodily injury claims.

Property cover is primarily residential household. Principal risks under property policies are damage from storm and flood, fire, escape of water and subsidence and theft of or accidental damage to contents.

CISGIL has entered into an indemnification agreement with Co-operative Insurance Society Limited (CISL), a fellow subsidiary within The Co-operative Banking Group, to assume financial responsibility for the run off of general insurance business formerly written by CISL. In return, CISGIL received a premium in 2006, settled by transfer of assets, equivalent to the net technical liabilities of this business included in CISL's financial statements at 2005 year end. This exposes CISGIL to the risk of these assets being insufficient to cover the claims arising from this business, although this risk is diminishing over time. This business in run off is currently pending a Part VII transfer from CISL. This transfer will not affect how CISGIL manages the risks in its business.

Objectives and strategy

CISGIL's objective in managing general insurance risk is to ensure that insurance risks are understood and accepted in accordance with detailed underwriting rules developed with regard to the documented insurance risk appetite, and that pricing appropriately reflects the underlying risk. General insurance risk is managed through the underwriting strategy, reinsurance arrangements, proactive claims handling and the claims provisioning process.

The objective of the underwriting strategy is to ensure that the underwritten risks are diversified in terms of type and amount of risk, industry/demographic profile and geography, and only those risks which conform with underwriting criteria are accepted. Exposure mix and the frequency and average costs of claims are monitored throughout the year and where significant deviations from expectation are identified remedial action is taken. A programme of reinsurance is in place which is determined in accordance with the risk appetite of the business as further described below.

The overriding objective in claims handling is to ensure all claims are properly scrutinised and paid where they fall within the terms and conditions of the policy. The proper scrutiny of claims is facilitated by the use of various technical aids such as a pricing database, weather validation and fraud databases and the use of claims specialists.

Reinsurance strategy

Part of the CISGIL insurance risk strategy includes a reinsurance programme to reduce its losses to large exposures. There are two major reinsurance programmes in place:

- catastrophe excess of loss cover to restrict losses from a single weather event such as flood or storm; and
- individual excess of loss cover to restrict losses from individual large claims, particularly large bodily injury claims on the motor book.

The appropriate level of reinsurance is determined by management, which relies on outputs from CISGIL's capital modelling tool. A range of potential programmes are input through the model and are ranked based on various pre-defined metrics, including risk appetite. This process means that the final choice of reinsurance optimises the risk/reward trade off and ensures an objective, risk-based approach to decision making which ensures efficient use of capital.

Sources of uncertainty in the estimation of future claim payments and premium receipts

The nature of insurance contracts is that the obligations of the insurer are uncertain as to the timing or quantum of liabilities arising from contracts. CISGIL takes all reasonable steps to ensure that it has information regarding its claims exposures. However, given the uncertainty in establishing claims provisions, it is likely that the final outcome will prove to be different from the original liability established.

Uncertainty over the timing of claims relates to liabilities which have occurred but are not yet reported and the interval between claim notification and settlement. Recognised statistical methods are used to assess the payment of claims, both in respect of claims already notified and those yet to be notified. Bodily injury claims and associated legal costs, which are a significant element of outstanding claims on the motor and liability accounts, have a longer period to settlement, potentially several years. Periodic payment orders (PPOs) are a specific form of settlement of these claims, where the underwriter is required to pay regular inflation adjusted amounts for the life of the claimant, thus significantly extending the period to final settlement. There is a higher degree of uncertainty associated with these long tail claims than property damage claims which are settled more quickly. The statistical methods used to assess the timing of future payments rely on past patterns being repeated in future with allowance for known changes to claims operations.

Notes to the financial statements continued

38. Financial risk management continued

In terms of monetary values placed on claims liabilities, uncertainty arises from a number of sources. Inflation assumptions, to which long tail claims are sensitive, are set with regard to current conditions and expectations for economic influences relevant to the claim type but future experience may diverge. Bodily injury claims in particular are sensitive to changes in the legislative and regulatory environments where court decisions, guidance from the Lord Chancellor or statutory changes can affect unsettled liabilities.

In addition to cost inflation and other external factors referred to above, the amount and timing of claim payments will be affected by changes in the organisation's claims handling processes. The calculation of provisions represents CISGIL's current view of the degree of acceleration as a result of improvements in processing. Estimations are also made in respect of pipeline premiums, non-recoverable premium debts and doubtful reinsurance recoveries. In calculating the pipeline premiums, projections are based on past patterns of premium processing. Changes in processing cycles and in attrition rates could alter these past trends.

Investment risk**Objective and strategy**

The principal objective of CISGIL's investment risk management strategy is to manage the return on investments with an acceptable level of risk. Investment risk is managed within an asset and liability management (ALM) framework to ensure this objective is achieved. An overriding constraint on the investment strategy is to ensure that at all times CISGIL has sufficient assets to meet its solvency and capital requirements.

The RC specifically monitors ALM exposures and controls the effectiveness of the market and credit policies. The business management of asset risk is conducted through ALCO in line with mandated limits. Exposures to market and credit risk are managed through diversifying investments across asset classes, issuers and markets.

The principal ALM technique used is to invest in assets which are predominantly fixed interest securities with a similar duration profile to the liabilities under the general insurance contracts.

CISGIL sets a strategic asset allocation range with reference to a suitable benchmark for each asset class taking account of the investment risks. Controls and limits are set for each risk and sub risk type and managed within the risk management procedures accordingly. CISGIL considers the capital adequacy and solvency of the company when establishing and controlling the assets and risk limits.

CISGIL market risk

Market risk includes the risks that arise from fluctuations in values of, or income from, assets, or in interest rates to the extent that there is a mismatch between assets and liabilities. CISGIL normally matches the insurance liabilities arising under its general insurance contracts with a portfolio of predominantly fixed interest debt securities of a similar average duration to the liabilities arising under those contracts. To enhance certainty over the investment return generated from these assets, management practice is generally to maintain holdings to maturity.

The value of, or income from, assets held is subject to volatility from changes in short term money market interest rates. Proceeds from maturing investments are also subject to risk over the future return on reinvestment. Index-linked investments are used to match periodical payment liabilities by amount and duration. However, interest rate risk arises because of the time value of money and the potential duration to settlement of claims.

Short term insurance liabilities (normally less than five years) are not directly affected by changes in the level of market interest rates, as they are contractually non-interest bearing.

CISGIL matches cash flows of assets and liabilities in this portfolio by estimating their mean duration. The mean duration of liabilities is calculated using historical claims data to determine the expected settlement pattern for claims arising from insurance contracts in force at the balance sheet date (both incurred claims and future claims arising from the unexpired risks at the balance sheet date). Mean durations are:

	2012	2011
Insurance liabilities	2.99 years	2.63 years
Financial assets	1.99 years	2.69 years

The mean duration of assets remains within the boundaries of the investment mandate.

Specific debt securities are held to match periodical payment orders and provisions relating to asbestos exposure within the electric industry ('EIROS' claims). In order to do this, an expert opinion on life expectancy is used along with an expectation of long term average earnings. Amounts and mean durations are:

	Amount £m	Duration years
Periodical payments		
Insurance liabilities	33	17.1
Financial assets	34	15.2
EIROS claims		
Insurance liabilities	3	11.1
Financial assets	3	14.4

CISGIL writes contracts of insurance in the United Kingdom and insurance liabilities and borrowings are denominated in Sterling. Funds are invested solely in assets denominated in Sterling and consequently there is no direct exposure to currency risk.

Sensitivity analysis

The only significant aspect of market risk to which CISGIL is exposed is interest rate risk. The market value of CISGIL's assets is subject to volatility from changes in short term money market interest rates.

An increase of 100 basis points in interest yields would reduce the carrying value of CISGIL's assets at the end of the financial period by £21m (2011: £27m). CISGIL invests predominantly in fixed rate securities and has adopted a policy of recognising investment assets on an 'available for sale' basis. The impact upon profit during the period would not be material as movements would be recognised directly in other comprehensive income as a reduction of £16m net of tax (2011: £20m). Conversely, the impact of a decrease of 100 basis points in interest yields would be recognised directly in other comprehensive income as an increase of £17m net of tax (2011: £21m). The probability of this interest yield change over one year is modelled as 19%.

The sensitivity analysis above assumes a reasonably possible movement in yield curve with all other variables held constant. Furthermore the calculation assumes that a change in base rate would have an immediate and equal impact at all points on the yield curve. The method used for this calculation increases the implied redemption yield by 100 basis points and uses this modified yield to calculate the revised market value of each bond in the portfolio.

At the end of the period CISGIL held £314m of cash deposits as a result of the maturity or sale of AFS assets towards the end of 2012. Prior to reinvesting the assets in 2013, the deposits will not generate the same level of return as if they were invested as AFS assets. The exact quantification of this risk depends on the timing and nature of the reinvestment of these deposits in 2013.

CISGIL has £65m (2011: £65m) of issued subordinated debt at varying margins above three month LIBOR. The effect on profit of a 100 basis point movement in three month LIBOR would be £0.5m per annum net of tax (2011: £0.5m). Additionally, CISGIL has a further £20m of subordinated debt with a fixed coupon of 10% which is not sensitive to a change in LIBOR.

CISGIL credit risk

CISGIL's principal credit risk exposures are as follows:

- default of debt securities and reinsurance counterparties failing to meet financial obligations when due;
- default of debt securities and reinsurance counterparties entering into restructuring arrangements that may adversely affect the market value of the debt security or reinsurance recoverable; and
- adverse movement in credit spreads impacting on its corporate bond portfolio.

A credit policy and exposure framework has been established to monitor counterparty and credit risk exposures on an ongoing basis through the use of appropriate risk limits. CISGIL structures the levels of counterparty risk and asset concentration risk it accepts by placing limits and controls over exposure to a single debt instrument and counterparty, or counterparty group, and seeks to actively diversify investment holdings and counterparty exposures across markets and economic segments. Reinsurance counterparty exposures are reviewed quarterly and the investment exposure is reviewed monthly. Where concern exists over counterparty credit quality, watch lists are maintained and actively managed.

Where reinsurance is used to manage insurance risk, there is a risk that the reinsurer fails to meet its obligations in the event of a claim. Creditworthiness of reinsurers is considered regularly together with reinsurer exposures.

Other risk mitigation techniques employed to manage exposure to counterparty default include transacting only through a diversified range of authorised counterparties and the requirement for certain transactions (including investment and trading in futures, stock lending and gilt repo transactions) to be fully collateralised on a daily basis.

At the balance sheet date there were no significant concentrations of credit risk. The table below provides an analysis at the balance sheet date of the credit rating of those assets subject to credit risk, and excludes any assets that were classed as impaired at that date.

	AAA £m	AA £m	A £m	BBB and below £m	Not rated £m	Total £m
2012						
Financial assets at fair value through income or expense:						
– Deposits with approved credit institutions (fixed rate)	–	–	314	–	–	314
Available for sale assets:	–	–	–	–	–	0
– Listed debt (fixed rate)	28	77	495	110	27	737
– Listed debt (variable rate)	–	–	33	4	–	37
Loans and receivables at amortised cost	–	–	–	–	50	50
Reinsurance assets	–	15	22	–	7	44
Insurance receivables and other assets	–	2	9	3	211	225
	28	94	873	117	295	1,407
Assets not subject to credit risk						30
						1,437

Notes to the financial statements continued

38. Financial risk management continued

	AAA £m	AA £m	A £m	BBB and below £m	Not rated £m	Total £m
2011						
Financial assets at fair value through income or expense:						
– Deposits with approved credit institutions (fixed rate)	–	63	1	–	–	64
Available for sale assets:						
– Listed debt (fixed rate)	21	56	604	238	19	938
– Listed debt (variable rate)	–	–	29	3	–	32
Reinsurance assets	1	30	8	–	11	50
Insurance receivables and other assets	–	1	17	4	215	237
	22	150	659	245	245	1,321
Assets not subject to credit risk						102
						1,423

Credit ratings are determined by taking an average of ratings provided by Moody's Investors Service, Standard & Poor's and Fitch.

The maximum exposure to credit risk, before making allowance for collateral held, is represented by the carrying value of each financial asset in the table. Collateral of £282m is held as security against a reverse repo with balance of £275m as at period end (2011: £nil). This item sits within deposits with approved credit institutions within financial investments at fair value through profit or loss on the balance sheet.

Eurozone risk

CISGIL remains a low risk UK based operation. It has no direct credit exposure to sovereign debt for European countries. There is currently limited detailed knowledge of indirect exposure to European sovereign debt. Indirect exposure is managed as knowledge of an institution's direct exposure is made public. At this point, if the exposure is considered to be in excess of the risk appetite, action will be taken to reduce the risk through the sale of the relevant holdings. Indirect exposure to European countries is also considered as part of the reinsurance placement. The asset profile of the prospective companies is analysed and those which are over exposed are not included in placement of the programme.

The table below shows exposure to European countries:

	Up to 1 year £m	1 to 5 years £m	5 to 10 years £m	Total £m
2012				
France	–	7	26	33
Germany	–	–	8	8
Norway	–	11	–	11
Spain	19	6	–	25
Sweden	–	60	13	73
Switzerland	–	7	–	7
	19	91	47	157
2011				
France	–	7	33	40
Netherlands	12	–	4	16
Norway	15	10	7	32
Spain	–	60	–	60
Sweden	33	19	–	52
Switzerland	–	6	–	6
	60	102	44	206

CISGIL has no exposures to European countries as a result of repo arrangements. The above exposures arise from listed debt (fixed and variable rate).

CISGIL liquidity and funding risk

CISGIL is exposed to calls on its available cash resources, mainly from claims. Liquidity risk is the risk that cash may not be available to pay obligations when due. The CISGIL Board sets limits on the minimum proportion of maturing funds available to meet such calls and on the minimum level of borrowing facilities in place to cover claims at unexpected levels of demand.

A liquidity risk policy has been established and risk is managed through ALCO. This sets out the requirement to hold a proportion of financial assets in cash and liquid fixed interest stocks to pay claims for a specified time period in stressed conditions. The level of cash held is monitored regularly and reported to ALCO on a monthly basis. Liquid assets are considered to be:

Asset type	Value included as liquid assets
Gilts	100%
Cash	100%
Corporate bonds: AAA	80%
AA	70%
A	60%
BBB	50%
All other investments	0%

The assessed stressed scenario is a one in 100 year windstorm loss before reinsurance recoveries. The requirement is that 20% of the ultimate cost of the storm is required in liquid funds to cover immediate payments. The ultimate cost is calculated by the GI actuarial team at least every year, based on the Individual Capital Assessment (ICA) models. Based on the latest catastrophe model, the one in 100 year windstorm loss is £158m, giving a liquidity requirement of £32m against actual near liquid assets of £773m.

In addition, CISGIL has access to overnight borrowing facilities with The Co-operative Bank plc, a fellow subsidiary. Overnight borrowings are subject to The Co-operative Bank plc's regulatory exposure limits for related counterparties. These borrowings are on normal commercial terms and represent an unsecured, uncollateralised obligation of CISGIL.

The following table indicates the time profile of undiscounted cash flows arising from financial liabilities (based upon contractual maturity), and insurance liabilities (based upon estimated timing of amounts recognised in the balance sheet).

	Carrying value £m	Gross nominal out flow £m	Up to 1 year £m	1 to 2 years £m	2 to 3 years £m	3 to 4 years £m	4 to 5 years £m	More than 5 years £m
2012								
Insurance contract liabilities	1,051	1,051	563	134	92	54	43	165
Financial liabilities at amortised cost:								
– Subordinated debt	85	95	34	2	2	57	–	–
– Other reinsurance liabilities	2	2	2	–	–	–	–	–
– Insurance and other payables	22	22	22	–	–	–	–	–
– Cash and cash equivalents	12	12	12	–	–	–	–	–
	1,172	1,182	633	136	94	111	43	165
Other liabilities	11							
Total recognised liabilities	1,183							

	Carrying value £m	Gross nominal out flow £m	Up to 1 year £m	1 to 2 years £m	2 to 3 years £m	3 to 4 years £m	4 to 5 years £m	More than 5 years £m
2011								
Insurance contract liabilities	1,064	1,064	609	129	98	44	54	130
Financial liabilities at amortised cost:								
– Subordinated debt	85	98	33	3	3	2	57	–
– Other reinsurance liabilities	9	9	9	–	–	–	–	–
– Insurance and other payables	24	24	24	–	–	–	–	–
– Cash and cash equivalents	9	9	9	–	–	–	–	–
	1,191	1,204	684	132	101	46	111	130
Other liabilities	6							
Total recognised liabilities	1,197							

2011	Held for trading £m	Designated at fair value £m	Loans and receivables £m	Available for sale £m	Liabilities at amortised cost £m	Cash flow hedges £m	Total £m
Assets							
Cash and balances at central banks	–	–	6,696	–	–	–	6,696
Loans and advances to banks	–	–	2,007	–	–	–	2,007
Loans and advances to customers	–	114	33,652	–	–	–	33,766
Fair value adjustments for hedged risk	–	–	366	–	–	–	366
Investment securities	–	343	805	3,423	–	–	4,571
Derivative financial instruments	164	594	–	–	–	218	976
Equity shares	–	–	–	6	–	–	6
Amounts owed to other Co-operative Group undertakings	–	–	179	–	–	–	179
Total financial assets	164	1,051	43,705	3,429	–	218	48,567
Non-financial assets							389
Total assets							48,956
Liabilities							
Deposits by banks	–	–	–	–	3,303	–	3,303
Customer accounts	–	–	–	–	34,991	–	34,991
Customer accounts – capital bonds	–	1,430	–	–	–	–	1,430
Debt securities in issue	–	–	–	–	4,165	–	4,165
Derivative financial instruments	143	838	–	–	–	106	1,087
Other borrowed funds	–	–	–	–	1,259	–	1,259
Amounts owed to other Co-operative Group undertakings	–	–	–	–	132	–	132
Total financial liabilities	143	2,268	–	–	43,850	106	46,367
Non-financial liabilities							316
Total liabilities							46,683
Capital and reserves							2,273
Total liabilities and equity							48,956

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 Banking Group, and the purposes for which they are held, are outlined below.

Loans and advances to customers and customer accounts

The provision of banking facilities to customers is the prime activity of the Bank and loans and advances to customers and customer accounts are major constituents of the balance sheet. Loans and advances to customers include retail mortgages, corporate loans, credit cards, unsecured retail lending and overdrafts. Customer accounts include retail and corporate current and saving accounts. The Bank has detailed policies and procedures to manage risks. Retail mortgage lending and much of the lending to corporate and business banking customers is secured.

Loans and advances to banks and investment securities

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

Deposits by banks and debt securities in issue

The Bank issues Medium Term Notes within an established Euro Medium Term Note programme and also issues certificates of deposit and commercial paper as part of its normal treasury activities. These sources of funds alongside other borrowed funds are invested in marketable, investment grade debt securities, and short term wholesale market placements and are used to fund customer loans.

Other borrowed funds

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

Notes to the financial statements continued

38. Financial risk management continued**Derivatives**

A derivative is a financial instrument that derives its value from an underlying rate or price such as interest rates, exchange rates and other market prices. Derivatives are an efficient means of managing market risk and limiting counterparty exposure. The Bank uses them mainly for hedging purposes and to meet the needs of customers.

The most frequently used derivative contracts are interest rate swaps, exchange traded futures and options, caps and floors, forward rate agreements, currency swaps and forward currency transactions. Terms and conditions are determined by using standard industry documentation. Derivatives are subject to the same market and credit risk control procedures as are applied to other wholesale market instruments and are aggregated with other exposures to monitor total counterparty exposure which is managed within approved limits for each counterparty.

Foreign exchange

The Bank undertakes foreign exchange dealing to facilitate customer requirements and to generate incremental income from short term trading in the major currencies. Structured risk and trading related risk are managed formally within position limits approved by the Banking Group Board.

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 as defined within IFRS 7:

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

2012	Fair value at end of the reporting period using			Total £m
	Level 1 £m	Level 2 £m	Level 3 £m	
Non-derivative financial assets				
Held for trading:				
– Investment securities	960	–	–	960
Designated at fair value:				
– Loans and advances to customers	–	142	11	153
– Investment securities	1,845	–	–	1,845
Available for sale financial assets:				
– Investment securities	2,185	1,605	–	3,790
– Equity shares	–	–	6	6
Derivative financial instruments	–	783	36	819
Total assets carried at fair value	4,990	2,530	53	7,573
Non-derivative financial liabilities				
Designated at fair value				
Customer accounts – capital bonds	–	888	–	888
Derivative financial instruments	–	955	13	968
Total liabilities carried at fair value	–	1,843	13	1,856

2011	Fair value at end of the reporting period using			Total £m
	Level 1 £m	Level 2 £m	Level 3 £m	
Non-derivative financial assets				
Held for trading:				
– Investment securities	–	–	–	–
Designated at fair value:				
– Loans and advances to customers	–	102	12	114
– Investment securities	343	–	–	343
Available for sale financial assets:				
– Investment securities	1,837	1,586	–	3,423
– Equity shares	–	–	6	6
Derivative financial instruments	–	951	25	976
Total assets carried at fair value	2,180	2,639	43	4,862
Non-derivative financial liabilities				
Designated at fair value				
Customer accounts – capital bonds	–	1,430	–	1,430
Derivative financial instruments	–	1,075	13	1,088
Total liabilities carried at fair value	–	2,505	13	2,518

The carrying values of financial instruments measured at fair value are determined in compliance with the accounting policies in note 21 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 £142m (2011: £102m) 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.

Notes to the financial statements continued

38. Financial risk management continued**Loans and advances to customers**

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

Loans and advances to customers include 25 year fixed rate mortgages of £11m (2011: £12m) which are fair valued through income or expense using unobservable inputs. 25 year fixed rate mortgages are valued using future interest cash flows at the fixed customer rate and estimated schedule of customer repayments. Cash flows are discounted at a credit adjusted discount rate; the credit adjustment is based on the average margin of new long dated (five years or greater) fixed rate business written in the last six months, and subject to quarterly review. The eventual timing of future cash flows may be different from that forecast due to unpredictable customer behaviour, particularly on a 25 year product. The valuation methodology takes account of credit risk and has increased the valuation by £0.5m in 2012 (2011: £0.5m decrease). A reasonable change in the assumptions would not result in any material change in the valuation.

Equity shares

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

Amounts owed to other Co-operative Group undertakings

Amounts owed to other Co-operative Group undertakings are to the Silk Road Finance Number One (Silk Rd 1) subsidiary, relating to the legal transfer of loans and advances on securitisation. The amounts are fair valued to eliminate an accounting mismatch of the swap derivative as discussed above.

Revaluation of the £1,764m (2011: £2,131m) mortgage pool from carrying to fair value is based on assumed timing of future mortgage capital and revenue receipts, discounted to present value using a credit adjusted discount rate. During 2012, the Bank's amounts owed to other Co-operative Group undertakings decreased due to reanalysis of inter company balances.

The amortisation profile is as per the swap's valuation methodology, assuming some annual prepayment, but is extended beyond any bond maturity, until all the mortgages themselves mature, which is circa 25 years. Similarly, the revenue receipts are calculated as per the swap valuation methodology, but extended until all the mortgages mature. For fixed rate mortgages, revenue receipts are based on fixed customer rates within the assumed amortisation profile. For tracker, SVR and discount products, revenue receipts are assumed to be based on forward LIBOR rates plus the product margins. Fixed and tracker mortgages are assumed to revert to SVR at the end of any offer period. All mortgages in the covered bond pool were originated pre 31 December 2007.

The fair value of the swap is based on a valuation model that reflects the mortgage cash flows over a three year period using a discount rate based on LIBOR spreads. This derivative eliminates on consolidation.

Derivative financial instruments

Derivative financial instruments include internal interest rate swaps entered into between the Bank and Silk Rd 1.

The purpose of the swaps is to convert the fixed and base rate linked revenue receipts of the pool of mortgage assets to the same LIBOR linked basis as the intercompany loan. Under this swap arrangement Silk Rd 1 pays to the swap counterparty, the monthly mortgage revenue receipts of the pool of assets and receives from the swap counterparty LIBOR plus a contractual spread on the same notional balance; the spread being sufficient to cover the intercompany loan and any expenses.

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

The fair value of the swaps is based on a valuation model that reflects the mortgage cash flows over a three year period using a discount rate based on LIBOR spreads. These derivatives eliminate on consolidation.

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

	Fair value at beginning of period £m	Purchases £m	Sales £m	Profit or loss including impairment £m	Fair value at end of period £m
2012					
Loans and advances to customers	12	–	–	(1)	11
Derivative assets	25	–	–	10	35
Equity shares	6	–	–	–	6
Derivative liabilities	(13)	–	–	1	(12)
	30	–	–	10	40
2011					
Loans and advances to customers	12	–	–	1	13
Derivative assets	17	–	–	8	25
Equity shares	7	–	–	(2)	6
Derivative liabilities	(27)	–	–	14	(13)
	9	–	–	21	30

Fair values of financial instruments not carried at fair value

The carrying values of financial instruments measured at amortised cost are determined in compliance with the accounting policies in note 21.

The table below sets out a summary of the carrying and fair values of:

- financial assets classified as loans and receivables; and
- financial liabilities classified as held at amortised cost,

unless there is no significant difference between carrying and fair values.

	Carrying value £m	Fair value £m
2012		
Financial assets		
Loans and receivables:		
– Loans and advances to banks	1,904	1,903
– Loans and advances to customers	33,186	33,223
– Fair value adjustments for hedged risk	354	354
– Investment securities	295	302
– Amounts owed by other Co-operative Group undertakings	256	256
Financial liabilities		
Financial liabilities at amortised cost:		
– Deposits by banks	3,612	3,627
– Customer accounts	35,884	36,108
– Debt securities in issue	4,714	4,940
– Other borrowed funds	1,259	1,161
– Amounts owed to other Co-operative Group undertakings	112	112
	Carrying value £m	Fair value £m
2011		
Financial assets		
Loans and receivables:		
– Loans and advances to banks	2,007	2,004
– Loans and advances to customers	33,652	33,870
– Fair value adjustments for hedged risk	366	366
– Investment securities	805	799
– Amounts owed by other Co-operative Group undertakings	179	179
Financial liabilities		
Financial liabilities at amortised cost:		
– Deposits by banks	3,303	3,305
– Customer accounts	34,991	35,139
– Debt securities in issue	4,165	4,008
– Other borrowed funds	1,259	1,093
– Amounts owed to other Co-operative Group undertakings	132	132

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

Loans and advances to banks/deposits by banks

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

The fair value of floating rate placements and overnight deposits is their carrying amount. The estimated fair value of fixed interest bearing deposits is based on discounted cash flows using prevailing money market interest rates for debts with similar credit risk and remaining maturity. A credit loss adjustment has been applied based on expected loss amounts derived from the Bank's regulatory capital calculations.

Notes to the financial statements continued

38. Financial risk management continued**Loans and advances to customers**

Fixed rate loans and advances to customers are revalued to fair value based on future interest cash flows (at funding rates) and principal cash flows discounted using an appropriate market rate. Forecast principal repayments are based on redemption at the earlier of maturity or repricing date with some overlay for historic behavioural experience where relevant. The eventual timing of future cash flows may be different from the forecast due to unpredictable customer behaviour. It is assumed there is no fair value adjustment required in respect of interest rate movement on variable rate assets. A credit loss adjustment has been applied based on expected loss amounts derived from the Bank's regulatory capital calculations. The fair value of Group assets are higher than carrying value primarily because the current levels of interest rates are lower in comparison to the fixed levels of interest originated, and are reduced by the increased expectation of losses outweighs the impact of interest rates and fair value is lower than carrying value. However, in the Group, the fair value is higher because included within the carrying value are assets acquired in the merger with Britannia Building Society that were at a significant discount to their exposure amount.

Investment securities

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

Customer accounts

The estimated fair value of deposits with no stated maturity, which includes non-interest bearing deposits, is the amount repayable on demand. The estimated fair value of fixed interest bearing deposits and other borrowings without quoted market price is based on discounted cash flows using interest rates for new debts with similar remaining maturity.

Debt securities in issue and other borrowed funds

The aggregate fair values are calculated based on quoted market prices. For those notes where quoted market prices are not available, a discounted cash flow model is used based on a current yield curve appropriate for the remaining term to maturity.

Assets pledged

Assets are pledged as collateral under repurchase agreements with other banks. These deposits are not available to finance the Banking Group's day to day operations.

Investment securities sold under repurchase agreements

	2012 £m	2011 £m
Carrying amount of assets not derecognised	1,907	2,114
Carrying amount of associated liabilities	1,831	1,703
Fair value of assets not derecognised	1,908	2,115
Fair value of associated liabilities	1,828	1,869
Net position	80	246

Associated liabilities are included within deposits by banks.

The Banking Group has loans and advances to banks of £250m (2011: £256m) under reverse sale and repurchase agreements and against which it holds gilts with a fair value of £250m (2011: £268m). These transactions are conducted under terms that are usual and customary to standard stock lending, securities borrowing and reverse purchase agreements. The Banking Group is permitted to sell or repledge the assets received as collateral in the absence of their default. The Banking Group is obliged to return equivalent securities. At period end the fair value of collateral repledged amounted to £250m (2011: £268m). The Banking Group do not adjust for the fair value of securities received under reverse sale and repurchase agreements.

CISGIL Fair Values

The following summarises the major methods and assumptions used in estimating the fair values of financial instruments reflected in the financial statements:

Financial investments at fair value through income or expense

The fair value of financial assets designated at fair value through income or expense, being short term fixed rate deposits, approximates to their nominal amount.

Available for sale assets

Fair value of listed debt securities is based on clean bid prices at the balance sheet date without any deduction for transaction costs.

Available for sale assets are regularly reviewed for impairment. Objective evidence of impairment can include default by a borrower or issuer, indications that a borrower or issuer will enter bankruptcy or the disappearance of an active market for that financial asset because of financial difficulties.

These reviews give particular consideration to evidence of any significant financial difficulty of the issuer or measurable decrease in the estimated cash flows from the investments.

Borrowed funds

Fair value measurement is calculated on a discounted cash flow basis using prevailing market interest rates.

Receivables and payables

For receivables and payables with a remaining life of less than one year, the nominal amount is deemed to reflect the fair value, where the effect of discounting is immaterial.

	2012 Carrying value £m	2012 Fair value £m	2011 Carrying value £m	2011 Fair value £m
Financial liabilities				
Other borrowed funds	85	83	85	70

Financial asset and liability classification

The table below analyses financial instruments by measurement basis as detailed by IAS 39 (Financial Instruments: Recognition and Measurement).

	Designated at fair value £m	Loans and receivables £m	Available for sale £m	Other amortised cost £m	Total £m
2012					
Assets					
Reinsurance assets	–	45	–	–	45
Financial assets at fair value through income or expense	314	–	–	–	314
Available for sale assets	–	–	774	–	774
Other financial assets	–	213	–	–	213
Total financial assets	314	258	774	–	1,346
Non-financial assets					91
Total assets					1,437
Liabilities					
Other borrowed funds	–	–	–	85	85
Overdrafts	–	–	–	13	13
Other financial liabilities	–	–	–	24	24
Total financial liabilities	–	–	–	122	122
Non-financial liabilities					1,039
Total liabilities					1,161
Capital and reserves					276
Total liabilities and equity					1,437
2011					
Assets					
Reinsurance assets	–	50	–	–	50
Financial assets at fair value through income or expense	64	–	–	–	64
Available for sale assets	–	–	969	–	969
Other financial assets	–	191	–	–	191
Total financial assets	64	241	969	–	1,274
Non-financial assets					149
Total assets					1,423
Liabilities					
Other borrowed funds	–	–	–	85	85
Overdrafts	–	–	–	9	9
Other financial liabilities	–	–	–	33	33
Total financial liabilities	–	–	–	127	127
Non-financial liabilities					1,050
Total liabilities					1,177
Capital and reserves					246
Total liabilities and equity					1,423

Notes to the financial statements continued

38. Financial risk management continued

The following table provides an analysis of financial assets that are valued at fair value by the three level fair value hierarchy as defined within IFRS 7:

- **Level 1** – fair value measurements are those derived from quoted prices (unadjusted) in active markets for identical assets or liabilities.
- **Level 2** – fair value measurements are those derived from inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (ie as prices) or indirectly (ie derived from prices).
- **Level 3** – fair value measurements are those derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

Valuation of financial instruments

2012	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Assets				
Financial assets at fair value through income or expense	–	314	–	314
Available for sale assets	–	773	–	773
Total financial assets at fair value	–	1,087	–	1,087

2011	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Assets				
Financial assets at fair value through income or expense	–	64	–	64
Available for sale assets	–	969	–	969
Total financial assets at fair value	–	1,033	–	1,033

The valuation techniques using observable inputs primarily relate to debt securities that would otherwise be fair valued using quoted market prices but where there has been short term temporary market inactivity. In obtaining relevant fair values CISGIL has obtained security specific prices from third party market makers based on what the third parties would have traded these particular securities for at the period end.

The following table allows comparison of debt securities (other than those classified at fair value through income or expense) on the basis of the current carrying amount, fair value and amortised cost (pre impairment).

Investments in debt securities as available for sale financial assets:

	2012 £m	2011 £m
Carrying amount	773	969
Fair value	773	969
Amortised cost	775	988

39. Detailed analysis of loss on discontinued operations, net of tax

Details of income and expenses relating to the Life Insurance business and TCAM were as follows:

	2012 £m	2011 £m
Gross premiums:		
Non-participation contracts	29	33
Participation contracts	298	375
Outward reinsurance premiums:		
Non-participation contracts	(15)	(15)
	312	393
Analysis of gross written premiums:		
Premiums under individual contracts	323	403
Premiums under group contracts	4	5
	327	408

	2012 £m	2011 £m
Life contracts:		
Premiums from life assurance business	237	310
Premiums from pensions business	88	96
Premiums from permanent health business	2	2
	327	408

Investment income

	2012 £m	2011 £m
Interest income from debt securities at fair value through profit or loss	346	342
Dividend income from equities at fair value through profit or loss	129	163
Rental income from investment properties	106	108
Cash and cash equivalents interest income	11	12
Interest income from derivative financial instruments	2	11
	594	636

Net gains/(losses) on remeasurement of financial and other assets at fair value through income or expense

	2012 £m	2011 £m
Listed equities	383	(458)
Unlisted equities	56	1
Listed debt securities	298	860
Unlisted debt securities	120	458
Derivatives	(142)	614
Investment properties	(8)	36
Net losses on remeasurement of financial liabilities at fair value through profit or loss	(120)	(458)
Other investments	(2)	2
	585	1,055

Notes to the financial statements continued

39. Detailed analysis of loss on discontinued operations, net of tax continued

	2012 £m	2011 £m
Gross claims paid		
Long term insurance contracts:		
– death benefits	148	137
– surrender benefits	515	474
– maturity claims	370	344
– annuity and other benefits	204	190
Less recovered from reinsurers		
Long term business:		
– death benefits	(11)	(11)
– annuity and other benefits	(151)	(137)
Net claims paid	1,075	997

40. Detailed analysis of assets and liabilities held for sale

Details of assets and liabilities relating to the Life Insurance business and TCAM were as follows:

Derivatives – assets classified as held for sale

	2012 £m	2011 £m
Derivative financial assets at FVTPL – held for trading:		
Financial future contracts	2	1
Interest rate swaptions	428	264
Interest rate swaps	657	871
FTSE options	108	159
Forwards	5	4
Total return swaps	44	188
	1,244	1,487

Derivatives – liabilities classified as held for sale

	2012 £m	2011 £m
Financial future contracts	1	18
Interest rate swaps	1,115	1,066
Total return swaps	26	92
Forwards	26	21
	1,168	1,197

Investments – assets classified as held for sale

	2012 £m	2011 £m
Listed equities	4,029	4,583
Unlisted equities	976	998
Listed debt securities – fixed rate	8,619	7,637
Listed debt securities – floating rate	1	134
Unlisted debt securities – fixed rate	3	4
Unlisted debt securities – floating rate	2,608	2,550
Deposits with credit institutions – fixed rate	1,227	1,569
Investment properties	1,468	1,574
	18,931	19,049

The value of securities pledged in connection with repo and other transactions is £565m (2011: £1,366m). The value of securities received in connection with repo and other transactions is £450m (2011: £576m). A liability of £25m (2011: £755m) is included within financial liabilities in respect of repurchase liabilities.

Analysis of insurance and participating contract liabilities

	2012 £m	2011 £m
Gross		
Long term insurance contracts:		
– Insurance contracts	3,572	3,177
– Insurance participating contracts	13,904	14,256
– Investment participating contracts	671	627
– Adjustment for funeral bonds	(445)	(381)
	17,702	17,679
Recoverable from reinsurers		
Long term insurance contracts:		
– Insurance contracts	(2,231)	(2,019)
– Insurance participating contracts	(1,385)	(1,468)
	(3,616)	(3,487)
Net		
Long term insurance contracts:		
– Insurance contracts	1,341	1,158
– Insurance participating contracts	12,519	12,788
– Investment participating contracts	671	627
Net insurance liabilities	14,531	14,573
– Adjustment for funeral bonds	(445)	(381)
Net liabilities after adjustment for funeral bonds	14,086	14,192

Notes to the financial statements continued

40. Detailed analysis of assets and liabilities held for sale continued
Capital position statement 2012 (CISL only)

	Long term business (excl. stakeholder) £m	With profits stakeholder fund £m	Shareholder funds £m	Total long term business £m
Available capital resources				
Shareholders' funds held outside fund	–	–	200	200
Shareholders' funds held in fund	–	–	–	–
Total shareholders' funds	–	–	200	200
Adjustments onto regulatory basis:				
– Unallocated divisible surplus	1,240	–	–	1,240
– Adjustments to assets	(21)	–	–	(21)
Total available capital resources	1,219	–	200	1,419
With profits liabilities on realistic basis:				
– Options and guarantees	1,527	–	–	1,527
– Other policyholder obligations	11,292	257	–	11,549
Total participating contract liabilities	12,819	257	–	13,076
– Non-participating life assurance	1,342	–	–	1,342
Insurance and participating contract liabilities per capital position statement	14,161	257	–	14,418

Capital position statement 2011 (CISL only)

	Long term business (excl. stakeholder) £m	With profits stakeholder fund £m	Shareholder funds £m	Total long term business £m
Available capital resources				
Shareholders' funds held outside fund	–	–	200	200
Shareholders' funds held in fund	–	–	–	–
Total shareholders' funds	–	–	200	200
Adjustments onto regulatory basis:				
– Unallocated divisible surplus	1,033	–	–	1,033
– Adjustments to assets	(58)	–	–	(58)
Total available capital resources	975	–	200	1,175
With-profits liabilities on realistic basis:				
– Options and guarantees	1,737	–	–	1,737
– Other policyholder obligations	11,337	226	–	11,563
Total participating contract liabilities	13,074	226	–	13,300
– Non-participating life assurance	1,158	–	–	1,158
Insurance and participating contract liabilities per capital position statement	14,232	226	–	14,458

Reconciliation to insurance and participating contracts liability

	2012 £m	2011 £m
Insurance and participating contract liabilities as per capital position statement	14,418	14,458
Add back reinsurance	3,616	3,487
Outstanding claims reserves	113	115
Less funeral bonds	(445)	(381)
Insurance and participating contract liabilities	17,702	17,679

Long term life insurance contracts – assumptions, changes in assumptions and sensitivity**Capital management policies and objectives**

The liabilities of the business fund shown in the capital position statement are calculated following FSA rules and guidance. CISL has a general reserve of £200m which is a separate shareholder-owned fund held outside the business which, if available, may be used in exceptional circumstances to help meet the business fund's solvency requirements.

The whole of the profits of the business are applied for the sole benefit of the long term business policyholders. This includes the making of reserves with the aim of preserving the strength of the fund for the benefit of current and future life assurance and pensions policyholders. Similarly, any losses incurred within the fund are borne by the policyholders, either through a reduction in the working capital of the fund or through a reduction in their benefits.

The working capital of the fund is the excess of assets within the fund over the amount needed to meet liabilities, including those arising from the regulatory requirement to treat customers fairly when setting discretionary benefits. The working capital is managed to ensure that the long term business fund can meet its solvency requirements under a range of adverse conditions and to meet business plans.

Risks that may affect the long term business fund are managed according to documented risk management policies, which require risks and capital to be monitored and reported regularly, and decisions made according to delegated authorities; details are provided in CISL's risk management section. Actions to control risk and manage the working capital of the fund include the use of reinsurance, the matching of assets and liabilities (including using derivatives) and the setting of discretionary benefits at appropriate levels, as described in the Principles and Practices of Financial Management (PPFM).

In exceptional circumstances, assets held outside the fund (share capital and general reserve), if available, may be used to help meet the long term business fund's solvency requirements. In some circumstances, this may require a transfer of assets into the fund. In such cases the fund would be managed with the aim of repaying these assets (accumulated with interest at an appropriate level) over time from within the fund.

Policy options and guarantees

Personal and free-standing pension scheme pure endowment contracts issued prior to March 1999 contain options guaranteeing a minimum annuity rate at vesting. The value of the options is calculated using a market consistent stochastic approach. For a representative set of policies, the asset shares are projected to the date of vesting. If, based on projected market interest rates at the date of vesting, the annuity that would then be payable is less than the guaranteed annuity; additional provision is made with the additional costs being calculated on a market consistent basis. Assumptions used in the calculation relating to expenses, mortality experience and the proportion of policies that reach vesting are best estimates based on experience investigations carried out during 2012. At 31 December 2012, provisions amounting to £837m (2011: £897m) have been made to cover the future cost of meeting guarantees of this type.

For accumulating with-profits business, provision has been made for the guarantee that no market value reduction will apply on death, or on surrender of premiums paid prior to 1 April 2000. The value of the guarantee is calculated using a market consistent stochastic approach, and assuming that annual bonuses are at expected future levels. Provision has been made for the current value of the excess of the guaranteed payout on surrender over the projected asset share. Expense and mortality assumptions used in the calculation are best estimates based on experience investigations carried out during 2012. At 31 December 2012, provisions amounting to £53m (2011: £67m) have been made to cover the future cost of meeting guarantees of this type. The cost of meeting maturity guarantees on life and pensions savings products is calculated stochastically using market consistent interest rates. It is assumed that annual bonuses continue to be declared at the levels applicable following the bonus declaration arising out of the current valuation.

Provision has been made for the present value of the excess of the guaranteed payout at maturity over the projected asset share. Expense and mortality assumptions used in the calculation are best estimates based on experience investigations carried out during 2012. At 31 December 2012, provisions amounting to £641m (2011: £781m) have been made to cover the future cost of meeting guarantees of this type.

Basis of assessing liabilities

The long term business provision is calculated twice a year having regard for the principles laid down in Chapters 1.2 and 1.3 of the Prudential Sourcebook for Insurers (INSPRU). In December 2006, the FSA issued a policy statement (PS06/14) allowing insurers to change the capital and reserving requirements of non-profit business to a more realistic basis. The Society adopted the changes under this policy statement at 12 January 2008, and continues to do so at 31 December 2012.

Notes to the financial statements continued

40. Detailed analysis of assets and liabilities held for sale continued

Participating business methodology

Provisions for participating business are calculated as the value of the with-profits benefits reserve plus the cost of options, guarantees and smoothing. Retrospective methods are used to calculate with-profits benefits reserves for all products apart from whole of life policies for which a prospective method is used.

Retrospective methods of calculation involve the accumulation of monthly cash flows in respect of premiums plus investment income (including unrealised gains/losses and allowances for allocations in respect of past miscellaneous surplus) less policy charges, expenses and tax.

Prospective methods are used to calculate with-profits benefits reserves for all Ordinary and Industrial Branch whole of life policies. Prospective methods of calculation involve determining the present value of the future cash flows in respect of premiums plus investment return, less policy charges and expenses, benefits payable (including guaranteed benefits, bonuses declared and an element of potential future bonuses) and tax.

The cost of guarantees, options and smoothing is calculated using a market consistent stochastic model. Policies are grouped by similar nature, term and size for each product. Stochastic projections are performed using grouped model points representing individual contracts. The market consistent asset model has been used to calculate the costs of guarantees, options and smoothing.

The model is calibrated according to the rules within INSPRU and tests are performed to ensure that the model reproduces current market prices of traded instruments and is arbitrage-free.

Non-participating business methodology

Reserves for conventional non-participating business are valued prospectively, using a gross premium approach, by subtracting the actuarial value of the estimated future premium income from the value of the future benefit outgo. Prudent assumptions are used in these calculations but some allowance is made for expected future lapses.

The value of future profits that are expected to arise on non-participating contracts (being the present value of future cash flows under these contracts) is calculated using realistic assumptions and, for presentational purposes, is deducted from the reserves to determine the provision for conventional participating business.

Provisions for unit linked policies are determined by reference to the value of the units allocated to policies at the accounting date. Additional sterling reserves of £5m (2011: £4m) for insurance contracts and £6m (2011: £5m) for investment contracts to provide for the excess of expenses over anticipated charges is made.

Although the gross insurance liabilities and the related reinsurance are fairly stated on the basis of the information currently available, the eventual liability may vary as a result of subsequent information and events.

The provisions, estimation techniques and assumptions are periodically reviewed with any changes in estimates reflected in the income statement as they occur.

Assumptions used in valuing the realistic liabilities

The overall objective of the CISL reserving policy is to produce reliable and accurate estimates. Assumptions used in valuing the realistic liabilities are proposed by the Actuarial Function Holder and agreed by the CISL Board.

In general, assumptions used in the valuation of realistic liabilities are based on the results of the most recent experience investigations and are considered to be best estimates of future experience. Where data is not significant enough to make firm conclusions, industry data is also considered. The assumptions most significant in the valuation of the realistic liabilities are:

- interest rates
- future bonuses
- expenses and expense inflation
- mortality, morbidity and persistency
- tax

Interest rates used in valuing the realistic liabilities

A risk free future interest rate of 2.32% (2011: 2.48%) is assumed when calculating prospective asset shares and the value of in-force business on non-participating contracts in compliance with the requirements of INSPRU.

Liabilities for non-participating contracts require a prudent assumption to be made regarding future interest rates and are determined by reference to recent investment returns on assets backing the contracts and consideration of the long term view of these returns.

In calculating the value of in-force business on non-participating contracts, future profits are discounted using an interest rate that is 1% above the risk free rate of return.

In determining the value of options and guarantees, the interest rate is stochastic with an average of the risk free curve across all scenarios. The risk free curve varies by duration.

Future bonuses

Prospective asset share calculations and the valuation of options and guarantees use the latest proposed annual rates, and assume they will continue at these levels.

Expenses and expense inflation

Expense assumptions for prospective asset shares and value of the in-force business on non-participating contracts are determined based on the latest experience and are adjusted, where appropriate, to reflect any expected changes in patterns in the future.

Reserves for non-participating contracts require a prudent explicit allowance to be made for the future expenses of maintaining contracts in force.

The level of future expense inflation is determined with reference to historical trends and expectations of how future per policy expenses will change. The assumption used in determining the provisions is calendar year specific up to 2017, reverting to a long term assumption of 6.1% per annum (2011: 5.1% per annum).

Mortality, morbidity and persistency

Wherever appropriate, mortality and persistency assumptions used are based on the results of the most recent experience investigations. Mortality assumptions are based on percentages of standard tables published by the Continuous Mortality Investigation Bureau (CMIB) and vary by product. Persistency assumptions (including early retirement rates on pension policies) vary by product and the number of years that a policy has been in force. Where data is not of a significant enough size to make firm conclusions, industry data is also considered. Critical illness assumptions are also based on percentages of standard tables published by CMIB.

In valuing guaranteed annuity options on personal pension policies, on retirement at the normal retirement age and after allowing for any tax free cash sums, all guaranteed annuity options that are 'in-the-money' are assumed to be taken.

Mortality, morbidity and persistency assumptions have been updated to reflect the results of the 2012 experience investigations and new CMIB models for future assumed annuitant mortality improvements, but these changes have not had major impacts on the insurance contract liabilities.

Tax

It is assumed that the current tax legislation and associated tax rates remain unchanged. The tax rate assumption used for netting interest rates and expenses is 20% (2011: 20%).

Sensitivity analysis

The capital position of the long term business fund is sensitive to a number of economic and insurance variances since the fund contains a number of different policyholder options and guarantees. Some of the main sensitivities of the fund can be examined by applying the stress tests prescribed by the FSA in calculating the Risk Capital Margin (RCM). The tests carried out in calculating the RCM are cumulative, so the results of each stress depend on the impact of the stresses which precede it, and the individual results may change if the stresses were applied in a different order.

RCM stress tests (applied cumulatively)

	Reduction in working capital £m
20% fall in equity values and 12.5% fall in property values	66
Increase of 89 basis points in bond yields for credit risk test	21
17.5% fall in long term gilt yields	(6)
32.5% improvement in persistency rates	133
Total RCM before management actions	214

In calculating the RCM, it has been assumed that no management action would be taken under the stressed conditions.

The RCM has been calculated to be £214m (2011: £330m). The excess working capital of the fund after the RCM is therefore £1,005m (2011: £674m). The RCM is covered 5.7 times (2011: 3.0 times) by working capital.

Other stress tests (applied cumulatively)

	Reduction in working capital £m
5% fall in assurance mortality rates	2
5% fall in annuitant mortality rates	53
10% increase in renewal expenses	70
1% increase in renewal expense inflation	151

Notes to the financial statements continued

40. Detailed analysis of assets and liabilities held for sale continued
Change in long term insurance liabilities and reinsurance assets

	2012			Net £m
	Non-participating insurance contracts £m	Participating insurance contracts £m	Reinsurance £m	
At beginning of period	3,177	14,756	(3,475)	14,458
New liabilities	227	108	–	335
Changes in liabilities during period	(23)	(8)	–	(31)
Effect of changes in non-economic assumptions	(27)	(33)	–	(60)
Effect of changes in asset shares	–	(52)	–	(52)
Effect of changes in economic conditions	7	(212)	–	(205)
Other	211	(114)	(124)	(27)
At end of period	3,572	14,445	(3,599)	14,418
Outstanding claims	–	130	(17)	113
Insurance contract liabilities	3,572	14,575	(3,616)	14,531

Movement in working capital of the long term business fund

	2012 £m	2011 £m
At beginning of period	975	951
Opening adjustments	44	71
Changes to insurance assumptions	60	(1)
Economic variances	107	34
Insurance variances	5	(46)
Other factors	28	(34)
At end of period	1,219	975

Opening adjustments

Opening adjustments consist of improvements to the actuarial models and data sources used to calculate the working capital.

Changes to insurance assumptions

Changes to insurance assumptions include changes to longevity, persistency, mortality and expense assumptions to reflect the latest experience investigations.

Economic variances

The underlying basis for liability calculations is that all assets earn the risk free rate in the future. Economic variances arise from the following:

- investment returns in the current calendar year more than (2011: more than) the assumed risk free rate helping to reduce (2011: reduce) the cost of meeting policy guarantees;
- a decrease (2011: decrease) in assumed future risk free rates which has increased (2011: increased) the cost of policy guarantees; and
- assumed future volatility of equity and fixed interest assets has decreased (2011: increased) which has decreased (2011: increased) the cost of policy guarantees.

Insurance variances

Insurance variances include:

- variances between actual and assumed experience during the financial period
- changes to endowment mis-selling compensation costs
- new business profits or losses
- one-off expenses
- the cost of closing the field sales force during 2011

Other factors

Other factors include the impact of changes to the short term assumed asset mix reflecting current asset holdings.

Risk Management

Due to the sale of the Life & Savings business being classified as discontinued (see note 9 for further details), the main risks are disclosed in this note.

CISL insurance risk

The risk under any contract derives from the possibility that the insured event occurs and the uncertainty of the amount and timing of the resulting claim.

The principal risk that CISL faces under its insurance contracts is that the actual claims and the benefit payments exceed the carrying amount of the insurance liabilities. This could occur because the frequency or severity of claims and benefits are greater than estimated. Insurance events and the actual number and amount of claims and benefits will vary from year to year from the estimates established.

Other than long term business

This includes the run off of existing general insurance business and investment activity attributable to the shareholder. CISL ceased writing new general insurance business with effect from 15 January 2006. The major classes of general insurance business formerly written were motor and property, together with some liability, pecuniary loss and personal accident risks. Almost all risks under general insurance policies covered a 12 month duration and all risks directly underwritten were confined to the UK market.

All the benefits and burdens of the general insurance business in run off were transferred to CISGIL, under the terms of an indemnification agreement.

Long term business

The majority of the long term business consists of participating savings business, including deferred pensions. In addition, cover is provided in respect of mortality risk (both term insurance and whole of life) and critical illness. Principal risks associated with these policies arise from policyholder mortality or longevity, morbidity and persistency.

Improvements in pensioner longevity pose a potential risk of increases in the cost of annuities in payment, guaranteed benefits under deferred annuity contracts and cost of guaranteed annuity options (GAOs) on personal pension contracts.

Persistency risk arises where more policies than expected reach their investment guarantee dates resulting in a potential increase in the cost of guarantees, or more policyholders opt to take an annuity at retirement rather than a lump sum under pension triviality regulations. This is particularly significant in relation to personal pension contracts where the risk is that more policyholders than expected reach their retirement date, which is the date on which GAOs become available.

Frequency and severity of claims

Factors that could increase the overall frequency of claims include epidemics for term assurance products, increased healthcare screening (such as cancer screening) resulting in earlier or more claims than expected for critical illness products, and more rapid improvements in longevity than expected for in-payment and deferred annuity business (for example from developments in medical science).

For participating policies, a significant amount of the insurance risk is shared with the participating contract holders. Insurance risk is also shared on critical illness and waiver of premium policies, both of which allow for premium rate reviews to enable changes in actual experience from expectation to be reflected in future premiums. A premium review is conducted annually for these policies. For all other policies, there are no mitigating terms and conditions that reduce the insurance risk accepted.

Insurance risk is affected by the policyholders' rights to terminate the policy, pay reduced or no future premiums or to take up a guaranteed annuity option. Consequently, the amount of insurance risk is subject to policyholder behaviour.

Risk management objectives and strategy

CISL's objective in managing long term business insurance risk is to ensure that insurance risks are understood and accepted in accordance with its documented underwriting policy and that policy pricing appropriately reflects the underlying risk. CISL manages long term business insurance risk through the use of underwriting, product design and pricing and the use of reinsurance arrangements. Risk is managed and monitored across the portfolio. The majority of term assurance and critical illness policies are reinsured on a quota share basis. A significant proportion of in-payment annuity business and deferred annuity business is also reinsured.

Sources of uncertainty in the estimation of future benefit payments and premium receipts

Uncertainty in the estimation of future benefit payments and premium receipts arises from the uncertainty regarding long term changes in mortality levels and variability in policyholder behaviour regarding termination and alteration of policies.

The amount of insurance risk under contracts with GAOs depends upon the number of policyholders who exercise their option. The lower the current market interest rate is in relation to the rates implicit in the guaranteed annuity option, the greater the likelihood that policyholders will choose to exercise the option.

Concentration of insurance risk

The existence of GAOs on personal pension products therefore gives rise to a significant concentration of financial risk and insurance risk.

Investment risk

Investment risk management objective and strategy

The principal objective of CISL's investment risk management strategy is to optimise the return on investments commensurate with an acceptable level of investment and insurance risk. Investment risk is managed within a framework for asset and liability management (ALM), to ensure that this objective is achieved. An overriding constraint on the fund's investment strategy is to ensure that the fund has sufficient assets to meet its solvency and capital requirements at all times.

The whole of the profits of the long term business must be applied for the sole benefit of the long term business policyholders. This includes the creation of reserves with the aim of preserving the strength of the fund for the benefit of the current and future long term business policyholders. Similarly any losses incurred within the fund are borne by the long term business policyholders, either through a reduction in the working capital of the fund, or through a reduction in their benefits. The working capital of the fund is the excess of assets within the fund over the amount needed to meet liabilities, including those arising from the regulatory requirement to treat customers fairly when setting discretionary benefits. The working capital is managed to ensure that the long term business fund can meet its solvency requirements under a range of adverse conditions and to meet business plans. In exceptional circumstances, assets held outside the fund (share capital and general reserve) may, if available, be used to help meet the long term business fund's solvency requirements.

Risks that may affect the long term business fund are managed according to documented risk management policies. These policies require risks and capital to be regularly monitored and reported, and require decisions to be made according to delegated authorities. Investment risk is managed according to the Market, Credit and Liquidity Risk Policy. Actions to control risk and manage the working capital of the fund are described in the Principles and Practices of Financial

Notes to the financial statements continued

40. Detailed analysis of assets and liabilities held for sale continued

Management (PPFM) and include the use of reinsurance, matching assets and liabilities (including using derivatives) and setting discretionary benefits at appropriate levels. The Executive Risk Committee specifically monitors ALM exposures and controls the effectiveness of the risk management policies.

The principal ALM technique of CISL's long term business fund is to match the assets to the insurance and investment contract liabilities with reference to the type of benefits payable to contract holders. Separate asset portfolios and funds are maintained in respect of traditional with-profits policies, accumulating with-profits policies, non-participating policies and linked liabilities. CISL invests across asset classes, issuers and markets, to help reduce the investment risk that arises from holding any single type of asset.

As part of its ALM framework, the CISL sets a strategic asset allocation range with reference to a suitable benchmark for each asset class taking account of the CISL's risk appetite, the shareholder and long term insurance and investment liabilities, long term investment performance and the investment risks. Controls and limits are set for each risk and sub-risk type and managed within the risk management procedures accordingly. CISL considers capital adequacy and solvency when establishing and controlling the assets and risk limits.

CISL market risk

Market risk within the long term business fund is managed as follows:

- long term insurance liabilities arising from non-participating policies are closely matched with fixed interest securities. This close matching is achieved by holding assets whose cash flows correspond to the expected aggregate cash flow of these liabilities;
- assets held to meet expected participating policy guarantee costs and the working capital of the fund, are invested in fixed interest securities to reduce cash flow interest rate risks;
- interest rate swaps and swaptions are held to meet the expected guaranteed annuity option liabilities;
- equity options and futures are held to reduce a proportion of the equity price risk arising from using equities to back guaranteed benefits on participating contracts;
- a portfolio of gilt total return swaps and interest rate swaps are held to hedge the risk of adverse movements in swap spreads;
- an internal hedge between the working capital of the fund and with-profit asset shares has been set up to protect the fund's solvency position from falls in risky assets such as equity, property, corporate bonds and alternatives; and
- for unit linked investment contracts, assets are directly matched with liabilities.

CISL manages its cashflow interest rate risk by using interest rate swaps and deposits. CISL enters into interest rate swaps and gilt repurchasing arrangements to manage borrowing requirements.

Sensitivity analysis

At the end of 2012, the only aspect of market risk to which the shareholder is exposed is from interest rate risk arising in the other than long term business fund which holds a significant cash balance. This fund has now fully liquidated its equity and derivative holdings. An increase or decrease of 10 basis points in prevailing interest rates would be expected to generate a corresponding increase or decrease in pre tax profit of circa £0.3m per annum. We consider that the probability of a change in base rate of this magnitude over the coming year would be less than 10%.

In the long term business fund, fluctuations in the value of assets held in respect of participating policies will be met by an equivalent change to policyholder benefits subject to any guarantees provided under such policies. Where policy guarantees mean that such fluctuations cannot be met by a change to policyholder benefits, changes to asset values will be met by the working capital of the long term business fund. In addition, fluctuations in financial assets backing non-participating policies and participating policy guarantees will also impact the working capital of the fund.

CISL credit risk

CISL's principal credit risk exposure relates to the default of debt securities and reinsurance counterparties. This default could be caused by a counterparty failing to meet financial obligations when due or entering into restructuring arrangements that may adversely affect the market value of the debt security or reinsurance recoverable.

CISL monitors counterparty and credit risk exposures on an ongoing basis through the use of appropriate risk limits. This places limits and controls over the exposure to a single debt instrument, single counterparty or counterparty group, and seeks to actively diversify investment holdings and counterparty exposures across markets and economic segments. Counterparty exposures are subject to review at least annually and, where concern exists over counterparty credit quality, the exposure is monitored and actively managed.

The use of reinsurance to manage insurance risk creates an additional risk that the reinsurer fails to meet its obligations in the event of a claim. Creditworthiness of reinsurers is considered regularly together with reinsurer exposures. Additionally, in respect of the reinsurance of in-payment and deferred annuity business, CISL has taken a charge over assets to safeguard expected future reinsurance recoveries.

Financial responsibility for the benefits and burdens of the general insurance business of CISL in run off has been passed to CISGIL, via an indemnification agreement. If CISGIL were unable to fulfil its contractual obligations, financial responsibility for these claims would revert to CISL.

Other risk mitigation techniques employed to manage exposure to counterparty default include transacting only through a diversified range of authorised counterparties or brokers and the requirement for derivative transactions (including investment and trading in futures, swaptions, stock lending and gilt repo transactions) to be fully collateralised regularly.

At the balance sheet date there were no significant concentrations of credit risk. The table provides an analysis at the balance sheet date of the credit rating of assets subject to credit risk.

	AAA £m	AA £m	A £m	BBB and below £m	Not rated £m	Total £m
2012						
Reinsurance assets	–	2,887	750	–	–	3,637
Financial assets at fair value through income or expense:						
– Listed debt (fixed rate)*	6,111	449	1,406	640	13	8,619
– Listed debt (floating rate)	–	–	1	–	–	1
– Unlisted debt (fixed rate)	3	–	–	–	–	3
– Unlisted debt (floating rate)	–	2,608	–	–	–	2,608
– Deposits with approved credit institutions (fixed rate)	–	–	1,219	18	–	1,237
– Derivatives	–	–	1,242	2	–	1,244
Loans and receivables at amortised cost:						
– Loans	–	–	–	–	1	1
– Insurance receivables and other assets	48	10	94	15	45	212
– Cash and cash equivalents	3	1	66	(4)	–	66
	6,165	5,955	4,778	671	59	17,628
Assets not subject to credit risk						6,485
						24,113

* Includes £4,941.6m of UK gilt edged securities.

	AAA £m	AA £m	A £m	BBB and below £m	Not rated £m	Total £m
2011						
Reinsurance assets	–	2,570	938	–	–	3,508
Financial assets at fair value through income or expense:						
– Listed debt (fixed rate)*	4,976	524	1,366	762	9	7,637
– Listed debt (floating rate)	70	–	64	–	–	134
– Unlisted debt (fixed rate)	4	–	–	–	–	4
– Unlisted debt (floating rate)	–	2,550	–	–	–	2,550
– Deposits with approved credit institutions (fixed rate)	–	1,065	628	–	–	1,693
– Derivatives	–	437	1,054	1	–	1,492
Loans and receivables at amortised cost:						
– Loans	–	–	–	–	2	2
– Insurance receivables and other assets	43	43	76	20	54	236
– Cash and cash equivalents	–	13	36	6	–	55
	5,093	7,202	4,162	789	65	17,311
Assets not subject to credit risk						7,175
						24,486

* Includes £2,620m of UK gilt edged securities.

The maximum exposure to credit risk is best represented by the carrying value of each financial asset in the table. Collateral of £3,766m (2011: £3,271m) is held as security for reverse repo balances of £1,043m (2011: £425m) reported within deposits with approved credit institutions, the unlisted floating rate debt of £2,608m (2011: £2,550m), and derivative positions of the long term business fund. Collateral consists of securities, delivered by value or cash.

Equivalent (but not necessarily identical) collateral must be returned at the completion of the transaction period. No collateral was sold or repledged in the period (2011: £nil). There were no defaults in the period (2011: £nil).

Notes to the financial statements continued

40. Detailed analysis of assets and liabilities held for sale continued

Eurozone risk

CISL has no direct credit exposure to sovereign debt or financial institutions in Greece, Portugal, Ireland, Italy or Belgium. CISL has no direct exposure to sovereign debt in Spain and credit exposure to financial institutions in Spain is closely monitored and currently represents 0.4% of the long term fund. There is currently no detailed knowledge of indirect exposure to European sovereign debt (other than UK). Indirect exposure is managed as knowledge of an institution's direct exposure is made public. At this point, if the exposure is considered to be in excess of the risk appetite, action will be taken to reduce the risk through the sale of the relevant holdings.

The table below shows the exposure to European countries by type of asset and by maturity.

	Certificates of deposit £m	Bonds £m	Total exposure £m
2012			
Denmark	–	26	26
France	–	16	16
Germany	–	288	288
Netherlands	–	79	79
Norway	–	2	2
Spain	–	59	59
Supranational	–	693	693
Sweden	–	26	26
	–	1,189	1,189

	Up to 5 years £m	5 to 10 years £m	10 to 15 years £m	15 to 20 years £m	20 to 25 years £m	More than 25 years £m	Total £m
2012							
Denmark	–	–	26	–	–	–	26
France	1	–	–	–	–	15	16
Germany	20	–	31	131	49	57	288
Netherlands	–	–	1	43	–	35	79
Norway	2	–	–	–	–	–	2
Spain	1	–	27	32	–	–	60
Supranational	55	103	67	270	–	197	692
Sweden	1	–	–	–	–	25	26
	80	103	152	476	49	329	1,189

	Certificates of deposit £m	Bonds £m	Total exposure £m
2011			
Denmark	25	25	50
France	–	100	100
Germany	50	205	255
Netherlands	25	32	57
Spain	–	76	76
Supranational	–	677	677
Sweden	160	17	177
Switzerland	75	–	75
	335	1,132	1,467

	Up to 5 years £m	5 to 10 years £m	10 to 15 years £m	15 to 20 years £m	20 to 25 years £m	More than 25 years £m	Total £m
2011							
Denmark	25	–	25	–	–	–	50
France	–	–	–	33	35	31	99
Germany	81	–	25	40	27	82	255
Netherlands	25	5	–	–	–	27	57
Spain	–	–	68	9	–	–	77
Supranational	50	87	88	186	84	182	677
Sweden	160	–	–	–	–	17	177
Switzerland	75	–	–	–	–	–	75
	416	92	206	268	146	339	1,467

CISL held no currency futures and currency forward contracts denominated in Euros at the end of the period, the net exposure being £nil (2011: £1m).

CISL liquidity and funding risk

Liquidity risk is the risk that cash may not be available at a reasonable cost to pay obligations when due. CISL is exposed to calls on its available cash resources mainly from claims arising, collateral arrangements on derivatives and reinsurance contracts.

Liquidity risk is managed through the internal requirement to hold a proportion of financial assets in cash and liquid stocks to pay claims and other cash flows for a specified time period in stressed conditions, where liquid assets are considered to be:

Asset type	Value included as liquid assets
Gilts	100%
Cash	100%
Corporate bonds: AAA	80%
AA	70%
A	60%
BBB	50%
Equity	60%
All other investments	0%

The minimum liquid assets proportion is currently approximately 15% of the long term business fund. This is determined using CISL's internal economic capital assessment and is regularly reviewed considering the nature, cause, effect and probability of extreme case scenarios in the light of changing natural, social and economic conditions. The current extreme scenario assumes:

- increase in claims and surrenders by 50%
- increase in expenses by 10%
- no reinsurance recoveries received
- no investment income received

Furthermore, a minimum of £700m of gilts is held to meet extreme collateral payments on derivative contracts. This ensures that a sufficient amount of liquid assets are available to post additional collateral at short notice in the event of sudden changes in derivative values.

Based on the latest internal assessment, the liquidity requirement is £2.1bn (2011: £2.0bn) against actual available liquid assets of £9.6bn (2011: £8.7bn).

CISL is active in the gilt repo market as part of its cash management activities and maintains short term borrowing facilities to enable settlement.

Notes to the financial statements continued

40. Detailed analysis of assets and liabilities held for sale continued

The following tables indicate the time profile of undiscounted cash flows arising from financial liabilities (based upon contractual maturity) and insurance liabilities (based upon estimated timing of outflow of amounts recognised in the balance sheet):

	Carrying value £m	Gross nominal outflow £m	Up to 1 year £m	1 to 5 years £m	5 to 10 years £m	10 to 15 years £m	More than 15 years £m
2012							
Insurance and participating contract liabilities	18,233	18,233	1,990	4,391	4,176	3,280	4,396
Financial liabilities at fair value through income or expense (held for trading):							
– Derivatives	1,168	2,738	322	338	436	488	1,154
Financial liabilities designated at fair value through income or expense:							
– Investment contract liabilities	360	360	360	–	–	–	–
– Other reinsurance liabilities	2,608	4,426	66	310	511	650	2,889
Financial liabilities at amortised cost:							
– Amounts owed to credit institutions (fixed rate)	25	25	25	–	–	–	–
– Insurance and other payables	136	136	136	–	–	–	–
– Other reinsurance liabilities	1	1	1	–	–	–	–
Net asset value attributable to unit holders	57	57	57	–	–	–	–
	22,588	25,976	2,957	5,039	5,123	4,418	8,439
Other liabilities	1,346						
Total recognised liabilities	23,934						

	Carrying Value £m	Gross nominal outflow £m	Up to 1 year £m	1 to 5 years £m	5 to 10 years £m	10 to 15 years £m	More than 15 years £m
2011							
Insurance and participating contract liabilities	18,162	18,162	2,105	4,461	4,086	3,121	4,389
Financial liabilities at fair value through income or expense (held for trading):							
– Derivatives	1,200	3,122	539	346	431	438	1,368
Financial liabilities designated at fair value through income or expense:							
– Investment contract liabilities	314	314	314	–	–	–	–
– Other reinsurance liabilities	2,550	4,423	63	383	521	659	2,797
Financial liabilities at amortised cost:							
– Amounts owed to credit institutions (fixed rate)	755	755	755	–	–	–	–
– Insurance and other payables	171	171	154	17	–	–	–
– Other reinsurance liabilities	–	1	1	–	–	–	–
	23,152	26,948	3,931	5,207	5,038	4,218	8,554
Other liabilities	1,175						
Total recognised liabilities	24,327						

Currency risk

Currency risk is the risk that cash flows or fair values fluctuate as a result of changes in foreign exchange rates. CISL writes contracts of insurance in the UK and insurance and investment liabilities are denominated in sterling. As the long term business fund invests in an internationally diversified range of assets, currency futures are used to ensure that the currency risk to the fund is not significant. The shareholder funds are invested solely in assets denominated in sterling and therefore no currency risk is present.

Fair values of financial instruments

The following summarises the major methods and assumptions used in estimating the fair values of financial instruments reflected in the financial statements:

Financial investments at fair value through income or expense

Background

CISL's long term business and shareholder investment portfolios are predominantly invested in listed debt, listed equity or government issued securities. There are a small number of unlisted holdings, particularly in the long term business fund, which are valued using either a model valuation or a valuation based upon net asset value (NAV).

Valuation approach

Investment assets are classified as fair value through income or expense which means that they are fair valued in the balance sheet with valuation movements passing through the income statement.

Holdings of listed debt, listed equity and government issued securities are valued based on observable market price feed data, with all non-moving valuations validated against an alternative price source. Where the market for listed debt is inactive, an average of market maker quotes is used as the valuation basis. No significant assumptions are required.

Fair value of short term fixed rate deposits is their carrying amount.

For unlisted debt securities, where model valuation is used, the valuation is driven by the assumptions used in the model and will be sensitive to changes in these assumptions. The most significant holding for which valuation is based upon a model relates to an unlisted loan note held by the long term business fund which, at the period end, is valued at £2,608m (2011: £2,550m). The floating rate note is structured such that cash flows will fund the discharge of an equivalent financial liability arising from a reinsurance arrangement. The valuation of the loan note is sensitive to changes in the gilt yield curve however any change in value would be offset by an equivalent change in the value of the financial liability.

Fair value of other unlisted debt securities represents the discounted expected principal and interest cash flows. Interest rate assumptions used in the valuation are based upon gilt yields of appropriate maturity adjusted for credit risk.

A small proportion of the portfolio is invested in unlisted equity securities, participation in collective investment pools and partnerships for which fair values are determined using a range of valuation techniques. These include reference to other recent arm's length transactions, reference to other instruments that are substantially the same, and discounted cashflow techniques.

CISL derives the fair value of certain holdings based primarily upon NAV. In aggregate such investments represent a small proportion of the overall fund and are undertaken as part of a considered, long term investment strategy. CISL considers this approach to be materially representative of fair value for these investments as it reflects the Society's share of rights and obligations under the investment, because:

- the most significant of these investments has been made in open ended funds, where the underlying investment is predominantly in listed stocks and the holding can be readily redeemed, subject to a suitable notice period, with no redemption fees or charges;
- smaller individual investments in various close-ended private equity funds are typically undertaken as part of a long term commitment and the CISL does not seek to trade these holdings;
- for the most significant of these holdings oversight and challenge of the underlying valuations which comprise the NAV is provided by leading fund administrators; and
- as CISL's investment in these holdings forms a small proportion of the overall portfolio, a reasonable adjustment to any of the variables underlying the valuation model would not have a material impact on the financial position.

Loans and receivables at amortised cost

The estimated fair value of loans and receivables, carried at amortised cost, represents the discounted amount of future cash flows expected to be received. Expected cash flows are discounted at current market interest rates based on original credit spreads to determine fair value.

Derivative financial instruments

Index futures and forward contracts are marked to market using clean bid listed market prices at the balance sheet date without any deduction for transaction costs. All other derivatives are valued at broker quotes, which are validated using pricing models or discounting techniques.

Where model valuation is used for the 'over the counter' derivatives, the valuation is driven by the assumptions used in the model and will be sensitive to changes in these assumptions. Model inputs are derived from observable market data appropriate to the instrument, such as interest rates and volatility (interest rate, equity and currency). Typically derivatives are held for risk mitigation purposes, particularly in respect of risks associated with the valuation of long term business technical provisions. So although the valuation of each instrument is sensitive to changes in the underlying valuation assumptions, any change in value would be broadly offset by an opposing change in the valuation of the life insurance and participating contract liabilities (further details are provided in the risk management section of these financial statements).

In all instances, model valuations are supplied by counterparties and validated using in-house models.

Insurance and other receivables and payables

For receivables and payables with a remaining life of less than one year, the nominal amount is deemed to reflect the fair value. All other receivables and payables are discounted to determine the fair value.

Investment contract liabilities

Fair value of investment contract liabilities is measured as the fair value of the underlying assets. The fair value of the underlying assets is stated within the valuation approach section above.

Notes to the financial statements continued

40. Detailed analysis of assets and liabilities held for sale continued

The table below shows a comparison of the carrying value and fair values of financial instruments where there is a significant difference in value. In all other instances fair values are not materially different to carrying values.

	2012		2011	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Financial assets				
Loans at amortised cost	1	2	2	2

The tables below analyse financial instruments by measurement basis as detailed by IAS 39:

2012	Held for trading £m	Designated at fair value £m	Loans and receivables £m	Other amortised cost £m	Total £m
Assets					
Reinsurance assets	–	–	3,636	–	3,636
Financial assets at fair value through profit or loss	–	17,473	–	–	17,473
Loans at amortised cost	–	–	1	–	1
Derivative financial instruments	1,244	–	–	–	1,244
Insurance receivables and other assets	–	–	212	–	212
Cash and cash equivalents	–	–	66	–	66
Total financial assets	1,244	17,473	3,915	–	22,632
Non-financial assets					1,480
Total assets					24,112
Liabilities					
Investment contract liabilities	–	360	–	–	360
Derivative financial instruments	1,168	–	–	–	1,168
Amounts owed to credit institutions	–	–	–	25	25
Insurance and other payables	–	–	–	136	136
Other reinsurance liabilities	–	2,542	–	1	2,543
Total financial liabilities	1,168	2,902	–	162	4,232
Non-financial liabilities					19,636
Total liabilities					23,868
Capital and reserves					244
Total equity and liabilities					24,112

2011	Held for trading £m	Designated at fair value £m	Loans and receivables £m	Other amortised cost £m	Total £m
Assets					
Reinsurance assets	–	–	3,508	–	3,508
Financial assets at fair value through profit or loss	–	17,599	–	–	17,599
Loans at amortised cost	–	–	2	–	2
Derivative financial instruments	1,492	–	–	–	1,492
Insurance receivables and other assets	–	–	236	–	236
Cash and cash equivalents	–	–	55	–	55
Total financial assets	1,492	17,599	3,801	–	22,892
Non-financial assets					1,594
Total assets					24,486
Liabilities					
Investment contract liabilities	–	314	–	–	314
Derivative financial instruments	1,200	–	–	–	1,200
Amounts owed to credit institutions	–	–	–	755	755
Insurance and other payables	–	–	–	170	170
Other reinsurance liabilities	–	2,469	–	1	2,470
Total financial liabilities	1,200	2,783	–	926	4,909
Non-financial liabilities					19,337
Total liabilities					24,246
Capital and reserves					240
Total equity and liabilities					24,486

The following table details financial assets held by CISL which are measured at fair value. As per IFRS 7, an entity is required to provide a breakdown of such assets and detail the basis on which the fair value has been determined. The valuations are categorised into a three level hierarchy:

- **Level 1** – fair value measurements are those derived from quoted prices (unadjusted) in active markets for identical assets or liabilities;
- **Level 2** – fair value measurements are those derived from inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (ie as prices) or indirectly (ie derived from prices); and
- **Level 3** – fair value measurements are those derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

Based upon guidance issued by the Committee of European Securities Regulators (CESR), CISL classifies these securities in Level 1 only if it can be demonstrated on an individual security by security basis that these are quoted in an active market, ie that the price quotes obtained are representative of actual trades in the market (through obtaining binding quotes or through corroboration to published market prices).

Level 1 financial instruments are mainly equities listed on a recognised exchange, UK Government bonds and exchange traded derivatives. This category also includes unlisted equities, in the form of collective investments, where published net asset values reflect the price at which units can be issued or redeemed.

Level 2 financial instruments are mainly listed corporate bonds, overseas government bonds or unlisted debt and over the counter derivatives for which the valuation can be determined based upon discounted cash flow or by reference to readily available market inputs such as interest rates, inflation assumptions etc.

Corporate bonds have generally been classified as Level 2 as the prices provided by third party pricing sources do not meet the definition of Level 1 as they include inputs which are not based on actual transaction prices.

Unlisted floating rate debt is valued by reference to net present value of future cash flows discounted using an appropriate swap yield curve and is matched by a corresponding liability whose value is linked to the value of the note. Accordingly both asset and liability are classified as Level 2.

Level 3 financial instruments include interests in private equity funds and, where appropriate, listed corporate bonds for which prices are not available or for which the market is inactive.

A small proportion of the portfolio is invested in unlisted equity securities, participation in collective investment pools and partnerships for which fair values are determined using a range of valuation techniques. These include reference to other recent arm's length transactions, reference to other instruments that are substantially the same and discounted cashflow techniques.

All debt securities are classified as at fair value through income or expense.

Notes to the financial statements continued

40. Detailed analysis of assets and liabilities held for sale continued
Valuation of financial instruments

2012	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial assets				
Financial instruments at fair value through income or expense:				
– Listed equities	4,029	–	–	4,029
– Unlisted equities	300	372	304	976
Listed debt:	–	–	–	–
– Fixed rate	4,942	3,678	–	8,620
– Floating rate	–	1	–	1
Unlisted debt:	–	–	–	–
– Fixed rate	–	3	–	3
– Floating rate	–	2,608	–	2,608
Deposits with credit institutions	–	1,236	–	1,236
Total financial instruments at fair value through income or expense	9,271	7,898	304	17,473
Derivative financial instruments	2	1,242	–	1,244
Total financial assets at fair value	9,273	9,140	304	18,717
Financial liabilities				
Investment contract liabilities:				
– Unit linked	–	360	–	360
Derivative financial instruments	1	1,167	–	1,168
Other financial liabilities:				
– Gilt repos	–	25	–	25
– Reinsurance liability	–	2,542	–	2,542
Total financial liabilities at fair value	1	4,094	–	4,095
2011				
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial assets				
Financial instruments at fair value through income or expense:				
Listed equities	4,583	–	–	4,583
Unlisted equities	283	431	285	999
Listed debt:	–	–	–	–
– Fixed rate	3,895	3,742	–	7,637
– Floating rate	70	64	–	134
Unlisted debt:	–	–	–	–
– Fixed rate	–	3	–	3
– Floating rate	–	2,550	–	2,550
Deposits with credit institutions	–	1,693	–	1,693
Total financial instruments at fair value through income or expense	8,831	8,483	285	17,599
Derivative financial instruments	1	1,491	–	1,492
Total financial assets at fair value	8,832	9,974	285	19,091
Financial liabilities				
Investment contract liabilities:				
– Unit linked	–	314	–	314
Derivative financial instruments	18	1,182	–	1,200
Other financial liabilities:				
– Gilt repos	–	755	–	755
– Reinsurance liability	–	2,469	–	2,469
Total financial liabilities at fair value	18	4,720	–	4,738

The assets held at the balance sheet date and categorised as Level 3, utilising 'valuation techniques using significant unobservable inputs', mainly comprise a number of small individual investments in close-ended private equity funds.

Only a small proportion of CISL's assets are valued at fair value using unobservable (Level 3) inputs. Typically these holdings are valued using valuations obtained from external parties which are reviewed internally to ensure that they are appropriate. The Banking Group has limited access to the key assumptions and data underlying these valuations and therefore no sensitivity analysis has been presented. Whilst the valuations would be sensitive to changes in assumption it is not considered that such changes would generate a material impact on the financial statements.

The table below shows a reconciliation between the opening balance and closing balance for the period for Level 3 financial instruments at fair value through income or expense:

Assets	2012 £m	2011 £m
Opening balance	285	233
Gains/(losses) in income or expense	(2)	30
Purchases	50	70
Settlements	(29)	(48)
Closing balance	304	285

Assets	2012 £m	2011 £m
Total (losses)/gains for the period included in income or expense for Level 3 assets held at the end of the reporting period	(1)	31

41. Capital resources

	2012 £m	2011 £m
Share capital	70	70
General reserve	200	200
Retained earnings and other reserves	4,220	4,751
	4,490	5,021
Perpetual non-cumulative preference share	60	60
Subordinated debt	1,112	1,084
Total capital resources	5,662	6,165

Capital management

The Group defines capital as its share capital, reserves and the financial liabilities in the Banking Group as stated below. The Group's policy is to maintain a strong base and to be more prudent than industry norms as it is not able to raise equity externally. The Group still recognises the need to maintain a balance between the potential higher returns that might be achieved with greater gearing and the advantages and security afforded by a sound capital position.

Due to the two very different natures of our businesses, the Group manages capital separately between the Trading Group and Banking Group.

The Trading Group is not regulated and manages capital to ensure an appropriate balance between investing in the future growth of the Group whilst making member payments to stakeholders. The Group annually assesses the affordability of proposed member payments against actual. During the period, the Group made member payments of £104m (2011: £142m) to its stakeholders, invested in future growth by implementing capital expenditure of £528m (2011: £594m). Total member funds were down by £531m (2011: up by £215m).

The Banking Group mainly comprises The Co-operative Bank plc, CIS General Insurance Limited and Co-operative Insurance Society Limited which are regulated entities. Their submissions to the FSA in the period have shown that these individually regulated operations have complied with all externally imposed solvency requirements throughout the period.

Retained earnings exclude cumulative gains on cashflow hedges of £63m (2011: gain of £72m) and cumulative gains on available for sale assets of £43m (2011: gain of £6m).

Capital resources include a general reserve of £200m which is currently held within Co-operative Insurance Society Limited outside the long term business fund. The reserve has been hypothecated to support the long term insurance business.

Notes to the financial statements continued

41. Capital resources continued

The following are also included in the calculation of total CBG capital resources:

- The Co-operative Bank plc preference shares which carry the right to a fixed non-cumulative preference dividend at a rate of 9.25%, payable 31 May and 30 November;
- subordinated debt which consists of three debt issues by The Co-operative Bank plc, £150m step-up callable subordinated notes 2019, £150m subordinated notes 2021 fixed rate until 2016, then moving to floating rate and £275m subordinated notes 2021 fixed rate until 2021;
- floating rate subordinated notes 2016 were issued on 18 May 2006 at a discount of 0.14%. The Bank may redeem all, but not less than all, of the notes at the principal amount on 18 May 2011, and on any quarterly interest payment date thereafter;
- fixed rate subordinated notes 2022 were issued on 19 December 2012, at par. The notes are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders will be subordinated in right of payment of the claims of depositors and other creditors of the Bank;
- fixed rate subordinated notes 2024 were issued on 17 March 2004 at a discount of 1.148%. The Bank may redeem all, but not less than all, of the notes at the principal amount on 2 December 2019, and on any quarterly interest payment date thereafter;
- fixed rate subordinated notes 2033 were issued on 28 March 2002, at a discount of 0.93%. The notes are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders will be subordinated in right of payment of the claims of depositors and other creditors of the Bank; and
- upon transfer of engagements, the Britannia permanent interest bearing shares (PIBS) were converted into perpetual subordinated debt of the Bank (Perpetual Subordinated Bonds).

From 1 August 2009, the Bank assumed a liability to each PIBS holder for a subordinated deposit equal to the principal amount of their PIBS. These deposits have automatically been applied in subscription to either perpetual subordinated bonds having an interest rate of 13% in respect of the 'first perpetual subordinated bonds' or perpetual subordinated bonds having an interest rate of 5.5555% in respect of the 'second perpetual subordinated bonds' for an amount corresponding to the principal amount of that holder's PIBS.

The right of repayment to the holders of subordinated debt are subordinated to the claims of depositors and other creditors of the Bank. Subordinated debt is stated at its regulatory value.

42. Reclaim Fund assets and liabilities

The Group is required to consolidate Reclaim Fund Limited ('RFL') as it is a 100% owned subsidiary of the Group. However the Fund is a not for profit organisation whose surplus is entirely for the benefit of Big Lottery Fund and the Group derives no financial benefit from RFL nor can it access RFL's reserves. For this reason RFL's balance sheet has not been consolidated on a line-by-line basis but instead is separately disclosed within the Group balance sheet. The analysis of Reclaim Fund assets and liabilities is set out below:

	2012 £m	2011 £m
Reclaim fund assets – cash	435	315
Provision for reclaims of dormant account balances	211	(146)
Provision for future distributions to Big Lottery Fund	150	(95)
Reclaim fund liabilities	361	(241)

Accounting policies

The calculation of the provision for future repayments of dormant account balances is inherently complex, with significant amounts of uncertainty. The Directors have applied a cautious level of stress within the calculation of the provision which they believe implicitly accounts for the long term nature of the provision.

The Group also records a provision for future distributions to the Big Lottery Fund. This represents amounts which the RFL intends to pay over to the Big Lottery Fund in future periods of which timing is uncertain. The Dormant Bank and Building Society Accounts Act (2008) dictates that the RFL is obliged to pay over the excess of dormant account monies received, after deduction of running costs to the Big Lottery Fund for ongoing distribution to the benefit of the community. Distributions to the Big Lottery Fund are recognised in the Income statement when a constructive or legal obligation exists for payment.

Analysis of profits from regional business activities (unaudited)

	2012		2011 (restated*)	
	Sales £m	Profit £m	Sales £m	Profit £m
Central and Eastern	1,250	85	1,284	80
North	1,607	91	1,618	102
North West and North Midlands	1,250	69	1,256	79
Scotland and Northern Ireland	1,151	90	1,125	92
South East	1,404	102	1,370	92
South and West	1,373	89	1,380	92
Wales/Cymru	573	43	588	46
Sales and contribution from regional business activities	8,608	569	8,621	583
Sales and profit from non-regional businesses and regional business overheads	1,798	(255)	2,233	(188)
Co-operative Banking Group	2,210	(253)	2,214	201
Discontinued items – Trading Group	(1)	(1)	(643)	(68)
Intercompany eliminations	(18)	(2)	(22)	(2)
Net revenue and underlying segment operating profit before significant items	12,597	58	12,403	526

* Profit in 2011 has been restated to reclass £48m of Group operating costs into sales and profit from non-regional businesses and overheads.

Regional businesses are The Co-operative Food, The Co-operative Funeralcare, The Co-operative Pharmacy and The Co-operative Motor Group. The regional profits represent store contribution and are before central administration costs, significant items, profits of associated undertakings and after central charges in respect of internal rents, which are designed to reflect the use of Trading Group property by the business at a commercial rate.



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!

Co-operative Group Limited

Registered under the Industrial and Provident Societies Act

Registered office: 1 Angel Square, Manchester M60 0AG

Registered number: 525R

www.co-operative.coop