The Co-operative Group
Building for the future

Annual Report & Accounts 2011

Building the right momentum

2011 has been a time of severe challenge for the UK economy. Customers and businesses alike have been assailed by rising costs, credit squeeze and uncertainty about the future to an extent unparalleled in recent times.

Against this background we have performed solidly, delivering profitability in line with expectations while maintaining our core capital and liquidity.

More importantly, we have been building for the future and investing in the services, systems and structure we need to deliver real value to our customers and members, while setting out to realise the true potential of our brand.

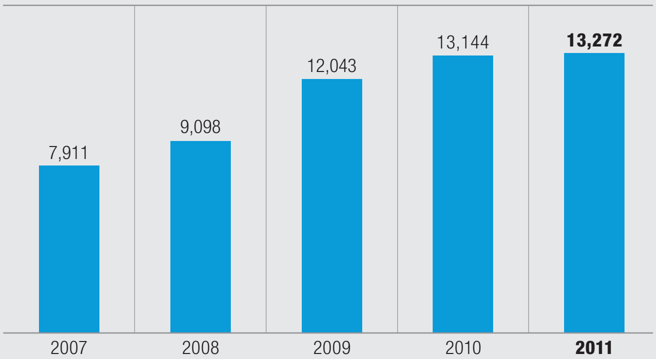
It is especially in hard times like these, that our customers and members look to us to hold firm in our commitment to bring both value and values to the market. Our investment in our vision and plans for long term growth mean that when better times come – and they will – we will have the foundations in place to build lasting success.

Headlines

Financial headlines

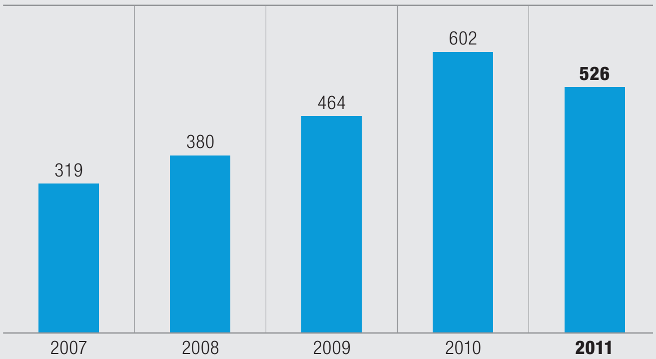
Gross sales	Operating profit before significant items	Underlying operating profit	Members funds (Total equity)	Amount paid to members
£13.3bn +1%	£585m +1%	£526m –13%	£5.0bn +4%	£142m +37%

Gross sales £m



As per note 2: Revenue

Underlying operating profit £m*



As per note 1: Operating segments

Operating headlines

Co-operative Food delivers resilient performance
Co-operative Food has now completed the integration of Somerfield and has weathered the worst of the enduring economic downturn. It is now well placed to move into a development phase spurred on by a focus on product innovation, major improvements to supply chain and a new customer-focused strategy.

Transformation of our Banking Group
Co-operative Banking Group continues to deliver stable operating profits while maintaining robust capital and liquidity levels. Meanwhile a major transformation programme is focused on delivering a truly integrated and customer-centred core banking operation.

Strong results from Specialist Businesses
Co-operative Specialist Businesses enjoyed good year on year growth, with a diversified portfolio offsetting pressure in specific sectors. In addition to profit growth, improvements in employee engagement and customer satisfaction to record levels, ensured a strong year across the entire balanced scorecard.

* Underlying operating profit measures the normal underlying business performance and removes from operating profit the following volatile or one-off costs: property disposal losses, investment property valuation fluctuations, significant items, fair value amortisation and Financial Services Compensation levy. It is shown in the operating segments note (note 1).

Who we are

The Co-operative Group is the UK's largest consumer co-operative, offering a wide range of services including food, financial services, pharmacy, funerals, legal services, life planning, motor vehicles and electrical goods. We also operate commercial activities in security and clothing and have established a joint venture with Thomas Cook, which constitutes the UK's largest travel agency. The Group generates an annual turnover of £13.3bn, employs more than 102,000 people and operates over 5,000 retail trading outlets serving more than 21 million customers per week.

Our purpose, vision and aims

Our purpose is:

To serve our members by carrying on business as a co-operative in accordance with co-operative values and principles.

Our vision is:

To build a better society by excelling in everything we do.

Our aims are:

– 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 ethical leader

– To be an exemplary employer

– To inspire others through co-operation

The Co-operative business model

As a co-operative, the Group is jointly owned by over 7.2 million individual members and in the region of 80 Independent Co-operative Societies. We are in business to serve them 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. Our pioneering involvement in Fairtrade and combating climate change reflects the values of our members and their desire to build a better future for themselves, their families, their communities and the wider world.

Individual members of the Group exercise democratic control by serving on its 48 area committees and seven Regional Boards, or by voting in elections, attending twice yearly members meetings held throughout the country or participating in other consultation initiatives.

Our profits are shared with each member, in proportion to how much they trade with us over the year. Our member democracy model offers individuals the opportunity to play a direct role in the future development of the Group. Members may stand for election to their area committees; area committee members in turn are elected to Regional Boards and ultimately to the Group Board.

How we are governed

The Co-operative Group is owned and democratically controlled by its members, who elect representatives to oversee the business. The Group Board is entirely non-executive, and consists of 20 directors, fifteen of whom are elected from our Regional Boards while the remaining five are elected from Independent Co-operative Societies. Each year one-third of Board members are required to seek re-election.

Three Subsidiary Boards are responsible for our major business units – Co-operative Food, The Co-operative Banking Group and Co-operative Specialist Businesses.

The Group Board is responsible for the long term success of the Group by:

- Ensuring that the Group's affairs are conducted and managed in accordance with its purpose and objectives, the best interests of the Group and those of its individual and Independent Society Members
- Determining the vision and strategy of the Group in consultation with the Group Chief Executive and the Executive
- Overseeing the Group Chief Executive and the Executive in the day to day management of the Group
- Monitoring performance against key financial and non-financial indicators
- Overseeing the Group's risk management systems
- Setting standards in governance matters

The Group Chair, Len Wardle, is elected from the Group Board and is a non-executive director of the business. He leads the Board in determining strategy and objectives.

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 implements the agreed strategic objectives and is accountable to the Board for the financial and operational performance of the Group. With effect from 1 January 2011 the Group Chief Executive has led a unified Group Executive.

More details on our governance model are contained in the corporate governance section of the directors' report.

What we do

Food

We are the UK's leading community food retailer, selling food and family consumables UK-wide through 2,801 local, small and medium stores

Key facts

- 5th largest food retailer in the UK
- 2,801 stores – one in every UK postal area
- 14.5m customers served per week
- 60% of UK customers shop at a Co-operative Food store over the year
- Market-leading policies in place to promote animal welfare and healthy eating

Headlines 2011

- Invested heavily in reorganisation of supply network for smarter, quicker service
- Product innovation and marketing focus stress value
- Ethical leadership shown in promoting healthy eating and animal welfare through own-brand product lines

See page 10

Banking Group

We are Europe's most sustainable financial services provider, 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

Key facts

- UK's most diversified mutual
- Includes The Co-operative Bank, Insurance, Investments, Asset Management and internet bank **smile**
- Vision to become the compelling co-operative alternative
- Ethical lending and investment principles agreed with customers and members

Headlines 2011

- Transformation programme improving customer experience and access to full product range
- Life and savings review concluded as Banking Group focuses firmly on core banking proposition

See page 11

Specialist businesses

Offers a range of consumer and B2B services, operating where appropriate through both physical and online channels. Also explores market opportunities via other Co-operative Group businesses and through joint venture where appropriate

Pharmacy

Community pharmacy business, operating nationwide through over 750 community pharmacies. Now operating online and as the UK's second largest outpatient dispensing service provider

Key facts

- 3rd largest pharmacy chain in the UK, and the largest in Wales
- New channels opened up via e-Pharmacy and outpatient dispensing contracts

Funeralcare

The UK's leading funeral director carrying out over 100,000 funerals each year

Key facts

- Operates over 850 funeral homes as well as four crematoria and two woodland burial grounds
- Conducts 18% of all funerals in UK

Legal services

The Co-operative Legal Services is at the forefront of regulatory changes, enabling a wide range of consumer-friendly legal services to be offered, with the aim of becoming the preferred provider of consumer legal services in the UK

Life planning

Our Life Planning Business is responsible for the Group's Funeral Planning Business (Development, Distribution and Investment) and in addition incorporates the Group's Will Writing Services to enhance the customer proposition

Sunwin Services Group

A support services business, offering managed security, IT services, cash management, and fire and security solutions

Motor

One of the top 50 car dealers in the UK, with over 23 sites across the Midlands and the North of England

E-Store

Online electrical store, focusing on good customer communications and excellent user experience. New website in place

Corporate Clothing

Designs, manufactures and distributes business wear and uniforms, focusing on quality, style and choice

See page 12

Estates

Plays dual role as property investor and provider of UK-wide property services to The Co-operative Group. Focused on maximising value from property portfolio through effective investment and disposal of non-core properties

Key facts

- Over 10,000 properties under management across the UK
- One of the largest and most diverse land and property operations in the UK

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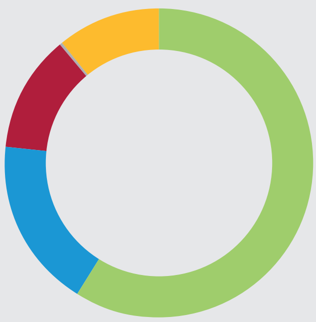
Contribution to Group revenue

Food	59.1%	£7,348m
Banking Group	17.8%	£2,214m
Specialist Businesses	12.2%	£1,518m
Estates	0.3%	£36m
Federal	10.6%	£1,314m



Chair's overview

"It is due to our customer-focused approach to doing business that in 2011, in spite of the economic downturn, we were able to press ahead with our business strategy to unify our corporate structures, pursue growth opportunities, increase our membership and revitalise our social responsibility agenda."
Len Wardle

Over the last 12 months we have seen growing discontent across the world, with the economic and political structures that govern our lives. From the Arab Spring to the 'Occupy' movement to the demonstrations against cuts in public spending, people are frustrated with political and economic systems that benefit the few and impoverish the many. In the UK we are hearing calls for more ethical and responsible forms of capitalism to halt the growing loss of trust in all aspects of public life.

After many years in which ruthless competition, unbridled markets and the primacy of the individual have dominated the political landscape, we are now witnessing the rediscovery of social and community values. Co-operation, as an economic model, is being held up as one possible response to the current crisis.

However, we have some way to go before there is a real understanding among politicians and the general public about what the consumer co-operative business model actually means. It is neither capitalism (good or bad) nor state centralised planning (left or right). The consumer co-operative is instead a compelling alternative to both.

A customer-centred approach to our business
The Co-operative Group is different because it is structured to put the interests of customers at the heart of its business strategy. It is our members, rather than shareholders, who own the business and maintain its governance; this is what puts the needs and priorities of our customers at the very centre of our thinking. It's what enables us to make decisions for the long term rather than be blown off course by the need to satisfy jittery, short term, stock-market investors or those seeking to make a quick profit from exploiting others. It is due to this customer-focused approach to doing business that in 2011, in spite of the economic downturn, we were able to press ahead with our business strategy to unify our corporate structures, pursue growth opportunities, increase our membership and revitalise our social responsibility agenda.

Maintaining competitive performance in challenging conditions
The current economic conditions mean that in 2011 we did not quite match the exceptional performance we achieved in 2010. This was neither unexpected nor limited to ourselves, and our immediate priority has been to remain competitive in all of our markets. Our profits are still solid this year but we have taken prudent action to reduce costs where possible. We have also invested in promotions and deals that recognise the difficulties our members and customers are facing.

Meanwhile, we remain committed to growing our business to secure its long term sustainability. We continue to look for the right opportunities for mergers and acquisitions as well as the best way to achieve more organic growth. Our negotiations with Lloyds Banking Group demonstrate both our ambition and the care we take to ensure we act at all times in the best interests of our members.

We remain highly ambitious for the future of The Co-operative Group; this has led us to undertake significant research into our members and customers during 2011. Our aim is to understand more clearly what attracts them to us and how we should develop our Co-operative brand and membership proposition in the future. This research, the biggest of its kind in the UK last year, was undertaken as part of our Unity programme which is bringing the whole of the Group closer together through re-organising management structures and operations and changing the way we present ourselves to the public. The research findings will greatly inform our thinking during 2012 and allow us to develop the next phase of Unity, reflecting The Co-operative's determination to act as one business and put our customers at the heart of everything we do.

Driven by our co-operative ideals

Despite the profound economic downturn we are living through – indeed, spurred on by its severity – we have stayed true to our co-operative ideals. Rather than play down our social responsibility agenda we have recognised the need to promote it even more strongly. In 2011 we launched Project Revolution, reminding people of our radical heritage and our commitment to responsible retailing and commercial integrity.

Behind the media campaign was our new three year ethical plan which is closely linked to our business planning cycle. The plan has reinforced the Group's position as the most socially responsible business in the UK. Our practical and tangible commitments to local communities, tackling poverty, responding to climate change and promoting co-operation mark us out as leaders in this field. In February 2012 we announced the next set of targets for this vital area of our work.

2012 – The International Year of Co-operatives

In 2012 we have a unique opportunity to explain our business model and its associated values of honesty, openness, fairness, social responsibility and caring for others. The United Nations has designated 2012 as the International Year of Co-operatives and The Co-operative Group is playing a major role in promoting co-operation both in the UK and around the world. Over the next 12 months we are increasing our commitment to the local communities in which we trade, while supporting co-operative enterprise both in the UK and globally with financial help and strategic advice. In November in Manchester we will host one of the biggest gatherings of the worldwide Co-operative Movement ever to take place. It will be a chance to showcase to the world both our own achievements as the UK's biggest consumer co-operative, and the benefits that co-operation can bring to individuals, families and communities across the globe.

Building for the future

As this report demonstrates, we continue to build for the future, creating a co-operative business that is leading the way in bringing trust and honesty to the market place and re-establishing public confidence in the integrity of commerce. Co-operation is an idea whose time has most definitely come.

This success has not been by chance and I want to take this opportunity to express my appreciation to my fellow directors, including Nigel Keane who retired in May and Richard Samson who retired in September, and all our elected members, for the role they have played. I also offer my thanks to Peter Marks, our Group Chief Executive, and his management team for their hard work and dedication in a difficult economic climate.

Len Wardle

Len Wardle, Chair
The Co-operative Group

Group Chief Executive's overview

"We will not allow the current economic downturn to knock us off the course we have set. We have the resources, the resolve and above all, the ability and belief to make our vision a reality."
Peter Marks

When I announced The Co-operative Group's annual results in March 2011, I noted that the retail business – and indeed the UK economy – was going through the toughest time I had seen in more than 40 years. So it is with some pride that I am able to reflect on a year of solid performance and respectable profitability. Even though the scale of our success does not quite match that of 2010, the five-year trend is still firmly upward.

Investing in the future

It is in times such as these that a business shows its true colours; we have revealed ours by building for the future, with nearly £600m in capital investments across the Trading Group and Banking Group. We set ourselves on this course in 2007 when we recognised the importance of scale, centralisation and a revitalised brand for our long term future. We will not allow the current economic downturn to knock us off the course we have set. We have the resources, the resolve and above all, the ability and belief to make our vision a reality.

Of course, pursuing our long term vision does not mean ignoring the immediate impact of the downturn, particularly on families and communities across the UK. We have invested significantly in discounts and special offers; although these may have impacted on our short term profits, our first duty in times of income and job insecurity is to help our customers make it through. In the long term, success is built on relationships and the loyalty of customers who remember that we ourselves remained loyal to them when times were tough.

Solid and creditable performance

Within this context of short term pressures and long term investment, the Co-operative family of businesses has delivered solid and creditable results.

Our Food business has weathered some of the worst market conditions in recent years while completing the largest integration programme in UK food retail history. Underlying profits are £309.4m, 20% down on 2010 but once again the five-year trend remains firmly upward. We have invested significantly in both product innovation and supply chain infrastructure; while the increased scale afforded by the acquisitions of recent years allow us to reduce prices for members and improve our competitiveness. We are in a strong position to both maintain the progress of recent years and build future success.

Our Banking Group has delivered a solid performance for the year, with an operating result (excluding discontinued operations) of £200.9m, in line with last year. The retail sector in particular posted a 78% improvement in operating results over 2010. Corporate and business banking continues to reflect the challenges of the corporate lending market with impairments significantly higher than 2010, but corporate asset growth and improved arrears management offer significant opportunities for the coming year. Capital and liquidity remain strong, backed by a healthy and improving loans to deposits ratio.

Our Specialist Businesses, delivering a diverse range of services from pharmacy to funerals, has delivered very positive results, with profits increasing over 10% to £99.4m.

Our Pharmacy business was significantly impacted at the start of the year by reductions in Government funding, but has recovered to post a healthy operating profit of £29.7m. A new e-pharmacy channel has been launched, as well as a ground-breaking outpatient dispensing contract with Doncaster and Bassetlaw NHS Trust.

£585m
Operating profit before significant items (+0.5%)

£13.3bn
Gross sales (+1.0%)

£13.6m
Amount invested in communities and abroad during 2011

7.2m
Members (as at 1/1/12; +24%)

3,376m
Member points earned (–1.7%)

Platinum+
Highest ranking retailer or financial services business in the BitC Corporate Responsibility Index

Our Funeralcare business posted profits of £53.6m, thanks in part to the successful sales of Funeral Plans through funeral homes. Funeralcare has invested in infrastructure improvements and expansion of our crematorium estate, while pioneering a more ecological alternative with resomation, on which we hold the worldwide patent.

Meanwhile, our Life Planning and Legal Services businesses have come together to lay the groundwork for significant growth. The Group is awaiting the outcome of its application to become one of the first Alternative Business Structure (ABS) organisations to be appointed by the Solicitors Regulation Authority, and we aim to establish ourselves as the consumer lawyer of choice. We have also piloted the provision of legal services through the Co-operative Bank branch network, an excellent example of the kind of cross-sales potential within the Group, and a precursor to the kind of integrated service proposition that the Unity programme is designed to foster.

Our Motors business has increased sales to £277m as well as being recognised by Land Rover as UK dealer of the year. Our E-store and Clothing businesses have both performed well in difficult market conditions; the E-store business outperformed the sector leaders for internet sales, while Clothing increased its profits by 113%. Our business-to-business provider Sunwin Services Group also increased its profits by 12%, even as companies cut back on security and office services.

A strategy for long term growth

Measured growth has been a keynote of our strategy since 2007; the Somerfield acquisition in particular was a step-change for our Food business, increasing its scale and reach to allow the business to compete effectively with the market leaders. As I write we are completing the acquisition of David Sands Ltd, with 28 stores, a depot and back office support in Fife, Kinross and Perthshire. This strengthens our position as the fourth biggest food retailer in Scotland, and is a key step in our plan to open 300 new food stores across the UK in the next three years.

We are now looking to bring about a similar step-change for the Banking Group. We are currently in exclusive negotiations with Lloyds Banking Group to possibly take over more than 630 Lloyds TSB branches. This acquisition, if it comes off, would grow our banking business to nearly 1,000 branches, transforming the bank into the sixth largest in the UK.

With or without the Lloyds branches however (and any agreement will depend first and foremost on safeguarding the interests of our members and customers), we are determined to grow our banking business. Already recognised as the most ethical and responsible provider on the UK high street, the 'compelling co-operative alternative' is beginning to prove increasingly attractive to customers and investors alike. The Group is investing significantly in building the systems we need to deliver a superlative customer service and enable us to offer a competitive alternative to the 'Big Five'. This is a ground-breaking initiative, the first of its kind in the UK; in terms of size and complexity it presents an unprecedented challenge but successful delivery will facilitate future growth, whether organic or by acquisition.

A unified business model

The Group's most far-reaching strategic initiative of 2011 however, is the Unity programme. Our diversified business mix is a source of strength in times such as these, offering not only significant cost synergies but the opportunity to develop cross-business relationships with our customers. However, to realise our true potential as a consumer co-operative we need to evolve. Bringing our retail and financial services divisions together will not only deliver a range of strategic and tactical benefits, but will enable us to offer members and customers a truly unified and consistent service proposition.

Unity will also 'go public' in the coming months with a unified marketing approach, supporting the next phase of our ongoing brand rejuvenation.

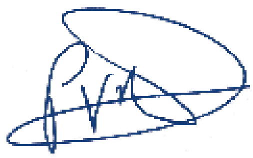
The most concrete expression of our integrated future is the new Group head office, which will be ready for occupation later this year. Built to complement the environment and the local community, our new headquarters is more than just a building; it is a demonstration of our faith in the future and our deep-rooted commitment to a sustainable future.

Looking ahead

2012 will be a historical year for the UK, as we look forward to the Queen's Diamond Jubilee and the London Olympics. It is to be hoped that events like these and Euro 2012 will lift the national mood and provide a spur to consumer confidence. All we need is a good summer!

This is also the International Year of the Co-operative, an opportunity to showcase the key contribution the Co-operative Movement has made to building a better future. It is a matter of pride to me to be a part of that story, and I believe that despite the ongoing challenges of a fragile economy it is within our power to deliver a better future for our members, our customers and our communities. It was out of adversity that the Rochdale Pioneers emerged to change the face of business; and it is my belief that we too, can drive real change.

While the challenges of today's market need to be addressed, at The Co-operative Group we are focused primarily on building for the future. The hardships of the last couple of years have made it clear that UK customers want, and deserve, better. They deserve better service, better choice, a better life for their communities. At The Co-operative Group, that is the future we were created to deliver.



Peter Marks, Group Chief Executive

Key Performance Indicators

As a co-operative business we do not measure our success purely in financial terms, but across a broad range of factors, both at Group level and within each business.

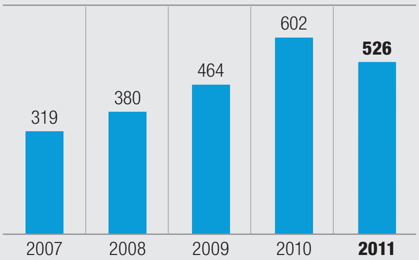
These fall under the following broad categories:

- Financial
- People
- Customer
- Membership
- Social responsibility

Individual businesses across the Group use slightly different measures to match their particular needs, but there is a high degree of consistency at the top level and our co-operative values and principles run through them.

Financial

Underlying Group profit



Why it's important

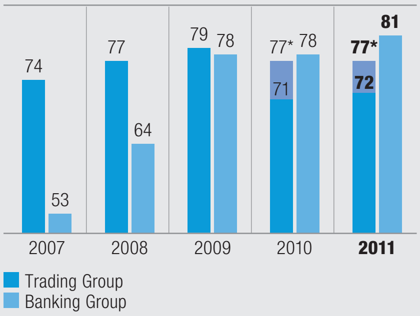
As a co-operative business we operate for the benefit of our members, with whom our profits are shared. The ability to fulfil our social responsibilities depends on commercial success and sustainability. Our key financial aims are to grow profitably, measured in terms of underlying operating profit,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

How we performed

The Group's underlying operating profit for 2011 was £526m, a decrease of £76m on 2010. Although down on 2010's record performance it is notable that 2011's result was better than 2009 and the five-year trend is extremely positive. This, in the midst of the longest and deepest economic downturn in living memory. Similarly, although Trading Group ROCE of 10.5% was down on 2010, it was up on the 2009 result of 9.6%. For The Co-operative Bank, the key liquidity measure is the loans to deposits ratio, which improved to 94% (2010 103%), while core tier 1 capital was maintained at 9.6%. Further information on financial performance can be found in the Financial Review on page 16.

People

Employee engagement



* 2011 Talkback measures are on a different, more demanding, basis than prior years. The asterisk scores are the historical comparatives. From 2012 engagement will only be measured on the new, more challenging basis.

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 engagement.

How we performed

Over the last five years the Group's regular Talkback survey has indicated consistently high and improving 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, Group employee engagement scores remained stable with a very encouraging improvement of one point on the new basis to 72 points.

The Banking Group has traditionally run its own survey, which also indicates high and improving engagement levels (currently 81%).

The method of calculating employee engagement scores differs between Trading Group and Banking Group and therefore are not comparable to one another. As the Group continues to work together ever more under Project Unity the Talkback survey will be extended to cover colleagues across the whole Group.

Customer

Why it's important

Customers are key stakeholders of The Co-operative; one of our strategic aims is 'to meet the needs of customers and the community'.

Performance in customer satisfaction is measured through customer surveys. The Co-operative Food, Pharmacy and Funeralcare each carry out regular customer satisfaction surveys, while The Co-operative 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

The Co-operative Food
A Customer Satisfaction Index (CSI) of 79.1% was achieved, exceeding the 2011 target of 78.3%.

The Co-operative Pharmacy
A CSI of 91.7% was achieved, exceeding the 2011 threshold target of 90%.

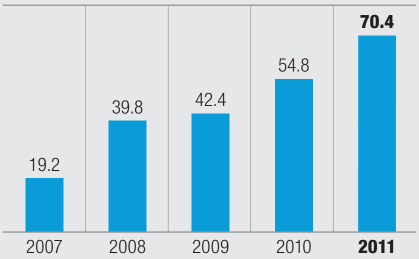
The Co-operative Funeralcare
Satisfaction results remained extremely high with 98% of customers saying they were satisfied with the overall experience. Customer service questionnaires are also used to calculate a Funeralcare Excellence Score (FES). The 2011 FES score was 92.4, up significantly from 2010 and exceeding the threshold target of 90.

The Co-operative Banking Group
The Co-operative Banking Group customer advocacy measure exceeded its 2011 target in relation to the 'top five' peer group average, averaging 10.3% points above the group across the year.

Membership

Membership engagement

Total customer dividend paid to members during the year* (£m)



	2007 (m)	2008 (m)	2009 (m)	2010 (m)	**2011 (m)**
Total members	2.7	3.4	5.1	5.8	**7.2**
Members who cross trade	0.2	0.4	0.8	1.3	**1.4**

Why it's important

Membership engagement lies at the heart of our business. We are owned by our members, we manage our business for their benefit and share the profits with them. 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 Co-operative business
- Total customer dividend paid to members

How we performed

In 2011 we had 7.2 million members, up 24% on last year and we returned record dividends to those members of over £70m. An increasing number of our members are cross-trading across our businesses and as part of Project Unity we will offer even more opportunity for this to increase.

* Because member payments are approved by members at the Annual General Meeting ('AGM'), the dividend paid to members in 2011 is based on 2010 trade with the Group and 2010 Group profitability.

Social responsibility

Corporate Responsibility Index

	2011	2010	2009
CR Index score	**98%**	96%	96%
CR Index rank	**Platinum Plus**	Platinum Plus	Platinum

Why it's important

The Co-operative movement was founded to serve a social purpose, rather than a purely commercial one. We exist not just to serve our communities but to contribute to their long term good health. Social responsibility is in our DNA.

As an ethical leader we benchmark ourselves against the Corporate Responsibility Index (CRI) operated by Business in the Community (BitC). This, the foremost UK corporate responsibility standard, assesses management practice in a range of environmental and social impact areas, including four key themes:

- Community
- Environment
- Marketplace
- Workplace

How we performed

In 2011 The Co-operative Group retained its 'Platinum Plus' status, a classification introduced in 2010 and achieved by only ten businesses to date. The Platinum Plus award reflects a score of 98% derived from weighted scores achieved across five strategic areas.

Introduction
Business review
Governance
Financials

Performance review

Food

Food performance	2011 £m	+/– change
Net revenue	7,348	–2.7%
Underlying operating profit	309.4	–20.4%
Key facts		
Stores		2,801
Customers served		14.5m per week
Employees		75,000

Market overview

2011 has been a challenging year for the food retail market, primarily because it has been a very difficult year for customers. With increased economic uncertainty and challenges for the UK customer, food volumes have decreased for the first time in many years.

Given these external challenges, results for The Co-operative Food have been in line with expectations. Operating profits before significant items are down 20.4% from £388.6m in 2010 to £309.4m in 2011. Sales are down 2% on a like-for-like basis, while inflationary increases added £63m to the business' cost base.

Business strategy overview

With the economic uncertainty set to continue, the outlook for 2012 looks set to be as challenging as 2011. However the predicted growth in both the convenience and small supermarket channels is forecasted to be above overall food sector growth in the next five years. The Co-operative Food's 2,801-strong store estate (4,000 including CRTG), serves 14.5 million customers every week; statistics show that 60% of the population shops in a Co-operative in a year. The business is therefore ideally placed to play a key role in an emerging market sector.

To fulfil its potential, The Co-operative Food has set out to ensure its stores are 'right for the customer', with new products developed to meet changing customer needs. The business has also invested in remodeling its supply chain to ensure customers consistent access to their most popular lines. Meanwhile the business is taking a lead, via its ethical strategy, on key social issues such as healthy eating and animal welfare.

Performance review

A priority for the Food business has been to gain a deeper understanding of its customers in order to anticipate and satisfy their needs. Customer research has indicated some scope for improvement in product availability, range, and value. Improvements are already starting to be delivered via change programmes such as SMART (Store Merchandising and Replenishment Transformation), product innovation and investment in reducing prices and a new 'fewer, deeper, stronger' promotional package. The successful relaunch of the premium Truly Irresistible range in 2011 and the continued growth of our Eat In range, added to the high demand for our Christmas range, demonstrate that there is a strong customer demand for the Co-operative own brand.

As value becomes more important for customers in their decision of where to shop we have introduced more competitive pricing on the most popular lines for Co-operative customers, and improved promotional packages. The own label development plan for 2012 introduced ranges to help to address customers' value concerns. Meanwhile TV advertising and new point-of-sale packages have been designed to 'shout value'.

Customer convenience is also a priority. Contactless payment is being trialled in four Manchester city centre stores. An additional 50 sites within the M25 area will be upgraded with contactless-enabled chip and pin terminals after Easter 2012, while a further 125 stores within the M25 will join the trial from early May. The significance of locating most of the trial sites in the M25 area is that they will all be online for contactless payment ahead of the London Olympic Games, where this point-of-sale technology is expected to be promoted and used prominently. A decision will be made by the end of 2012, on whether to roll-out contactless payment to all food stores.

Customer convenience is also at the heart of The Co-operative Food's ongoing acquisition programme. 32 new stores were opened in 2011, including 12 stores opening in 12 days during December. The focus for this latest programme of acquisitions has been to secure city centre locations. New stores were opened in Edinburgh and London, where the high-profile Strand store opened in February 2011.

Sitting behind the expanding store network, and playing a key role in delivering market-leading customer service, is a revitalised support and supply network. Significant progress has been made in 2011 as the store replenishment strategy was overhauled. New distribution centres have been opened at Newhouse and Andover; a third at Avonmouth is due to open later this year and Castlewood will open in early 2013.

Delivery frequencies to many stores have been increased and new depot delivery schedules are being introduced. The roll-out of InStock (an element of the SMART system) is on track with 1,400 stores online by November 2011 and full roll-out due to be completed by the end of March 2012. This system automatically locks down both range and orders for each store, improving availability and freeing up store teams to focus on customer service.

The Co-operative Farms business is now more closely integrated with Food and has performed well over the year, partly due to increases in cereal prices but also due to extensive efficiencies at pack houses supported by good buying practices. Going forward, we aim to continue our support for British farmers as well as our Co-operative farmers who work hard to produce our own-grown British produce such as potatoes and apples. A new tenancy (including a pack house) in Kent and one in Herefordshire form a key part of this strategy.

A partnership has also been established with Wiseman Dairies, part of Muller, to launch a dedicated supply chain, and has already been recognised with a Good Dairy award. Under this partnership agreement, contracted British farmers will supply to Wiseman, the equivalent volume of fresh milk required to supply all Co-operative brand fresh milk annually.

Underpinning all of this is the continuing engagement and commitment to the customer, shown by store colleagues throughout a difficult year. Delivering real value and top-class customer service demands personal commitment from every member of the store team. Despite the challenges of the past year colleague engagement scores have increased to 72.

Colleagues have also been demonstrating their commitment to the community as a whole. The Co-operative Food raised over £5.3m for Mencap; one team of 22 colleagues from the North West Operations team raised £10,000 from family, friends and workmates to climb England's highest mountain, Scafell Pike.

The commitment of colleagues throughout the business to delivering real benefits to their communities, was recognised when The Co-operative Food was named Responsible Retailer of the Year at the Oracle Retail Week Awards for the fourth year running, while being named Green Retailer of the Year at The Grocer Awards for the second year in succession.

The business' products and services were also recognised this year, with the new 'Big Deals' value campaign, launched in January 2012 receiving industry praise by Retail Week magazine.

Outlook

In the coming year The Co-operative Food will continue to focus on creating a dynamic culture of passion, drive and energy across the Food business in all of our stores, depots and support centres.

The food retail market is going through an unusually tough phase; however, building on the opportunities available and the time and resources invested in capitalising on these opportunities, The Co-operative Food aims to deliver service, value and convenience to customers across the country. In doing so, the business is well placed to navigate its way through these difficult times and consolidate its position as the UK's favourite community retailer – locally reliable and locally relevant.

The Co-operative Banking Group

The Co-operative Banking Group performance	2011	+/– change
Operating result (including discontinued operations)	£216.1m	+3.1%
Operating result (excluding discontinued operations)	£200.9m	–0.5%
Core tier 1 capital ratio	9.6%	Unchanged
Bank loans to deposit ratio	94%	Improved 9%
Key facts		**No.**
Branches (excluding an additional three in the Isle of Man)		342
Employees		10,545

Market overview

2011 has been a difficult year for the financial sector. Constrained capital markets, squeezed margins and a lack of customer confidence have impacted heavily, while the eurozone crisis continues to inhibit growth. Meanwhile the long term outlook remains unclear.

Business strategy overview

The aim of The Co-operative Banking Group is to deliver the 'compelling co-operative alternative'. To achieve this we have focused on restructuring our business round its core banking proposition, upgrading core banking systems and extending key services to all customers, while maximising opportunities for growth. Care is taken to balance the demands of capital, liquidity and profit.

Performance review

The continued resilience of the Banking Group is a positive endorsement for the co-operative model. The 2011 operating result of £216.1m (2010: £209.7m) reflected a strong performance in the Retail sector, partly offset by a difficult year for the Corporate sector.

The income statement benefited from gains on the sale of Treasury assets of £37.2m (2010: £11.4m) as part of our liquidity management strategy, and a £20m reduction in total credit risk expected over the life of the Optimum mortgage book (2010: £15m). These helped offset the cost of funding increased liquidity, as we prudently enhanced this core element of our financial strength.

Excluding discontinued operations, the operating result was £200.9m, 0.5% lower than 2010 (2010: £202.0m). Operating profit of £90.5m (2010: £105.5m) was adversely impacted by a £90.0m provision for payment protection insurance (PPI) mis-selling (2010: £4.3m). Our liquidity and capital position remains sound, with an improved Co-operative Bank loans to deposit ratio of 93.9%, and a Bank core tier 1 ratio of 9.6%.

As a member-owned financial institution, customers trust the Banking Group to put them at the heart of its business. Levels of advocacy for the Banking Group in 2011 were 10.3 percentage points above the average of its top five competitors. Colleague engagement has also increased during 2011, reaching 81%, compared with 78% in November 2010. Meanwhile the Banking Group was named 'Europe's most sustainable bank' for the second successive year.

During 2011 the Banking Group introduced current account servicing into the Britannia branches, creating 245 more places to bank. To date, some 62,000 current accounts have been opened via these branches (nearly 45,000 during 2011). We have also continued to attract customers switching their current account; during 2011, 10.8% more customers made The Co-operative Bank their main bank.

Meanwhile the Banking Group is transforming its business infrastructure. Improvements have been made to core banking systems, including a new Financial Crime Management system, an upgrade to the banking mainframe system, the re-platforming of the telephony system and new credit card issuing and management systems. The first phase of its new payments hub, covering BACS payments, was implemented in November; the second phase covering card payments will be rolled out in 2012.

Transformation extends beyond the systems infrastructure. An innovative young driver insurance policy was launched in 2011, incorporating 'smartbox' pay as you drive technology, while an in-store banking programme was piloted in a number of The Co-operative Group's food stores.

We have been granted preferred bidder status by Lloyds Banking Group for the sale of 632 Lloyds TSB branches. This is a significant opportunity; a combination of these branches and our own branch network would significantly strengthen our ambition as a real challenger in relationship banking in the UK. Our current bid is non-binding and we would only proceed if we could reach an agreement that was in the interests of our members and other stakeholders. Any transaction would be subject to regulatory approval.

Performance review continued

Performance overview – Retail and Corporate and Business Banking
The Co-operative Banking Group consists of two primary operating segments – Retail, and Corporate and Business Banking (CABB). The Retail business offers a range of banking and general insurance products and services to individuals and households throughout the UK. CABB includes corporate banking, business banking, business services, Platform (intermediary mortgage business) and Optimum (closed book of pre-merger intermediary and acquired loan book assets).

The Retail operating result (excluding discontinued operations) for 2011 was £138.3m, 77.8% up on 2010, with strong mortgage margins maintained and impairment levels significantly below 2010. The average loan to value ratio remained below 50%, in line with 2010. The General Insurance business has also had a successful year, delivering growth in profits of 42.0%, before significant items and distributions.

The Retail customer proposition continues to attract industry recognition, winning Moneysupermarket's 'Best Current Account Provider 2011' and Moneyfacts 'Best Longer Term Fixed Rate Mortgage Product' awards. The business was again shortlisted for 'Best Financial Services Provider' at the 2011 Which? Awards.

During 2011, the Banking Group concluded the strategic review of its Life and Savings Business. Following this review, the Field Sales channel has been closed, while the business is in exclusive discussions with north west based mutual Royal London, regarding the sale of CIS, and tCAM, its asset management company. The Banking Group has also enhanced its bancassurance relationship with AXA Wealth Ltd, to ensure customers have continuing access to expert financial advice across its branch network.

The CABB operating result for 2011 was £14.5m (2010: £54.7m). Corporate banking has delivered an operating loss of £36.4m in 2011 (2010: profit of £2.5m), reflecting a rise in impairment losses during another difficult year for the industry. In 2011 the Optimum portfolio, a closed book of intermediary and acquired mortgage book assets, reduced in size, as planned, by 5.5% to £7.7bn, and delivered a profit of £52.7m (2010: £61.2m).

The Reclaim Fund Ltd (RFL), a wholly owned subsidiary of The Co-operative Banking Group, commenced trading during 2011 following authorisation from the FSA to collect dormant customer account funds from UK financial institutions, retaining sufficient funds for future reclaims by customers and distributing surplus funds to good causes via the Big Lottery Fund. During 2011, RFL collected £369m of dormant savings account balances; provisions of £147m have been made for possible reclaim by customers, and a £143m provision made for the future payment of funds to the Big Lottery Fund. In line with previous expectations, £48m was distributed during 2011, while £74m of surplus funds has been retained to establish the necessary capital base. The Fund is a not-for-profit organisation whose surplus is entirely for the benefit of the Big Lottery Fund; the Group derives no financial benefit and is unable to access RFL's reserves. For this reason the £74m surplus has been included in significant items.

Outlook
The outlook for the financial services industry remains difficult, and latest indications point to ongoing challenges, particularly in the Corporate sector. Increasing regulatory requirements will also continue to weigh heavily on earnings. However, our focus remains on ensuring our continued financial resilience, enabling us to look forward with confidence to the future.

Specialist businesses

	Net revenue		Operating profit	
	2011 £m	+/– change	2011 £m	+/– change
Pharmacy	754	(2.3)%	29.7	(11.2)%
Funeralcare	328	5.0%	53.6	20.4%
Legal Services	29	21.0%	4.5	15.5%
Life Planning	11	12.7%	(1.7)	42.0%
Sunwin Services Group	31	6.3%	6.3	12.0%
Motors	277	3.9%	3.2	8.4%
E-store	82	(6.6)%	1.6	(25.1)%
Clothing	6	23.2%	1.0	112.7%
Other central items	–	–	1.2	–
Total	**1,518**	**0.8%**	**99.4**	**10.4%**

Despite the economic downturn which has impacted nearly every business sector, the Group's portfolio of specialist businesses has performed well with profits up 10.4% from £90.1m to £99.4m.

In addition to a strong financial performance, customer satisfaction also improved year on year to record levels, with particularly high scores of 91.7% and 98% being recorded in Pharmacy and Funerals respectively.

Employee engagement also improved significantly, being up four points from 70 to 74. This represents the highest score for a business area in the Group's Talkback Survey, with improvements experienced in nearly all of our separate businesses.

The Specialist Businesses strategy is to drive forward each of our core businesses ensuring they deliver great service and value to our members and customers. Key to this is anticipating and responding to member and customer needs, innovating and investing in new technologies and routes to market as appropriate and looking to leverage benefits from working more closely together as part of the Co-operative family of businesses.

Pharmacy

Key facts	
Branches	776
Customers	202,000 per week
Employees	6,797

In 2011 the UK pharmacy industry saw a further significant reduction in government funding. By the end of 2011 this reduction had cost The Co-operative Pharmacy business some £18m. In this context, results have held up well. Operating profits before significant items have decreased 11.2% from £33.4m to £29.7m.

The Co-operative Pharmacy's strategy is to address the new market realities by improving the sustainability of its business model. Unnecessary cost and wastage have been reduced and margins on products and services improved. A new sales and stock tracking system was introduced in 2010, and has helped deliver outstanding cost savings over the last year.

Cost however, has not been the only focus for the business. A fundamental review of in-store processes was undertaken to ensure a relentless focus on customer service, and a number of non-customer centred processes have been taken out of our day to day branch operations. This has enabled us to reduce customer waiting times and drive like-for-like prescriptions dispensed to market leading increases in the last quarter.

Six new branches opened in communities without a local service, furthering business reach and sales potential while underpinning social inclusion. Meanwhile, a new e-Pharmacy channel offers customers greater choice of access, freeing them from reliance on a local branch.

This determination to build our Pharmacy business around customers and communities has seen full year like-for-like sales volumes increase by 1.5%, or roughly 1m prescriptions, which compares favourably with our closest competitors.

A 'new-look' pharmacy was also trialled in eight stores, featuring new products, new consumer messaging and new decor. The pilot produced highly encouraging results. The Pharmacy business intends to build on this encouraging start over the coming year by overhauling its 'over the counter' product range, which currently constitutes some 8% of volume business.

Other important avenues for growth include the emerging market for outpatient dispensing contracts, offering hospital trusts a more customer-friendly alternative to expensive in-house operations. The Co-operative Pharmacy secured its first outpatient dispensing contract this year, with Doncaster & Bassetlaw NHS Trust. This was supplemented with the completion of two further contracts just after year end, to place the Co-operative Pharmacy second in this emerging market segment. Contracts such as these present a valuable opportunity to expand into an exciting new area.

A key factor in establishing sustainable, long term growth is colleague engagement. During 2011 The Co-operative Pharmacy invested heavily in training store managers and senior professionals to make a real difference in their own stores. Engagement scores in The Co-operative Pharmacy increased from 68 in 2010 to 73 in 2011 demonstrating the value of this investment.

The business' commitment to creating a positive working environment was recognised with a successful bid for Investors in People accreditation. This, as much as our process improvements and pursuit of new opportunities, gives us a solid grounding for success in the coming years.

Funeralcare

Key facts	
Funeral homes	888
Funerals	100,210
Employees	4,057

As UK death rates continue to decrease, The Co-operative Funeralcare has continued to rise to the challenge. Operating profits are up 20.4% on 2010, from £44.5m to £53.6m, supported by improvements in our masonry offer and coffin range, allied with a modest increase in market share.

The Co-operative Funeralcare's strategy is to maintain its pre-eminence in the market by offering first-class products and services, investment in future technologies and a relentless focus on people (whether colleagues or customers) to deliver the kind of personal service that clients require at what can be one of the most difficult times in their lives.

The Funeralcare business is committed to maintaining the highest standards. A dedicated standards team makes regular site visits to audit services and facilities, while Customer Service Questionnaires are used to monitor customer care. Questionnaires also feed into a Funeral Excellence Score (FES) based on a range of quality factors. The 2011 FES score increased from 91.2% to 92.4%, a new record level.

Customer care was the driver for significant changes to Funeralcare's coffin range, to ensure that customers benefit from an informed and flexible choice. The business has also developed its masonry service with encouraging results, as more and more customers arranging Co-operative Funeralcare burials now also purchase their headstones from us.

The Co-operative Funeralcare continues to invest in its ability both to deliver outstanding service now, and to anticipate future customer needs. The funeral home network has benefited from £13m in estate and £8m in fleet investment during 2011. The business has also acquired a long term contract with Shropshire Council, increasing our crematorium estate from three to four. Whilst The Co-operative Funeralcare leads the market for funeral services there is still significant potential to increase investment in the area of developing and operating crematoria.

Looking to the future, The Co-operative Funeralcare has invested in resomation, a new and environmentally attractive technology for which it holds worldwide patents. These are early days for resomation, which is now legal in a number of US states and we have sold our first unit in Florida. It is anticipated that demand will gradually increase as resomation represents a significant opportunity to offer a more environmentally sustainable alternative to cremation and burial.

Underpinning both this year's results and the business' investment in the future is its commitment to people – whether colleagues or the communities they serve. Despite the challenges of a slow-growth economy and a declining death rate, engagement amongst colleagues remains high, and indeed the Group's colleague survey for 2011 shows Funeralcare engagement scores have increased from 75 in 2010 to 78 in 2011.

Our commitment to our communities is based on a dedication to providing a sensitive, responsive service to bereaved families. This year Funeralcare launched an ethical strategy to highlight how key social and environmental issues would be managed in the day to day running of our business. 93% of the coffins manufactured by The Co-operative Funeralcare are made from wood certified by the FSC® (Forest Stewardship Council), while Funeralcare is now the first UK wide carbon-neutral funeral director. Investment in new technologies such as Resomation will play a key part in delivering this strategy in the future.

Performance review continued

The Co-operative Funeralcare has built its ongoing success on understanding the client experience and investing the utmost care in every aspect of funeral arrangements. The business will continue to respond to and pre-empt customer needs, driving excellence in everything it delivers.

Legal Services

The Co-operative Legal Services was founded six years ago and has gone from strength to strength, growing from four colleagues to nearly 500, with an exciting plan for future growth. Results for 2011 have been very positive with operating results up 15.5% from £3.9m to £4.5m.

Legal Services' strategy, in the wake of the deregulation of the legal services market, is to provide consistently great, good value legal advice to the ordinary person, backed by our scale, reputation, systems, service standards and training. The business has applied for a licence (Alternative Business Structure ABS) to offer a broad range of consumer legal services. We aim to provide Co-operative members and customers with accessible, high-quality legal advice and services at a competitive price, challenging the legal 'postcode lottery'.

To support its strategy the business has recruited three leading family law practitioners, and plans to extend its operations to provide support for families in England and Wales.

The legal services business has already been putting its principles into practice with a pilot scheme to offer Wills, Estate Planning, Probate and bereavement advice and Funeral Plans in 30 Co-operative Bank branches. The pilot has shown the value of collaboration across Co-operative businesses (which lies at the heart of Project Unity) and will now be rolled out nationwide, while the service proposition will be enhanced to further customer needs and provide them with broader benefits from Co-operative services.

Life Planning

2011 saw record sales for Funeral Planning products provided through the Life Planning Business. The total number of funeral planning products sold by the Group increased by 9.3%. The Life Planning business is focused on securing future funeral business for Funeralcare. The Group have adopted a new accounting policy for Funeral Plans in 2011 and now accounts for funeral plan sales under IAS 18 instead of IFRS 4. This means that only a small amount of revenue is recognised at the time of sale, approximately equivalent to the cost of upfront marketing and administration.

The sales function of the Life Planning business was brought together with the sales function from the Legal Services business to provide an enhanced customer proposition. This allows the business to optimise third-party B2B relationships and generate further opportunities to cross-sell products and services and provide an enhanced service to our business partners and their customers.

Growth in like-for-like sales has been driven by strong performance in Funeral Plan sales through the Co-operative Funeralcare branches (with sales volumes through this channel up by 11.3% year on year). This has been supported by growth in our Legal Charge products, whereby customers are invited to use their Whole of Life product purchased through our Corporate Partners towards their funeral costs and plan for their funeral. Sales of Legal Charges have risen 15.4% year on year.

Sunwin Services Group

The Sunwin Services Group provides a range of services to business, including cash in transit, ATM support, IT services and managed security. Despite the economic climate and the temptation for businesses to cut overheads and administrative costs, Sunwin has delivered creditable results with operating profits up 12.0% from £5.6m to £6.3m, through the gaining of new contracts as customers realise the benefits of the cost-effective service The Sunwin Services Group provides.

Opportunities exist for future business growth within this area, although clearly the ongoing fragility of the UK economy will continue to be a factor.

Motors

The Co-operative car dealerships have performed well in the face of extremely tough economic conditions, exacerbated by a general customer reluctance to spend on big discretionary purchases such as cars. Sales have increased by 3.9% from £266.6m to £277.0m. The business continues to seek opportunities for growth and has invested in a new Land Rover franchise in Bradford. The Leeds Land Rover franchise has also benefited from a major refit.

The strength of The Co-operative Motors brand has attracted a range of accolades over the last 12 months. The rebranding of the business was recognised as 'Best Marketing Initiative' at the Automotive Management Awards. The business has also been shortlisted for both Dealer Group of the Year and Green Dealer Group of the Year. Since the turn of the year the business has garnered further awards, with Land Rover naming the Bradford franchise its Land Rover Dealer of the Year while the Leeds dealership won 'Service Centre of the Year'.

E-store

The electrical retail sector (including online) has been hit particularly badly by the economic downturn as customers have less disposable income to spend on luxury items, while the depressed housing market has affected sales of major kitchen appliances. Margins have also been under pressure, contributing to a 25.1% reduction in profits. However, performance compares positively with other electrical retailers; sales have fallen slightly by 6.6% from £87.9m to £82.1m (in a market which has fallen much further), while Christmas internet sales (a key period for online businesses) were up 16% on 2010 following the launch of our new website.

The E-store business strategy is to maintain a competitive pricing policy while focusing on excellent customer experience together with a fast, reliable and flexible delivery service. Significant numbers of customer e-mails, letters, and thank you cards attest to our success. The new E-store website is now live and is the only major internet electrical retailer to feature Feefo reviews (the only reviewer accredited and recognised by Google). To date we have had almost 3,000 reviews with an excellent overall customer service rating of 97%.

While primarily an Internet business, E-store includes an Electrical Buying Group for other Co-operative societies, an Insurance replacement business and a service supporting The Co-operative Food's in-store electrical offer. In 2011 the buying group encountered a difficult year with purchases down 5% compared to 2010, occasioned by difficult Non Food trading conditions, but viewed nevertheless as a solid performance.

E-store launched a redesigned website in October 2011, featuring a new look and feel, improved customer information and content and improved functionality (including product and service videos, buying guides, and enhanced product images). To underpin the business' move towards a multichannel proposition, a fully transactional kiosk will be piloted in selected Food stores in Q2 2012.

Clothing

The clothing business has also experienced a challenging year as inflationary pressures combined with a depressed clothing market impacted on margins. Nevertheless operating profits for 2011 are up over 100% from £0.49m to £1.04m on the back of increased sales, and a focus on cutting costs and overheads.

Estates

Estates performance	2011 £m	+/– change
Net revenue	36.1	+1.4%
Operating profit	19.1	+1.6%
Key facts		
Investment portfolio	2,340	
Properties under management: over 10,000		

The Co-operative Estates team plays a dual role in the success of the Group, as a business unit generating revenue in its own right, and as a provider of property services to Group businesses.

Business strategy overview
The Estates team's business strategy is to maximise value from its property portfolio through effective investment and disposal of non-core properties; and to maximise the effectiveness of the Group estate through cost effective property management, whilst meeting the needs of the trading businesses.

Performance review
As a business unit, active property management and tight cost control have helped deliver a successful trading result for 2011. Underlying operating profit for the year was £19.1m which was £0.3m or 1.6% above the previous year.

Investment properties under management made a significant contribution to Group results for the year. Portfolio value has grown despite depressed property conditions and compares favourably to the IPD benchmark. Meanwhile disposal of non-core properties yielded £33m in cash during 2011 which helped realise capital that can be invested in other Group projects and assist with Group cashflow. In addition the Estates team continue to deploy a range of approaches to optimise the value of provisions relating to the onerous lease estate.

As a service provider Estates plays a key role in managing the Group's 5000-plus Trading properties nationwide. During the year the team managed the opening of 32 new Food stores and 24 Funeralcare branches, as well as the relocation of 11 Pharmacy branches; 8 new Pharmacy contracts were also completed. Over 420 food store refurbishments have also been completed.

Estates' contribution to infrastructure management includes enabling the Group to reduce its carbon footprint. Initiatives introduced to reduce carbon emissions and wastage are ongoing, but notably the Group recently achieved the target of reducing operational greenhouse gases by 35% five years ahead of target. Planning consent was secured in the year to build two new windfarms on Co-operative farmland at Coldham and Biggleswade. The intention is that these windfarms will be managed as joint ventures to help deliver the Group's target of generating 25% of energy requirements through its own renewable resources by 2017.

2011 has seen the Estates team achieve recognition, both for its key projects and for the team itself. Accolades included the BIFM Client of the Year and Energy Buyer of the Year at the 2011 Energy Awards.

Outlook
Looking ahead, the Estates team is helping to shape the future of the Group's home in Manchester. The NOMA urban regeneration project was officially launched in April, and constitutes 20 acres of commercially focused, innovative and highly sustainable development.

Situated at the core of NOMA is 1 Angel Square, the Co-operative Group's new headquarters. Scheduled for occupation from September, the new building is more than just an architectural challenge. In replacing the paper-based, office-centred templates of traditional offices, its flexible working spaces and innovative use of technology will usher in a whole new working environment and culture for Group colleagues.

The building will be populated from September onwards, with migration freeing up a number of other buildings in the area for redevelopment. Here too, the focus is on making positive changes to our environment, bringing older buildings back to life in ways that are both socially proactive and commercially viable.

It is appropriate that even as Estates plays a key role in supporting change across the Group, the team itself has restructured to provide a single, consistent end to end service across the business, from acquisition to disposal and everything property related in between. Even as the challenges increase, so do the opportunities, and the Estates team is looking forward to playing an ongoing role in maximising those opportunities for the Group.

Financial review

The financial statements report a resilient performance for the Group under tough economic conditions and low levels of consumer confidence. Despite enduring low interest rates, declining food volumes and downward pressure on discretionary spend, we continue to invest in improving and growing our core businesses to ensure their long term future. In doing so the Group has maintained its high level of financial strength in both Trading and Banking, evidenced by its key debt, capital and liquidity ratios.

Headlines	2011 £m	2010 £m	+/– change
Gross sales	13,272	13,144	1.0%
Underlying operating profit	526	602	(12.6)%
Profit before member payments	373	396	(5.8)%
Member payments	142	104	36.5%
Net assets	5,056	4,839	4.5%
Trading Group net debt	1,488	1,440	£48m
Bank liquidity (loans to deposits)	94%	103%	Improved 9%
Bank capital (CT1)	9.6%	9.6%	–

Restatement

The 2010 income statement and balance sheet have been restated from those previously reported to reflect the impact of an accounting policy change in relation to funeral bonds. The income statement has also been restated to remove the impact of businesses that have become discontinued in the current year.

Trading Performance

Overall Group sales were up 1.0% on 2010 (0.2% excluding VAT) with increases in Banking Group and Specialist Businesses offsetting a fall in Food.

In Food sales were down 2.7% (including VAT and fuel) overall and 2% on a like-for-like basis (including VAT excluding fuel). The like-for-like sales decline improved each successive quarter and the business reported positive like-for-like sales over the Christmas period. During the year we completed a planned store disposal programme and finished the Somerfield integration, including the re-branding of all retained stores. The grocery market overall reported declining volumes for the first time in many years. Within the Banking Group, interest income was up as was general insurance premium income. Retail banking did particularly well despite the enduring low interest rates and a highly competitive market place – evidence of our compelling brand, competitive product offering and high levels of customer advocacy. All Specialist Businesses except Pharmacy and E-Store increased sales on the previous year. In Pharmacy prescription volumes were up by 1.6% but sales were down in value terms due to cuts in government funding. E-store's sales were down by 6.6% in a market hit hard by the economic downturn and pressure on consumers' disposable income. Encouragingly we did much better than some our of high street competitors, in particular over the Christmas period when internet sales were up 16%.

Group underlying operating profit before significant items decreased by 12.6%. Underlying operating profit in Food was down by 20.4%, Banking Group profits were in line with last year and Specialist Businesses were collectively up 10.4%.

Food fell back from record profits in 2010 as a result of reduced sales and inflationary cost pressure. The business reacted to market conditions to offer better value to customers in the form of targeted price cuts and upweighted promotions. In addition the business made significant overhead cost savings and continues to drive out efficiencies in all non-customer facing areas of expenditure. This will ensure that it remains resilient through the remainder of the economic downturn and puts the business in a good position to benefit from an expected increase in sales in 2012, in line with the emerging trend and customer-focused strategy. The Banking Group delivered a resilient result for the year with a strong performance in Retail (banking and insurance) offsetting severe challenges in the Corporate business. The results benefited from gains on the sale of Treasury assets of £37m and a reduction of £20m in total credit risk expected over the life of the Optimum mortgage book. Within Specialist Businesses, Funeralcare had a very positive year with underlying operating profit up 20.4%. A modest increase in market share (in a decreasing market) was underpinned by improvements in product mix, value-added services and efficiencies in operating costs and overheads. Pharmacy operating profits were down £3.7m (11.2%) but this was after suffering an estimated £18m of reduced government funding on prescriptions. Allowing for this, this business also had a very strong year, increasing margins, reducing wastage, operating and overhead costs and improving stock control and working capital. Pharmacy operating profit included the costs in the year of operating a manufacturing joint venture in China, the investment in which has been written off at year end. But for a conservative change in accounting policy (reducing profit recognition on funeral plan sales) all other Specialist businesses contributed positively to overall operating profits and all but E-Store were up on the previous year.

Further detail on the trading performance of individual businesses can be found in the relevant sections of the Performance Review.

Financial strength and cash flow

Overall Group net assets (Members' Funds) increased by £217m to £5,056m.

During the year the Trading Group diversified and strengthened its funding position by issuing two Eurobonds totalling £800m with £450m maturing in 2020 and £350m in 2026. This is the first time that the Group has had significant long term debt providing certainty and stability well into the future. The proceeds of these issues paid down part of the 5 year bank debt raised in 2008 to fund the acquisition of Somerfield. The remaining facilities are due for renewal in 2013 and the aim is to refinance these in the first half of 2012. In line with the original terms of the bank debt, the Group also repaid £100m in July 2011.

Overall Trading Group net debt increased by £48m in the year (2010: £158m decrease). A moderate reduction in underlying cash profit on top of continued investment in both significant change costs (up £93m versus 2010 – see components of significant items below), and net capital expenditure (up approximately £100m versus 2010 – see below), was offset by a highly favourable net working capital movement. Net debt levels were maintained comfortably inside facilities and covenant limits throughout the year rising slightly in the final quarter, reflecting the controlled commitment to long term investment plans.

The Group continues to take a prudent approach to banking and does not over commit. The Co-operative Bank's key liquidity measure – the loan to deposit ratio – has strengthened from 103% to 94%, and its Core Tier one capital ratio is unchanged at 9.6%. In support of plans for long term growth the Bank successfully raised funds during the year via residential mortgage backed securities and covered bonds.

Items excluded from underlying operating profit

In addition to underlying trading profits there are several non-trading, non-cash items within the income statement. These are highlighted in the notes to the accounts and the more significant items are explained below.

An amount for 'fair value amortisation' is included in 'Other income' on the face of the income statement and analysed in note 4 to the accounts. When the

Britannia Building Society transferred its engagements to the Co-operative Group in 2009, the net assets were restated to fair value. This included adjustments to reflect the prevailing interest rates charged and received on both assets and liabilities. These adjustments unwind over future periods and in 2011 generated a net credit to the income statement of £86m compared with a charge of £14m in 2010. The volatility of this item leads to its appropriate exclusion from underlying operating profit.

Other items consistently not included in underlying operating profit because of their non-trading or volatile nature are gains/losses on property disposals, changes in the value of investment properties and the Financial Services Compensation Scheme Levies.

Finance income and costs
Finance income of £75m (2010: £45m) relates to net pension scheme interest and is £30m favourable to 2010 because of higher expected returns on plan assets of £480m (2010: £452m).

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 £26m credit in 2011 compared with a £24m charge in 2010.

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. The majority of these items relate to major one-off programmes aimed at delivering step changes in our business, efficiency, capability and scale.

	2011 £m	2010 £m
Banking Group integration/transformation	**90**	66
PPI Provision	**90**	4
Food distribution network restructuring costs	**54**	–
Food integration and restructuring	**16**	41
Project Unity	**23**	–
China Joint Venture impairment	**8**	–
Reclaim Fund	**(74)**	–
Other (net)	**3**	6
Total	**210**	117

Following the merger of the Banking Group with Britannia in 2009, we continue to invest significant amounts in integrating and transforming the enlarged business. The integration phase has taken significant strides forward most notably with the extension of personal banking capabilities into the full 340 branch network. In parallel with this we are investing heavily to replace ageing legacy banking systems and infrastructure with completely new, modern, flexible systems and processes that are fit for purpose and provide the capacity for growth.

We recorded a one-off charge of £90m to cover claims for potential mis-selling of Payment Protection Insurance (PPI). Although an industry-wide issue, as a member owned organisation, we are committed to doing the right thing for our customers and will deal with complaints in a fair, personal, easy and responsible manner.

Within the Food business, we are coming to the end of a distribution network strategy that has involved replacement, modernisation and rationalisation of the previous network over several years, accommodating merger and acquisition impacts along the way. In 2011 we opened two major new facilities, started to build a third and decommissioned seven centres.

The integration of Somerfield into the Food business successfully completed in the year with all retained stores re-branded, and all store and central support systems, people and processes fully integrated.

Project Unity was launched at the beginning of the year with the objectives of bringing together functional support teams and the corresponding systems and processes to more efficiently and effectively serve the whole Group, and, more importantly to reap the benefits of all the Group’s businesses working together to serve a common customer and member base.

After 4 years investing in and operating a pharmaceutical manufacturing facility in China with a local partner, Pharmacy has made the strategic decision to exit the joint venture. The decision is based on the ability to source equivalent products from alternative sources at cheaper prices and the inability to drive sufficient volumes through the facility. It is expected that a commercial exit will complete in 2012. The accumulated cost of the investment has been prudently written off at the year end.

The Reclaim Fund Ltd (‘the Fund’) is a wholly owned subsidiary of the Co-operative Banking Group which, under authorisation of 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 into its financial statements. For clarity, in the consolidated income statement, the Fund’s retained surplus for the year has been separately reported in significant items. Further explanation is provided in the Banking Group performance review on page 11.

Discontinued operations
Further to note 9 in the accounts, explanation is provided below of those items classified as discontinued during the year.

	2011 £m	2010 £m
Travel	**22**	(8)
Food stores	**(25)**	(30)
Life and Savings	**15**	8
Other	**(1)**	(1)
Profit/(loss) before tax	**11**	(31)
Tax	**15**	8
Profit/(loss) after tax	**26**	(23)

The Group’s Travel business transferred into a joint venture with Thomas Cook on 30th September 2011, with the Group retaining a 30% interest in the new entity. As such the results of Travel, leading up to the start of the joint venture have been reported within discontinued operations together with the imputed profit on disposal of the business to the joint venture. The results for Travel in 2010 have also been reclassified for comparative purposes. The Group’s share of profit or loss of the joint venture has, subsequent to 30 September, been reported in the share of associates and joint ventures, in the income statement.

Discontinued food stores relates to those stores identified for closure or disposal as part of the Somerfield integration programme that were closed and/or disposed of in the year, thus completing the original programme. The reported figure includes trading losses suffered in those stores prior to closure/disposal and any terminal loss arising thereon.

After a strategic review of the Group’s Life and Savings business it is highly probable that the business will be sold off during 2012. The £15m profit reported in 2011 comprises investment returns of £8m and profit of £7m from The-Co-operative Asset Management company (TCAM).

Financial review continued

Capital Expenditure

	2011 £m	2010 £m
Trading Group	**376**	343
Banking Group	**219**	149
Gross	**595**	492
Disposal proceeds	**(30)**	(103)
Net	**565**	389

Gross capital investment in Trading businesses was £376m (£343m) with the largest components being store/branch refurbishments (£100m), acquisition of new stores/branches (£40m), distribution depots and equipment (£50m), vehicles (£40m) and the Group's new head office building (£53m). Disposal proceeds were down £72m primarily due to the large number of store disposals in 2010 linked to the Somerfield integration.

As noted above, the Banking Group is investing heavily to build a flexible and modern infrastructure that will drive business growth. Capital spend of £219m relates almost entirely to this programme and includes the cost of software in use or in development (included within intangible assets) and related computer hardware (included within tangible assets).

Tax

The tax charge on continuing business is £49m (2010: £58m). The effective tax rate is 21% (2010: 20%) against a standard blended rate of tax of 26.5%. The main reasons for the reduced effective tax rate are, the impact on deferred tax balances of the reducing UK corporation tax rate (27% to 25%), non-taxable investment income and credits relating to prior years as a consequence of reaching agreements with HMRC on tax computations relating to those years.

Pensions

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

	2011 £m
Combined opening net deficit	**(4)**
Service cost	**(85)**
Pensions interest	**75**
Actuarial gains	**379**
Actuarial losses	**(379)**
Contributions	**136**
Other	**10**
Combined closing net surplus	**132**

The IAS 19 scheme valuations produced a combined surplus of £132m at the year end against an opening deficit of £4m. Assumptions underpinning the valuations remain very prudent.

The service cost of £85m charged against operating profits was £13m higher than in 2010, largely due to the discount rate relating to bond movements. With scheme assets and liabilities of around £8.5 billion there is huge potential volatility in actuarial gains and losses although coincidentally these netted to nil in the year. Actuarial losses of £379m were largely caused by a further shift in bond rates at the year end which caused a sharp change in the discount rate from 5.2% to 4.6% and this was partly offset by lower inflation. Actuarial gains of £379m on scheme assets were principally caused by a strong performance on the swap portfolio.

The funding was also supported by deficit payments in the year of £47m.

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.

Dividends are recorded in the income statement once they have been approved. In 2011 the Group approved and paid a final dividend relating to 2010 profits and an interim dividend relating to 2011 profits. The split of the dividend between the various member categories is subject to Board approval. Dividends paid in 2011 are summarised in the table below.

	2011 £m	2010 £m
To individual members	**(78)**	(55)
To employees who are members	**(32)**	(20)
To corporate members	**(22)**	(19)
Community distribution	**(10)**	(10)
Total	**(142)**	(104)

Individual Dividend: 5.4 million members traded with the Group in 2010, up by 2 million on 2009. They earned 3,434 million points in the year. A dividend of £70m was paid to members, equating to an earned rate of 2 pence per point.

Employee Dividend: 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. In 2010 the full time equivalent number of qualifying employees was 72,578, almost 50% up on the previous year. The 2011 total employee dividend was £32m equating to £500 per full time employee, the same as the prior year.

Corporate Dividend: The definition of qualifying purchases was unchanged from the previous year. Corporate members spent £1,645m on qualifying purchases with the Society. Based on the £22m available for distribution the payout rate per £100 of qualifying transactions was 132p.

Community Dividend: The £10m available for distribution for the benefit of the community was allocated by the Group Values & Principles Committee.

Our people

'Building for the future' is an appropriate metaphor for the Group this year, as we prepare to open our new head office in Manchester. As a genuine 'building for the future' it has been designed around our most important asset – our people.

Our people strategies cover the full range of colleague interaction with the business; two areas on which we will focus in this report are colleague development, and diversity and engagement. These two strategies play an important part in the creation of a dynamic, people-centred working culture, attuned to sustainable future growth.

Colleague development

The Co-operative Group is investing in building for the future, focusing on developing new talent, improving performance and planning for future business needs.

Launched in May 2011, The Co-operative Apprenticeship Academy is designed to provide young people with recognised qualifications, professional competence and skills, coupled with first-hand business experience to enhance their career progression.

The programme has clearly struck a chord with young people around the country; our website has already attracted 90,000 hits and 10,000 applications. 400 apprentices have already begun their training and the programme will offer an additional 1,600 places by 2013.

The Group's graduate training scheme offers four distinctive career paths centred on Finance, Business Management, HR and Retail Operations. Each programme is structured to give graduates experience in a variety of functions across our family of businesses as well as a structured development programme. The programme is ranked 29th in the Top 50 Companies for Graduates to Work For, and features at No 75 in the Times Top 100 Graduate Employers.

As well as developing potential for the future the Group is investing in leadership development, an essential factor in empowering excellent performance. A Group-wide portal called the Leadership Development Zone has been designed and launched, which provides our senior leaders with a range of tailored learning and development solutions from video and 'how to kits' through to business school programmes. The portal is regularly refreshed and members of the Group Executive actively sponsor campaigns to encourage leaders to access leadership development opportunities. The Zone is proving to be a powerful tool in empowering leaders to take charge of their personal development wherever they sit in our Group of businesses.

Engagement and diversity

Key initiatives in 2011 have included a business-wide diversity census, updating our diversity strategy after the recent mergers and acquisitions, as well as a number of award-winning diversity initiatives.

Our Making Opportunities project, designed to help more people with learning difficulties find roles in the workplace, won the Workplace Diversity award at the Personnel Today Awards on the way to being named Overall Winner. Our integration of over 30,000 employees following the Somerfield and Britannia mergers also won the Managing Change award.

Meanwhile we have climbed more than 50 places in the Stonewall Diversity Index, from 64th in early 2011 to 11th at the time of writing (we are the only retailer in the top 100). Our LGBT network Respect has also been shortlisted for the Outstanding Employee Network Group of the Year Award at the European Diversity Awards.

We are also investing in maximising colleague engagement, a key driver in delivering excellent business performance. We monitor and support engagement via our Talkback questionnaire. As part of the Unity programme Talkback will be rolled out Group-wide this year to give us a consistent Group-wide picture and a fresh approach.

Our commitment to engagement has been independently endorsed by our accreditation as an Investor in People. Awarded after an in-depth assessment process the IiP award attests to a clear and effective link between business strategy, colleague communication and personal development.

Pensions strategy review

A major challenge for the Group has been the review of our pensions strategy to find an appropriate and consistent pension offer to all colleagues. With ten schemes to manage following numerous acquisitions and mergers and 55,000 colleagues in scope for auto-enrolment, this is one of the largest pensions transformation programme in the UK. Bucking the national trend, The Co-operative Group has taken the decision not to abandon defined benefit pensions. Our solution has been to offer colleagues a fair, sustainable package, geared to their needs and circumstances and offering an element of choice.

In line with the Government's new pension requirements we will auto-enrol all eligible colleagues in a workplace pension scheme, but we have gone beyond the minimum requirement. We have designed a high-standard defined contribution scheme, which allows colleagues entering it to 'trade up' to a defined benefit scheme should they want to.

Unity programme

The Group's commitment to colleague development and engagement extends beyond the present into the way we are building for the future. Unity is a far-reaching change programme designed to harness our business scale and diversity to offer our customers a truly comprehensive service. The programme focuses on creating a fully integrated business with a common leadership and support structure, centralised shared services and integrated people policies.

Building for the future requires investment – in technology, systems and products and in new and innovative working environments. The Co-operative Group's new head office is the most visible symbol of that investment; but the cornerstone, now and in the future, will always be our people.

Social goals

In the midst of the current, global economic challenges, and with increasing calls for more ethical and responsible forms of business, it is entirely appropriate that the United Nations should herald 2012 as the International Year of Co-operatives. The co-operative model is being seen as increasingly relevant to a more balanced, sustainable economy and The Co-operative has been at the forefront of this renaissance.

In 2011, our approach to sustainability was revitalised with the launch of The Co-operative Ethical Plan. Refreshed each year in consultation with our democratically elected member representatives, the Plan sets ambitious targets across issues of primary concern for members.

Our approach continues to earn us an impressive reputation and during 2011 we achieved a raft of awards, including winner of the Observer's Ethical Business Award; first place in Business in the Community's Climate Change Award and 'Platinum Plus' in their Corporate Responsibility Index; a leading ranking in the Sunday Times' Best Green Companies List; and winner of The Financial Times' award for Europe's Most Sustainable Bank.

Materiality, strategy and governance

The Co-operative Group has always had a purpose beyond profit, and we recognise that certain injustices need to be challenged.

We are owned by our members and accountable to them through our democratic structure. The Group Values and Principles Committee, made up of elected members, oversees our approach to sustainability and members help shape our innovative ethical policies.

Our Ethical Plan sets out targets across eight priority areas that we review annually with our members through our Values and Principles Committee to ensure that it continues to show the way forward for corporate sustainable development in the UK. In addition, we have a suite of ethical policies and strategies for our major businesses and in 2011, launched an Ethical Strategy for our Funerals business.

We've been reporting our sustainability performance for over a decade and have been judged around the world as a leader for our openness and honesty.

Performance overview

Keeping communities thriving

We have a presence in every postal code area in the UK, providing access to products and services at the heart of the community. In 2011, we invested £13.6m in communities at home and around the world, – and we are aiming to invest 10% of monies available for distribution by 2013, with a target to support 10,000 community initiatives each year, that's one new project every hour, every day.

With our customers, members and employees, in 2011, we raised £7m – well above our £5m target – for our Charity of the Year partners, Mencap and sister charity ENABLE in Scotland, to improve the lives of young people with a learning disability around the UK.

Our members helped over 2,430 local community groups by donating their share of the profits to The Co-operative Membership Community Fund, and colleagues volunteered over 162,000 hours to community projects.

Supporting co-operatives

We believe in 'co-operation amongst co-operatives', seeking to maximise the growth of responsible businesses and contribute to the development of a more diverse and sustainable economy. Against a challenging economic backdrop, the UK co-operative sector continues to grow and there are now over 5,000 co-operatives nationwide.

We are investing £17m over the next three years to support the growth and development of co-operatives in the UK and overseas. Through The Co-operative Enterprise Hub, we continue to provide professional business advice and training to help new co-operatives get off the ground and help existing co-operatives to grow and become more sustainable. Over 700 co-operatives have benefited to from the Hub's support to date.

Inspiring young people

We aim to bring about a cultural shift in the way that young people are viewed and treated in the UK, and to help them change their world. Our Inspiring Young People programme aims to benefit one million young people by 2014.

We launched our Green Schools Revolution in September 2011, a new sustainability education programme for primary and secondary schools. So far, over 3,000 UK schools have registered to take part and we aim to engage 6,000 or schools across the UK by 2014.

In 2011, we established a Co-operative Academy school in Leeds, the third Academy to be launched to date, and we aim to establish a total of six by the end of 2013, delivering an innovative curriculum within a values-led ethos. This forms part of the Group's wider work supporting Co-operative Schools, which includes establishing a co-operative society, to which over 200 schools are currently enrolled.

Protecting the environment

Our longstanding commitment to the environment speaks for itself. We have cut our greenhouse gas emissions by 35% since 2006, well ahead of our 2017 target, saving half a million tonnes of greenhouse gases each year. We're aiming for a 50% cut in emissions by 2020, and to generate the equivalent of 25% of the electricity we use from our own renewable sources by 2017. We are looking forward to the completion of our state-of-the-art head office in 2012, which will set new standards for the UK in sustainable design, construction and operation.

We take seriously our role as a campaigner and influencer of public policy. During 2011, we lobbied at a UK and EU level as part of our Clean Energy Revolution campaign. The campaign's focus is to inspire the growth of co-operative and community owned renewable energy projects and end the use of unconventional fossil fuels such as shale gas and tar sands.

In 2011, our focus on sustainable product sourcing was recognised through a leading ranking in a number of industry initiatives: the Marine Conservation Society's Supermarket Seafood Survey; WWF Palm Oil Buyers Scorecard; and Pesticide Action Network UK's Supermarket Comparison. We were also the first UK retailer to graduate from WWF's Global Forest and Trade Network for our wood and paper-based products.

Tackling global poverty

We believe that, when undertaken fairly, trade and finance have an unparalleled capacity to improve quality of life and we're proud that over a million people benefit each year from our work. We support thousands of Fairtrade producers and their communities around the world and we will continue to show the greatest commitment to Fairtrade in the UK. Our Fairtrade product availability remains second to none and our market share for Fairtrade far exceeds that of our overall sales; on top of this, we have committed that if a primary commodity from the developing world can be Fairtrade it will be Fairtrade in our stores by 2013.

In 2011, we entered into a partnership with CARE International UK to support 'lendwithcare.org'. This innovative scheme allows people in the UK to lend directly to entrepreneurs in the developing world, helping them work their way out of poverty. Our aim is to facilitate 30,000 loans by the end of 2012. The Co-operative Bank is also spearheading The Global Development Co-operative – a new development fund that aims to raise funds to provide much needed finance to co-operatives in the developing world.

Responsible finance

We have long recognised that a responsible approach to finance is crucial for sustainable development. The Co-operative Bank is the only UK bank to have a customer-led Ethical Policy and, in 2011, we launched the world's first ethically screened insurance products. Since the Policy was launched in 1992, we have withheld over £1bn of investment from business activities that our customers say are unethical. At the same time, we have seen our commercial lending grow to £9bn.

Looking forward, we have increased our commitment to finance energy efficiency and renewables from £400m to £1bn. We are also focusing on improving the safety of Britain's roads through insurance premium discounts for young safer drivers worth £20m and safety workshops in partnership with road safety charity, Brake.

Responsible retailing

We recognise the importance of our role in improving the nation's health and it is our firm belief that ethical and healthy offerings should be accessible to everyone. We continue to reduce salt, saturated fat and sugar in our own-brand products. Our Healthier Choice options are no more expensive than our standard lines and the nutritional content of our Simply Value products is at least as good as standard equivalent lines.

Animal welfare is a long standing priority for our members, so we aim for good baseline welfare standards across our entire own-brand range. In 2011, we extended our higher welfare Elmwood standards to fresh pork and sausage products and we are on track to convert our own-brand salmon to Freedom Food standard in 2012. The development of a dedicated supply chain for our milk products has also improved animal welfare standards for dairy cows.

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 process used to identify and monitor key risks across all divisions of the Group is described on note 39.

Our risks 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.

Risk		Mitigation
Group risks		
Economic conditions/ severe recession	The Group could be adversely impacted by the general UK economic conditions as well as market trends in the specific business markets we operate. Opinions are divided on the timing and sustainability of an economic recovery. The Bank in particular is subject to volatility of financial markets and turmoil in the Eurozone. 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 and an increase in funding costs.	• 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.
Brand and reputation	The Group's reputation could be damaged by a significant adverse event perception which could lead 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.	• Continual monitoring of our corporate reputation and brand standards. • Commitment to our Social Goals Strategy, reported through the annual Sustainability Report. • Implementation of comprehensive procurement policies. Close monitoring by senior management, and proactive PR to manage the impact of key events, taking into account the potential collective impact of individual issues, increasing focus on the Banking Group as brand awareness grows, and the potential media/public reaction due to the way in which the Banking Group is changing as a business. • Prudent 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.
Pension costs	The Group's pension arrangements are regarded as an important part of our 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.	• 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. • A Group Pensions Strategy review is currently underway incorporating new pension requirements for employees from November 2012. • Engagement of external advisors and actuaries as appropriate. • Triennial valuation of all schemes. • Continuous engagement of employees on all relevant pension issues.
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.	• Robust disaster recovery and business continuity plans developed and tested.

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Risk		Mitigation
Group risks		
Energy prices	We are exposed to the risk of rising energy prices.	• The Group operates a buying policy under which an agreed proportion of forecast energy requirements is secured at fixed prices.
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.	• 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.
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.	• 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.
Financial capacity	The Group must be able to generate and maintain sufficient funds to meet business needs.	• 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.
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.	• 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 ethnical sourcing.
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.	• We deploy robust technical quality assurance policies, procedures and audits.

Principal risks and uncertainties continued

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

Risk		Mitigation
Banking risks		
Credit risk	Credit risk is the current or prospective risk to earnings and capital arising from a borrower's failure to meet the terms of any contract with the Bank or its failure to perform as agreed. For CIS and CISGIL, this includes issuers of corporate bonds, counterparties to financial transactions and reinsurers.	• 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 policies are approved by Risk Committee (delegated authority from the Board) annually and are the responsibility of the Banking Risk Officer. The policies determine 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. • As uncertainty continues in the Eurozone we closely monitor developments daily across all countries as they affect sovereign and inter-bank lending. • A number of pre-emptive and defensive management actions have been taken to reduce the risk.
Liquidity risk	Liquidity risk is the risk that The Banking Group's resources will prove inadequate to meet its commitments. It arises from the timing of cash flows generated from the Banking Group's assets and liabilities (including derivatives).	• Liquidity risk arising from the structure of the balance sheet (structural liquidity) is managed to policies developed by ALCO. The Group's liquidity management policies are reviewed and approved annually by the Bank's Risk Committee and compliance reviewed monthly by ALCO. The Bank's policy is to ensure that sufficient funds are available at all times to meet demands from depositors, to fund agreed advances, to meet other commitments as and when they fall due, and to ensure the Board risk appetite is met. • 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 risk appetite for liquidity risk is defined as survival to a number of stress tests, adherence to specific ratios and compliance with all regulatory limits. The stress tests encompass survival across various timescales and a range of adverse liquidity events, both firm specific and market wide, which covers all aspects of the liquidity risk the Bank is exposed to. • The Bank monitors its liquidity position on a daily basis against the Board-approved liquidity risk appetite and stress scenario. 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.
Market risk	Market risk arises from the effect of changes in market prices of financial instruments, on income derived from the structure of the balance sheet, execution of customer and interbank business and proprietary trading. The majority of the Bank's market risk arises from changes in interest rates.	• Interest rate risk policy statements, approved by the Risk Committee on behalf of the Board, specify the scope of the Bank's wholesale market activity, market risk limits and delegated authorities. The policy is managed by the Bank's ALCO which meets monthly and its prime task is to assess the interest rate risk inherent in the maturity and repricing characteristics of the Bank's assets and liabilities. The Bank seeks to minimise the volatility of future earnings from interest rate changes and all interest rate risk exposure is removed from the retail 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.

Risk		Mitigation
Banking risks		
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. This includes the risks managed by CISGIL and CIS. 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 CISGIL business.	• CIS'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. CIS 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. • 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. • 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.
Mis-selling risk	There is a risk of regulatory enforcement and reputational damage that could arise from mis-selling, that could result in brand damage, resulting in a loss of new and existing business.	• We have rigorous controls in place to prevent instances of future mis-selling, including compliant sales practices and staff training. • We detect and correct any weaknesses on a timely basis through compliance monitoring team reviews, review of complaints and root cause analysis.

The Co-operative Group Board of Directors

Len Wardle (r)
Age 67. 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 The Co-operative Banking Group Ltd, The Co-operative Bank plc, Co-operative Insurance Society Ltd, and CIS General Insurance Ltd. Member of the Group Remuneration & Appointments Committee, the Governance Working Party, the Political Strategy Working Group, the Diversity Strategy Group and the Future (non-commercial) Federal Requirements Working Group.

Jenny Barnes (r)
Age 51. Joined the Board in 2009. Civil Servant. 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 the Diversity Strategy Group.

Steven Bayes (r)
Age 50. 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 53. Joined the Board in 2007. Trade Liaison Manager. Member of the North West & North Midlands Regional Board. Non-executive director of Co-operative Banking Group Ltd, The Co-operative Bank plc, Co-operative Insurance Society Ltd and CIS General Insurance Ltd. Member of the Group Audit & Risk Committee and the Governance Working Party.

Marilynne Burbage (r)
Age 69. 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 Working Party, the Political Strategy Working Group and the Future (non-commercial) Federal Requirements Working Group. Also a Director of The Co-operative Foundation.

Eric Calderwood (r)
Age 59. Joined the Board in 2006. University Lecturer. Member of the Scotland & Northern Ireland Regional Board. Director of Co-operative Food Board. Also Director of Co-operatives UK Ltd and Chair of The Manx Co-operative Society.

Martyn Cheatle (i)
Age 50. Joined the Board in 2010. Chief Executive, Midlands Co-operative Society. Director of Co-operative Food Board, Member of the Group Audit and Risk Committee and the Future (non-commercial) Federal Requirements Working Group.

Herbert Daybell (r)
Age 64. Joined the Board in 2009. Retired Publisher. Member of Central & Eastern Regional Board. Director of Co-operative Food Board. Chair of the Group Values & Principles Committee.

Paul Flowers (r)
Age 61. Group Deputy Chair. Joined the Board in 2008. Superintendent Methodist Minister. Member of the North Regional Board. Chair of Co-operative Banking Group Ltd, The Co-operative Bank plc, Co-operative Insurance Society Ltd, and CIS General Insurance Ltd. Chair of the Group Remuneration & Appointments Committee and the Diversity Strategy Group. Member of the Political Strategy Working Group.

Stuart Ramsay (r)
Age 54. 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 Working Party and the Political Strategy Working Group. Also, a representative on The Co-operative Party NEC.

Ray Henderson (r)
Age 65. Joined the Board in 2009. Retired Telecoms Engineer. Member of the North Regional Board. Director of Co-operative Food Board. Member of the Future (non-commercial) Federal Requirements Working Group.

Chris Herries (r)
Age 65. Joined the Board in 2009. Retired Teacher/Oxfam District Manager/Horticulturalist. Member of the South & West Regional Board. Director of Co-operative Specialist Businesses Board, Member of the Group Remuneration & Appointments Committee, the Governance Working Party and the Diversity Strategy Group. Director of Co-operatives UK Ltd. Also a Member of the Future (non-commercial) Federal Requirements Working Group.

Ursula Lidbetter (i)
Age 49. Group Deputy Chair. Joined the Board in 2009. Chief Executive, Lincolnshire Co-operative Society. Chair of Co-operative Food Board. Member of the Group Audit & Risk Committee and the Group Remuneration & Appointments Committee.

Mark Smith (i)
Age 52. Joined the Board in 2010. Chief Executive of Southern Co-operatives. Director of Co-operative Specialist Businesses Board.

Steve Watts (r)
Age 60. Group Deputy Chair. Joined the Board in 2000. Retired Pricing, Research and Information Manager. Member of 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 & Risk Committee.

(r) regional representative
(i) independent society representative

Liz Moyle (r)
Age 63. Joined the Board in 2011. Retired. Director of Co-operative Specialist Businesses Board. Member of the Future (non-commercial) Federal Requirements Working Group.

David Pownall (r)
Age 54. 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.

Ben Reid (i)
Age 57. Joined the Board in 2000. Chief Executive of The Midcounties Co-operative. Non-executive director of Co-operative Banking Group Ltd, The Co-operative Bank plc, Co-operative Insurance Society Ltd and CIS General Insurance Ltd. Chair of the Group Audit & Risk Committee, and a member of Co-operative Banking Group Audit Committee. Also a Member of the Group's Values and Principles Committee.

Patrick Grange (r)
Age 69. Joined the Board in 2007. Farmer and Business Consultant. Member of the North West & North Midlands Regional Board. Director of Co-operative Food Board. Also a Member of the Group Audit & Risk Committee and the Group Remuneration & Appointments Committee.

Board compositions

Co-operative Food Board

Ursula Lidbetter
Group Deputy Chair & Chair of Food Board

Len Wardle
Group Chair

Jenny Barnes
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

Euan Sutherland
Independent Professional Non-Executive Director

Peter Marks
Group 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

Liz Moyle
Group Director

David Pownall
Group Director

Stuart Ramsay
Group Director

Mark Smith
Group Director

Peter Marks
Group Chief Executive

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

Rodney Baker-Bates
Independent Professional Non-Executive Director & Deputy Chair of The Co-operative Banking Group

Duncan Bowdler
Group Director

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

Anne Gunther
Independent Professional Non-Executive Director

Peter Harvey
Independent Professional Non-Executive Director

Paul Hewitt
Professional Non-Executive Director

Merlyn Lowther
Independent Professional Non-Executive Director

Bob Newton
Independent Professional Non-Executive Director

Ben Reid
Group Director

Peter Marks
Group Chief Executive

Barry Tootell
Acting Chief Executive of The Co-operative Banking Group

Martyn Wates
Chief Executive Specialist Businesses & Group Deputy Chief Executive

Management Executive

Peter Marks
Group Chief Executive

Age 62. Entire working life spent within The Co-operative Movement, having started with the Co-op in Bradford in 1967. Named Orange Leader of the Year in 2009 in the National Business Awards. 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 45. 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
Acting Chief Executive Officer, Banking Group

Age 50. Qualified accountant with over 20 years of banking experience and was previously Chief Financial Officer. Executive director of The Co-operative Banking Group Limited, Co-operative Insurance Society Limited, The Co-operative Bank plc, CIS General Insurance Limited and Britannia Treasury Services.

Sean Toal
Acting Chief Executive, Food

Aged 42. Joined the Group Executive in September 2011 after holding various senior roles in the Food Executive team. Recently appointed Chief Operating Officer for Food with responsibility for Retail Operations and Logistics together with Supply Chain, Trading and Marketing.

Moira Lees
Group Secretary

Age 53. Heads the Group's Secretariat, covering the Governance, Membership and Legal functions. Also Secretary of The 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.

Steve Humes
Group Chief Financial Officer

Age 46. 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.

Richard Bide
Group HR Director

Age 55. Joined the Executive in 2003. Richard joined the Group from Centrica plc, where he was Group Director of Human Resources. Prior to that, he was Group Director of Human Resources for Tate & Lyle plc, following 15 years with ICI plc in a wide range of HR-related roles.

Martyn Hulme
Managing Director Co-operative Estates

Aged 50. 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.

Mark Craig
Director of Corporate Affairs

Age 56. 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.

Gill Barr
Group Marketing Director

Age 54. Joined the Group Executive in January 2011. Gill's previous positions include Marketing Director of John Lewis plc, and Business Development Director at Woolworth plc, as well as a range of senior positions within Kingfisher plc, KPMG and Freemans plc. Gill is also a Non-Executive Director of Morgan Sindall plc.

Andy Haywood
Chief Information Officer

Age 48. 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.

Report of the Group Board of Directors

The directors submit their report, business review and audited financial statements, for the 52 weeks ended 31 December 2011. The comparative information is for the 52 weeks ended 1 January 2011.

Business review

A full business review of the development and performance of the Group and its operating subsidiaries during the financial year and any significant events since the year end, are set out on pages 10 to 15 of this report. This review also sets out the key financial and non-financial performance indicators on pages 8 and 9 and any significant events since the year end. In addition, the principal risks and uncertainties facing the Group are set out on pages 22–25. Note 38 of the financial statements provides details of the Group's principal subsidiaries and the nature of each organisation's business.

Principal activities

The major activities of the Group include food retailing, funerals, pharmacies, legal services, farming and until 1 October 2011 Travel. It is the parent organisation of The 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 profit before taxation was £231m (2010 (restated): £292m), a decrease of £61m on 2010.

A more detailed review of the business is contained in the business review on pages 10 to 15.

The directors recommend a final distribution of £102.5m in respect of 2011 comprising: a payment of £17.3m to Independent Societies at a rate of 100p per £100 qualifying purchases from the Group during the year; individual payments of £50.8m; community distributions of £10m and employee distributions of £24.4m based on employee membership of the Group. An interim individual distribution of £16.9m was approved at the Half Year General Meeting on 5 November 2011 taking the total individual payment to £67.7m at a rate of 1.75 pence per point and giving total overall distributions of £119.4m in respect of 2011.

Employees

The Group and its subsidiary undertakings employed 102,007 persons at 31 December 2011 (1 January 2011: 114,561) and their aggregate remuneration for the year was £1,731.8m (1 January 2011: £1,812.6m).

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 20–21. In addition, the Group's new Sustainability Report, which is to be published in Summer 2012, will describe how the Group manages its social, ethical and environmental impact.

Political and charitable donations

In line with the co-operative principle of concern for community, The Co-operative operates an extensive programme of community investment, which embraces everything from small grants awarded by local member committees to international strategic alliances designed to tackle issues such as global poverty and climate change. With the launch in 2011 of the Ethical Operating Plan, 'Keeping Communities Thriving' has been accorded a central position in business strategy, and the community investment programme has been increasingly focused towards fulfilling this and the Plan's other objectives. The Co-operative uses the internationally recognised London Benchmarking Group (LBG) standard to measure its overall contribution to the community, and this takes into account not only cash and in-kind donations, but also staff volunteering time and management costs. Reporting in line with the LBG, community investment made by The Co-operative in 2011 was £11.7m.

The Co-operative 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 Party works to raise awareness of the benefits of co-operative and mutual models, and to influence government 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.

In 2011 an annual donation of £533,000 (2010: £536,000) was made to the Co-operative Party. In addition, £234,000 (2010: £213,000) 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 2011 devolved elections in Scotland and Wales, and a further £5,000 to support the Party's activity during the Scottish Labour leadership campaign. In addition, a number of donations totalling £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.

Furthermore, during the course of 2011, a number of donations were made to support various local Labour Party and Co-operative Party events, and a small in-kind donation of £450 for the use of office space for Labour Party events.

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 party political conferences and, in 2011, the Group was represented at the conferences of The Co-operative Party, Liberal Democrat Party, Labour Party, The Conservative Party, Plaid Cymru and the Scottish National Party.

Market value of land and buildings

Freehold and leasehold land and buildings held by the Group (excluding investment properties) are held on the balance sheet at historic cost and have not been revalued. These have been internally assessed at a market value of £2,198m, which is £693m higher than historic cost.

Report of the Group Board of Directors continued

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 31 December 2011, trade creditors expressed as number of days outstanding was 48 days (1 January 2011: 44 days) for the Group.

Compliance with the Groceries (Supply Chain Practices) Market Investigation Order 2009 and the Groceries Supply Code of Practice (together 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 – the Commission's investigation confirmed our business relations with our suppliers to be in good health.

Naturally, we have taken our responsibilities under the Code seriously both in anticipation of its coming into force and since 4 February 2010. A significant investment has been made in robust compliance processes and systems (both within our Food business and, to the extent it retails grocery items, our Pharmacy operation), including the appointment of a Code Compliance Officer, the creation of a rolling programme of internal audits to test compliance, the implementation of a comprehensive training programme for all employees involved in dealings with our suppliers, the launching of an online supplier portal, and the provision of regular reports of progress and status to the Group's Audit and Risk Committee to ensure that Committee retains effective oversight of Code compliance.

A small handful of alleged breaches of the Code have been asserted by suppliers but all of these have been found, on examination, not to engage the provisions of the Code in fact.

Accordingly, we are pleased to be able to report that the Group has received no formal supplier complaints under the Code, nor has the dispute resolution process it provides for been activated by any supplier.

Bribery Act

The new Bribery Act was introduced as UK law in July 2011. This legislation sets out a number of new criminal offences including bribing a foreign public official, giving or receiving a bribe, and a corporate offence of failing to have adequate measures in place to prevent bribery.

Since last year the Group has been making preparations for the new Act including a statement from the Chief Executive outlining the Group's position in respect of this legislation, reviewing current policies and procedures, procurement and due diligence processes and identifying all high risk functions across the Group. All suppliers, sub contractors, business partners and other agents to the Group have been communicated with to ensure they are aware of their own obligations.

The Group's existing Code of Business Conduct has been revised to include an updated Gifts and Hospitality policy as well as revisions to the whistle-blowing procedures. A new hospitality register has been developed to ensure that all offers of gifts or hospitality are captured and audited centrally.

An Anti-Bribery computer-based training programme has been developed by the Group's Risk function, and has been made available to all employees in order to make them aware of their responsibilities under the new Bribery Act.

Corporate governance statement

The Co-operative Group is an Industrial and Provident Society that is jointly owned and democratically controlled by its members. 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 Co-operative Group to comply with the UK Corporate Governance Code (the Code); however, the Group Board 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. In that regard it aims to conform to the spirit of the Code.

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

This Corporate governance section of the Directors' report describes the key governance mechanisms operating within the Group.

Group Board composition and independence

The Group Board consists of 20 Directors, of whom 15 are elected from the Regional Members Constituency and five are elected from Independent Co-operative Societies. There is currently one vacancy in the Independent Members' Constituency which will be filled following the elections in 2012.

Under the Rules of the Group, a third of directors are subject to re-election each year. Following a contested election, Liz Moyle (Co-operative Group, Wales/Cymru Region) was appointed to the Board on 21 May 2011.

With effect from the same date, the following directors were re-elected to the Board for a three year term:

- Steven Bayes, The Co-operative Group North Region;
- Patrick Grange, The Co-operative Group North West & North Midlands Region;
- Len Wardle, The Co-operative Group, South East Region;
- Stuart Ramsay, The Co-operative Group, Scotland and Northern Ireland Region;
- Ursula Lidbetter, Lincolnshire Co-operative.

Nigel Keane (The Co-operative Group, Wales/Cymru Region), stood down as a Director at the end of his term of office on 21 May 2011. In addition, further to his resignation as Chief Executive Officer of East of England Co-op Society, Richard Samson stood down as a director on 30 September 2011.

The following directors are subject to re-election during 2012:

Regional Constituency:
- Jenny Barnes, South & West Region
- Eric Calderwood, Scotland and Northern Ireland Region
- Herbert Daybell, Central & Eastern Region
- Ray Henderson, North Region
- David Pownall, North West and North Midlands Region

Independent Society Member Constituency:
- Ben Reid, The Midcounties Co-operative
- Mark Smith, The Southern Co-operative

In addition, there is a two year casual vacancy in the Independent Members' Constituency.

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. Independent Society Members enter into material transactions with the Group. In addition, Independent Society Members 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.

The Group Board believes that all of its directors make valuable contributions to the operation of the Group. There is no senior independent director as the Group Board is wholly made up of non-executive directors. It is the Group Board's view that this role is not appropriate for their Board because of its democratic nature.

The current composition of the three Subsidiary Boards is shown on page 27. Two Independent Professional Non-Executive Directors (IPNEDs) are appointed to each of the Food and Specialist Businesses Boards and six are appointed to The Co-operative Banking Group Board.

Board diversity
The Group Board composition is entirely non-executive, elected directors, however, 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. The Board has established a Diversity Strategy Group, 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 main Group Board.

Of the 20 directors on the Group Board, five 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. The Diversity Strategy Group will give consideration to the Board's policy on diversity during 2012 in light of the Lord Davies' independent review in 2011 into Women on Boards.

Role and responsibilities of the Group Board and Subsidiary Boards
The role of the Group Board is to focus on the strategic objectives of the Group. It 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 arm. 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.

The Group Board is responsible for the long term success of the Group and as such 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.

In addition, the Group Board is responsible for monitoring performance against key financial and non-financial indicators, overseeing the system of risk management, and setting standards in governance matters. The Board also receives regular reports from the three Subsidiary Boards.

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. He has no involvement in the running of the day to day business of the Group. The Group Chair facilitates the effective contribution of directors and ensures that there is good communication with members. The Group Chair is supported by three Group Deputy Chairs.

The Secretary to the Board
The Group Secretary is professionally qualified and is responsible for advising the Group Board through 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.

With effect from 1 January 2011, a new Group structure was created to facilitate a common strategic approach for all the businesses.

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 the detailed scrutiny of their respective businesses. The subsidiary boards also contribute towards the formulation of the strategy of the business. Joint Board meetings are arranged from time to time to consider wider Group strategic issues.

Report of the Group Board of Directors continued

The number of meetings of each Board and attendance of directors is set out in the table on page 36. Meetings are generally 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.

Board and committee papers are distributed at least eight days in advance of meetings. This provides the opportunity for directors to prepare fully for meetings. The minutes of all meetings are circulated to all directors. The Board has access to its own secure website where additional supporting material is available.

In September 2011, the Group Board approved the roll-out of a secure software application supported by iPad technology to provide access to Board papers for all directors serving on the Group Board, subsidiary boards and committees. The principal aims are to increase security and to provide a more environmentally friendly solution in the distribution of papers by eliminating hard copy production as far as possible. The intention is to eliminate the hard copy distribution by the summer of 2012.

Group Board committees

The Group Board governs through clearly identified Board committees which are detailed on the following pages. The terms of reference for each committee is available on the Group's website at www.co-operative.coop.

Group Audit & Risk Committee – information on the Group Audit and Risk Committee is given on page 33.

Group Remuneration & Appointments Committee – information on the Group Remuneration & Appointments Committee is in the report on page 37.

Group Chair's Committee – The committee comprises four members, Len Wardle (Group Chair), Paul Flowers (Group Deputy Chair), Ursula Lidbetter (Group Deputy Chair) and Steve Watts (Group Deputy Chair), together with any other directors the Board decides from time to time. It has authority to act between Group Board meetings if required. The remit of the committee covers all areas reserved to the Group Board.

Governance Working Party – The Governance Working Party meets as required to consider any matter that relates to the good governance of the Group that the Group Board request. There are five directors on this body: Len Wardle, (Group Chair), Duncan Bowdler, Marilynne Burbage, Chris Herries and 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 five Group directors: Herbert Daybell (Chair), Jenny Barnes, Marilynne Burbage, Stuart Ramsay and Ben Reid. There are also seven regional representatives 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.

Diversity Strategy Group – this Strategy Group was established in 2010, with the remit of considering the overall diversity strategy for the Group and in particular, employee, member and diversity issues relating to the goods and services provided by the Group. The Strategy Group comprises the Group Chair – Len Wardle, the Chair of the Group Values & Principles Committee – Herbert Daybell and a representative from each of the three subsidiary boards – Jenny Barnes Co-operative Food Board – Chris Herries, Co-operative Specialist Businesses Board and Paul Flowers, The Co-operative Banking Group Board, who is also Chair of the Strategy Group.

Political Strategy Working Group – this working group considers and makes recommendations to the Group Board, the Group Values & Principles Committee or Management on any matter that relates to the political engagement of the Society. It monitors the overall Group approach to the political engagement strategy, in particular Government at all levels, including the European Union, Westminster, the devolved legislatures, regional structures within England and local government throughout the UK, political parties, funding within the political environment, engagement at political conferences and other events, political consequences and outcomes of our Social goals strategy, Engagement of members in public policy interventions and any other matters of political strategy development, which fall within its remit, as determined by the Working Group or the Group Board. The composition of this Group comprises: Group Chair – Len Wardle, the Chair of Group Values & Principles Committee – Herbert Daybell, Marilynne Burbage, Paul Flowers and Stuart Ramsay.

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 furtherance of their duties.

Insurance and Indemnities

The Group maintains appropriate directors' and officers' liability insurance cover in respect of legal action against its directors and officers, which is renewed on an annual basis.

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.

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 to The Co-operative Group. 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.

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.

Effectiveness

Induction and Continuing Professional Development

In line with the Walker Review and the Code, the Group has reviewed the induction programme for new directors. All newly elected directors and IPNEDs 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.

The directors' website has been used 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.

Performance evaluation

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

A three year programme of assessment of Board and Committee effectiveness exercises and peer evaluations was introduced during the year. In 2011, one-third of the Board was subject to a peer evaluation selected on length of service from first appointment to that Board, subject to having served at least one year on the relevant Board as at 30 June 2011.

An internal self assessment Board effectiveness exercise is also underway.

The final phase of the three year programme will involve the internal peer evaluation exercise of one-third of the Board, supported by an externally facilitated board effectiveness exercise for the three Subsidiary Boards.

Membership Involvement

As a co-operative, the Group is jointly owned by over 7.2 million individual members and in the region of 80 Independent Society Members. Individual members of the Group exercise democratic control by serving on its 48 area committees and seven Regional Boards, or by voting in elections (351,685 individual members voted in 2011) (2010: 260,000), attending twice yearly members' meetings held throughout the country or participating in other consultation initiatives.

The Group provides learning and development opportunities for members to ensure they 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, web chats and surveys.

Group Audit & Risk Committee

Committee Overview

Composition

The committee comprises six members as follows:

Ben Reid (Chair of the Committee)
Duncan Bowdler
Martyn Cheatle
Patrick Grange
Ursula Lidbetter
Steve Watts

In addition, the Chair of the Banking Group Audit Committee together with the Chair of the Banking Group Risk Committee, attend meetings.

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

Full details of attendance at committee meetings is shown on page 36.

All the committee are considered to have the necessary ability and experience to understand financial statements: The Code requires that at least one member of the committee has recent and relevant financial experience. The Board considered this requirement during the year at the time it considered its Board appointments and concluded that the Chair of the Committee, Ben Reid, fulfils this requirement. Biographical details of each member of the committee are contained on pages 26–27.

The committee met four times during the financial year and held additional meetings to discuss the tender of the external audit.

Role

The main responsibilities of the committee are to:

- Monitor the integrity of the Group's financial statements and any formal announcements relating to the Group's performance, together with any significant financial reporting judgments contained in the financial statements.
- Monitor the effectiveness of the external audit process and make recommendations to the Group Board, for it to put to the members in general meeting, in relation to the appointment, reappointment and remuneration of the external auditor and to approve the remuneration and terms of engagement of the external auditor.
- Review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements.
- 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 reporting to the Group Board, identifying any matters in respect of which it considers that action or improvement is needed.
- Review annually the Group's systems of internal controls and the processes for monitoring and evaluating the risks facing the Group.
- Review the effectiveness of the Internal Audit function and approve upon the recommendation of the Group Chief Executive, the appointment and termination of the head of that function.
- Review the Group's whistleblowing procedures to ensure the arrangements are in place to support employees and suppliers to raise concerns on a confidential basis including support from an external independent service.
- Review the minutes and receive reports of the CBG Audit Committee and its Risk Committee.
- Annually review its terms of reference and recommend to the Board any changes required as a result of the review.

Report of the Group Board of Directors continued

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 the system of internal controls. This 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. However 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.

Since the publication of the Turnbull Report in September 1999, on 'Internal Control: Guidance for Directors on the Combined Code by the Institute of Chartered Accountants in England and Wales', the directors have continued to review the effectiveness of the Group on 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 Business are reviewed and approved by the Group Board. Results are reported against budget and previous year. The relevant Executives consider any significant changes and variances, and remedial action is taken where appropriate
- 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 committee keeps the effectiveness of the process under regular review. Details on the Society key risks can be found on pages 22 to 25. The Group operates a risk management process that identifies the key risks facing each business. Each business has a risk register that identifies the likelihood and impact of those risks occurring 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 & Risk Committee. The information is consolidated for the Group Risk Management Committee, which provides reports, four times a year, to the Group Audit & Risk Committee on how the key risks are being managed. 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.

The specific responsibilities of the committee are currently as follows:

- Defining and maintaining the policy, methodology and standards for risk management
- Identification of significant risks affecting the Group as a whole, communicating these to the businesses and corporate departments to ensure progress and action plans to address the identified risk
- Oversight of the business risk management committees, including ensuring that progress is made on action plans reported
- Ensuring the systems of risk management are operating throughout the year and providing regular reports to the Group Board and Audit & Risk Management Committee that explain the significance and likelihood of the risks and the necessary actions being taken by management to manage those risks

Attendees at the Group Risk Management Committee meetings include the Group Chief Executive (Chair), the Chief Financial Officer, the Group Secretary, the Banking Group Chief Financial Officer, the Banking Group Director of Risk, the Director of Strategic Planning and Change (Secretary to committee), the Pensions Finance and Risk Controller, the Head of Ethics, Social Goals and Sustainability and the Head of 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.

Monitoring

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, by the Group's external auditors and external regulators.

The Group Audit & 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 & Risk Committee, is an annual 'letter of assurance' process, by which the 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 reporting any key control improvements required. The outcome of these letters is reported to the Group Audit & Risk Committee. The directors are then able to review the system of internal controls and ensure it complies with the Turnbull Report guidance. The committee considers that there have been no weaknesses that have resulted in any material losses or contingencies that have not been disclosed.

External Audit

One of the duties of the Audit & Risk Committee is to make recommendations to the Board in relation to the appointment of external auditors. In line with good corporate governance an external audit tender exercise took place in early 2011 and a resolution to re-appoint KPMG Audit Plc as the external auditor was put to and approved by the Group's Annual General Meeting on 21 May 2011.

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 committee has put in place safeguards to ensure that the independence of the audit is not compromised, including a policy on the conduct of non-audit services from the external auditor that ensures independence is not compromised. The external auditors are permitted to provide some non-audit services that are not, and are not perceived to be, in conflict with their independence. 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. The pre-approval of the committee is required for services above certain thresholds determined by the committee. In addition, the following assignments are prohibited from being performed by the external auditors:

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

The performance of the external auditors is formally monitored annually to ensure it meets the needs of the Group and the results are reported to the committee.

Internal Audit

Internal Audit is an independent appraisal function that derives its authority from the Group Board through the Group Audit & 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 risk management.

Internal Audit seeks to discharge the responsibilities set down 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 and to report and advise on the proper and effective use of resources.

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 judgments 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 detect and prevent 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.

Statement on Going Concern

After making all appropriate enquiries, the directors have reasonable expectations that the Society 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 Society's financial statements. More detail of the rationale for adopting the going concern basis is set out in the general accounting policies section on page 55.

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.

Auditor

The current auditor is KPMG Audit Plc. A resolution to re-appoint KPMG Audit Plc and authorise the directors to fix their remuneration is to be proposed at the Annual General Meeting on 26 May 2012.

By Order of the Board
Moira Lees, Group Secretary

28 March 2012

Report of the Group Board of Directors continued

Director	Group Board	Group Audit & Risk Committee	Group Remuneration & Appointments Committee	Specialist Businesses Board	Co-operative Food Board	Co-operative Banking Group	Governance Working Party
Number of meetings held	9	4	7	11	11	11	4
Jenny Barnes	9 (9)				11 (11)		
Steven Bayes	8 (9)			11 (11)			
Duncan Bowdler	8 (9)	4 (4)				10 (11)	4 (4)
Marilynne Burbage	9 (9)			11 (11)			4 (4)
Eric Calderwood	9 (9)				10 (11)		
Martyn Cheatle	8 (9)	1 (2)			10 (11)		
Penny Coates				9 (11)			
Mike Cutt				10 (11)			
Herbert Daybell	9 (9)				11 (11)		
Paul Flowers	9 (9)		7 (7)			11 (11)	
Patrick Grange	9 (9)	4 (4)	6 (7)		11 (11)		
Ray Henderson	9 (9)				11 (11)		
Chris Herries	9 (9)		7 (7)	11 (11)			4 (4)
Nigel Keane	4 (4)	2 (2)		5 (5)			
Ursula Lidbetter	9 (9)	3 (4)	7 (7)		11 (11)		
John Longworth					11 (11)		
Liz Moyle	5 (5)			5 (5)			
David Pownall	9 (9)			11 (11)			
Stuart Ramsay	9 (9)			11 (11)			3 (4)
Ben Reid	6 (9)	4 (4)				9 (11)	
Richard Samson	6 (7)				5 (8)		
Mark Smith	8 (9)			10 (11)			
Euan Sutherland					9 (11)		
Len Wardle	9 (9)		7 (7)	10 (11)	8 (11)	11 (11)	4 (4)
Steve Watts	9 (9)	2 (2)	7 (7)	11 (11)		7 (7)	

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

Remuneration report

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 26 May 2012.

Introduction

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

- A description of the role of the Remuneration & Appointments Committee;
- A summary of the Group's remuneration policy, including statements of policy in relation to Executives' and directors' remuneration;
- Details of the terms of the service contracts and the remuneration of each Executive for the 2011 financial year; and
- Details of the current terms of office and the remuneration of each director for the 2011 financial year.

Role of the Remuneration & 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 incentive schemes and ensure that they support the Group's strategy, values and objectives, and authorise payments under any incentive schemes in line with their rules; and
- Receive, review and decide on issues raised in relation to retirement benefit schemes across the Group and advise the Board on these issues as appropriate.

In respect of the directors, including IPNEDs, the committee's responsibilities include:

- Ensuring there is a timely review of the remuneration and expenses policy of 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
- 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.

Members of the Committee during 2011 comprised Paul Flowers (Group Deputy Chair and Chair, Banking Group, who also chairs the Committee), Patrick Grange, 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 (Moira Lees) and the Group HR Director (Richard Bide) 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 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. The committee met seven times in the period under review.

To ensure that it receives independent advice on remuneration matters, the Committee retained New Bridge Street (an Aon Hewitt company) as its independent advisor 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.

Remuneration report continued

Policy on Executives' Remuneration

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

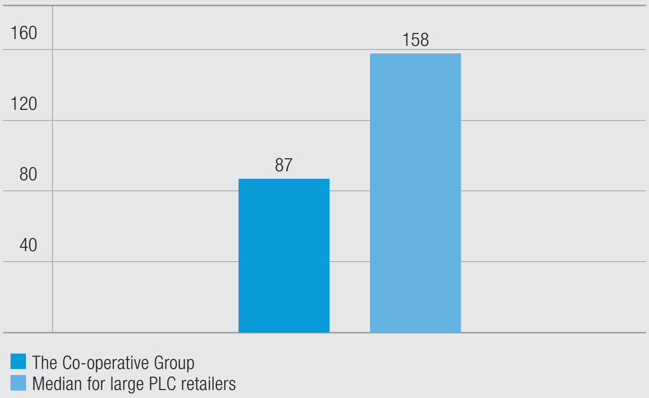
- The importance of attracting, retaining and motivating senior Executives of the appropriate calibre to further the success of the Group;
- The linking of reward to individual and business performance and the strengthening of co-operative values, which include a strong belief in stewardship of all of 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'). These are based on performance metrics linked to the Group's Key Performance Indicators. However, the committee does not consider it appropriate to adhere to the size of incentive pay typically available in public limited companies (plcs) and accordingly the amounts payable under these plans are lower than in comparable plcs. Furthermore, the committee carefully considers the motivational impact of its incentive 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.

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 retail sector, in which the Group competes for talent. The chart opposite 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.

The Society's highest-to-lowest total pay ratio is significantly lower than the typical ratio in PLCs

Chief Executive total pay as a multiple of the lowest pay (full-time)



Data taken from 2010/11 being the most up-to-date market data available at time of publication.
Highest total pay = 2010/11 salary, bonus paid in relation to 2010/11, expected value of long term incentives at grant, pension and benefits, net of income tax and employees' national insurance (based on 2010/11 rates), sourced from Report & Accounts.
Lowest total pay = 2010/11 salary (based on the over 18 hourly rate and standard full-time working week) and bonus paid in relation to 2010/11 (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 2010/11 rates). The information in the chart is not subject to audit.

On 22 July 2011 Neville Richardson stepped down as Chief Executive, Banking Group and Barry Tootell was appointed Acting Chief Executive from this date. Tim Hurrell stepped down as Chief Executive, Food on 19 September 2011 and Sean Toal was appointed Acting Chief Executive from this date. Both Neville Richardson and Tim Hurrell continued in employment until 31 December 2011 (see Table 1(a) on page 42 for more details). Permanent appointments to these Chief Executive roles are pending. In addition, from 1 January 2011 Martyn Wates assumed the new role of Deputy Group Chief Executive/Chief Executive, Specialist Businesses and was replaced as Group Chief Financial Officer by Stephen Humes.

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

Element	Remuneration objective	Details
Base salary	To provide a competitive base salary to attract and retain talented leaders.	Reviewed annually. Targeted around market median.
Benefits	To provide executive benefits in line with normal market practice.	Car or car allowance, fuel card, phone and life assurance.
Pension	To aid retention and reward long service, whilst controlling the Group's liabilities.	The Group provides a Defined Benefit pension plan (on the same career-average basis as other employees in the Group), or an equivalent cash pension allowance.
Annual Incentive Plan	To incentivise and reward executives for delivery of superior annual performance based on the Group's annual business objectives and co-operative values.	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 plcs. (See pages 38 and 39)
Long Term Incentive Plan	To incentivise and reward executives for delivery of superior long term performance based on the Group's objectives and values, and to retain talent.	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 plcs. (See page 39)

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. Base salary is the only element of remuneration that is pensionable. Salaries received by Executives in respect of 2011 are set out in Table 1(a) on page 42.

Annual incentive plan

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 basic salary. Bonus is only payable for achieving or exceeding 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 2011 for different roles and the weighting of each measure.

Role	Group measures	Divisional measures
Group Chief Executive Group CFO Group Secretary Group HR Director Director of Marketing Director of Communications	Group profit (70%) Group corporate responsibility (10%) Colleague engagement (10%) Customer satisfaction (10%)	n/a
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%)	CBG profit (23.33%) CBG efficiency (23.33%) Divisional colleague engagement (10%) Divisional customer advocacy (10%)

Remuneration report continued

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 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 25% of the opportunity (ie 15% 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. Bonus payments, adjusted for the impact of the disposal of the Travel business, for full year 2011 ranged between 29% and 57% of salary.

For 2012, the maximum bonus potential will remain at 60% of base salary and similar financial and non-financial metrics to those for 2011 will be used, with appropriate targets.

Long term incentive plan (LTIP)

Executives also participate in a 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 plan cycle 2009–11 was completed in January 2012. The plan cycle 2010–12 remains outstanding, and grants were made in 2011 covering the 2011–13 cycle. Details of payments due under the 2009–11 plan cycle are set out in Table 1(b) on page 43. For members of the Group Executive participating in the plan cycle 2009–11, no payments have vested under this LTIP due to the Return on Capital Employed (ROCE) underpin measure not being met. For Neville Richardson and Barry Tootell, payments have been earned under the Banking Group LTIP 2009–11.

The committee set the following metrics and targets for the 2011–13 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.

Claw-back

With effect from the 2010 LTIP grant, and for annual incentive payments in respect of 2011 performance onwards, a claw-back provision will apply in line with developing market practice. This enables the committee to seek to recoup part or all of an annual incentive or LTIP payment, in the exceptional event that it was based on mis-stated performance results or an Executive is dismissed for gross misconduct.

Service contracts

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. The details of the termination payments made to Executives leaving the Group during 2011 are disclosed in Table 1(a) (on page 42).

Dates of appointment for Executives are also disclosed in Table 1(a).

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.

Pensions

The Group offers every employee the opportunity to join a pension scheme. Generally, the pension scheme in which an employee accrues pension benefits is determined by their original employer within the Group (or other business prior to merger with, or acquisition by, the Group). For current Executives, these are provided through The Co-operative Group Pension (Average Career Earnings) Scheme ('the PACE Scheme') and, following the merger with United Co-operatives on 29 July 2007, the United Norwest Co-operatives Employees' Pension Fund and the Yorkshire Co-operatives Limited Employees' Pension Fund ('the United Schemes').

The PACE Scheme, which is a registered occupational pension scheme, provides pensions based on 1/60th of average pensionable earnings, revalued by inflation for each year of pensionable service from 6 April 2006 (the date the PACE Scheme was implemented). Benefits accrued as at 5 April 2006, in respect of membership of the scheme preceding the PACE Scheme, continue to be linked to final pensionable salary at a member's date of leaving or retirement, whichever is earlier. Pensions are also payable to dependants on death and a lump sum is payable if death were to occur in service.

The United Schemes, which are also registered occupational pension schemes, broadly provide pensions based on 1/60th of final pensionable salary for each year of pensionable service. Pensions are also payable to dependants on death and a lump sum is payable if death occurs in service.

Executives who are members of the PACE Scheme currently contribute 6% of their pensionable salary, whilst Executives who are members of the United Schemes contribute between 8% and 9% of their pensionable salary depending on the relevant scheme. The Group pays the balance of the cost of providing benefits.

The Group Chief Executive was paid a pension allowance in lieu of pension accrual in a Group occupational pension scheme.

Where paid, the rate of pension allowance is based on the employer contribution rate to the PACE Scheme. This is currently 16.7% of pensionable salary (16% prior to July 2011), reverting to 16% of pensionable pay from October 2012.

Prior to the merger with Britannia Building Society on 1 August 2009, Neville Richardson had a contractual arrangement under which he accrued pension benefits above the lifetime allowance in an unfunded employer-financed retirement benefit scheme (EFRBS). This contractual arrangement was revised from 1 August 2009 and the rate of benefit aligned more closely to Group executive pension policy. This arrangement was further adjusted from 1 August 2011 so that the rate of future pension accrual made available under the Britannia Scheme was aligned to that provided by the PACE Scheme, with no further accrual in the EFRBS.

In 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.

On this basis the Group Secretary and Chief Executive, Specialist Businesses opted out of future pension accrual from 6 April 2011 and 27 May 2011 respectively and were paid a pension allowance.

The Managing Director, Estates, Group Chief Financial Officer and Acting Chief Executive, Banking Group opted for restricted pension accrual from 6 April 2011 and were paid a restricted pension allowance.

The Director of Marketing did not accrue pension benefits in a Group occupational pension scheme and was not paid a pension allowance.

All other Executives accrued full pension benefits as members of either the PACE Scheme or one of the United Schemes during the year.

Supplementary life cover is provided to Executives in order to provide total life cover of 4 times salary when aggregated with benefits from the relevant pension scheme, as appropriate.

Additional pension details are available in Table 2 (on page 44).

Directors

The Group directors do not have service contracts. The years of their first election are shown in Table 3 (on page 45). All Group directors are subject to a three year term of office, following which they can be re-elected if eligible.

Group directors' fees are determined by the Group's members. Fees are increased in line with the Retail Prices Index (RPI) every year. The increase in fees in 2011 was 4.8%.

The basic remuneration for a Group director is £10,868 per annum. Those Group directors appointed to serve on the Board of Co-operative Banking Group receive an additional annual fee of £16,301. 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 45).

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 £50,000. The term of office of two of IPNEDs expire in 2012, with the term of office of the remaining two expiring in 2013. In addition, the Group Board appoints six IPNEDs and one Professional Non-Executive Director to the Board of The Co-operative Banking Group (CBG). Details of the fees paid are shown in Table 4.

By the Order of the Board
Paul Flowers, Chair
Group Remuneration & Appointments Committee

28 March 2012

Remuneration report continued

Table 1(a) – Executives' emoluments

	Notes	Date of appointment (Note 1)	Basic salary £000	Other supplements (Note 2) £000	Performance related bonus – annual (Note 3) £000	Performance related bonus – long term £000	Benefits in kind (Note 4) £000	2011 Total emoluments (Note 5) £000	2010 Total emoluments (Note 5) £000
Peter Marks		29 July 2007	970	161	490	–	40	1,661	2,118
Gill Barr	8	31 January 2011	277	15	152	–	1	445	–
Richard Bide		15 September 2003	338	9	171	–	10	528	745
Mark Craig		1 September 2010	180	2	91	–	18	291	94
Martyn Hulme		1 September 2010	230	24	119	–	1	374	120
Stephen Humes		1 January 2011	400	33	202	–	10	645	–
Tim Hurrell	6	30 July 2008	454	2	183	–	17	656	1,089
Moira Lees		28 November 2007	289	55	146	–	–	490	524
Neville Richardson	3, 6	1 January 2011	398	8	109	220	3	738	–
Martyn Wates		24 September 2007	565	64	321	–	18	968	1,099
Sean Toal	7	19 September 2011	114	–	47	–	6	167	–
Barry Tootell	3, 7	22 July 2011	223	22	153	110	2	510	–

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

Note 2 The figures relate to full or partial pension allowances in lieu of a pension provision, car allowance, fuel cards, phone and healthcare supplements (ie non-P11D items).

Note 3 Performance related bonus – annual refers to bonus amounts earned in respect of 2011 with no pro-rating to reflect time on the Group Executive. For Neville Richardson and Barry Tootell, to comply with the FSA Remuneration Code, 50% of the 2011 annual bonus quoted is deferred for six months subject to further performance conditions and clawback. In addition, as Neville Richardson is not eligible for 2012–14 LTIP, 60% of the 2011 annual bonus has been deferred (50% for 3 years and 50% for 3.5 years) to comply with FSA deferral rules. The deferred amount is subject to performance conditions and is not quoted in the emoluments table. This amount equates to £162,967.

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

Note 5 Excludes pension values (see Table 2), but includes the cash supplements mentioned above if the executive member opted out of their respective pension scheme.

Note 6 Neville Richardson, Chief Executive, Banking Group and Tim Hurrell, Chief Executive, Food stepped down from their roles on 22 July and 19 September respectively. 2011 total emoluments exclude the following loss of office compensation: Neville Richardson £1,390,000, Tim Hurrell £1,061,000. In addition, Neville Richardson and Tim Hurrell received payments of £380,000 and £270,000 respectively for continued employment to 31 December 2011.

Note 7 Barry Tootell was appointed as Acting Chief Executive, Banking Group on 22 July 2011 and Sean Toal as Acting Chief Executive, Food on 19 September 2011, pending permanent appointments to these roles. Their salaries, other supplements and benefits in kind have been pro-rated in the table above to cover their time on the Executive. The annual bonus represents the amount payable for 2011 in total.

Note 8 Gill Barr received a one-off, taxable lump sum payment of £60,000 to cover relocation expenses upon appointment; this sum is not included in the table above.

Note 9 Neil Braithwaite, Mike Austin, John Nuttall and David Hendry ceased to be members of the Executive on 31 December 2010 and are therefore no longer included in this report. Mike Austin, John Nuttall and David Hendry are still employed by the Group.

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 6)	Maximum award opportunity at end of year
Peter Marks	2011–2013		–	£970,000	–	–	£970,000
	2010–2012		£900,000	–	–	–	£900,000
	2009–2011		£880,000	–	£0	£880,000	–
Gill Barr	2011–2013		–	£225,000	–	–	£225,000
Richard Bide	2011–2013		–	£253,500	–	–	£253,500
	2010–2012		£238,500	–	–	–	£238,500
	2009–2011		£233,250	–	£0	£233,250	–
Mark Craig	2011–2013		–	£135,000	–	–	£135,000
Martyn Hulme	2011–2013		–	£172,500	–	–	£172,500
	2010–2012		£52,339	–	–	–	£52,339
	2009–2011		£51,041	–	£0	£51,041	–
Stephen Humes	2011–2013		–	£400,000	–	–	£400,000
	2010–2012		£82,823	–	–	–	£82,823
	2009–2011		£81,000	–	£0	£81,000	–
Tim Hurrell	2011–2013	1	–	£633,000	–	£422,000	£211,000
	2010–2012	1	£595,000	–	–	£198,333	£396,667
	2009–2011		£565,000	–	£0	£565,000	–
Moira Lees	2011–2013		–	£216,750	–	–	£216,750
	2010–2012		£202,500	–	–	–	£202,500
	2009–2011		£180,000	–	£0	£180,000	–
Neville Richardson	2011–2013	2	–		–	–	–
	2010–2012	3, 4	£664,000	–	–	£221,333	£442,667
	2009–2011	4	£329,767	–	£220,085	£109,682	–
Sean Toal	2011–2013		–	£92,250	–	–	£92,250
	2010–2012		£90,000	–	–	–	£90,000
	2009–2011		£75,000	–	£0	£75,000	–
Barry Tootell	2011–2013	2	–		–	–	–
	2010–2012	4	£288,750	–	–	–	£288,750
	2009–2011	4	£164,500	–	£109,787	£54,713	–
Martyn Wates	2011–2013		–	£565,000	–	–	£565,000
	2010–2012		£515,000	–	–	–	£515,000
	2009–2011		£500,000	–	£0	£500,000	–

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

Note 1 Two-thirds of the 2011–13 award and one-third of the 2010–12 award lapsed at the end of the year due to cessation of employment to reflect period as an employee during the performance period.

Note 2 2011 awards not made as yet as waiting for FSA approval. Awards will be made to cover the period 2011–13 – Barry Tootell maximum opportunity £305,250 and Neville Richardson maximum opportunity £238,000 (being a pro-rated award to reflect period as an employee during the performance period). Additional conditions apply to these LTIP awards to comply with the FSA Code which must be met to enable the award to vest. On vesting 50% of the award is payable and 50% retained for an additional six months subject to additional requirements.

Note 3 One-third of the award lapsed at the end of the year due to cessation of employment to reflect period as an employee during the performance period.

Note 4 2009 and 2010 grants relate to CBG LTIP awards with performance solely relating to CBG over a three year period, together with additional conditions to comply with the FSA Code. For the 2010 awards, on vesting 50% of award is payable and 50% retained for an additional six months subject to additional requirements.

Note 5 Mike Austin, Neil Braithwaite, David Hendry and John Nuttall were previously members of the Group Executive but have stepped down in the year ending 31/12/2010. 2009–2011 maximum potential awards of £94,000, £116,000, £161,000 and £136,500 respectively lapsed in full during the year due to the ROCE underpin measure not being achieved. 2010–2012 maximum potential awards of £96,000, £118,500, £165,000 and £139,500 respectively are still valid and will be paid out in 2013 should the relevant LTIP targets be achieved.

Note 6 Entitlement to award under the terms of the 2009–2011 Trading Group LTIP has lapsed during the year as a result of the pre-defined ROCE underpin measure not being achieved.

Remuneration report continued

Table 2 – Pension details of the Executive

	Notes	Years of service	Total accrued pension at 31 December 2011 £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 31 December 2011 net of members' contributions £000	Transfer value of total accrued pension at 1 January 2011 £000	Transfer value of total accrued pension at 31 December 2011 £000	Increase in transfer values net of members' contributions £000
Peter Marks	4	44	–	–	–	–	–	–	–
Gill Barr	5	0	–	–	–	–	–	–	–
Richard Bide		8	35	7	5	79	439	659	200
Mark Craig		17	71	16	13	310	1,166	1,711	531
Martyn Hulme	6	21	85	9	5	59	1,018	1,561	531
Stephen Humes	7	11	52	10	8	81	451	699	234
Tim Hurrell	8	15	144	19	12	264	2,928	3,788	806
Moira Lees	9	30	130	1	(5)	(118)	2,104	2,487	379
Neville Richardson	10	13	43	(98)	(105)	(2,830)	2,903	1,161	(1,788)
Sean Toal	11	11	58	7	4	25	488	717	204
Barry Tootell	12	3	21	5	4	33	166	274	94
Martyn Wates	13	16	158	10	2	10	1,588	2,261	656

Note 1 The total accrued pension is that which would be paid annually on retirement at normal retirement age based on service to 31 December 2011 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 and Britannia Building Society. 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 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.

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

Note 4 Peter Marks was paid a pension allowance in lieu of pension provision.

Note 5 Gill Barr became a member of the Executive on 31 January 2011. She is not a member of an occupational pension scheme and was not paid a pension allowance.

Note 6 Martyn Hulme opted for restricted pension accrual from 6 April 2011 and was paid a restricted pension allowance.

Note 7 Stephen Humes became a member of the Executive on 1 January 2011. He opted for restricted pension accrual from 6 April 2011 and was paid a restricted pension allowance.

Note 8 Tim Hurrell left the Group on 31 December 2011. He became entitled to a deferred pension from his United Scheme when he left the scheme at the same date. The details shown in the table are calculated at that date.

Note 9 Moira Lees opted out of the PACE Scheme from 6 April 2011 and became entitled to a deferred pension and the details on the table are calculated at that date. She was paid a pension allowance in lieu of pension provision. Deferred pensions are revalued under the PACE Scheme rules but no account has been taken of this in the above table.

Note 10 Neville Richardson left the Group on 31 December 2011. He became entitled to a deferred pension from the Britannia Scheme when he left the scheme at the same date. The details shown in the table are calculated at that date. During the year Neville chose to take the value of his EFRBS as a taxable lump sum of £2,120,000 rather than as pension. The negative numbers shown in the table reflect the effect of this.

Note 11 Sean Toal became an acting member of the Executive on 19 September 2011.

Note 12 Barry Tootell became an acting member of the Executive from 22 July 2011. He opted for restricted pension accrual from 6 April 2011 and was paid a restricted pension allowance.

Note 13 Martyn Wates opted out of his United Scheme from 27 May 2011 and became entitled to a deferred pension and the details on the table are calculated at that date. He was paid a pension allowance in lieu of pension provision. Deferred pensions are revalued under his United Scheme rules but no account has been taken of this in the above table.

Note 14 Mike Austin, Neil Braithwaite and John Nuttall were included in the 2010 Remuneration report. They left the Executive on 31 December 2010 and are therefore excluded from Table 2.

Table 3 – Directors' remuneration

	Notes	Year first elected	Term expires	2011 Remuneration £000	2010 Remuneration £000
Jenny Barnes		2009	2012	31	30
Steven Bayes		2009	2014	33	29
Duncan Bowdler		2007	2013	37	36
Marilynne Burbage		2009	2013	31	27
Eric Calderwood		2006	2012	36	34
Martyn Cheatle	1	2010	2013	23	12
Herbert Daybell		2009	2012	36	31
Paul Flowers	4, 5	2008	2013	128	103
Patrick Grange		2007	2014	38	34
Ray Henderson		2009	2012	32	30
Chris Herries		2009	2013	39	33
Nigel Keane	2	2009	n/a	16	32
Ursula Lidbetter	1	2009	2014	38	28
Liz Moyle	3	2011	2014	19	n/a
David Pownall		2007	2012	33	29
Stuart Ramsay		2009	2014	33	28
Ben Reid	1	2000	2012	40	38
Richard Samson	1, 7	2005	n/a	15	21
Mark Smith	1	2010	2012	22	11
Len Wardle	5	1992	2014	139	135
Steve Watts	6	2000	2013	54	67

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 Nigel Keane stepped down as a director following the expiry of his term of office on 21 May 2011.
Note 3 Liz Moyle was appointed a director of the Group on 21 May 2011.
Note 4 Paul Flowers fee covers his role as Chair of the CBG 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 Richard Samson stepped down as a director of the Group on 30 September 2011, leaving a casual vacancy which will be filled following the 2012 elections.

Remuneration report continued

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

	Notes	Subsidiary Board	Year appointed	2011 Remuneration £000	2010 Remuneration £000
John Longworth		Food	2010	50	28
Euan Sutherland		Food	2010	50	28
Penny Coates		Specialist Businesses	2010	50	28
Mike Cutt		Specialist Businesses	2010	50	28
Rodney Baker Bates	3, 4	The Co-operative Banking Group	2009	75	66
David Davies	3, 4, 5	The Co-operative Banking Group	2003	85	68
Peter Harvey	3, 6, 7	The Co-operative Banking Group	2009	68	57
Chris Jones	3, 8, 9	The Co-operative Banking Group	2009	102	72
Stephen Kingsley	3, 10, 12	The Co-operative Banking Group	2009	93	58
Bob Newton	3, 10	The Co-operative Banking Group	2007	88	56
Piers Williamson	3, 7, 12	The Co-operative Banking Group	2005	46	58
Anne Gunther	3, 13	The Co-operative Banking Group	2011	19	–
Merlyn Lowther		The Co-operative Banking Group	2011	16	–
Professional non-executive director					
Paul Hewitt	3, 15	The Co-operative Banking Group	2003	68	66

Note 1 The Food and Specialist Businesses Board IPNEDs receive a fee of £50,000 per annum.
Note 2 The Food and Specialist Businesses Board IPNEDs were appointed on 16 June 2010.
Note 3 Under their service contracts, the IPNEDs and PNED receive a fee from June 2011 of £59,996 per annum.
Note 4 The Banking Group Deputy Chairs receive an additional fee of £15,720 per annum.
Note 5 David Davies receives £11,004 as the Chair of PACE.
Note 6 The Chair of the Banking Group Exposures Committee receives an additional £5,240 per annum.
Note 7 The Chair of the Banking Group Risk Management Committee receives an additional £11,004 per annum.
Note 8 The Chair of Illius Properties Limited receives a fee of £15,000 per annum.
Note 9 Chris Jones stepped down from the Banking Group Board with effect from 31 August 2011. His remuneration also incorporates his compensation for loss of office of £57,002.
Note 10 The Chair of the Banking Group Transformation Committee receives an additional £7,336 per annum.
Note 11 Stephen Kingsley stepped down from the Banking Group Board on 16 June 2011. His remuneration also includes his compensation for loss of office of £57,002.
Note 12 Piers Williamson stepped down from the Banking Group Board on 8 September 2011.
Note 13 Anne Gunther was appointed to the Banking Group Board on 8 September 2011.
Note 14 Merlyn Lowther was appointed to the Banking Group Board on 7 September 2011.
Note 15 The Chair of the Banking Group Audit receives an additional £11,004 per annum.

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 year ended 31 December 2011 set out on pages 48 to 168. 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's 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 more fully explained in the Statement of Directors' Responsibilities set out on page 35, the Society's directors are responsible for the preparation of financial statements which 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 (APB'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 APB's website at www.frc.org.uk/apb/scope/private.cfm.

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 31 December 2011 and of the Society's profit for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the EU; and
- 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 respect of 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 30 to 33 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
Manchester

28 March 2012

Consolidated income statement
for the year ended 31 December 2011

	Notes	Year ended 31 December 2011 Before significant items £m	Year ended 31 December 2011 Significant items £m	Year ended 31 December 2011 Total £m	Year ended 1 January 2011 (restated*) Before significant items £m	Year ended 1 January 2011 (restated*) Significant items £m	Year ended 1 January 2011 (restated*) Total £m
Revenue	2	**12,408**	**(90)**	**12,318**	12,388	(4)	12,384
Operating expenses	3	**(12,071)**	**(200)**	**(12,271)**	(11,906)	(143)	(12,049)
Other income	4	**248**	**80**	**328**	100	30	130
Operating profit	1	**585**	**(210)**	**375**	582	(117)	465
Finance income	5	**75**	**–**	**75**	45	–	45
Finance costs	6	**(66)**	**–**	**(66)**	(115)	–	(115)
Share of (loss) profit of associates and joint ventures	13	**(11)**	**–**	**(11)**	1	–	1
Profit before member payments		**583**	**(210)**	**373**	513	(117)	396
Member payments	7			**(142)**			(104)
Profit before tax				**231**			292
Taxation	8			**(49)**			(58)
Profit after tax but before loss on discontinued operations				**182**			234
Profit/(loss) on discontinued operations, net of tax	9			**26**			(23)
Profit for the year				**208**			211
Attributable to:							
Equity holders of the parent				**205**			210
Non-controlling interests				**3**			1
Profit for the year				**208**			211

* For an explanation of the restatement of the prior year figures, see the general accounting policies section on page 55 and note 44.

Consolidated statement of comprehensive income
for the year ended 31 December 2011

	Notes	2011 £m	2010 (restated*) £m
Profit for the year		**208**	211
Other comprehensive income:			
Changes in available for sale assets		**(7)**	(3)
Actuarial gains on employee pension schemes	15	**–**	177
Changes in cashflow hedges		**24**	(25)
Foreign currency translation differences for foreign operations		**–**	1
Tax on items taken directly to consolidated statement of comprehensive income	8	**(4)**	(42)
Other comprehensive income for the year, net of tax		**13**	108
Total comprehensive income for the year		**221**	319
Total comprehensive income attributable to:			
Equity holders of the parent		**218**	319
Non-controlling interests		**3**	–
		221	319

* For an explanation of the restatement of the prior year figures, see the general accounting policies section on page 55 and note 44.

Consolidated balance sheet
As at 31 December 2011

	Notes	2011 £m	2010 (restated*) £m
Assets			
Trading Group assets			
Property, plant and equipment	10	**2,511**	2,463
Intangible assets	11	**1,520**	1,544
Investment property	12	**340**	339
Investments	13	**67**	30
Derivatives	14	**79**	15
Pension assets	15	**431**	277
Trade and other receivables	18	**29**	42
Deferred tax assets	16	**133**	136
Total Trading Group non-current assets		**5,110**	4,846
Inventories and biological assets	17	**610**	590
Income tax receivable		**13**	–
Trade and other receivables	18	**478**	457
Cash and cash equivalents		**267**	400
Assets held for sale	19	**1**	54
Total Trading Group current assets		**1,369**	1,501
Total Trading Group assets		**6,479**	6,347
Banking Group assets			
Cash and balances at central banks		**6,696**	1,735
Reclaim fund assets	43	**315**	–
Derivatives	14	**981**	1,729
Loans and advances to banks	20	**2,007**	2,394
Loans and advances to customers	21	**33,782**	34,999
Fair value adjustments for hedged risk	21	**366**	167
Investments	22	**5,949**	24,190
Investments in associates and joint ventures	13	**3**	3
Reinsurance contracts	23	**71**	3,102
Income tax		**45**	39
Intangible assets	11	**401**	317
Property, plant and equipment	10	**202**	169
Deferred tax assets	16	**55**	105
Prepayments and other receivables	18	**332**	527
Assets held for sale	19	**24,266**	–
Total Banking Group assets		**75,471**	69,476
Total assets		**81,950**	75,823

	Notes	2011 £m	2010 (restated*) £m
Liabilities			
Trading Group liabilities			
Interest-bearing loans and borrowings	25	**1,534**	1,620
Trade and other payables	26	**558**	406
Derivatives	14	**141**	119
Provisions	27	**303**	284
Pension liabilities	15	**253**	231
Deferred tax liabilities	16	**299**	254
Total Trading Group non-current liabilities		**3,088**	2,914
Interest-bearing loans and borrowings	25	**163**	159
Income tax payable		**–**	22
Trade and other payables	26	**1,444**	1,396
Provisions	27	**118**	146
Liabilities held for sale	19	**–**	71
Total Trading Group current liabilities		**1,725**	1,794
Total Trading Group liabilities		**4,813**	4,708
Banking Group liabilities			
Amounts owed to credit institutions	28	**3,328**	3,815
Customer accounts	29	**35,073**	32,380
Capital bonds	30	**1,430**	1,795
Derivatives	14	**1,091**	1,237
Insurance and participation contracts	23	**1,064**	17,448
Debt securities in issue	31	**4,165**	4,212
Investment contracts	32	**–**	316
Unallocated divisible surplus	33	**–**	1,037
Other borrowed funds	34	**1,259**	975
Income tax payable		**30**	61
Trade and other payables	26	**428**	2,751
Deferred tax liabilities	16	**40**	125
Pension liabilities	15	**46**	50
Provisions	27	**111**	74
Reclaim fund liabilities	43	**241**	–
Liabilities held for sale	19	**23,775**	–
Total Banking Group liabilities		**72,081**	66,276
Total liabilities		**76,894**	70,984
Equity			
Members' share capital	24	**70**	70
Retained earnings		**4,703**	4,576
Other reserves		**248**	160
Total equity attributable to equity holders of the parent		**5,021**	4,806
Non-controlling interests		**35**	33
Total equity		**5,056**	4,839
Total equity and liabilities		**81,950**	75,823

* The Group has changed its accounting policy on funeral bonds. A full third balance sheet has not been published as the majority of balance sheet lines are unchanged and full disclosure of changes made to the prior year adjustments to 2010 and 2009 comparatives are given in note 44 to the accounts.

Board's certification

The financial statements on pages 48 to 168 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
Steve Watts, Deputy Chair
Peter Marks, Group Chief Executive
Moira Lees, Group Secretary

28 March 2012

Consolidated statement of changes in equity

for the year ended 31 December 2011

	2011					
	Members' share capital £m	**Retained earnings £m**	**Other reserves £m**	**Total shareholder interest £m**	**Non-controlling Interest £m**	**Total equity £m**
Balance at 2 January 2011	**70**	**4,576**	**160**	**4,806**	**33**	**4,839**
Profit for the year		**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 cashflow hedges		**–**	**73**	**73**	**–**	**73**
Net cashflow hedge gains transferred to the income statement		**–**	**(49)**	**(49)**	**–**	**(49)**
Actuarial gains and losses on employee pension schemes (note 15)		**–**		**–**	**–**	**–**
Tax on items taken directly to other comprehensive income (note 8)		**(1)**	**(3)**	**(4)**	**–**	**(4)**
Total other comprehensive income	**–**	**(1)**	**14**	**13**	**–**	**13**
Contributions by and distributions to members:						
Members' share interest	**–**	**(1)**	**–**	**(1)**	**–**	**(1)**
Dividend – non-controlling interests	**–**	**–**	**–**	**–**	**(1)**	**(1)**
Total contributions by and distributions to members	**–**	**(1)**	**–**	**(1)**	**(1)**	**(2)**
Changes in ownership interests in subsidiaries:						
Acquisition of non-controlling interest		**(2)**	**–**	**(2)**	**–**	**(2)**
Changes in ownership interests in subsidiaries	**–**	**(2)**	**–**	**(2)**	**–**	**(2)**
Balance at 31 December 2011	**70**	**4,703**	**248**	**5,021**	**35**	**5,056**

Other reserves

Other reserves consist of the following five reserves. The nature and purpose of each reserve is described below:

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 year end balance is £74m (2010: £nil) following the surplus created in other income within the year (see note 4). Further details of the balance sheet items can be found in note 43.

Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of the Tasly Sants Pharmaceutical Distributors Limited investment (see note 13). The year end balance is £2m (2010: £2m). There have been no movements during the year (2010: £1m credit). The investment has been fully impaired at the end of the year.

Hedging reserve

The hedging reserve comprises the effective portion of the cumulative net change in fair value of cashflow hedging instruments. The year end balance is £72m (2010: £53m). There was a £24m credit (2010: £24m debit) movement during the year offset by a £5m tax debit (2010: £7m credit) 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 years. There have been no movements during the year (2010: £nil). The balance in 2011 and 2010 was £95m.

Available for sale investments reserve

Co-operative Bank and CISGIL mainly hold debt securities as available for sale. Subsequent valuation is at fair value with differences between fair value and carrying value recognised in equity as they arise. The year end balance is £5m (2010: £10m). There has been a £64m gain (2010: £3m) following the revaluation of available for sale assets during the year. £71m of losses (2010: £6m of losses) were transferred to the income statement during the year. A tax credit of £2m (2010: £nil) has also been credited to this reserve.

	2010 (restated*)					
	Members' share capital £m	Retained earnings £m	Other reserves £m	Total shareholder interest £m	Non-controlling Interest £m	Total equity £m
Balance at 3 January 2010	72	4,237	179	4,488	35	4,523
Effect of restatement (see note 44)		4	–	4		4
Profit for the year		210	–	210	1	211
Other comprehensive income:						
Gains less losses on available for sale assets		–	3	3	–	3
Available for sale assets cumulative gains transferred to the income statement		–	(6)	(6)	–	(6)
Net changes in fair value of cashflow hedges		–	(24)	(24)	(1)	(25)
Actuarial gains and losses on employee pension schemes (note 15)		177	–	177	–	177
Foreign currency translation differences		–	1	1	–	1
Tax on items taken directly to other comprehensive income (note 8)		(49)	7	(42)	–	(42)
Total other comprehensive income	–	128	(19)	109	(1)	108
Contributions by and distributions to members:						
Shares withdrawn	(2)	–	–	(2)	–	(2)
Members' share interest	–	(1)	–	(1)	–	(1)
Dividend – non-controlling interests	–	–	–	–	(2)	(2)
Total contributions by and distributions to members	(2)	(1)	–	(3)	(2)	(5)
Changes in ownership interests in subsidiaries:						
Acquisition of non-controlling interest		(2)	–	(2)	–	(2)
Changes in ownership interests in subsidiaries	–	(2)	–	(2)	–	(2)
Balance at 1 January 2011	70	4,576	160	4,806	33	4,839

* For an explanation of the restatement of the prior year figures, see the general accounting policies section on page 55 and note 44.

Consolidated statement of cash flows
for the year ended 31 December 2011

	Notes	2011 Trading Group £m	2010 Trading Group (restated*) £m	2011 Banking Group £m	2010 Banking Group £m	2011 Total £m	2010 Total (restated*) £m
Net cash from operating activities	35	**562**	579	**4,161**	(956)	**4,723**	(377)
Cash flows from investing activities							
Acquisition of property, plant and equipment		**(375)**	(343)	**(54)**	(38)	**(429)**	(381)
Proceeds from sale of property, plant and equipment		**29**	102	**–**	1	**29**	103
Purchase of intangible assets		**–**	–	**(165)**	(111)	**(165)**	(111)
(Acquisition)/proceeds from sale of investments		**(4)**	(13)	**1**	–	**(3)**	(13)
Interest paid in Banking Group		**–**	–	**–**	11	**–**	11
Internal dividends received (paid)		**72**	77	**(72)**	(77)	**–**	–
Disposal of discontinued operation, net of cash acquired		**(51)**	–	**–**	–	**(51)**	–
Proceeds from sale and maturity of investment securities in Banking Group		**–**	–	**4,514**	3,757	**4,514**	3,757
Purchase of investment securities in Banking Group		**–**	–	**(3,668)**	(1,506)	**(3,668)**	(1,506)
Net cash from investing activities		**(329)**	(177)	**556**	2,037	**227**	1,860
Cash flows from financing activities							
Interest paid on borrowings		**(77)**	(76)	**(67)**	(56)	**(144)**	(132)
Repayment of share capital		**–**	(2)	**–**	–	**–**	(2)
Increase in corporate investor shares	25	**5**	10	**–**	–	**5**	10
Preference dividends paid		**–**	–	**(5)**	(6)	**(5)**	(6)
Dividends paid to non-controlling shareholders in subsidiary undertaking		**(1)**	(1)	**–**	(1)	**(1)**	(2)
Member payments		**(135)**	(114)	**–**	–	**(135)**	(114)
Additional payments to pension schemes		**(47)**	(51)	**–**	–	**(47)**	(51)
(Repayment)/issue of borrowings	25	**(106)**	(117)	**171**	–	**65**	(117)
Finance lease (repaid)/receipts		**(5)**	2	**–**	–	**(5)**	2
Net cash from financing activities		**(366)**	(349)	**99**	(63)	**(267)**	(412)
Net increase in cash and cash equivalents		**(133)**	53	**4,816**	1,018	**4,683**	1,071
Cash and cash equivalents at beginning of year		**400**	347	**3,402**	2,384	**3,802**	2,731
Cash and cash equivalents at end of year		**267**	400	**8,218**	3,402	**8,485**	3,802
Analysis of cash and cash equivalents							
Cash and balances with central banks		**–**	–	**6,696**	1,735	**6,696**	1,735
Less mandatory deposits with Bank of England	36	**–**	–	**(38)**	(36)	**(38)**	(36)
Loans and advances to banks	20	**–**	–	**1,020**	1,479	**1,020**	1,479
Short term investments		**–**	–	**241**	230	**241**	230
Cash held in Reclaim fund	43	**–**	–	**315**	–	**315**	–
Cash and cash equivalents per balance sheet		**267**	400	**–**	–	**267**	400
Amounts due to credit institutions		**–**	–	**(16)**	(6)	**(16)**	(6)
		267	400	**8,218**	3,402	**8,485**	3,802

* For an explanation of the restatement of the prior year figures, see the general accounting policies section on page 55 and note 44.

Cash and cash equivalents include deposits of £58m (2010: £61m) 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).

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 New Century House, Manchester M60 4ES.

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 year ended 31 December 2011. 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 allowed 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

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 and the Group's general and life insurance businesses. 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.

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

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. In forming this view, the Directors have assessed the Banking Group's operations separately as they are funded separately to the rest of the Group.

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 Performance Review on pages 10 to 15). The Directors have also assessed the financial risks facing the Group, its liquidity position and borrowing facilities. These are described principally in note 39 to the accounts. In addition, notes 39 and 42 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.

The Trading Group meets its working capital needs through a number of facilities which are discussed in more detail in note 39. Management has assessed the Trading Group's ability to operate within the level of its current facilities, including compliance with all financial covenants and concluded that the going concern assumption is still applicable. Furthermore, the Group is currently in negotiations with its bankers to re-finance facilities expiring in 2013. These discussions are currently well advanced and should be concluded shortly.

The Banking Group continues to stress test and review forecasts which take into account a number of potential changes in trading performance and funding retention. It meets its day to day liquidity requirements through managing both its retail and wholesale funding sources, and is required to maintain a sufficient buffer over regulatory capital requirements in order to continue to be authorised to carry on its business. These stress tests provide assurance that the Banking Group is sufficiently capitalised and adequately positioned in excess of liquidity stress tests. More details can be found in note 39.

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 (note 9 and 19)
- Pensions (note 15)
- Provisions (note 27)
- Non-current asset impairment (note 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 year ended 31 December 2011 and the comparative year.

Restatement and changes in accounting policies

In accordance with IFRS 5, the income statement comparatives have been restated to reclassify the results of businesses that have become discontinued in the current accounting year. More details of the discontinued operations are shown in notes 9 and 40.

The Group has changed its accounting policy on funeral bonds such that bonds sold by the Trading Group are now accounted for in line with IAS 18 instead of IFRS 4 as was applied in previous years. Full details of the impact of the prior year adjustment are set out in note 44.

The Group has reclassified the provision for customer compensation relating to Payment Protection Insurance from operating expenses to a deduction in revenue. Following the judicial reviews in 2011, the provisioning has increased substantially and therefore it is considered more appropriate to reflect the provision as a reduction in revenue as this is where the revenue is initially recognised.

The Group has taken the opportunity to simplify and improve the clarity of the accounts in 2011. As a result, certain notes have been simplified and certain items of income and expenditure have been reclassified where appropriate.

The Group has adopted the following amendments and interpretations which have not had a significant impact on the Group's results:

- Revised IAS 24 Related Party Disclosures (2009);
- Amended IFRIC 14 The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction;
- Annual Improvements (2010) included an amendment to IFRS 7 which clarifies the level of disclosure in relation to credit risk and collateral held and provides relief from disclosure of renegotiated loans;
- 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:

- Amended IFRS 7 Disclosures: Transfers of financial assets (2010);
- 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 1 Presentation of items of other comprehensive income (2010)*;
- Amended IAS 12 Income taxes: Deferred Tax – Recovery of underlying assets (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 increase the net pension finance cost included in net finance costs 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 standard's objective is to gradually phase out IAS 39 Financial Instruments: Recognition and Measurement. Phase one of this process specifically requires financial assets to be classified at amortised cost or at fair value. Consequently, the available for sale (AFS) category currently used by the Bank and General Insurance business will become void. Subsequent development phases for IFRS 9 included key areas such as impairment, hedge accounting and the offsetting of assets and liabilities.

Early adoption is permitted, once endorsed by the EU. The impact of IFRS 9 is likely to be material to the Bank once it becomes effective as of 1 January 2015. Management will assess the changes once endorsed by the EU.

* 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 whose operating results are regularly reviewed by the Group's Chief Executive Officer. The Group has five reportable segments that are grouped according to their products and services. Federal relates to the activities of a joint buying group that is operated by the Group for retail Co-operative Society members. This is run on a cost recovery basis and therefore no profit is derived from its activities.

A summary of the operations of the businesses and further financial information on segments which have been aggregated below can be found on pages 10 to 15.

	2011				
	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	**7,348**	**309**	**(70)**	**249**	**(219)**
Banking Group	**2,214**	**201**	**(107)**	**219**	**(135)**
Specialist Businesses	**1,518**	**99**	**(9)**	**35**	**(58)**
Estates	**36**	**19**	**–**	**80**	**(2)**
Federal	**1,314**	**–**	**–**	**–**	**–**
Corporate, Group costs and other adjustments	**(22)**	**(102)**	**(24)**	**12**	**(7)**
Total	**12,408**	**526**	**(210)**	**595**	**(421)**

	2010 (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	7,553	389	(28)	250	(211)
Banking Group	2,030	202	(70)	149	(133)
Specialist Businesses	1,504	90	–	32	(56)
Estates	36	19	–	51	(2)
Federal	1,286	–	–	–	–
Corporate, Group costs and other adjustments	(21)	(98)	(19)	10	(7)
Total	12,388	602	(117)	492	(409)

* Specialist Businesses' revenue and underlying segment operating profit have been restated due to the change in accounting policy for funeral bonds (see the general accounting policies section and note 44). Revenue and underlying segment operating profit from the Banking Group has also been restated in the prior year as its Life and Savings business became a discontinued operation in 2011.

a) in prior years, the 13 individual operating businesses of the Group were shown as separate segments however in line with the appointment of the Chief Executive Specialist Businesses, the results of Pharmacy, Funeralcare, Life Planning, Legal Services, Motors, Sunwin Services, E-Store and Clothing have been aggregated into the Specialist Businesses segment. This treatment is consistent with the requirements of IFRS 8.

b) underlying segment operating profit is segment operating profit before significant items, property disposals, the Financial Services Compensation Scheme levy, fair value amortisation and the change in value of investment properties.

c) 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.

d) additions to non-current assets excludes additions to financial instruments, deferred tax assets, post employment benefit assets and rights arising under insurance contracts.

e) the Group's external revenue and non-current assets are primarily within the United Kingdom. The Group does not have a major customer who accounts for 10% or more of revenue.

f) in addition to the revenue above, the Banking Group revenue with other Group operating segments was £7m (2010: £8m). Specialist Businesses revenue with the Banking Group was £17m (2010: £13m) and with Food was £42m (2010: £44m), mainly through its Sunwin Services business. All transactions between reportable segments are performed at arm's length.

Notes to the financial statements continued

1. Operating segments continued

A reconciliation between underlying segment operating profit and profit before tax is provided below:

	Note	2011 £m	2010 (restated*) £m
Underlying segment operating profit		**526**	602
Change in value of investment properties	4	**9**	14
Property disposal losses	3	**(19)**	(8)
Financial Services Compensation Scheme levy	27	**(17)**	(12)
Fair value amortisation	4	**86**	(14)
Operating profit before significant items		**585**	582
Significant items (net)	2, 3, 4	**(210)**	(117)
Underlying interest payable	6	**(81)**	(80)
Underlying profit before member payments		**294**	385
Finance income	5	**75**	45
Non-cash finance costs	6	**15**	(35)
Share of profit of associates and joint ventures	13	**(11)**	1
Member payments	7	**(142)**	(104)
Profit before tax		**231**	292

2. Revenue

	2011 £m	2010 (restated*) £m
Sale of goods and provision of services	**8,902**	9,093
Federal sales	**1,314**	1,286
Banking Group:		
– Interest and similar income	**1,369**	1,326
– Fee and commission income	**240**	237
– Gross earned premiums	**641**	496
– Premiums ceded to reinsurers	**(36)**	(29)
Intercompany eliminations	**(22)**	(21)
Net revenue	**12,408**	12,388
Value Added Tax	**864**	756
Gross sales	**13,272**	13,144
Significant items excluded from the above analysis are as follows:		
Provision for customer compensation relating to Payment Protection Insurance (see note 27)	**(90)**	(4)

* The prior year figures have been restated following the change in accounting policy for funeral bonds and discontinued operations, see the general accounting policies section on page 55 and note 44.

2. Revenue continued

Accounting policies

Gross sales

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

Sale of goods and provision of services from retail activities

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 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. The provision of services within the Group is immaterial to disclose further information.

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 have 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 loss, expectations of future loss are higher than at origination, and interest spreads have widened because of deteriorating market conditions, the calculation of EIR is the same as shown above with the exception that the estimates of future cash flows include credit losses.

Fee and commission income

Fee and commission income is predominantly made up of arrangement and other fees relating to loans and advances to customers that are included in the effective interest calculation. Commitment fees received are deferred and included in the effective interest 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 earned premiums comprise premiums receivable on those contracts which were incepted during the financial year, 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 premiums written:

- 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 year 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.

Notes to the financial statements continued

3. Operating expenses

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

	2011 £m	2010 (restated*) £m
Cost of sales		
– Trading activities	**(7,380)**	(7,581)
– Banking activities – Interest expense and similar charges	**(948)**	(1,103)
– Banking activities – Gross claims incurred	**(522)**	(362)
– Banking activities – claims recovered from reinsurers	**28**	15
– Banking activities – Fee and commission expense	**(81)**	(82)
Employee benefits expense (see below)	**(1,674)**	(1,724)
Net loss on disposal of property, plant and equipment	**(19)**	(8)
Operating lease rentals	**(226)**	(241)
Impairment losses on loans and advances and investments	**(115)**	(96)
Contributions to defined contribution plans	**(6)**	(5)
Subscriptions and donations	**(2)**	(2)
Significant items within operating expenses are as follows:		
Integration costs	**(28)**	(108)
Restructuring costs	**(156)**	(29)
Impairment of investment	**(8)**	–
Acquisition costs	**(5)**	–
Other costs	**(3)**	(6)
	(200)	(143)

* The prior year figures have been restated following the change in accounting policy for funeral bonds and to reclassify discontinued operations, see the general accounting policies section on page 55 and note 44.

Integration costs relate to the integration of support systems, people and processes following the acquisition of Somerfield and the merger between Britannia and The Co-operative Bank plc. Restructuring costs relate to transformational changes to the Banking Group's systems to replace ageing legacy banking systems and infrastructure with completely new, modern, flexible systems and processes. This balance also includes costs relating to the Unity Programme which will bring together functional support teams and the corresponding systems and processes to more efficiently and effectively serve the whole Group. Thirdly, the costs relate to spend in relation to the supply chain rationalisation programme within Food.

The impairment of investments relates to the impairment of the Group's 50% holding in Tiajin Tasly Sants Pharmaceutical Distributors Limited (see note 13 for more information).

Employee benefits expense

	2011 £m	2010 (restated*) £m
Wages and salaries	**(1,492)**	(1,553)
Social security costs	**(97)**	(99)
Pension costs	**(85)**	(72)
	(1,674)	(1,724)

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

	2011	2010
Full-time	**40,146**	43,908
Part-time	**66,251**	64,365
	106,397	108,273

Key management personnel compensation

For details regarding key management personnel compensation, refer to pages 37 to 46.

3. Operating expenses continued

Auditors' remuneration and expenses

	2011 £m	2010 £m
Audit of financial statements	**1.0**	1.2
Audit of subsidiaries	**0.5**	0.7
Other services pursuant to such legislation	**0.1**	0.2
Services relating to:		
Taxation	**1.4**	0.4
Corporate finance	**0.7**	–
Information technology	**0.5**	0.4
Pensions	**0.3**	–
Other	**1.1**	1.1
Total	**5.6**	4.0

Services performed by the auditors which were capitalised by the Group and are not included in the above analysis were £1.3m (2010: £0.6m) in relation to the transformational changes in Banking Group mentioned above.

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

Other income is defined as income from activities outside the normal trading activities of the Group.

	2011 £m	2010 (restated*) £m
Other investment income in relation to the Banking Group	**58**	59
Net (losses)/gains on remeasurement of financial and other assets at fair value through income or expense	**(1)**	–
Net gains on remeasurement of financial and other assets available for sale	**16**	6
Net gains on sale of investment securities – loans and receivables	**37**	–
Fair value amortisation	**86**	(14)
Change in value of investment property	**9**	14
Rental income from investment property	**27**	25
Other fee and commission income in Banking Group	**16**	10
	248	100
Significant items within operating expenses are as follows:		
Reclaim fund surplus	**74**	–
Pension curtailment	**6**	–
Federal contribution to integration costs	**–**	30
	80	30

* Other income has been restated in the prior year following the Life and Savings business being reclassified as a discontinued operation during 2011.

Fair value amortisation

When the 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 2011 represent a net credit to the income statement of £86m (2010: charge of £14m).

Notes to the financial statements continued

4. Other income continued

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. The Group has consolidated this Company as it is 100% owned by the Group and its Board contains members of the Executive Committee of The Co-operative Bank plc. Other income of £74m has been recognised as principally the net difference between the amount received in respect of dormant accounts and the provisions and distributions returned to dormant account holders and the Big Lottery Fund respectively. Amounts received in respect of dormant accounts were £368m in 2011. The Reclaim fund had expenses totalling £295m in the year including: £241m of provisions created, £48m of distributions and £5m of set up and administrative costs. The Group derives no financial benefit from the fund and the surplus created is for provision of regulatory capital to the fund and is held in a separate, non-distributable reserve. More details of the Reclaim fund and its balance sheet can be found in note 43.

Accounting policies

Investment income in relation to the Banking Group

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 profit or loss 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

	2011 £m	2010 £m
Net pension finance income	**75**	45

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

6. Finance costs

	2011 £m	2010 (restated*) £m
Loans repayable within five years	**(60)**	(75)
Loans repayable wholly or in part after five years	**(20)**	(4)
Corporate investor share interest	**(1)**	(1)
Underlying interest payable	**(81)**	(80)
Fair value movement on quoted debt	**(16)**	(5)
Fair value movement on interest rate swaps	**42**	(19)
Discount unwind of provisions	**(11)**	(11)
Non-cash finance costs	**15**	(35)
Finance costs	**(66)**	(115)

Financial expenses 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 year.

* Following the change in accounting policy for funeral bonds (see page 55 and note 44 for more information), the fair value movement on funeral bonds of £5m reported in 2010 has been reversed as the Group no longer follows IFRS 4 insurance accounting with respect to funeral bonds.

7. Member payments

	2011 £m	2010 £m
To individual members	**(78)**	(55)
To employees who are members	**(32)**	(20)
To corporate members	**(22)**	(19)
Community distribution	**(10)**	(10)
	(142)	(104)

Further details of membership payments are shown in the Financial Review on page 18.

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 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 equity shareholders in their capacity as customers or employees (rather than as members), or member payments to non-members such as charitable organisations, are treated as charges in 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

	2011 £m	2010 (restated*) £m
Current tax credit/(charge)	**12**	(26)
Deferred tax charge	**(45)**	(24)
Total tax	**(33)**	(50)
Deduct tax credit on discontinued businesses	**(16)**	(8)
Total tax on continuing businesses	**(49)**	(58)

The tax on the Group's net profit before tax differs from the theoretical amount that would arise using the above standard rate of corporation tax of 26.5% (2010: 28%) as follows:

	2011 £m	2010 (restated*) £m
Profit before tax	**231**	292
Current tax at 26.5% (2010: 28%)	**61**	82
Expenses not deductible for tax (including significant items)	**18**	(3)
Depreciation and amortisation on non-qualifying assets	**12**	10
Non-taxable investment income	**(21)**	(5)
Adjustment in respect of previous periods	**(8)**	(21)
Losses taxed at lower rate	**(2)**	(4)
Other	**(11)**	(1)
Tax charge on continuing business	**49**	58

* Following the change in accounting policy for funeral bonds, the deferred tax charge has been restated (see page 55 and note 44 for more information). Taxation in 2010 has also been restated following the Life and Savings business being reclassified as a discontinued operation.

Notes to the financial statements continued

8. Taxation continued

Tax on items taken directly to consolidated statement of comprehensive income

	2011 Tax (expense)/ benefit £m	2010 Tax (expense)/ benefit £m
Changes in available for sale assets	**1**	–
Actuarial gains and losses on employee pension scheme	**(1)**	(49)
Effective portion of cash flow hedges transferred to the cash flow hedging reserve	**(5)**	7
Revaluation of equity instruments	**1**	–
	(4)	(42)

Of the tax taken directly to the consolidated statement of comprehensive income, £28m (2010: £55m) relates to deferred taxation. See note 16 on deferred tax.

The Chancellor's Budget on 23 March 2011 announced that the UK corporation tax rate will reduce from 28% to 23% over a period of 4 years from 2011. The first reduction in the UK corporation tax rate from 28% to 26% was substantively enacted on 29 March 2011 and was effective from 1 April 2011. These rate changes will reduce the Group's future current tax charge accordingly. The reduction in the rate from 26% to 25% with effect from 1 April 2012 was substantively enacted on 5 July 2011. The tax disclosures for the period reflect the deferred tax at the 25% substantively enacted rate. It has not yet been possible to quantify the full anticipated effect of the further 2% rate reduction, although this will further reduce the Group's future tax charge and reduce the Group's deferred tax assets and liabilities.

Accounting policies

Income tax on the profit or loss for the year 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 equity, 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 Limited (CIS) comprises tax attributable to both policyholders' returns and shareholder's 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/(loss) on discontinued operations, net of tax

Following a strategic review of the Life and Savings business, a 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 the 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). The Group considers the sale highly probable in accordance with IFRS 5 and therefore the results of the current and prior period have been included in discontinued operations and the assets and liabilities in 2011 have been reclassified as held for sale (see note 19).

On 1 October 2011, the Group transferred its travel business into a joint venture with Thomas Cook Group plc. The venture is 30% owned by the Group. Therefore, the results of the Travel business are also included within discontinued in both the current and prior year. A small number of former Somerfield foodstores and former Department and Home Stores are also included within the current year and prior year discontinued figures.

Results of discontinued operations	2011 £m	2010 £m
Revenue	**643**	895
Expenses	**(2,341)**	(2,482)
Other income	**1,766**	1,622
Results from operating activities before significant items	**68**	35
Significant items	**(2)**	–
Share of losses of discontinued associates and joint ventures	**–**	(2)
Results from operating activities	**66**	33
Profit on sale of discontinued operations	**5**	–
Income tax excluding tax attributable to policyholder returns	**16**	8
Income tax relating to tax attributable to policyholder returns	**(61)**	(64)
Profit/(loss) for the year	**26**	(23)

9. Profit/(loss) on discontinued operations, net of tax continued

The losses from the discontinued operations in 2011 are attributable entirely to the owners of the Group. The share of losses of discontinued associates and joint ventures in 2010 relates to Co-operative Holidays Limited (see note 13).

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

	2011 £m	2010 £m
Gross earned premiums	**408**	484
Less premiums ceded to reinsurers	**(15)**	(17)
Net premiums	**393**	467
Expenses:		
Claims paid	**(997)**	(897)
Technical charges	**(832)**	(854)
Change in unallocated divisible surplus	**(16)**	16
Investment expenses and charges	**(98)**	(99)
Fee and commission expenses	**(30)**	(35)
Other operating expenses	**(111)**	(147)
Other income:		
Fee and commission income and income from service activities	**75**	64
Investment income	**636**	613
Gains less losses arising from financial instruments and other assets	**1,055**	944
Results from operating activities	**75**	72
Income tax excluding tax attributable to policyholder returns	**(4)**	(2)
Income tax relating to tax attributable to policyholder returns	**(61)**	(64)
Result for the year, net of income tax	**10**	6

Further details of income and expenses relating to the Life and Savings business and TCAM can be found in note 40.

	2011 £m	2010 £m
Cash flows used in discontinued operations:		
Net cash from operating activities	**61**	(7)
Net cash from investing activities	**–**	(8)
Net cash used in financing activities	**–**	(1)
Net cash used in discontinued operations	**61**	(16)

Net consideration received by the Group on discontinued items sold in 2011 was £19m (2010: £30m). This relates to foodstore disposals as mentioned above. The consideration for Travel was entirely satisfied by receipt of a 30% stake in the new joint venture. Consideration in the prior year was entirely satisfied in cash.

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 with a view to resale. The Group's travel business has been classified as a discontinued operation following the sale to the joint venture. The Life and Savings business is yet to be sold, but is a separate major line of business and held for sale (see note 19) at 31 December 2011. A small proportion of the losses in both years relate to the Group's former Department and Home Stores and a number of ex-Somerfield foodstores which were acquired exclusively with a view to resale. Management remains committed to selling these in the next 12 months.

Notes to the financial statements continued

10. Property, plant and equipment

	2011 £m	2010 £m
Trading Group	**2,511**	2,463
Banking Group	**202**	169
Total	**2,713**	2,632

For the year 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 (see note 22)	**(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 year	**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

Within property, land of £49m is held at valuation (2010: £49m). The historical cost equivalent is £1m (2010: £1m). The impairment charge of £13m (2010: £17m) relates largely to the impairment of depots in Food. The prior year figure related to loss making stores in Food. No impairment charge went through the statement of other comprehensive income in the year (2010: £nil).

For the year ended 1 January 2011

	Property £m	Plant £m	Total £m
Cost or valuation:			
At 2 January 2010	1,728	2,252	3,980
Additions	43	284	327
Disposals	(68)	(391)	(459)
Transfer to assets held for sale	(14)	(24)	(38)
Other transfers	28	(28)	–
At 1 January 2011	**1,717**	**2,093**	**3,810**
Depreciation:			
At 2 January 2010	197	1,075	1,272
Charge for the year	30	256	286
Impairment	3	14	17
Disposals	(16)	(369)	(385)
Transfer to assets held for sale	(3)	(9)	(12)
Other transfers	28	(28)	–
At 1 January 2011	**239**	**939**	**1,178**
Net book value			
At 1 January 2011	**1,478**	**1,154**	**2,632**
At 2 January 2010	1,531	1,177	2,708

10. Property, plant and equipment continued

	2011 £m	2010 £m
Plant includes assets held under finance leases as follows:		
Cost	**59**	30
Accumulated depreciation	**(24)**	(14)
Net book value	**35**	16

Other transfers in 2010 represent fully depreciated leasehold improvements which have been transferred from plant to property.

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 of other tangible fixed assets (excluding freehold land) on a straight-line basis over the anticipated working lives of the assets (Funeralcare vehicles are depreciated on a reducing balance basis of between 20% to 35%).

Useful lifes 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 held as a separate class of property, plant and equipment and is carried at fair value. Movements in fair value are recognised in the statement of comprehensive income.

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.

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.

Notes to the financial statements continued

11. Intangible assets

	2011 £m	2010 £m
Trading Group	**1,520**	1,544
Banking Group	**401**	317
Total	**1,921**	1,861

For the year 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 year	**–**	**25**	**20**	**77**	**5**	**–**	**127**
Impairment charge	**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

For the year ended 1 January 2011

	Goodwill £m	Licences £m	Computer software £m	Deferred acquisition costs £m	Other £m	Assets in course of construction £m	Total £m
Cost:							
At 2 January 2010	1,275	503	89	49	47	96	2,059
Additions – acquired separately	6	–	–	–	–	–	6
Additions – internally developed	–	–	3	86	–	111	200
Disposals	(4)	–	(10)	–	(1)	–	(15)
Transfer to assets held for sale	(6)	–	–	–	–	–	(6)
Other transfers	–	–	57	–	–	(57)	–
At 1 January 2011	**1,271**	**503**	**139**	**135**	**46**	**150**	**2,244**
Amortisation:							
At 2 January 2010	134	69	60	–	4	–	267
Charge for the year	–	24	19	77	3	–	123
Impairment charge	–	3	–	–	–	–	3
Disposals	(1)	–	(9)	–	–	–	(10)
Other transfers	(4)	4	–	–	–	–	–
At 1 January 2011	**129**	**100**	**70**	**77**	**7**	**–**	**383**
Net book value:							
At 1 January 2011	**1,142**	**403**	**69**	**58**	**39**	**150**	**1,861**
At 2 January 2010	1,141	434	29	49	43	96	1,792

11. Intangible assets continued

Goodwill

The components of goodwill are as follows:

	2011 £m	2010 £m
Somerfield (Food)	**862**	862
Alldays (Food)	**86**	86
Other Food	**132**	126
Other businesses	**63**	68
	1,143	1,142

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

Impairment

The components of impairment are as follows:

	2011 £m	2010 £m
Licences in Pharmacy branches	**–**	3
Goodwill in Food	**2**	–
	2	3

No impairment was charged to the statement of other comprehensive income in the period (2010: £nil).

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 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 7.5 – 12% (2010: 7.5 – 12%). Business-specific growth rates are used to extrapolate cash flows beyond the three-year plan. The cash flows for each business have been 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.

For CGUs within 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. Buying benefits and synergies have been included in cash flows. Sensitivity analysis has been performed for the Somerfield goodwill figure 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 other individual stores/smaller groups, annual cash flows 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.

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 10 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 of £1m relates to the transfer of engagements of Britannia Building Society. Goodwill impairment has been tested on this amount and no adjustment was considered necessary.

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.

Assets in course of construction and computer software

All additions to intangible assets in the year to 31 December 2011 and the year to 1 January 2011 relate to additions from internally developed assets.

Assets in the course of construction includes an amount of £193m (2010: £110m) relating to Finacle Implementation; a project to design and install a new banking system. These assets have not yet been commissioned for use and so 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 £50m (2010: £45m) of assets relating to Finacle Implementation which have been commissioned and which are being amortised over a period of ten years. A further £23m of assets relating to Finacle Implementation are held within property, plant and equipment as computer equipment and assets in course of construction.

Value in use was determined by discounting the future cash flows generated from the continuing use of the asset. Unless indicated otherwise, the value in use to 31 December 2011 was determined consistently to that in the year ended 1 January 2011.

Notes to the financial statements continued

11. Intangible assets continued

The value in use of assets in course of construction has been computed using the pre tax discount rate of 12.5% pa for Finacle Implementation assets (2010: 12.5%) and 12% for other assets (2010: 12%). Any cashflow estimate exceeding the period covered by the most recent forecasts was computed by extrapolating the projections based on the budgets/forecasts including adjustments for growth rates for subsequent years.

A sensitivity analysis has been performed on the assumptions used to determine the value in use for each material asset in the course of construction as at 31 December 2011. Management has concluded that value in use is most sensitive to the discount rate. It is possible that changes in these assumptions could decrease the carrying value. An increase of one percentage point in the discount rate would have decreased the value in use by £38m (2010: £39m).

Accounting policies

Goodwill

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.

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.

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 aquiree 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

Computer software is stated at cost less cumulative amortisation and impairment. 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 seven years.

Other intangible assets

Other intangible assets such as pharmacy licences and Deferred Acquisition Cost (DAC) assets that are acquired by the Group are stated at cost less the accumulated amortisation (see below) and impairment losses. Expenditure on internally generated goodwill and brands (except the brand generated as a result of the 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

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 the items in 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

Amortisation is charged to the income statement on a straight-line basis over the estimated useful lives of intangible assets. Goodwill and intangible assets with an indefinite useful life are 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–seven years (Core systems – maximum of ten years)
- Pharmacy licences: twenty 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

11. Intangible assets continued

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 non-current 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 6.8 years (2010: 6.8 years), being the expected term of a unit trust contract. Of the total value £15m (2010: £14m) is expected to be recovered after more than one year.

Deferred acquisition costs in the Long Term Insurance Business have been transferred to assets held for sale.

12. Investment properties

	2011 £m	2010 £m
Valuation at beginning of year	**339**	322
Additions	**13**	33
Transfers to other investments (note 13)	**(3)**	–
Disposals	**(18)**	(30)
Revaluation surplus recognised in income statement	**9**	14
Valuation at end of year	**340**	339

Investment properties have been valued as at 31 December 2011. The valuation was carried out by two external chartered surveyors: Colliers Conrad Ritblat Erdman and Smiths Gore; on the basis of open market value in accordance with the RICS Appraisal and Valuation Manual.

The properties are valued individually, and yields therefore vary on a property-by-property basis. Transfers in from property, plant and equipment arise from the end of owner-occupancy at former trading and administrative locations. If an investment property becomes owner-occupied, it is reclassified as property, plant and equipment, and its fair value at the dates of reclassification becomes its cost for subsequent accounting purposes.

The mean ERV yield over the whole estate at the year end is 6.4% (2010: 6.3%).

In the case of investment properties, it is assumed that uplifts on valuation principally reflect future rentals. Investment properties do not include those within Insurance and Banking activities which are disclosed in note 19 and note 22 respectively.

The transfer to other investments represents the transfer of Whitemill 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.

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 statement of comprehensive income.

Notes to the financial statements continued

13. Investments

During the year the Group transferred its travel business into a joint venture with Thomas Cook (TCCT Holdings UK Limited). The Group has a 30% interest in the venture and does not have the power to control its Board, accordingly it is not fully consolidated in the Group accounts but is accounted for as an associate under IAS 28. The investment in the venture was initially recorded at fair value, representing the discounted future cash flows from the venture to the Group.

A profit on disposal of £21m was recorded on the transfer of the Group's travel business into the venture. The profit represents the consideration received (net of selling costs), representing the fair value of the investment in the venture, the net liabilities of the travel business transferred to the venture and less the amount of profit deferred in relation to the value of the Co-operative Travel Brand that the Group is transferring over for use by the venture. The liability for providing the use of the brand to the venture is recorded at £45m and is amortised evenly over the anticipated useful life of the brand of five years.

The Group's share of losses in relation to associates and joint ventures for the year was £11m (2010: profit of £1m). Movements in investments in associates, joint ventures and other investments are as follows:

	2011 £m	2010 £m
Trading Group	**67**	30
Banking Group	**3**	3
Total	**70**	33

	2011			2010		
	Associates and joint ventures £m	**Other investments £m**	**Total £m**	Associates and joint ventures £m	Other investments £m	Total £m
At beginning of the year	**28**	**5**	**33**	27	5	32
Additions	**–**	**–**	**–**	1	–	1
Acquisition of associates	**53**	**–**	**53**	–	–	–
Transfer from investment properties (note 12)	**3**	**–**	**3**	–	–	–
Transfer to held for sale	**–**	**–**	**–**	(2)	–	(2)
Share of (losses)/profits	**(11)**	**–**	**(11)**	1	–	1
Impairment	**(8)**	**–**	**(8)**	–	–	–
Translation adjustments	**–**	**–**	**–**	1	–	1
At end of the year	**65**	**5**	**70**	28	5	33

The £65m of investments in associates and joint ventures (2010: £28m) comprises £44m in TCCT Holdings UK Limited (2010: £nil), £12m in Grangefern Properties Limited (2010: £11m), £nil in Tiajin Tasly Sants Pharmaceutical Distributors Limited (2010: £10m), £5m in Whitemill Windfarm Limited (2010: £2m), £3m in Britannia Personal Lending Limited (2010: £3m) and £1m of other (2010: £2m). The below represents aggregated financial information of the Group's joint ventures and associates if they were not adjusted for percentage owned:

	2011 Investments in associates and joint ventures £m	2010 Investments in associates and joint ventures £m
Current assets	**109**	36
Non-current assets	**184**	89
Total assets	**293**	124
Current liabilities	**391**	44
Non-current liabilities	**34**	44
Total liabilities	**425**	88
Income	**76**	34
Expenditure	**109**	35

The Group owns 30% of the ordinary shares in TCCT Holdings UK Limited, incorporated in England and Wales on 21 July 2011. Its principal activity is as a travel agency and tour operator. The entity has a year end date of 31 July.

The Group holds 60% of the ordinary share capital of Tiajin Tasly Sants Pharmaceutical Distributors Limited, incorporated in The People's Republic of China. The principal activity of Tiajin Tasly Sants Pharmaceutical Distributors Ltd is to manufacture generic medicines. The entity's result is not consolidated fully by the Group as despite having a 60% share interest, the Group has joint managerial and control of the board. The entity has a year end date of 31 December. The investment has been written down to zero based on management's assessment of its recoverable value in 2011.

The Group holds 50% of the ordinary share capital of Grangefern Properties Limited, incorporated in England and Wales. The entity's principal activity is property investment and development. The entity has a year end date of 31 December.

13. Investments continued

During the year the Group purchased 50% of the ordinary share capital of Whitemill 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 purchased the remaining 50% of the ordinary share capital in SEA Estates LLP during the year and this is now fully consolidated in the Group accounts.

Co-operative Holidays Limited, a joint venture disclosed in the prior year accounts, was discontinued in 2011.

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.

All the above entities are jointly managed and controlled by the Group and a third party and are accounted for as joint ventures under the equity method, with the exception of TCCT Holdings UK Limited which is classified and accounted for as an associate.

There were no contingent liabilities or commitments in respect of the Group's joint ventures or associates as at 31 December 2011 (2010: £nil), except for a guaranteed bank facility in Tiajin Tasly Sants.

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.

14. Derivatives

	Assets		Liabilities	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Trading Group	**79**	15	**(141)**	(119)
Banking Group	**981**	1,729	**(1,091)**	(1,237)

Trading Group

Derivatives held for non-trading purposes for which hedge accounting has not been applied are as follows:

	Contractual/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Interest rate swaps	**1,733**	**79**	**(141)**
Forward currency transactions	**8**	**–**	**–**
Total recognised derivative assets/(liabilities)	**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 39 on risk management.

Banking Group

Derivative financial instruments:

The analysis of derivatives in the current year above is for Banking and General Insurance activities only. The analysis in the previous year includes Banking, Life and General Insurance activities. As derivatives for the Life and Savings business were held for sale as at 31 December 2011, the analysis for the current year of the Life business can be found in note 41.

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:

The trading transactions are wholly interest rate related contracts including swaps, caps and floors, forward rate agreements and exchange traded futures. Trading transactions include derivatives where the Bank enters into a transaction to accommodate a customer together with the corresponding hedge transaction.

In the prior year, CIS purchased a series of interest rate swaption contracts 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 as the contracts are settled on a daily basis in arrears. FTSE put options are held to mitigate the impact of equity price risk.

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.

Notes to the financial statements continued

14. Derivatives continued

	Fair value assets		Fair value liabilities	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Derivatives held for trading:				
Interest rate swaps	**167**	256	**(142)**	(450)
Interest rate options	**2**	2	**(4)**	(2)
Interest rate swaptions	**–**	261	**–**	–
Forwards	**–**	–	**–**	(34)
Financial futures contracts	**–**	10	**–**	(10)
Total return swaps	**–**	189	**–**	(92)
FTSE options	**–**	146	**–**	–
Total derivative assets/(liabilities) held for trading	**169**	864	**(146)**	(588)
Derivatives held for hedging:				
Interest rate swaps designated as cashflow hedges	**218**	219	**(106)**	(162)
Interest rate swaps designated as fair value hedges	**137**	75	**(731)**	(412)
Interest rate swaps held for non-trading purposes for which hedge accounting has not been applied	**14**	23	**(51)**	(32)
Embedded derivatives – options	**29**	19	**(1)**	(18)
OTC interest rate options	**–**	–	**(4)**	(1)
Equity swaps	**113**	97	**–**	–
Forward currency transactions	**301**	432	**(52)**	(24)
Total derivative assets/(liabilities) held for non-trading	**812**	865	**(945)**	(649)
Total recognised derivative assets/(liabilities)	**981**	1,729	**(1,091)**	(1,237)

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 39.

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, whether the hedging instruments are expected to be 'highly effective' on offsetting the changes in fair value or cash flows of the respective hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within a range of 80%–125%.

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, and 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, known as 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 Banking Group's trading activities.

Mortgage commitments
Mortgage commitments, for example where the Bank has made an irrevocable offer of a loan to a customer, are designated at fair value through income or expense. Their subsequent derivative contracts are recorded in accordance with accounting policy 'Derivatives used for asset and liability management purposes' as stated above. The use of derivatives and their sale to customers as risk management products is an integral part of the Bank's and CIS' trading activities.

Notes to the financial statements continued

15. Pensions

The pension assets and liabilities in the balance sheet comprise:

	Assets 2011 £m	Assets 2010 £m	**Liabilities 2011 £m**	Liabilities 2010 £m	**Net 2011 £m**	Net 2010 £m
Trading Group schemes in surplus						
The Co-operative Group Pension (Average Career Earnings) Scheme (PACE)	**6,611**	6,071	**(6,242)**	(5,794)	**369**	277
Somerfield Pension Scheme	**763**	–	**(701)**	–	**62**	–
	7,374	6,071	**(6,943)**	(5,794)	**431**	277
Trading Group schemes in deficit						
United Norwest Co-operatives Employees' Pension Fund	**384**	366	**(532)**	(491)	**(148)**	(125)
Other former United Co-operatives Funds	**132**	129	**(177)**	(178)	**(45)**	(49)
Plymouth and South West and Brixham Funds	**70**	71	**(129)**	(114)	**(59)**	(43)
Lothian Borders & Angus Co-operative Society Limited Employees' Pension Fund	**57**	54	**(58)**	(54)	**(1)**	–
Somerfield Pension Scheme	**–**	627	**–**	(641)	**–**	(14)
	643	1,247	**(896)**	(1,478)	**(253)**	(231)
Banking Group schemes in deficit:						
Britannia Pension Scheme	**569**	509	**(611)**	(555)	**(42)**	(46)
EFRBS liabilities from the PACE scheme	**–**	–	**(4)**	(4)	**(4)**	(4)
	569	509	**(615)**	(559)	**(46)**	(50)

The Group operates a number of defined benefit pension schemes, the assets of which are held in separate trustee-administered funds.

The Group pension schemes are set out below. All of the former United Co-operatives pension schemes are closed to new entrants. In addition there exists the United Norwest Co-operatives Limited 1989 Discretionary Early Retirement Benefits Scheme (closed to new entrants from 5 November 1995) which provides additional benefits for long-serving employees who commenced employment prior to 6 November 1994, and the Leeds Co-operative Society Limited Managerial Staff Pensions Scheme. 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 scheme valuations for the United Norwest Fund, Britannia Scheme, Yorkshire Fund, Sheffield Fund, Leeds Fund and Brixham Fund. These are expected to be concluded in 2012.

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 2008
Somerfield Pension Scheme	April 2010
Britannia Pension Scheme	April 2008
Yorkshire Co-operatives Limited Employees' Superannuation Fund	January 2008
Sheffield Co-operative Society Limited Employees' Superannuation Fund	January 2008
Leeds Co-operative Society Limited Employee Pension Fund	January 2008
Lothian Borders & Angus Co-operative Society Limited Employees' Pension Fund	January 2009
Plymouth and South West Co-operative Society Limited Employees' Superannuation Fund	March 2010
Brixham Co-operative Society Limited Employees' Superannuation Fund	March 2008

Critical accounting estimates and judgments

The actuarial valuations of the schemes have been updated to 31 December 2011 in accordance with IAS 19.

	2011	2010
The principal assumptions used to determine the liabilities of the Group's pension schemes were:		
Discount rate	**4.60%**	5.20%
Rate of increase in salaries	**4.80%**	5.20%
Future pension increases where capped at 5.0% pa – Retail Price Index	**3.30%**	3.70%
Future pension increases where capped at 5.0% pa – Consumer Price Index	**2.80%**	3.20%
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	**2.00%**	2.00%
Expected return on plan assets	**6.10%**	6.40%

15. Pensions continued

The average life expectancy (in years) for mortality tables used to determine scheme liabilities for the largest schemes at 31 December 2011 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	21.9	23.4	23.3	25.0
United Norwest Fund	21.6	23.5	22.9	25.1
Britannia Scheme	23.5	25.8	25.0	27.4
Somerfield Scheme	21.9	23.2	23.4	24.8

Net pension finance income of £75m in the income statement includes £75m net pension finance income in respect of the PACE scheme, £2m net pension finance income in respect of the four defined benefit schemes operated by the former United Co-operative Group, £1m net pension finance cost in respect of Somerfield and a net pension finance cost of £1m for all remaining schemes. For all schemes including Britannia, there is £403m of interest on liabilities and £480m of expected return on scheme assets. Net pension finance income in the Britannia Building Society pension scheme of £2m is credited in operating expenses in the income statement.

The weighted-average asset allocations at the year end were as follows:

	2011	2010
Equities	**26%**	28%
Liability-driven instruments	**32%**	34%
Alternative growth	**12%**	7%
Property	**4%**	4%
Bonds	**21%**	20%
Diversified growth	**4%**	5%
Other[i]	**1%**	2%

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:

	2011 £m	2010 £m
The amounts recognised in the balance sheet are as follows:		
Present value of funded obligations	**(8,434)**	(7,809)
Present value of unfunded liabilities	**(20)**	(22)
Fair value of plan assets	**8,586**	7,827
Net retirement benefit asset	**132**	(4)

A movement in the discount rate of 0.1% would impact the scheme's liabilities by £170m, an adjustment to price and salary inflation of 0.1% would impact liabilities by £140m. An increase in the assumed long term rate of improvement in mortality from 1.0% pa to 1.5% pa would increase the liabilities by £260m.

	2011 £m	2010 £m
The amounts recognised in the income statement are as follows:		
Current service cost	**(85)**	(72)
Interest on liabilities	**(403)**	(405)
Expected return on scheme assets	**480**	452
Gains on settlement and curtailments		
– Significant items	**6**	–
– Non-significant items	**1**	–
	(1)	(25)
Actual return on scheme assets	**859**	905

Notes to the financial statements continued

15. Pensions continued

	2011 £m	2010 £m
Changes in the present value of the scheme liabilities are as follows:		
Opening defined benefit liabilities	**7,831**	7,319
Current service cost	**85**	72
Interest on liabilities	**403**	405
Contributions by members	**29**	30
Actuarial losses recognised in equity	**379**	274
Past service costs	**–**	1
Benefits paid	**(266)**	(270)
Gains on settlements and curtailments	**(7)**	–
Closing defined benefit liabilities	**8,454**	7,831

	2011 £m	2010 £m
Changes in the fair value of the scheme assets are as follows:		
Opening fair value of scheme assets	**7,827**	7,035
Expected return on scheme assets	**480**	452
Actuarial gains recognised in equity	**379**	451
Contributions by the employer	**134**	130
Contributions by members	**29**	30
Benefits paid	**(263)**	(271)
Closing fair value of scheme assets	**8,586**	7,827

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.

The Group expects to contribute £149m to its pension schemes in 2012.

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 portfolio is invested and the expectations for future returns of each asset class. The expected return for each asset class was then weighted based on the target asset allocation to develop the expected long term rate of return on assets assumption for the portfolio. This resulted in the selection of a range between 4.4% to 7.1% (2010: 5.3% to 7.3%) assumption for the year ended 31 December 2011.

	2011 £m	2010 £m	2009 £m	2008 £m	2007 £m
Amounts recognised in the balance sheet:					
Defined benefit liabilities	**(8,454)**	(7,831)	(7,319)	(5,335)	(5,605)
Scheme assets	**8,586**	7,827	7,035	5,592	5,905
Surplus/(deficit)	**132**	(4)	(284)	257	300
History of experience gains and losses:					
Experience adjustment on scheme liabilities	**(17)**	(377)	1	10	65
% of scheme liabilities	**0%**	5%	0%	0%	-1%
Experience adjustment on scheme assets	**(174)**	452	227	(609)	(26)
% of scheme assets	**–2%**	6%	3%	–11%	0%

The above two tables include three years history for the Somerfield. Britannia, Plymouth & South West and Brixham schemes, and four years for the Lothian Borders & Angus scheme – 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 25% (2010: 27%).

	2011 £m	2010 (restated*) £m
Net deferred tax comprises:		
Deferred tax asset		
Trading Group	**133**	136
Banking Group	**55**	105
	188	241
Deferred tax liability		
Trading Group	**(299)**	(254)
Banking Group	**(40)**	(125)
	(339)	(379)
Net deferred tax liabilities	**(151)**	(138)
Comprised of:		
Other temporary differences	**(76)**	(93)
Temporary differences arising on derivatives and interest	**8**	13
Other temporary differences arising on fair value and merger with Britannia Building Society	**3**	(35)
Retirement benefit obligations	**33**	(1)
Capital allowances on fixed assets	**55**	33
Capital allowances on assets leased to customers	**3**	4
Unrealised gains on investments, investment properties and rolled-over gains	**188**	310
Claims equalisation reserve	**7**	7
Tax losses	**(70)**	(78)
Acquisition costs deferred	**–**	(22)
	151	138

* The 2010 Trading Group deferred tax comparative has been restated following a change in the funeral bond accounting policy as outlined in note 44. The 2009 deferred tax assets balance has also been restated downwards by £1m.

The main components of the deferred tax liability are tax allowances on property, plant and equipment and intangible assets of £58m (2010: £36m), unrealised appreciation of investments of £1m (2010: £121m), potential liability on rolled over gains of £187m (2010: £189m), and net retirement obligations of £51m (2010: £13m).

These liabilities are offset by deferred tax assets arising in respect of acquisition costs of £nil (2010: £21m), timing differences arising on derivatives and interest of £8m (2010: £nil), and net retirement benefit obligations of £11m (2010: £13m), carried forward tax losses of £70m (2010: £77m) largely arising on acquisition of Somerfield and Britannia, plus £3m arising on fair value differences on the acquisition of Britannia (2010: £35m), taxation of special purpose vehicles under securitisation regime of £26m (2010: £37m) and deferred tax relief on other accounts provisions including holiday pay and onerous lease provisions of £49m (2010: £36m).

	2011 £m	2010 £m
At beginning of the year	**138**	49
Income statement charge/(credit):		
– Group	**45**	24
– CIS Life Business	**(43)**	17
Transfer of CIS Life business to liabilities held for sale	**(16)**	–
Charged to equity:		
– Retirement benefit obligations (per above)	**(1)**	49
– Other (per above)	**28**	(1)
At end of the year	**151**	138

Accounting policies

Deferred tax is provided, 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.

Notes to the financial statements continued

17. Inventories and Biological assets

	2011 £m	2010 £m
Inventories	**605**	586
Biological assets	**5**	4
	610	590

Inventories are comprised of the following:

	2011 £m	2010 £m
Raw materials, consumables and work in progress	**10**	8
Finished goods and goods for resale	**595**	578
	605	586

The year end inventories provision is £19m (2010: £12m), of which the majority relates to Food in both years. Charges of £8m (2010: credit of £25m) have been made to the income statement in the year, of which Pharmacy charged £3m (£nil) and Food charged £4m (credit of £25m) with £1m being from other businesses (2010: £nil). There was no inventory pledged as security for liabilities in the current or prior year.

Accounting policies

Inventories

Inventories are stated at the lower of cost, including attributable overheads and net realisable value.

Biological assets

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.

18. Trade and other receivables

	2011 £m	2010 (restated*) £m	2009 (restated*) £m
Non-current	**29**	42	–
Current	**478**	457	421
Trading Group	**507**	499	421
Banking Group	**332**	527	560
	839	1,026	981

	2011 £m	2010 (restated*) £m	2009 (restated*) £m
Trade receivables	**315**	289	315
Receivables arising from insurance	**207**	218	162
Prepayments and accrued income	**153**	154	258
Other receivables	**164**	365	246
	839	1,026	981

* The restated comparatives and the inclusion of the 2009 balances are due to the prior year adjustment in the accounting for funeral bonds. Details of this can be found in the general accounting policies section on page 55 and note 44.

Trade receivables are stated net of an impairment provision of £7.2m (2010: £7.8m). £0.2m (2010: £0.5m) has been credited to the income statement and £0.4m represents payments received in the year.

The analysis of other receivables in the current year excludes other receivables from the Life and Savings business. As other receivables for the Life business were held for sale as at 31 December 2011, the analysis for the current year of the Life business can be found in note 41.

Further details on the ageing of trade and other receivables of the Trading Group can be found in note 39.

The ageing of trade receivables which are overdue but not considered to be impaired are as follows:

	2011 £m	2010 £m
Amounts overdue:		
Less than three months	**21**	42
Three to six months	**2**	–
More than six months	**2**	3
	25	45

18. Trade and other receivables continued

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 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 have been reclassified as held for sale.

The majority of the prior year figures represent assets held for sale in the Travel business. These were sold into the joint venture with Thomas Cook which commenced on 1 October 2011. A small number of Somerfield foodstores which were earmarked for disposal following the acquisition of Somerfield remain within the current and prior year figure. Management still expects these remaining stores to be sold within the next 12 months.

	Assets held for sale		Liabilities held for sale	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Trading Group	**1**	54	**–**	(71)
Banking Group	**24,266**	–	**(23,775)**	–
Total	**24,267**	54	**(23,775)**	(71)

Assets classified as held for sale

	2011 £m	2010 £m
Property, plant and equipment	**1**	28
Intangible assets	**20**	6
Trade and other receivables	**221**	20
Loans and advances to customers	**2**	–
Derivatives	**1,487**	–
Investments	**19,049**	–
Reinsurers' share of technical provisions	**3,487**	–
	24,267	54

Liabilities classified as held for sale

	2011 £m	2010 £m
Derivatives	**(1,197)**	–
Deferred tax	**(16)**	–
Amounts owed to credit institutions	**(722)**	–
Insurance contracts	**(17,679)**	–
Investment contracts	**(314)**	–
Unallocated divisible surplus	**(1,052)**	–
Trade and other payables	**(2,706)**	(71)
Income tax payable	**(81)**	–
Provisions	**(8)**	–
	(23,775)	(71)

Further details of assets and liabilites held for sale relating to the Life and Savings business and TCAM can be found in note 41.

Notes to the financial statements continued

19. Assets and liabilities held for sale continued

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

	2011 £m	2010 £m
Items in the course of collection from other banks	**123**	140
Placements with other banks	**897**	1,339
Included in cash and cash equivalents	**1,020**	1,479
Other loans and advances to banks	**987**	915
Loans and advances to banks	**2,007**	2,394

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.

Securities lent to counterparties are retained on the balance sheet.

Securities borrowed are not recognised on the balance sheet, unless they are sold to third parties, in which case the purchase and sale are recorded. The obligation to return them is recorded at fair value as a trading liability.

21. Loans and advances to customers

	2011 £m	2010 £m
Gross loans and advances excluding Life and Savings	**34,440**	35,383
Life and Savings	**–**	6
Less allowance for losses on loans and advances	**(292)**	(223)
Less fair value adjustments for hedged risk	**(366)**	(167)
	33,782	34,999

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. The changes in fair value of fixed rate mortgages are disclosed on the balance sheet as fair value adjustments for hedged risk immediately below the loans and advances to customers. Fair value adjustments to loans and advance to customers attributable to portfolio-hedged risk in the Group are £366m (2010: £167m).

Securitisation

Loans and advances to customers include £9,100m (2010: £10,611m) securitised under the Group's securitisation and covered bond programmes. The Group remains exposed to substantially all of the risks and rewards of ownership of these assets. Included within Group deposits by banks (note 20) are £62m (2010: £67m) of loans from external third parties and within Group debt securities in issue (note 22) are £3,989m (2010: £3,100m) of fixed and floating rate notes, all secured on these mortgage assets. Included within the Bank amounts owed by other Co-operative Group undertakings are £4,750m (2010: £4,368m) of floating rate notes issued to the Bank and £1,000m (2010: £2,797m) of other loans, secured on these mortgage assets.

Concentration of exposure

The Group's exposure is virtually all within the United Kingdom. The following industry concentrations of gross advances before provisions are considered significant.

21. Loans and advances to customers continued

Gross loans and advances

	2011 £m	2010 £m
Property and construction	**4,247**	4,545
Retail, distribution and services	**392**	500
Business and other services	**4,461**	3,824
Personal	**25,340**	26,514
	34,440	35,383

Long term business

	2011 £m	2010 £m
Secured by mortgages	**–**	3
Secured by insurance policies	**–**	3
	–	6

Allowance for losses on loans and advances

	2011					2010				
	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**	**56**	**158**	**–**	**223**	3	51	140	–	194
Charge against profits	**5**	**77**	**37**	**13**	**132**	7	36	64	1	108
Amounts written off	**(5)**	**(27)**	**(27)**	**(1)**	**(60)**	(1)	(31)	(45)	(1)	(78)
Unwind of discount of allowance	**–**	**(1)**	**(2)**	**–**	**(3)**	–	(1)	(1)	–	(2)
Interest charged on impaired loans	**–**	**–**	**–**	**–**	**–**	–	1	–	–	1
At end of the year	**9**	**105**	**166**	**12**	**292**	9	56	158	–	223

Loans and advances to customers include £114m (2010: £74m) of financial assets at fair value through profit or loss designated at initial recognition to eliminate or significantly reduce a measurement or recognition inconsistency. Of these £37m (2010: £20m) are secured by real estate collateral.

Loans and advances to customers include finance lease receivables:

	2011 £m	2010 £m
Gross investment in finance leases, receivable:		
– No later than one year	**26**	28
– Later than one year and no later than five years	**63**	66
– Later than five years	**82**	79
	171	173
Unearned future finance income on finance leases	**(48)**	(44)
Net investment in finance leases	**123**	129
The net investment in finance leases may be analysed as follows:		
– No later than one year	**19**	21
– Later than one year and no later than five years	**41**	45
– Later than five years	**63**	63
	123	129

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 (2010: £1m).

Notes to the financial statements continued

21. Loans and advances to customers continued

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 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.

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. A key estimate within the provisioning model is the percentage of accounts that will be charged off. A 1% change would change the collective provision by £1m.

A new corporate collective provision of £10m has been raised in 2011 reflecting the continuing difficulties and uncertainties currently being experienced in this sector. This provision is based upon a pool of accounts which have been identified as having higher levels of risk. These accounts have been assessed across a risk scale with risk factors of either 30% or 100% attached to each case depending on their position in the scale. A key estimate within the corporate collective model is collateral valuation. A 10% movement in this estimate would change the provision by £3m.

Individual provisions

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. 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 discount 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 £8m.

A write back of £20m of the deep discount has been recognised during 2011 (2010: £15m write back) following a review of the other parameters of the model. Other parameters include forecasts of employment levels, interest rates and the number of accounts in arrears. Because of its steadily improving management of arrears levels, the Group believes there is potential for further write backs. However the level of write back recognised is prudent due to the remaining uncertainties in the exact timing of economic recovery.

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 £7m.

For further information on credit risk and impairment see the risk management section (note 39).

Effective interest rate

IAS 39 requires interest income to be recognised on an effective interest rate (EIR) basis, inclusive of directly attributable incremental transaction costs and fees, and discounts and premiums where appropriate. The EIR basis spreads the interest income over the expected life of the instrument. The expected life of an instrument is the period from its inception up to its redemption or maturity date, ie for the mortgage portfolio it would be its redemption date, whilst for the non-mortgage portfolio it would be its maturity date. On applying this approach to the mortgage portfolio, judgments are made in relation to estimating its average life. These judgments are made based on specific factors including product terms and historical repayment data. The estimates are updated in each reporting period to reflect actual performance. Key judgment areas, regularly reviewed for both current and expected levels of mortgage balance experience, are the average and total lives of the mortgage portfolio. An increase or decrease change in the average life by one year would increase or decrease gross interest income by 0.5% respectively.

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.

Regular way purchases and sales of financial assets are recognised on the trade date at which the Group commits to purchase or sell the asset. All other financial assets and liabilities are initially recognised on the trade date at which the Group becomes a party to the contractual provisions of the instrument.

Financial assets

The Bank classifies its financial assets (excluding derivatives) as either:

- Loans and receivables;
- Available for sale; or
- Financial assets at fair value through income or expense

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 accounting policy and assets reclassified from available for sale (see 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. 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.

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 include pledged assets and derivative financial instruments that are not designated as effective hedges.

   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.

Notes to the financial statements continued

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 default or delinquency by a borrower, restructuring of a loan or advance on terms that the Group would not otherwise consider, indications that a borrower or issuer will enter bankruptcy, or the disappearance of an active market for a security. In terms of forbearance, the Bank recognises all such cases within its provisioning methodology. For further information, see the the risk mangement note on pages 111 to 134.

   The Group considers evidence for impairment for loans and advances at both a specific asset and collective level. All individually significant loans and advances are assessed specifically for impairment. Loans and advances not individually significant are collectively assessed for impairment by grouping together loans and advances by similar risk characteristics.

   In assessing collective impairment the Group uses statistical modelling of historical trends of probability of default, timing of recoveries and the amount of loss incurred, adjusted for management's judgment as to whether current economic and credit conditions are such that actual losses are likely to be greater or less than suggested by historical modelling. Default rates, loss rates and future recoveries are regularly benchmarked against actual outcomes to ensure that they remain appropriate.

   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).

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.

22. Investments – Banking Group
Investments

	2011 £m	2010 £m
Fair value through profit or loss:		
Listed equities	**343**	5,530
Unlisted equities	**–**	970
Listed debt securities	**–**	6,506
Unlisted debt securities	**–**	2,154
	343	15,160
Available for sale:		
Unlisted equities	**9**	10
Listed debt securities	**4,065**	3,331
Unlisted debt securities	**324**	573
	4,398	3,914
Total fair value through profit or loss and available for sale investments	**4,741**	19,074
Loans at amortised cost	**805**	1,917
Deposits with credit institutions	**219**	1,548
Investment properties	**184**	1,651
	5,949	24,190

The above investments in the current year are held by CIS General Insurance Limited and The Co-operative Bank plc. In the prior year they also included the investments of CISL, but these have been transferred to assets held for sale in 2011. In The Co-operative Bank, repossessed properties are maintained off balance sheet against the mortgage portfolio as collateral.

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 2011, £4m was transferred from property, plant and equipment to investment properties (2010: £nil).

Notes to the financial statements continued

23. Insurance contracts liabilities and reinsurance assets

a) Analysis of insurance and participating contract liabilities

The analysis of insurance and participating contract liabilities in the current year below is for General Insurance activities only. The analysis in the previous year includes Life and General Insurance activities. As the insurance contracts for the Life business were held for sale as at 31 December 2011, the analysis for the current year of the Life business can be found in note 41.

	2011 £m	2010 £m
Gross		
Long term insurance contracts:		
– Insurance contracts	–	2,676
– Insurance participating contracts	–	13,223
– Investment participating contracts	–	586
	–	16,485
General insurance contracts:		
– Claims reported (including claims settlement)	**602**	517
– Claims incurred but not reported	**118**	130
– Claims settlement expenses	**17**	17
– Unearned premiums	**327**	299
Total gross insurance liabilities	**1,064**	17,448
Recoverable from reinsurers		
Long term insurance contracts:		
– Insurance contracts	–	(1,858)
– Insurance participating contracts	–	(1,190)
	–	(3,048)
Recoverable from reinsurers		
– Claims reported	**(31)**	(25)
– Claims incurred but not reported	**(36)**	(25)
– Unearned premiums	**(4)**	(4)
Total reinsurers' share of insurance liabilities	**(71)**	(54)
	(71)	(3,102)
Net		
Long term insurance contracts:		
– Insurance contracts	–	818
– Insurance participating contracts	–	12,033
– Investment participating contracts	–	586
	–	13,437
General insurance contracts:		
– Claims reported (including claims settlement)	**571**	492
– Claims incurred but not reported	**82**	105
– Claims settlement expenses	**17**	17
– Unearned premiums	**323**	295
– Provision for unexpired risks	–	–
	993	909
Total net insurance liabilities	**993**	14,346

Liabilities are stated positive in the above analysis.

23. Insurance contracts liabilities and reinsurance assets continued

Critical accounting estimates and judgments

b) General insurance contracts – assumptions, changes in assumptions and sensitivity

i) Basis of assessing liabilities

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) – Chain Ladder techniques; and
- Bornhuetter-Ferguson/Cape Cod techniques.

Extensive use of detailed claims data including individual case estimates is made to derive patterns in average claim 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 year end 2011 reserves.

The average period to settlement of such claims is:

- 10.7 years for Employers' liability (2010: 11.9 years);
- 14.0 years for Public and Product's liability (2010: 15.3 years); and
- 11.0 years in total (2010: 12.3 years).

In both cases, the discount rate is 4.0%. The current EIROS reserve amounts to £2m (2010: £3m).

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, 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. There is a governance process in place to ensure that 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 Periodic Reporting Committee (PRC) in order to advise management of the performance of the GI business. Detailed reports are produced on a quarterly basis providing information on the performance of the business against plan. These reports are presented to the Quarterly Reserving Forum Committee (QRF) and form the basis of reporting the GI performance to the Board on a quarterly basis.

ii) 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 £401m (2010: £381m) includes a movement of £40m (2010: surplus release of £27m) arising from an increase of reserves, as follows:

	2011 £m	2010 £m
Fire and Accident (increase)/release of surplus	**(6)**	6
Motor (increase)/release of surplus	**(31)**	20
Movement on claims handling expenses	**(3)**	1
Movement in gross insurance liabilities	**(40)**	27

iii) 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 and therefore 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 profit and loss risk is mitigated through holding management margin on the best estimate reserves that is proportional to the level of uncertainty.

Assumption

		2011		2010	
	Change in parameter	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%	**53**	**9.6%**	53	12.9%
Mean term to settlement – bodily injury and legal	+½ year	**14**	**2.5%**	11	2.6%
Rate of future inflation – bodily injury and legal	1%	**15**	**2.8%**	10	2.3%
Ogden discount rate – bodily injury	–¼%	**4**	**0.6%**	7	1.4%
Other classes					
Mean term to settlement (liability)	+ ½ year	**0.3**	**2.1%**	0.4	2.1%
Mean term to settlement (non-liability)	+½ year	**0.8**	**1.3%**	1.0	1.4%
Rate of future inflation (liability)	1%	**0.7**	**4.2%**	1.0	3.8%
Rate of future inflation (non-liability)	1%	**0.9**	**1.4%**	1.0	1.3%

c) Changes in General Insurance liabilities and reinsurance assets

i) Change in insurance contract liabilities (net of salvage and subrogation)

	Gross £m	Unexpired risk provision £m	Salvage and subrogation £m	Net £m
At beginning of the year	664	–	(46)	618
Movement in the year	73	–	(1)	72
At end of the year	**737**	**–**	**(47)**	**690**

ii) General insurance – claims and loss adjustment expenses

	2011			2010		
	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
Notified outstanding claims	**517**	**(25)**	**492**	457	(21)	436
Claims incurred but not reported	**130**	**(25)**	**105**	165	(22)	143
Claims settlement expenses	**17**	**–**	**17**	17	–	17
At beginning of the year	**664**	**(50)**	**614**	639	(43)	596
Claims paid during the year	**(484)**	**6**	**(478)**	(384)	7	(377)
Increase in liabilities:						
– arising from current and previous period claims	**557**	**(23)**	**534**	409	(15)	394
Total movement	**73**	**(17)**	**56**	25	(8)	17
Notified claims	**602**	**(31)**	**571**	517	(25)	492
Incurred but not reported	**118**	**(36)**	**82**	130	(25)	105
Claims settlement expenses	**17**	**–**	**17**	17	–	17
At end of the year	**737**	**(67)**	**670**	664	(50)	614

23. Insurance contracts liabilities and reinsurance assets continued

iii) General Insurance – provisions for unearned premiums

	2011 Gross £m	2011 Reinsurance £m	2011 Net £m	2010 Gross £m	2010 Reinsurance £m	2010 Net £m
Unearned premium provision						
At beginning of the year	**299**	**(4)**	**295**	221	(5)	216
Increase in the year	**669**	**(36)**	**633**	574	(28)	546
Release in the year	**(641)**	**36**	**(605)**	(496)	29	(467)
Movement in the year	**28**	**–**	**28**	78	1	79
At end of the year	**327**	**(4)**	**323**	299	(4)	295

iv) General Insurance – provisions for unexpired risk

	2011 Gross £m	2011 Reinsurance £m	2011 Net £m	2010 Gross £m	2010 Reinsurance £m	2010 Net £m
Unexpired risk provision						
At beginning of the year	**–**	**–**	**–**	9	–	9
Increase in the year	**–**	**–**	**–**	–	–	–
Release in the year	**–**	**–**	**–**	(9)	–	(9)
Movement in the year	**–**	**–**	**–**	(9)	–	(9)
At end of the year	**–**	**–**	**–**	–	–	–

Additional provision is made for unexpired risks where the claims and expense, 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 at the end of the financial year. The provision primarily relates to the motor class of business, however the full provision was released during 2010.

v) Analysis of claims development – gross of reinsurance

	Accident year 2002 £m	2003 £m	2004 £m	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	2011 £m	Total £m
At end of accident year	**592**	**572**	**551**	**480**	**419**	**385**	**347**	**326**	**411**	**497**	**4,580**
– One year later	**560**	**543**	**527**	**468**	**412**	**388**	**320**	**333**	**455**	**–**	**4,006**
– Two years later	**560**	**527**	**495**	**440**	**403**	**378**	**310**	**341**	**–**	**–**	**3,454**
– Three years later	**551**	**508**	**467**	**414**	**394**	**364**	**300**	**–**	**–**	**–**	**2,998**
– Four years later	**547**	**500**	**450**	**423**	**387**	**367**	**–**	**–**	**–**	**–**	**2,674**
– Five years later	**548**	**499**	**454**	**418**	**388**	**–**	**–**	**–**	**–**	**–**	**2,307**
– Six years later	**540**	**494**	**453**	**422**	**–**	**–**	**–**	**–**	**–**	**–**	**1,909**
– Seven years later	**547**	**496**	**453**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**1,496**
– Eight years later	**543**	**493**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**1,036**
– Nine years later	**544**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**544**
Estimate of cumulative claims	**544**	**493**	**453**	**422**	**388**	**367**	**300**	**341**	**455**	**497**	**4,260**
Cumulative payments to date	**(529)**	**(482)**	**(443)**	**(392)**	**(355)**	**(329)**	**(269)**	**(259)**	**(317)**	**(192)**	**(3,567)**
Provision before discounting	**15**	**11**	**10**	**30**	**33**	**38**	**31**	**82**	**138**	**305**	**693**
Provision for prior years before discounting											**29**
Discounting											**(2)**
Gross outstanding claims liabilities											**720**

	£m
Gross claims reported	**602**
Gross claims incurred but not reported	**118**
Gross outstanding claims liabilities	**720**

Notes to the financial statements continued

23. Insurance contracts liabilities and reinsurance assets continued

vi) Analysis of claims development – net of reinsurance

	Accident year										
	2002 £m	2003 £m	2004 £m	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	2011 £m	Total £m
At end of accident year	586	570	547	478	417	373	334	313	398	481	4,497
– One year later	553	541	525	466	409	378	305	321	434	–	3,932
– Two years later	554	525	493	437	401	370	296	325	–	–	3,401
– Three years later	541	506	465	411	392	358	292	–	–	–	2,965
– Four years later	538	498	448	420	386	360	–	–	–	–	2,650
– Five years later	539	495	452	414	385	–	–	–	–	–	2,285
– Six years later	531	491	451	415	–	–	–	–	–	–	1,888
– Seven years later	534	493	451	–	–	–	–	–	–	–	1,478
– Eight years later	531	490	–	–	–	–	–	–	–	–	1,021
– Nine years later	532	–	–	–	–	–	–	–	–	–	532
Estimate of cumulative claims	532	490	451	415	385	360	292	325	434	481	4,165
Cumulative payments to date	(523)	(480)	(441)	(391)	(355)	(324)	(263)	(254)	(313)	(188)	(3,532)
Provision before discounting	9	10	10	24	30	36	29	71	121	293	633
Provision for prior years before discounting											21
Discounting											(2)
Net outstanding claims liabilities											652

	£m
Net claims reported	570
Net claims incurred but not reported	82
Net outstanding claims liabilities	652

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 year 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 year 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 period in respect of contracts concluded before that date are expected to exceed the unearned premiums carried forward for those contracts. Provisions for unexpired risks are calculated separately for categories of business managed together and are determined after taking account of future investment income.

Such provisions ensure that the carrying amount of liabilities less related deferred acquisition costs is sufficient to cover the 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.

v) Acquisition costs

Costs directly associated with the acquisition of new business including commission payable are capitalised and amortised in accordance with the rate at which the gross premiums written associated with the underlying contract are earned.

24. Share capital

	Nominal and paid-up value Members' share capital	
	2011 £m	2010 £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 Group's interest-bearing loans and borrowings. During 2011, the Group refinanced and issued new bonds in replace of the unsecured bank loan facility. For more information about the Group's exposure to interest rate and foreign currency risk, see note 39.

	2011 £m	2010 £m
Non-current liabilities:		
Secured bank loan	**187**	190
Unsecured bank loans	**254**	1,146
5⅞% Eurobond Issue 2013*	**207**	211
5⅝% Eurobond Issue 2020*	**455**	–
6¼% Eurobond Issue 2026*	**356**	–
7⅝% First Mortgage Debenture Stock 2018*	**62**	54
Other loans	**4**	5
Non-current portion of finance lease liabilities	**9**	14
	1,534	1,620

	2011 £m	2010 £m
Current liabilities:		
Current portion of secured bank loan	**3**	3
Current portion of unsecured bank loans	**100**	100
Corporate investor shares	**51**	46
Current portion of finance lease liabilities	**5**	6
Other unsecured loans	**4**	4
	163	159

* These drawndown 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 debt may be issued to existing corporate members who hold fully paid corporate shares and are registered Industrial and Provident Societies. The terms and conditions under which such loans are withdrawn or repaid, and the rate of interest payable, is determined from time to time by the Society's Board.

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 £62m) to be paid to holders upon maturity.

The 5.875% Eurobond Issue 2013 has an original value of £200m (carrying amount of £207m), the 5.625% Eurobond Issue 2020 has an original value of £450m (carrying amount of £455m) and the 6.25% Eurobond Issue 2026 has an original value of £350m (carrying amount of £356m). All of which are to be paid to holders upon maturity.

The unsecured bank loans consist of a £354m term loan which is fully drawn as at 31 December 2011. The Group also holds a £300m revolving credit facility which is drawn at £5m as at 31 December 2011. The Group also holds uncommitted facilities of £50m which expire in August 2012 and a Bi-Lateral facility of £50m which expires in March 2015.

Whilst both these facilities terminate in full on 15 July 2013 the term loan has one intermediate repayment instalment of £100m due on 31 August 2012.

25. Interest-bearing loans and borrowings continued

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 the year ended 31 December 2011

	Start of the year £m	Non-cash movements £m	Cash flow £m	Movement in corporate investor shares £m	Transfer from non-current to current £m	End of the year £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)**

For the year ended 1 January 2010

	Start of the year £m	Non-cash movements £m	Cash flow £m	Movement in corporate investor shares £m	Transfer from non-current to current £m	End of the year £m
Cash and cash equivalents	347	–	53	–	–	400
Less:						
– Deposits held in trustee-administered bank accounts	(67)	–	6	–	–	(61)
– Interest-bearing loans and borrowings – non-current	(1,830)	(7)	117	–	100	(1,620)
– Interest-bearing loans and borrowings – current	(48)	(1)		(10)	(100)	(159)
Net debt	(1,598)	(8)	176	(10)	–	(1,440)

Finance lease liabilities

Finance leases have the following maturities in the Trading Group:

	2011 £m	2010 £m
Less than one year	**5**	6
Greater than one year but less than five years	**9**	13
Greater than five years	**–**	1
	14	20

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

	2011 £m	2010 (restated*) £m	2009 (restated*) £m
Current	**1,444**	1,396	1,473
Non-current	**558**	406	359
Trading Group	**2,002**	1,802	1,824
Banking Group	**428**	2,751	2,679
	2,430	4,553	4,511

	2011 £m	2010 (restated*) £m	2009 (restated*) £m
Trade payables	**1,140**	1,058	1,111
Value added tax, PAYE and social security	**27**	25	8
Accruals and deferred income	**419**	593	560
Other reinsurance liabilities	**9**	2,160	2,001
Member payments payable	**34**	27	37
Funeral bonds	**508**	401	351
Other payables	**293**	289	443
	2,430	4,553	4,511

* The restated comparatives and the inclusion of the 2009 balances are due to the prior year adjustment in the accounting for funeral bonds. Details of this can be found in the general accounting policies section on page 55 and note 44.

Other reinsurance liabilities in the current year above is for General Insurance activities only. The analysis in the previous year includes Life and General Insurance activities. As the reinsurance liabilities for the Life business were held for sale as at 31 December 2011, the analysis for the current year of the Life business can be found in note 41.

Further details on the maturity profile of trade and other payables of the Trading Group can be found in note 39.

Other payables in the Banking Group include finance lease obligations as follows:

	Present value of lease payments		Future minimum lease payments	
	2011 £m	2010 £m	2011 £m	2010 £m
Due within one year	**–**	–	**–**	–
Due between one year and five years	**–**	–	**–**	–
Due after five years	**1**	1	**2**	2
	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

Payables

The Group has changed its accounting policy on funeral bonds for 2011 such that bonds are now accounted for in line with IAS 18 instead of IFRS 4. Under the new accounting policy adopted 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

	2011 £m	2010 (restated*) £m	2009 (restated*) £m
Non–current	**303**	284	410
Current	**118**	146	57
Trading Group	**421**	430	467
Banking Group	**111**	74	82
	532	504	549

	Self Insurance £m	Onerous leases £m	Restructuring and integration £m	Litigation £m	FSCS levy £m	PPI £m	Regulatory/ other £m	2011 Total £m	2010 Total (restated*) £m
At beginning of the year	**76**	**207**	**62**	**40**	**21**	**4**	**94**	**504**	549
Credit to income statement	**–**	**(7)**	**(1)**	**(24)**	**–**	**–**	**(4)**	**(36)**	(41)
Arising from acquisitions	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	5
Charge to income statement	**38**	**48**	**43**	**–**	**17**	**90**	**5**	**241**	142
Discounting	**–**	**11**	**–**	**–**	**–**	**–**	**–**	**11**	11
Payments	**(35)**	**(25)**	**(39)**	**(4)**	**(11)**	**(32)**	**(34)**	**(180)**	(158)
Transfer to liabilities held for sale	**–**	**–**	**–**	**–**	**–**	**–**	**(8)**	**(8)**	(4)
At end of the year	**79**	**234**	**65**	**12**	**27**	**62**	**53**	**532**	504

* The restated comparatives and the inclusion of 2009 balances are due to the prior year adjustment in the accounting for funeral bonds. Details of this can be found in the general accounting policies section on page 55 and note 44.

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 year 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 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 £72m (2010: £52m) payable in the next five years. The costs have been discounted at rates ranging from 3.5% to 8%.

Restructuring and integration provision

This relates principally to costs associated with the integration of support systems, people and processes following the acquisition of Somerfield. A small proportion relates to merger costs between Britannia and The Co-operative Bank in relation to the restructuring of functional head office support teams and transformational changes to Banking systems and infrastructure. Costs are expected to be incurred over the period 2012–2014 with the majority being incurred in 2012 and 2013.

Litigation provision

During the year, the Group successfully concluded two substantial cases in its favour, resulting in a release of £24m. The remaining provision represents management's prudent estimate of 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

In common with other FSA authorised financial institutions doing business in the UK, the Group contributes to the Financial Services Compensation Scheme (FSCS). The FSCS covers financial institutions authorised to do business in the United Kingdom. When an institution is unlikely, or likely to be unable, to pay claims against it, its customers may be able to claim compensation from the FSCS. The FSCS raises funds to meet the known compensation claims through levies on other FSA authorised institutions.

The Group has provided £27m (2010: £21m) for its share of the levies in respect of the levy years ending 31 March 2012 and 31 March 2013 respectively.

At the date of these financial statements, it is not possible to estimate whether there will ultimately be additional levies on the industry, the level of the Group's market participation or other factors that may affect amounts or the timing of amounts that may ultimately become payable, nor the effect that such levies may have upon operating results in any particular year.

27. Provisions continued

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 until January 2009, the Bank, along with many other financial services providers, sold payment protection insurance PPI alongside non-mortgage credit products. The FSA issued a policy statement in August 2010 which amended the 'Disputes Resolution: Complaints' section of the FSA Handbook, setting out new rules for handling complaints, including complaints of PPI mis-selling. The new rules were challenged by the BBA (British Bankers' Association) which launched a judicial review heard in January 2011. The results of the review were announced on 20 April 2011 and the High Court dismissed the BBA arguments. Consequently the Bank must comply with the policy statement which requires complainants to receive adequate redress and the Bank to complete a proactive review of all past business to identify mis-sold policies where no complaint has been made. An additional provision of £90.0m has been recognised in the year, in respect of the expected cost to the Bank of carrying out this work and paying compensation.

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 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

	2011 £m	2010 £m
Items in course of collection	**49**	45
Deposits from other banks	**3,254**	2,893
Gilt repo liability	**–**	871
Other	**25**	6
	3,328	3,815

Gilt Repo liability represents CIS repurchase liabilities in respect of government guaranteed securities which are the subject of repurchase contracts. They were transferred to liabilities held for sale within 2011. The government guaranteed securities are included within investments. Amounts owed to credit institutions are measured at amortised cost. Other represents overnight borrowings and overdraft balances.

Included within deposits from other banks are liabilities of £1,703m (2010: £1,349m) secured on investment securities with a carrying value of £2,114m (2010: £1,551m) 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

	2011 £m	2010 £m
Retail	**26,511**	26,053
Corporate and Business Banking (CABB)	**7,649**	5,147
Other	**913**	1,180
	35,073	32,380

The Group has entered into interest rate swaps that protect it from changes in interest rates on the floating rate assets that are funded by its fixed rate customer accounts. Changes in the fair values of these swaps are offset by changes in the fair values of the fixed rate customer accounts.

Notes to the financial statements continued

30. Capital bonds

	2011 £m	2010 £m
Retail	**1,430**	1,795

The capital bonds are fixed term customer accounts with returns based on the movement in an index (eg FTSE 100) over the term of the bond. The capital bonds have been designated on initial recognition at fair value through income 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 £1,430m (2010: £1,756m). 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 £25m (2010: £29m). 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 £1m (2010: £nil).

Accounting policies

Certain non-derivative financial liabilities included within customer accounts (capital bonds) 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

	2011 £m	2010 £m
Certificates of deposits	**252**	639
Commercial papers	**–**	20
Fixed and floating notes	**3,913**	3,553
Debt securities in issue	**4,165**	4,212

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. Investment contracts

Investment contract liabilities all arise from unit linked contracts, and are measured at fair value by reference to the fair value of the underlying portfolio of assets and are designated in this measurement category at inception. None of the change in the liability is attributable to changes in the credit risk of the underlying assets. The maturity value of these financial liabilities is determined by the fair value of the linked assets at maturity date. There will be no difference between the carrying amount and the maturity amount at maturity date.

The movement in the liability arising from investment contracts is summarised below:

	2011 £m	2010 £m
At beginning of the year	**316**	260
Contributions	**33**	33
Account balance paid on surrender and related benefits	**(14)**	(13)
Movement in fair value	**(21)**	36
Transfer to liabilities held for sale	**(314)**	–
At end of the year	**–**	316

	2011 £m	2010 £m
Movement in fair value comprises:		
Investment return credited and related benefits	**(21)**	35
Management charges	**(4)**	(3)
Other income – management rebate	**4**	4
	(21)	36

33. Unallocated divisible surplus (UDS)

	2011 £m	2010 £m
At beginning of the year	**1,037**	1,053
Transfer from/(to) the income statement	**16**	(16)
Transfer to liabilities held for sale	**(1,053)**	–
At end of the year	**–**	1,037

The unallocated divisible surplus comprises the excess long term business net assets over the participating insurance and investment contract liabilities of the long term business. As long term business is transacted on a mutual basis the unallocated divisible surplus represents amounts due to participating contract holders, the allocation of which has yet to be determined and is therefore classified as a liability.

Accounting policies
CIS's long term business is transacted on a mutual basis and all surpluses arising on long term business are allocated, as appropriate, to participating contract holders. Its mutual status means that the long term business fund has no equity and the UDS represents amounts due to policyholders, the allocation of which is yet to be determined. Accordingly, the UDS is classified as a liability.

34. Other borrowed funds

	2011 £m	2010 £m
£150m Step up callable subordinated notes 2019	**150**	150
£60m 9.25% Non-cumulative irredeemable preference shares of £1 each	**60**	60
Floating rate subordinated notes 2016	**21**	104
5.625% Subordinated notes 2021	**150**	150
9.25% Subordinated notes 2021	**275**	–
Fixed rate subordinated notes 2024	**167**	144
Fixed rate subordinated notes 2033	**122**	99
Perpetual subordinated bonds	**283**	253
Issue costs, discounts and accrued interest	**31**	15
	1,259	975

£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.

£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 in the event of 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.

Notes to the financial statements continued

34. Other borrowed funds continued

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.

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.

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 element of the swap is received annually to match the payment to the noteholders. The floating payment element 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 pay 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 relevant prior 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

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 (further information is provided in note 29) and are subsequently presented in other borrowed funds. The dividends on these preference shares are recognised in the income statement as interest expense on an amortised cost basis using the effective interest method.

35. Reconciliation of operating profit to net cash inflow from operating activities

	Trading Group		Banking Group		Total	
	2011 £m	2010 (restated) £m	**2011 £m**	2010 (restated) £m	**2011 £m**	2010 (restated) £m
Operating profit after significant items	**213**	367	**162**	98	**375**	465
(Losses)/profits on discontinued operations before interest and tax	**(4)**	(38)	**15**	8	**11**	(30)
Depreciation and amortisation	**287**	276	**60**	56	**347**	332
Non-current asset impairments	**23**	21	**–**	–	**23**	21
Loss on disposal of non-current assets	**15**	8	**4**	1	**19**	9
Change in value of investment properties	**(9)**	(14)	**–**	–	**(9)**	(14)
Effect of exchange rate movements	**–**	–	**16**	(3)	**16**	(3)
Effect of non-cash pension costs	**(12)**	(11)	**2**	3	**(10)**	(8)
Increase in inventories	**(20)**	(29)	**–**	–	**(20)**	(29)
(Increase)/Decrease in receivables	**(2)**	12	**(69)**	(22)	**(71)**	(10)
Increase/(Decrease) in provisions and payables	**90**	(74)	**421**	36	**511**	(38)
(Decrease)/Increase in funeral bonds	**(3)**	25	**–**	–	**(3)**	25
Interest payable on subordinated liabilities	**–**	–	**85**	45	**85**	45
Impairment losses on loans and advances	**–**	–	**131**	97	**131**	97
Impairment losses on investments	**–**	–	**(40)**	(2)	**(40)**	(2)
Interest amortisation	**–**	–	**(16)**	(6)	**(16)**	(6)
Amortisation on investments	**–**	–	**(339)**	(43)	**(339)**	(43)
Fair value amortisation	**–**	–	**(86)**	14	**(86)**	14
Preference dividend	**–**	–	**6**	6	**6**	6
Profit on sale of investment	**–**	–	**–**	1	**–**	1
Tax (paid)/received	**(16)**	36	**(44)**	(91)	**(60)**	(55)
Net cash flow from trading activities	**562**	579	**308**	198	**870**	777
Decrease in deposits by banks	**–**	–	**364**	(3,144)	**364**	(3,144)
Increase in customer accounts	**–**	–	**2,307**	1,639	**2,307**	1,639
(Increase)/Decrease in debt securities in issue	**–**	–	**(141)**	472	**(141)**	472
(Increase)/Decrease in loans and advances to Bank	**–**	–	**(73)**	402	**(73)**	402
Increase in loans and advances to customers	**–**	–	**1,034**	(901)	**1,034**	(901)
Net movement of other assets and other liabilities	**–**	–	**86**	268	**86**	268
Investment property movement	**–**	–	**(93)**	(48)	**(93)**	(48)
Fair value through profit and loss movement	**–**	–	**(988)**	(509)	**(988)**	(509)
Derivative financial instruments movement	**–**	–	**400**	(84)	**400**	(84)
Assets available for sale movement	**–**	–	**(72)**	77	**(72)**	77
Reinsurance assets	**–**	–	**(406)**	(23)	**(406)**	(23)
Insurance and other receivables	**–**	–	**–**	(66)	**–**	(66)
Insurance and participation contract provisions	**–**	–	**1,322**	964	**1,322**	964
Unallocated divisible surplus	**–**	–	**15**	(16)	**15**	(16)
Investment contracts	**–**	–	**(2)**	56	**(2)**	56
Amounts owed to credit institutions	**–**	–	**(115)**	(201)	**(115)**	(201)
Other provisions	**–**	–	**243**	(12)	**243**	(12)
Net asset value attributable to unit holders	**–**	–	**(30)**	(12)	**(30)**	(12)
Increase in intangible assets	**–**	–	**(7)**	(13)	**(7)**	(13)
Other cash flow movements	**–**	–	**9**	(3)	**9**	(3)
Asset and liability movements in Banking Group	**–**	–	**3,853**	(1,154)	**3,853**	(1,154)
Net cash outflow from operating activities	**562**	579	**4,161**	(956)	**4,723**	(377)

The cash flows above and in the cashflow 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

36. Commitments and contingent liabilities

a) Capital expenditure committed by the Group at year end was £99m (2010: £186m). 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 31 December 2011, the future minimum lease payments under non-cancellable operating leases were:

	2011		2010	
	Land and buildings £m	**Other £m**	Land and buildings £m	Other (restated) £m
Within one year	**182**	**23**	181	23
In two to five years	**637**	**20**	635	22
In over five years	**2,380**	**–**	2,738	–
	3,199	**43**	3,554	45

The total of future minimum sublease payments expected to be received under non-cancellable subleases less than 50 years is £307m (2010: £311m).

c) Banking activities:

The table below gives the nominal principal amounts and risk weighted amounts of contingent liabilities and commitments. The nominal principal 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 guidelines implementing the Capital Requirements Directive (CRD).

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.

	2011		2010	
	Contract amount £m	**Risk-weighted amount £m**	Contract amount £m	Risk-weighted amount £m
i) Contingent liabilities:				
Guarantees and irrevocable letters of credit	**168**	**132**	134	99
	168	**132**	134	99
ii) Other commitments:				
Documentary credits and short term trade related transactions	**8**	**2**	3	1
Forward assets purchases and forward deposit placed	**45**	**1**	166	14
Undrawn formal standby facilities, credit lines and other commitments to lend (includes revocable and irrevocable commitments)[(a)]	**4,700**	**1,148**	4,591	1,089
	4,753	**1,151**	4,760	1,104

Notes

(a) Undrawn loan commitments include revocable commitments which are unused credit card limits of £2,182m (2010: £2,345m).

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.

At 31 December 2011, the mandatory reserve deposits held with the Bank of England were £38m (2010: £36m).

Within the Group and Bank, investment securities with a carrying value of £2,114m (2010: £1,551m) have been sold under sale and repurchase agreements. These assets have not been derecognised as the Group and Bank has retained substantially all the risks and rewards of ownership. Included within deposits by banks are the related liabilities of £1,703m (2010: £1,349m).

In addition, within the Bank, amounts owed by other Co-operative Group undertakings with a carrying value of £777m (2010: £989m) have been sold under sale and repurchase agreements. These assets have not been derecognised as the Bank has retained substantially all the risks and rewards of ownership. Included within deposits by banks are the related liabilities of £614m (2010: £779m).

The Group and Bank have loans and advances to banks of £256m (2010: £70m) under reverse sale and repurchase agreements and against which it holds gilts with a fair value of £268m (2010: £70m). These transactions are conducted under terms that are usual and customary to standard stock lending, securities borrowing and reverse purchase agreements. The Group is permitted to sell or repledge the assets received as collateral in the absence of their default. The Group is obliged to return equivalent securities. At 31 December 2011 the fair value of collateral repledged amounted to £268m (2010: £70m). The Group and Bank do not adjust for the fair value of securities received under reverse sale and repurchase agreements.

37. 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	2011 £m	2010 £m
Sales to associated undertakings and joint ventures on normal trading terms	(i)	**0.5**	0.4
Subscription to Co-operatives[UK] Limited	(ii)	**1.0**	0.9

(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 £1,355m (2010: £1,296m) and the amount due from corporate members in respect of such sales was £79m at 31 December 2011 (2010: £63m).

Transactions with directors and key management personnel

Disclosure of key management compensation is set out in the Remuneration Report on pages 37 to 46. A number of trading transactions are entered into with related parties 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 £9,886 (2010: £8,257).

b) Banking Group

A number of banking transactions are entered into with related parties 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 year end and related income and expense for the year are as follows:

	2011 £m	2010 £m
Loans, credit card and mortgage balances outstanding	**0.4**	0.7
Deposits at beginning of the year	**0.8**	0.7
Net movement	**0.2**	0.1
Deposits at end of the year	**1.0**	0.8

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 year and balances are as follows:

	2011 £m	2010 £m
At beginning of the year	**0.4**	0.1
Net movement	**0.1**	0.3
At end of the year	**0.5**	0.4

Notes to the financial statements continued

38. 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(iv):	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(iv):	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
Britannia Covered Bonds LLP(vi)	100	Mortgage acquisition and guarantor of covered bonds
Unity Trust Bank plc(iii)(iv)	27	Banking
Co-operative Bank Financial Advisers Ltd(iv)	100	Financial advisers
Trading:		
The Co-operative Clothing Ltd	100	Clothing manufacturing
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	E-Retailing
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
Co-operative Group Estates Services Ltd	100	Property management

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 2011.
(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) The Covered Bond LLP was established as a result of a £1.0bn covered bond retained issuance by the Bank during 2008. Loans and advances to customers of £2.3bn were transferred to the LLP. The transfer was funded by a loan of £1.0bn and capital contribution of £1.3bn. This issuance was redeemed during the year.

39. Risk management

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. For further information regarding the Group's approach to risk management please refer to the 'Principal risks and uncertainties' section from pages 22 to 25.

The principal risks facing the Group are set out below in the context of a) Trading Group risk; b) Banking risk; c) General Insurance risk and d) Life Insurance risk.

A) Trading Group risk

Introduction

The Trading Group meets its working capital needs through a number of facilities totalling £1,994m. During 2011, the Group refinanced £800m of these facilities through the issuance of two bonds. Under the current facilities a capital repayment of £100m is due in August 2012, a total of £454m is repayable between July 2013 and December 2013, and at the same time the current £300m revolving credit facility will expire. The remaining facilities of £290m (excluding the bonds issued in 2011) are due for repayment between 2015 and 2018. The Trading Group has prepared detailed forecasts and projections for the period to July 2013 which, taking account of reasonably possible changes in trading performance in the current economic environment, show the Trading Group is able to operate within the level of its current facilities, including compliance with all financial covenants. Furthermore, the Group is currently in negotiations with its bankers to re-finance facilities expiring in 2013. These discussions are currently well advanced and should be concluded shortly.

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 2011 £m	Carrying amount 2010 £m
Trade and other receivables (excluding prepayments and accrued income)	**401**	413
Interest rate swaps	**87**	15
Cash deposits	**267**	400

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 31 December 2011 was 74%. 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 31 December 2011, the Trading Group had interest rate swaps with a notional contract amount of £1,733m (2010: £1,150m).

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 31 December 2011 was a net liability of £62m (2010: £104m) comprising assets of £79m (2010: £15m) and liabilities of £141m (2010: £119m). These amounts are recognised as fair value derivatives.

Notes to the financial statements continued

39. Risk management continued

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.

	2011						
	Effective interest rate	**Total £m**	**6 months or less £m**	**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:							
5⅞% Fixed rate sterling eurobond	**5.875%**	**(200)**	**–**	**–**	**(200)**	**–**	**–**
5⅞% Effect of interest rate swaps	**–3.083%**	**–**	**(200)**	**–**	**200**	**–**	**–**
5⅝%Fixed rate sterling eurobond	**5.625%**	**(450)**	**–**	**–**	**–**	**–**	**(450)**
5⅝% Effect of interest rate swaps	**–2.136%**	**–**	**(450)**	**–**	**–**	**–**	**450**
6¼% Fixed rate sterling eurobond	**6.250%**	**(350)**	**–**	**–**	**–**	**–**	**(350)**
6¼% 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)**

	2010						
	Effective interest rate	Total £m	6 months or less £m	6–12 months £m	1–2 years £m	2–5 years £m	More than 5 years £m
Cash and cash equivalents	0.563%	400	400	–	–	–	–
Secured debt:							
First mortgage debenture 2018	7.625%	(50)	–	–	–	–	(50)
Investment Properties Loan	0.758%	(193)	(2)	(2)	(3)	(186)	–
Effect of interest rate swap	4.487%	–	–	–	–	–	–
Unsecured bond issues:							
5⅞% Fixed rate sterling eurobond	5.875%	(200)	–	–	–	(200)	–
5⅞% Effect of interest rate swaps	–3.393%	–	(200)	–	–	200	–
Other unsecured loans	0.584%	(1,252)	(1,246)	–	(1)	(5)	–
Effect of interest rate swaps	2.577%	–	744	–	(126)	(50)	(568)
Corporate investor shares	1.337%	(46)	(42)	(4)	–	–	–
Finance lease liabilities		(20)	(3)	(3)	(5)	(8)	(1)
		(1,361)	(349)	(9)	(135)	(249)	(619)

39. 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 joint venture with Thomas Cook Group plc has reduced the foreign currency exposure for the Group.

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 year 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 31 December 2011, the Trading Group had forward currency transactions in Euro and US Dollars with a notional contract amount of £8m (2010: £8m).

Liquidity risk

As at 31 December 2011, the Trading Group had available borrowing facilities totalling £1,994m (2010: £2,090m), which comprised uncommitted facilities of £50m (2010: £50m) and committed facilities of £1,944m (2010: £2,040m). These are detailed below:

Bank facilities as at 31 December 2011

	Expiry	£m
Uncommitted facilities	**July 2012/August 2012**	**50**
Syndicate Term Loan	**July 2013**	**354**
Syndicate Revolving Credit Facility	**July 2013**	**300**
Bilateral Facility	**March 2015**	**50**
Secured Investment Property Bilateral	**September 2015**	**190**
		944
Debenture	**December 2018**	**50**
Eurobond issue – 2013	**December 2013**	**200**
Eurobond issue – 2020	**July 2020**	**450**
Eurobond issue – 2026	**July 2026**	**350**
		1,994

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)**

The following are the maturities of financial liabilities as at 1 January 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	(193)	(193)	(2)	(2)	(3)	(186)	–
Secured debenture	(54)	(50)	–	–	–	–	(50)
Unsecured bank facility	(1,252)	(1,252)	–	(100)	(101)	(1,051)	–
Sterling Eurobond	(211)	(200)	–	–	–	(200)	–
Finance lease liabilities	(20)	(20)	(3)	(3)	(5)	(8)	(1)
Trade and other payables	(1,802)	(1,802)	(1,163)	(237)	–	(5)	(397)
Derivative financial liabilities							
Interest rate swaps used for hedging	(119)	(119)	–	–	(2)	(4)	(113)

Notes to the financial statements continued

39. Risk management continued

Sensitivity analysis

Interest rate risk

At 31 December 2011 if sterling (GBP) market interest rates had been 1% higher/lower with all other variables held constant, post-tax profit for the year would have been GBP £74m (2010: GBP £13m) higher and GBP £116m (2010: GBP £9m) 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 31 December 2011, if the Euro, US dollar, Australian dollar and New Zealand dollar had all strengthened by 10% against sterling (GBP) with all variables held constant, post-tax profit for the year would have been £0.5m (2010: £0.4m) lower, mainly as a result of foreign exchange losses on translation of EUR-denominated trade payables. Conversely, if the Euro, US dollar, Australian dollar and New Zealand dollar had all weakened by 10% against sterling (GBP) with all variables held constant, post-tax profit for the year would have been £0.4m (2010: £0.4m) higher.

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 31 December 2011 the total amount of guarantees/bonds outstanding is £83m (2010: £84m).

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 31 December 2011 and 1 January 2011 respectively are as follows:

	2011			2010		
	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	–	507	–	–	499	–
Cash and cash equivalents	–	267	–	–	400	–
Derivative financial assets and liabilities						
Interest rate swaps:						
Assets	–	79	–	–	15	–
Liabilities	–	(141)	–	–	(119)	–
Non-derivative financial liabilities						
Forward exchange contracts:						
Assets	–	–	–	–	–	–
Liabilities	–	–	–	–	–	–
Secured debt:						
First mortgage debenture 2018	(62)		–	(54)	–	–
Other secured loans	–	(190)	–	–	(193)	–
Unsecured bond issue:						
Fixed rate sterling eurobond	(1,018)	–	–	(211)	–	–
Funeral bonds	–	–	(508)	–	–	(401)
Unsecured bank facilities:						
Other unsecured loans	–	(358)	–	–	(1,253)	–
Corporate investor shares	–	(51)	–	–	(46)	–
Finance lease liabilities	–	–	(14)	–	–	(20)
Trade and other payables (excluding accruals, deferred income and funeral bonds)	–	(1,283)	–	–	(1,174)	–

39. Risk management continued

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.

Hierachy 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 31 December 2011 plus an adequate constant credit spread to discount financial instruments.

The interest rates used are as follows:

	2011	2010
Derivatives	**1.10%–2.70%**	0.91%–3.30%
Loans and borrowings	**4.85%–6.45%**	4.91%–7.30%

B) Banking risk

The Co-operative Banking Group (the Banking Group) companies, including Co-operative Insurance Society Limited, CIS General Insurance Limited and The Co-operative Bank plc, have a common Board composition.

The Banking Group has developed and implemented a common governance and organisation structure, which supports all the Boards within the Banking Group.

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

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

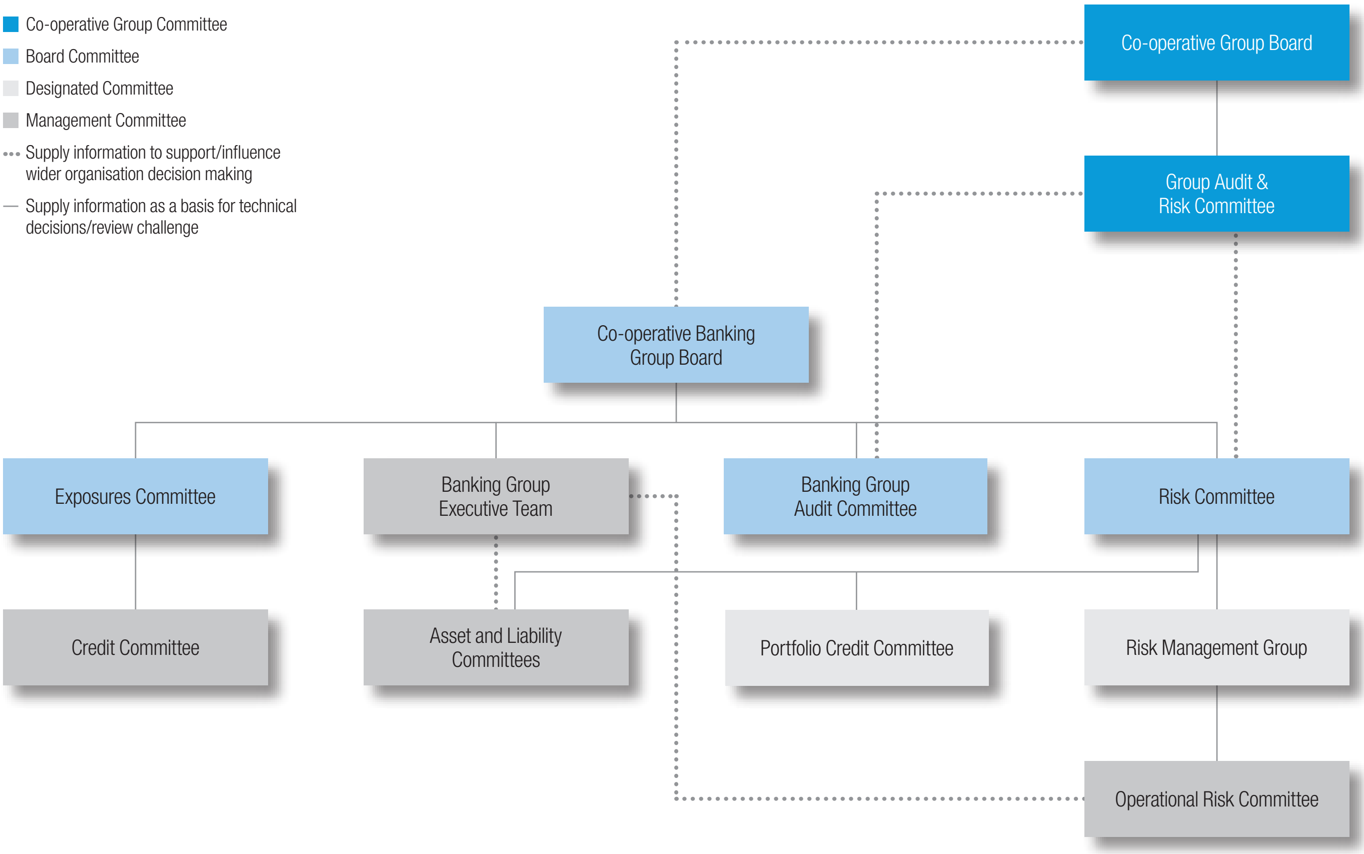
- oversee the risk management process;
- identify the key risks facing the business; and
- assess the effectiveness of planned management actions.

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

Notes to the financial statements continued

39. Risk management continued

Banking Group Risk management structure



Risk management committees

The Banking Group's Board delegates authority to the Banking Group's Risk Committee for monitoring compliance with the Banking Group Board approved risk appetite statements. This includes:

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

Risk Committee (RC): this committee is responsible for the oversight of the adequacy of capital for all risks (technical, operational and business model and external) across the Banking Group. This includes:

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

39. Risk management continued

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

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

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

Risk and capital management sub-committees

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

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

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

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

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

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

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

Banking Group significant risks

In this section, The Bank represents The Co-operative Bank plc and its subsidiaries.

The Bank's significant risks arise in four broad categories.

Risk type	Definition	Page
1. Credit risk	Credit risk is the current or prospective risk to earnings and capital arising from a borrower's failure to meet the terms of any contract with the Bank or their failure to perform as agreed.	114
2. Liquidity risk	Liquidity risk is the risk that the Bank's resources will prove inadequate to meet its commitments. It arises from the mismatch of timings of cash flows generated from the Bank's assets and liabilities (including derivatives).	129
3. Market risk	Market risk is the risk relating to changes in market prices of financial instruments, execution of customer and interbank business and proprietary trading. The majority of the Bank's market risk arises from changes in interest rates.	132
4. Operational risk	Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or external events. This encompasses the effectiveness of risk management techniques and controls to minimise these losses. This section applies to the Banking Group.	134

Notes to the financial statements continued

39. Risk management continued

1. Credit risk

1.1 Overview

Credit risk is an integral part of our business activities and is inherent in both traditional banking products (loans, commitments to lend, and contingent liabilities such as letters of credit) and in 'traded products' (derivative contracts (such as forwards, swaps and options), repurchase agreements, securities borrowing and lending transactions).

All authority to take credit risk derives from the Banking Group's Board. This authority is delegated to the Chief Executive and then on to other individuals. The level of credit risk authority delegated depends on seniority and experience, and varies according to the quality of the counterparty, associated security or collateral held.

1.2 Credit risk policies

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

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

1.2.1 Retail credit risk

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

1.2.2 Corporate credit risk

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

1.2.3 Wholesale credit risk

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

1.3 Credit exposure

1.3.1 Definitions

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

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

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

1.3.2 Analyses of credit exposure

The following analysis of credit exposure shows:

- carrying amounts by class of asset in the balance sheet;
- the gross credit exposure by class of asset (excluding allowance for losses and including credit commitments);
- the net credit exposure by class of asset (including both allowance for losses and credit commitments);
- an analysis of the net credit exposures by level of impairment or risk; and
- fair value adjustments.

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

39. Risk management continued

1. Credit risk continued

1.3.2 Analyses of credit exposure continued

2011	Loans and advances to banks £m	Loans and advances to customers £m	Investment securities loans and receivables £m	Investment securities available for sale £m	Investment securities fair value through income or expense £m	Derivative financial instruments £m	Total £m
Gross balance	2,007	34,058	808	3,466	343	976	41,658
Less: allowance for losses	–	(292)	(3)	(43)	–	–	(338)
	2,007	33,766	805	3,423	343	976	41,320
Analysis of credit risk exposure							
Gross balance	2,007	34,058	808	3,466	343	976	41,658
Credit commitments	40	4,859	–	–	–	–	4,899
Gross credit risk exposure	2,047	38,917	808	3,466	343	976	46,557
Less: allowance for losses	–	(292)	(3)	(43)	–	–	(338)
Net credit risk exposure	2,047	38,625	805	3,423	343	976	46,219
Analysis of net credit risk exposure by level of impairment or risk							
Individually impaired							
90 days past due or evidence of impairment	–	1,658	4	43	–	–	1,705
Impairment recognised	–	(114)	(3)	(43)	–	–	(160)
	–	1,544	1	–	–	–	1,545
Collectively impaired							
Less than 90 days past due	–	1,237	–	–	–	–	1,237
90–179 days past due	–	15	–	–	–	–	15
180 days plus past due	21	153	–	–	–	–	174
Impairment recognised	–	(178)	–	–	–	–	(178)
	21	1,227	–	–	–	–	1,248
Past due but not impaired							
0–29 days past due	–	272	–	–	–	–	272
30–59 days past due	–	87	–	–	–	–	87
60–89 days past due	–	51	–	–	–	–	51
	–	410	–	–	–	–	410
Neither past due nor impaired							
Low risk	2,001	31,579	768	3,334	343	971	38,996
Medium to high risk	42	4,261	55	89	–	5	4,452
	2,043	35,840	823	3,423	343	976	43,448
	(16)	(396)	(20)	–	–	–	(432)
Fair value adjustments	2,048	38,625	804	3,423	343	976	46,219

Notes to the financial statements continued

39. Risk management continued

1. Credit risk continued

1.3.2 Analyses of credit exposure continued

2010	Loans and advances to banks £m	Loans and advances to customers £m	Investment securities loans and receivables £m	Investment securities available for sale £m	Investment securities fair value through income or expense £m	Derivative financial instruments £m	Total £m
Gross balance	2,394	35,200	1,930	3,029	29	976	43,558
Less: allowance for losses	–	(223)	(13)	(72)	–	–	(308)
	2,394	34,977	1,917	2,957	29	976	43,250
Analysis of credit risk exposure							
Gross balance	2,394	35,200	1,930	3,029	29	976	43,558
Credit commitments	176	4,718	–	–	–	–	4,894
Gross credit risk exposure	2,570	39,918	1,930	3,029	29	976	48,452
Less: allowance for losses	–	(223)	(13)	(72)	–	–	(308)
Net credit risk exposure	2,570	39,695	1,917	2,957	29	976	48,144
Analysis of net credit risk exposure by level of impairment or risk							
Individually impaired							
90 days past due or evidence of impairment	–	1,790	25	72	–	–	1,887
Impairment recognised	–	(64)	(9)	(72)	–	–	(145)
	–	1,726	16	–	–	–	1,742
Collectively impaired							
Less than 90 days past due	–	797	119	–	–	–	916
90–179 days past due	–	18	–	–	–	–	18
180 days plus past due	21	143	–	–	–	–	164
Impairment recognised	–	(158)	(4)	–	–	–	(162)
	21	800	115	–	–	–	936
Past due but not impaired							
0–29 days past due	–	240	–	–	–	–	240
30–59 days past due	–	119	–	–	–	–	119
60–89 days past due	–	179	–	–	–	–	179
	–	538	–	–	–	–	538
Neither past due nor impaired							
Low risk	2,565	31,997	1,831	2,946	29	976	40,344
Medium to high risk	–	5,112	–	11	–	–	5,123
	2,565	37,109	1,831	2,957	29	976	45,467
Fair value adjustments	(16)	(478)	(45)	–	–	–	(539)
	2,570	39,695	1,917	2,957	29	976	48,144

The impairment analysis of loans and advances to customers has been restated to show a consistent comparison to 2011 following the inclusion of assets subject to forbearance in impairment definitions.

1.4 Analysis of impaired assets and associated collateral

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

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

1.4.1 Loans and advances to customers

1.4.1.1 How we oversee and control credit risk

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

39. Risk management continued

1. Credit risk continued

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

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

On pages 118 to 125 the management of credit risk by portfolio is described covering:

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

1.4.1.2 Assessment for impairment

The loan portfolios are periodically reviewed, usually once a month, to assess impairment. A loan will be deemed to be impaired where there is objective evidence that a loss event has occurred after recognition of an asset and by 31 December 2011. Further detail is provided in the following credit risk sections.

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

The following table analyses the gross balance by impairment classification for the Retail (secured and unsecured) and CABB (corporate, Platform and Optimum) business segments. It includes credit commitments, impairment provisions and fair value adjustments.

	Retail		CABB			Total
2011	**Secured £m**	**Unsecured £m**	**Corporate £m**	**Platform £m**	**Optimum £m**	**£m**
Individually impaired						
90 days past due or evidence of impairment	69	–	710	5	874	1,658
Impairment recognised	(3)	–	(105)	–	(6)	(114)
	66	–	605	5	868	1,544
Collectively impaired						
Less than 90 days past due	195	53	291	8	690	1,237
90–179 days past due	–	15	–	–	–	15
180 days plus past due	–	152	1	–	–	153
Impairment recognised	–	(164)	(12)	–	(2)	(178)
	195	56	280	8	688	1,227
Past due but not impaired						
0–29 days past due	40	6	–	5	221	272
30–59 days past due	27	–	–	4	56	87
60–89 days past due	10	–	11	2	28	51
	77	6	11	11	305	410
Neither past due nor impaired						
Low risk	13,972	2,585	9,285	1,468	4,269	31,579
Medium to high risk	230	1,130	1,067	87	1,747	4,261
	14,202	3,715	10,352	1,555	6,016	35,840
Fair value adjustments	(7)	–	(251)	–	(138)	(396)
	14,533	3,777	10,997	1,579	7,739	38,625

Notes to the financial statements continued

39. Risk management continued

1. Credit risk continued

2010	Retail Secured £m	Retail Unsecured £m	CABB Corporate £m	CABB Platform £m	CABB Optimum £m	Total £m
Individually impaired						
90 days past due or evidence of impairment	56	–	610	6	1,118	1,790
Impairment recognised	(3)	–	(56)	–	(5)	(64)
	53	–	554	6	1,113	1,726
Collectively impaired						
Less than 90 days past due	101	49	–	5	642	797
90–179 days past due	–	18	–	–	–	18
180 days plus past due	–	142	1	–	–	143
Impairment recognised	–	(158)	–	–	–	(158)
	101	51	1	5	642	800
Past due but not impaired						
0–29 days past due	45	6	–	3	186	240
30–59 days past due	39	–	–	4	76	119
60–89 days past due	15	–	127	3	34	179
	99	6	127	10	296	538
Neither past due nor impaired						
Low risk	15,304	2,782	8,773	808	4,330	31,997
Medium to high risk	369	1,203	1,418	74	2,048	5,112
	15,673	3,985	10,191	882	6,378	37,109
Fair value adjustments	(8)	–	(265)	–	(205)	(478)
	15,918	4,042	10,608	903	8,224	39,695

1.4.1.3 Secured residential credit risk

Acquisition and account management

Secured loans are mortgages originated directly to customers via branches, telephone and the internet in the retail business and via intermediaries in the Platform business. In 2011 55% (2010: 79%) of mortgages were originated through the retail business and 45% (2010: 21%) through Platform. Completions of retail and Platform prime mortgages have fallen whilst completions of buy to let mortgages originated through Platform have substantially increased.

Retail mortgages are prime residential mortgages and include loans originated via both Britannia and The Co-operative Bank branded sales channels.

Platform originates a combination of prime and 'almost prime' residential mortgages together with buy to let loans.

Loans 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.

Loan repayment methods may be capital and interest, where the loan is repaid over the term of the loan, or interest only, where the capital element of the loan is normally repaid at the end of the term.

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

	2011			2010		
	Amount advanced £m	**Average LTV %**	**% Interest only**	Amount advanced £m	Average LTV %	% Interest only
Retail prime	**791**	**58**	**12**	2,444	60	21
Platform prime	**182**	**66**	**22**	526	66	26
Total prime	**973**	**59**	**13**	2,970	61	22
Buy to let	**446**	**63**	**83**	69	60	88
Almost prime	**10**	**53**	**13**	39	55	24
Self certified	**–**	**–**	**–**	1	54	100
Total completions	**1,429**	**60**	**30**	3,079	61	23

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

39. Risk management continued

1. Credit risk continued

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

2011	Retail secured £m	Platform £m	Optimum £m	Total £m
Less than 50%	**5,524**	**182**	**484**	**6,190**
50% to 60%	**1,929**	**229**	**373**	**2,531**
60% to 70%	**2,001**	**417**	**673**	**3,091**
70% to 80%	**2,089**	**474**	**1,068**	**3,631**
80% to 90%	**1,762**	**113**	**1,605**	**3,480**
90% to 100%	**647**	**5**	**1,696**	**2,348**
Greater than 100%	**419**	**2**	**2,035**	**2,456**
	14,371	**1,422**	**7,934**	**23,727**

2010	Retail secured £m	Platform £m	Optimum £m	Total £m
Less than 50%	6,221	119	523	6,863
50% to 60%	2,124	132	407	2,663
60% to 70%	2,117	255	729	3,101
70% to 80%	2,281	306	1,197	3,784
80% to 90%	1,836	88	1,781	3,705
90% to 100%	736	4	1,827	2,567
Greater than 100%	482	–	1,981	2,463
	15,797	904	8,445	25,146

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

	2011			2010		
	Exposure £m	**Average LTV %**	**% Interest only**	Exposure £m	Average LTV %	% Interest only
Prime residential	**15,746**	**44**	**25**	17,126	43	25
Buy to let	**2,881**	**76**	**91**	2,557	78	91
Self-certified	**2,229**	**77**	**77**	2,386	76	77
Almost prime	**997**	**90**	**67**	1,059	89	68
Non-conforming	**1,874**	**77**	**66**	2,018	77	66
	23,727	**53**	**43**	25,146	52	42

Collateral

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

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

Notes to the financial statements continued

39. Risk management continued

1. Credit risk continued

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

	2011			2010		
	Impaired £m	Non-impaired £m	Total £m	Impaired £m	Non-impaired £m	Total £m
Exposure	**1,854**	**21,873**	**23,727**	2,026	23,120	25,146
Collateral	**1,786**	**21,751**	**23,537**	1,963	23,004	24,967
Cover	**96%**	**99%**	**99%**	97%	99%	99%

Impairment

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

Objective evidence of a loss event is considered to have occurred when:

- arrears outstanding are equivalent to 90 days or more; or
- the loan is subject to litigation; or
- the loan has passed its due date for repayment but has not been repaid; or
- the value of the collateral on a roll up mortgage has reduced below the loan balance outstanding; or
- the loan is identified as being subject to forbearance.

In addition, a provision may be held when:

- the loan is in arrears by less than 90 days; or
- there has been a material deterioration in the borrower's external credit score in the last 12 months.

Loans meeting the latter criteria are collectively assessed for impairment when a loss is expected in the event of repossession.

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

Impairment definitions were updated in the second half of 2011 to include mortgages subject to forbearance, or where collateral on roll up mortgages has reduced below the loan balance outstanding and mortgages which have past the due date for repayment but have not been repaid. These changes have resulted in a one off increase in impairment provisions of £2.8m.

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.

	2011			2010		
	Retail secured £m	Platform £m	Optimum £m	Retail secured £m	Platform £m	Optimum £m
Gross loans and advances to customers	**14,379**	**1,423**	**7,746**	15,830	898	8,138
Fair value adjustments	**7**	**–**	**138**	8	–	205
Other accounting adjustments	**(15)**	**(1)**	**50**	(41)	6	102
Gross customer balances	**14,371**	**1,422**	**7,934**	15,797	904	8,445
Impaired customer balances	**265**	**13**	**1,576**	238	11	1,777
Impaired as a % of gross customer balances	**2%**	**1%**	**20%**	2%	1%	21%
Credit protection						
Impairment provisions	**3**	**–**	**8**	3	–	6
Fair value adjustments	**7**	**–**	**138**	8	–	205
	10	**–**	**146**	11	–	211
Credit protection as a % of impaired customer balances	**4%**	**–**	**9%**	5%	–	12%

39. Risk management continued

1. Credit risk continued

Forbearance

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

- arrangements to repay outstanding arrears over a period of time, by making payments above the contractual amount. The loan will be deemed impaired, and arrears will continue to be reported, until the arrears have been cleared in full;
- short term concessions, where the borrower is allowed to make reduced repayments (or, in exceptional circumstances, no repayments) on a temporary basis to assist with a short term financial hardship. In these cases the shortfall on the repayments will accrue as arrears and the loan will be deemed to be impaired. Note that this treatment is distinct from a 'payment holiday', which is allowed as part of a customer's flexible mortgage contract. Payment holidays would not knowingly be allowed for customers experiencing financial hardship. However, in the absence of evidence to the contrary, loans that have had a payment holiday in the last two years have been treated as impaired within the year end accounts;
- temporary conversion of a mortgage to interest only repayments. This treatment has sometimes been used as an alternative to a concession for mortgage borrowers experiencing short term financial hardship. The capital repayments due in this period are added to the capital balance outstanding on the mortgage. These loans are identified as impaired;
- a permanent switch from capital and interest repayments to interest only repayments, provided the borrower declares they have an alternative means of repaying the capital at the end of the term. As the borrower is not required to prove they have an alternative repayment vehicle in place, there is a risk that borrowers have switched purely to reduce their repayments and may not in reality have a repayment vehicle. Consequently all loans that have switched to interest only after the origination of the loan are treated as impaired;
- an extension to the term of the mortgage to reduce the borrower's repayments. Term extensions may be offered proactively to a borrower experiencing financial hardship, or in response to a borrower's request. Loans that have had a term extension in the last two years are considered as impaired; and
- capitalisation, where outstanding arrears are added to the capital value of the loan to be repaid over the remaining term. This is only considered where it is appropriate for the borrower's circumstances, and where the borrower has been performing for at least six months. During 2011, 90 (2010: 605) loans had arrears capitalised of £0.3m (2010: £1.0m). These loans are not treated as impaired unless the borrower meets another impairment trigger (eg misses a mortgage payment).

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

The table below analyses retail mortgage forbearance by concession allowed:

	2011		2010	
	Exposure £m	**Impairment £m**	Exposure £m	Impairment £m
Arrangements	**546**	**26**	563	31
Concessions	**7**	**–**	7	–
Payment holidays	**176**	**–**	173	–
Interest only switches	**585**	**1**	569	–
Term extensions	**147**	**–**	177	–
Capitalisations	**10**	**–**	19	–
	1,471	**27**	1,508	31

1.4.1.4 Unsecured retail credit risk

Acquisition and account management

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

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

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

	2011 £m	2010 £m
Loans	**751**	833
Credit cards	**2,841**	3,043
Overdrafts	**377**	363
	3,969	4,239

Impairment

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

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

An overdraft is defined as impaired if the account has been overdrawn in excess of any agreed limit for 15 days, or if the agreed overdraft has expired but the account remains overdrawn.

Notes to the financial statements continued

39. Risk management continued

1. Credit risk continued

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

The table below shows:

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

	2011 £m	2010 £m
Gross loans and advances to customers	**1,518**	1,613
Fair value adjustments	**–**	–
Other accounting adjustments	**18**	41
Gross customer balances	**1,536**	1,654
Impaired customer balances	**297**	308
Impaired as a % of gross customer balances	**19%**	19%
Credit protection		
Impairment provisions	**163**	158
Fair value adjustments	**–**	–
	163	158
Credit protection as a % of impaired customer balances	**55%**	51%

Forbearance

Where a borrower is unable to clear their arrears in full, the Bank will endeavour to agree an arrangement with the borrower to repay the outstanding arrears over a period of time, or may agree to accept payments of less than the contractual amount during a period of temporary financial hardship. In these instances the loan continues to be reported as impaired until the arrears are cleared in full. Arrangements can be made directly with the customer or through a third party who they have chosen to represent them.

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

'Regular payers' are defined as accounts that are greater than 90 days in arrears and are making regular payments (irrespective of whether they are on a formal arrangement or not). These accounts continue to be reported as impaired, but the provision rate will reflect the specific probability of charge off for these accounts.

In 2010, the provisioning methodology used re-ages, rather than the 'regular payers' treatment criteria used for 2011. Re-ages applied only to accounts with early stage arrears, as opposed to 'regular payers' which includes all arrears stages.

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

	2011		2010	
	Current exposure £m	**Impairment £m**	Current exposure £m	Impairment £m
Regular payers	**94**	**70**	–	–
Re-ages	**–**	**–**	24	12
Standard collections	**41**	**23**	117	88
Negative disposable income	**17**	**16**	11	10
Fraud	**5**	**5**	3	3
Individual voluntary arrangements	**56**	**49**	51	45
	213	**163**	206	158

When all internal activities to rehabilitate the borrower have been exhausted, accounts are charged off and referred to Debt Collection Agencies (DCAs) to seek full recovery of the debt. The loan balance remaining on balance sheet reflects the amount expected to be recovered.

	2011			2010		
	Original balance £m	**Charged off £m**	**Current exposure £m**	Original balance £m	Charged off £m	Current exposure £m
DCAs	**97**	**90**	**7**	116	111	5

39. Risk management continued

1. Credit risk continued

1.4.1.5 Corporate credit risk

Acquisition and account management

New lending is approved by experienced staff within the centrally based credit underwriting team, independent from income generation. Lending discretions are based on the risk profile of the customer and the amount of exposure. The lending discretions of the Banking Risk Officer, Chief Executive Officer and Exposure Committee are operated to sanction the largest credit applications.

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

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

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

The table below shows the distribution of the corporate and business banking gross customer balances (including commitments) by sector and risk grade, where PD grades have been mapped to regulatory slotting categories for ease of interpretation in this report.

2011	Unrated £m	Strong £m	Good £m	Satisfactory £m	Weak £m	Default £m	Total £m
Accommodation, food and licensed services	319	61	53	31	2	110	576
Care	177	29	19	27	3	–	255
Education	69	46	12	1	–	–	128
Financial services	82	54	40	5	–	4	185
Football clubs	–	42	–	1	15	6	64
Housing associations	1,133	–	1	–	–	–	1,134
Manufacturing	92	16	40	21	24	2	195
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	123	174	1,466	768	585	563	3,679
Residential investment	11	59	229	116	24	155	594
Commercial construction	7	9	112	123	24	11	286
Residential development	2	2	65	35	13	4	121
Public sector entities	198	–	–	–	–	–	198
Renewable energy	437	–	–	–	–	10	447
Retail and wholesale trade	107	335	70	19	1	–	532
Services	460	103	51	61	8	22	705
Transport, storage and communication	169	53	11	7	15	24	279
Utilities	75	1	2	11	–	–	89
Business banking	1	33	8	3	1	–	46
Other	12	1	2	4	–	2	21
	3,571	1,085	3,492	1,243	742	921	11,054

Notes to the financial statements continued

39. Risk management continued

1. **Credit risk** continued

2010	**Unrated £m**	**Strong £m**	**Good £m**	**Satisfactory £m**	**Weak £m**	**Default £m**	**Total £m**
Accommodation, food and licensed services	186	54	29	36	2	26	333
Care	115	13	46	19	3	–	196
Education	54	36	11	1	–	–	102
Financial services	49	46	53	4	7	3	162
Football clubs	–	–	44	16	1	12	73
Housing associations	1,119	–	–	–	–	–	1,119
Manufacturing	95	12	38	23	22	8	198
Motor trade and garages	34	22	25	9	10	–	100
PFI	4	4	1,140	–	–	–	1,148
Professional services	71	25	17	20	4	4	141
Property and construction:							
Commercial investment	165	206	1,998	423	410	459	3,661
Residential investment	22	101	286	86	164	98	757
Commercial construction	3	9	150	93	34	18	307
Residential development	1	2	67	43	13	2	128
Public sector entities	185	–	–	–	–	–	185
Renewable energy	236	–	–	–	–	–	236
Retail and wholesale trade	103	162	277	33	–	–	575
Services	406	84	71	69	10	30	670
Transport, storage and communication	164	65	34	3	17	–	283
Utilities	60	–	–	1	–	1	62
Business banking	1	33	7	4	1	1	47
Other	10	2	2	4	–	2	20
	3,083	876	4,295	887	698	664	10,503

Collateral

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

Property collateral for corporate lending is categorised as security for property development or investment customers (ie 'property' lending) or owner occupied premises to secure mainstream loan and overdraft facilities. For general lending, in addition to taking charges over property assets owned by the Company, other security is taken in modest proportion to the total portfolio. This includes debentures or floating charges (supported by tangible security, where appropriate, including property, life policies and stocks and shares) and cash cover.

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

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

	2011		2010	
	Exposure £m	**Collateral £m**	Exposure £m	Collateral £m
Individually impaired	**732**	**386**	577	358
On watchlist	**1,253**	**1,069**	921	651
Neither individually impaired nor on watchlist	**2,696**	**2,444**	3,354	3,025
	4,681	**3,899**	4,852	4,034

Of the above, £48m is not held as first charge.

The December 2010 collateral table has been restated to exclude the portion of the fair value of collateral in excess of the committed exposure (less any provisions) against which it is held.

39. Risk management continued

1. Credit risk continued

Impairment

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

The Bank also reviews monthly all higher risk loans and considers the potential loss which might arise were the borrowers to fail (notwithstanding that continued trading remains the expectation). Events which may trigger higher risk status include a deteriorating balance sheet, material losses, trading difficulties (eg loss of material contracts or suppliers), breach of financial covenants, poor account conduct, arrears and material reduction in value of security. A collective impairment provision is raised against these loans based on the total estimated loss that may arise and the propensity for the borrower to fail. In such circumstances, the Bank works with the customers to resolve their business problems and agree a clear strategy, often with the support of external, independent professional advisors.

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

Objective evidence of impairment may include:

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

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

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

The table below shows:

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

	2011 £m	2010 £m
Gross loans and advances to customers	**8,992**	8,720
Fair value adjustments	**251**	266
Other accounting adjustments	**(100)**	(178)
Gross customer balances	**9,143**	8,808
Impaired customer balances	**961**	659
Impaired as a % of gross customer balances	**11%**	7%
Credit protection		
Impairment provisions	**117**	56
Fair value adjustments	**251**	266
	368	322
Credit protection as a % of impaired customer balances	**38%**	49%

Forbearance

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

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

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 and does not remove them from the watchlist until at least six months later. In the event of one off concessions (such as capitalisation of interest payments), the Bank removes the forbearance status 12 months after their occurrence, and retains the customers on the watchlist for at least the same period of time.

Notes to the financial statements continued

39. Risk management continued

1. Credit risk continued

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

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

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

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.

1.4.2 Investment securities

Policies are in place within Treasury with regard to the management and valuation of collateral, with daily monitoring undertaken. Repos and secured lending positions are revalued daily with margin calls on collateralised swaps predominantly made daily, save for several arrangements which permit calls on a weekly basis. Eligible financial collateral for Basel II reporting purposes includes gilts held under reverse repo agreements and cash held under both repo agreements and collaterised swap arrangements. The guarantees relied upon are either parental guarantees held against subsidiary exposures within bank groups or sovereign guarantees.

At the balance sheet date, the Bank has a total investment securities' portfolio of £4,616m (2010: £4,988m) of which £46m (2010: £97m) is considered impaired and against which £45m (2010: £85m) of provisions are held.

1.4.2.1 Impaired assets

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

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

1.4.2.2 Past due but not impaired

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

1.4.2.3 Neither past due nor impaired

The Bank only invests in high-quality treasury assets. Within the treasury investment security portfolio 89% (2010: 82%) of exposures have an external credit rating equivalent to Fitch A or above.

1.4.3 Loans and advances to banks

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

39. Risk management continued

1. Credit risk continued

1.5 Eurozone risk

The Bank remains a low risk UK based operation. It has no sovereign exposure to 'peripheral' eurozone countries (Portugal, Ireland, Italy, Greece and Spain). As at 31 December 2011 the Bank had a £90m (2010: £nil) exposure to the Government of Finland, repayable in over one year. It held no other European sovereign debt.

The Bank has no direct exposure to Greek financial institutions or any other counterparties. Other peripheral eurozone country limits and counterparty limits have continued to be managed downwards. Higher risk eurozone exposures to financial institutions, namely those to the other peripheral eurozone countries and Belgium, continue to be closely monitored. Management action has been proactively taken and, where necessary, additional actions are taken in light of any downgradings.

1.5.1 Direct exposures

The analysis below and on the following page 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 31 December 2011:

2011	Repayable within 30 days £m	Repayable within 1 year but more than 30 days £m	Repayable in over 1 year £m	Credit risk mitigation £m	Total exposure £m
Country					
Austria	–	44	–	(4)	40
Belgium	–	20	34	(34)	20
Denmark	8	–	–	–	8
France	175	5	135	–	315
Germany	39	105	38	(16)	166
Ireland	5	25	–	–	30
Netherlands	–	40	211	–	251
Portugal	–	34	–	–	34
Spain	59	84	34	(31)	146
Sweden	10	10	7	–	27
Switzerland	73	10	414	(264)	233
	369	377	873	(349)	1,270

2010	Repayable within 30 days £m	Repayable within 1 year but more than 30 days £m	Repayable in over 1 year £m	Credit risk mitigation £m	Total exposure £m
Country					
Austria	–	–	40	–	40
Belgium	98	43	46	–	187
Denmark	–	5	–	–	5
Finland	–	25	–	–	25
France	366	492	228	(273)	813
Germany	238	–	158	–	396
Ireland	–	99	33	–	132
Italy	261	151	–	–	412
Netherlands	10	–	–	–	10
Portugal	–	–	34	–	34
Spain	227	91	199	(33)	484
Sweden	–	–	–	–	–
Switzerland	1	17	140	(74)	84
	1,201	923	878	(380)	2,622

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

Credit risk mitigation takes the form of UK gilt collateral held in relation to reverse repo transactions, cash collateral held in relation to sold repo and derivative transactions, and government guarantees (including £34m by the Belgian Government) in relation to specific debt security holdings.

As at 31 December 2011, exposure to European multilateral development banks (not included in the above table given the supranational status associated with these institutions) stood at £529m (2010: £48m) before credit risk mitigation (£458m post credit risk mitigation (2010: £48m)) of which £82m matures within a year.

Notes to the financial statements continued

39. Risk management continued

1. **Credit risk** continued

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

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

2011	Bank and money market balances £m	Bonds £m	Derivatives £m	Other £m	Total exposure £m
Country					
Austria	–	40	–	–	40
Belgium	–	20	–	–	20
Denmark	1	–	–	7	8
France	–	63	25	228	316
Germany	–	103	24	39	166
Ireland	–	30	–	–	30
Netherlands	–	251	–	–	251
Portugal	–	34	–	–	34
Spain	–	126	19	–	145
Sweden	20	7	–	–	27
Switzerland	21	–	53	159	233
	42	674	121	433	1,270

2010	Bank and money market balances £m	Bonds £m	Derivatives £m	Other £m	Total exposure £m
Country					
Austria	–	40	–	–	40
Belgium	124	63	–	–	187
Denmark	–	5	–	–	5
Finland	–	25	–	–	25
France	526	229	36	20	811
Germany	263	103	31	–	397
Ireland	10	119	3	–	132
Italy	291	121	–	–	412
Netherlands	10	–	–	–	10
Portugal	–	34	–	–	34
Spain	257	190	37	–	484
Sweden	–	–	–	–	–
Switzerland	–	17	67	1	85
	1,481	946	174	21	2,622

In addition to the above exposures to financial institutions, in the overseas European Economic Area (EEA as defined by the European Banking Authority) and Switzerland, corporate customer exposures at 31 December 2011 totalled £184m (2010: £195m). There are no exposures to retail customers based outside of the UK and Channel Islands.

The Bank continues to monitor developments daily across all countries as they affect the Treasury portfolio. A number of pro-active management actions have been taken to reduce the risk, stress the portfolio and anticipate future downward rating actions. These include significant tenor reductions to improve flexibility, active limit management and revised strategy to take on more secured trading and lower risk business. Regular stress testing of the entire credit limits portfolio is undertaken.

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

The Treasury risk team reviews the entire portfolio and watchlists monthly for appropriate risk status bandings. The Exposures Committee review the watchlist on a monthly basis and provide their observations and required management actions as appropriate.

Red watchlist exposures totalled £277m as at 31 December 2011, this comprised holdings in FRNs issued by German (£75m), Irish (£30m) and Portuguese (£34m) financial institutions. Of these, FRNs totalling £202m reached maturity and were repaid in full during January and February 2012, the remaining £75m Red watchlist exposures being to German (£25m) and Spanish (£50m) financial institutions with the latest maturity dates 1st June 2012 (Spain) and 24 August 2012 (Germany).

39. Risk management continued

1. **Credit risk** continued

1.5.2 Indirect exposures

Treasury risk management monitoring extends beyond the direct risk incurred through counterparty trading, to the underlying exposures (eg to peripheral eurozone countries) which Treasury's counterparties may maintain on their own balance sheets. In analysing each counterparty's secondary exposure we assess the vulnerability and impact on that firm if it suffered different degrees of losses. We also perform stress testing to assess the impact of potential further downgrades on the credit risk of our exposure.

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

2. Liquidity risk

2.1 Capital and liquidity framework

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

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

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

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

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

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

2.2 Liquidity risk

2.2.1 Overview

Liquidity risk arising from the structure of the balance sheet (structural liquidity) is managed in line with policies developed by ALCO. The Bank's liquidity management policies are reviewed and approved annually by the RC (on behalf of the Banking Group's Board) and compliance reviewed monthly by ALCO. The Bank's policy is to ensure that sufficient funds are available at all times to meet demands from depositors, to fund agreed advances, to meet other commitments as and when they fall due, and to ensure the Banking Group Board's risk appetite is met.

The Banking Group operates within a liquidity risk framework of stress testing combined with a number of strategic and tactical measures which feed into an overall liquidity status score. This is supported with detailed contingency funding plans which are tested and reviewed on a regular basis. The Banking Group'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 Banking Group Board's risk appetite for liquidity risk is defined as survival in a number of stress scenarios, adherence to specific ratios and compliance with all regulatory limits. The stress tests encompass survival across various timescales and a range of adverse liquidity events, both firm specific and market wide, which cover all aspects of the liquidity risk to which the Bank is exposed.

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

The Bank manages liquidity risk by applying:

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

Notes to the financial statements continued

39. Risk management continued

2. Liquidity risk continued

The strategic measures approved by the Banking Group's Board and monitored monthly are:

- wholesale borrowing ratio, 17.8% (2010: 17.2%) – the amount of wholesale borrowing compared to total liabilities;
- liquid asset ratio, 15.5% (2010: 9.8%) – amount of total assets that are unencumbered high quality liquid assets as defined under BIPRU; and
- customer loan/deposit ratio, 93.9% (2010: 102.5%) – the ratio of customer loans to customer deposits.

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

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

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

Marketable assets are maintained as a liquidity pool against potential retail outflows. The liquidity pool is the highest quality debt and consists of government issued debt and cash at the Bank of England. Liquid assets increased at the end of 2011 as demonstrated by a liquid asset ratio of 15.5%, having averaged 12.1% during 2011 as a whole.

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

	2011 £m	2010 £m
Qualifying stock		
Operational balances with central banks	**6,378**	1,444
Treasury bills	**–**	1,998
Gilts	**1,086**	903
Multilateral development banks	**162**	51
	7,626	4,396

The Banking Group has access to a variety of medium term wholesale funding sources: securitisation, regulated covered bond and Euro Medium Term Notes. The Bank will issue from the programmes as funding requirements and market conditions permit.

ALCO discusses the actual liquidity position and projected position incorporating business plans. More frequent meetings are held if necessary, ie when the markets have a heightened period of stress or liquidity shortage. The meetings ensure that the business plans are accurate and can be flexed as required.

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

2.2.2 Liquidity gap

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

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

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

2.2.3 Gross cashflow maturity analysis

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

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

39. Risk management continued

2. Liquidity risk continued

2011	Carrying value £m	Gross nominal outflow £m	Less than 1 month £m	1–3 months £m	3–12 months £m	1–5 years £m	Over 5 years £m
Contractual cash flows							
Non-derivative liabilities							
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	5,187	148	138	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	47,552	25,336	3,365	8,139	7,920	2,792
Derivative liabilities							
Net outflow	1,088	2,137	285	31	205	559	1,057
	46,367	49,689	25,621	3,396	8,344	8,479	3,849
Other liabilities	316	–	–	–	–	–	–
Total recognised liabilities	46,683	49,689	25,621	3,396	8,344	8,479	3,849
Unrecognised loan commitments	4,752	4,753	4,571	161	21	–	–
Total liabilities	51,435	54,442	30,192	3,557	8,365	8,479	3,849
Behavioural adjustments							
Customer accounts	–	–	(20,526)	464	1,230	18,832	–
Debt securities in issue	–	–	–	–	–	–	–
Total liabilities – behavioural	51,435	54,442	9,666	4,021	9,595	27,311	3,849

2010	Carrying value £m	Gross nominal outflow £m	Less than 1 month £m	1–3 months £m	3–12 months £m	1–5 years £m	Over 5 years £m
Contractual cash flows							
Non-derivative liabilities							
Deposits by banks	2,938	2,931	776	416	774	965	–
Customer accounts	32,320	32,589	20,347	1,857	6,812	3,573	–
Customer accounts – capital bonds	1,795	1,750	11	64	255	1,363	57
Debt securities in issue	4,212	5,005	304	695	397	1,172	2,437
Other borrowed funds	975	1,800	46	5	58	421	1,270
Amounts owed to other Co-operative Group undertakings	189	189	189	–	–	–	–
	42,429	44,264	21,673	3,037	8,296	7,494	3,764
Derivative liabilities							
Net outflow	702	794	139	38	122	295	200
	43,131	45,058	21,812	3,075	8,418	7,789	3,964
Other liabilities	377	–	–	–	–	–	–
Total recognised liabilities	43,508	45,058	21,812	3,075	8,418	7,789	3,964
Unrecognised loan commitments	4,760	4,759	4,499	62	188	10	–
Total liabilities	48,268	49,817	26,311	3,137	8,606	7,799	3,964
Behavioural adjustments							
Customer accounts	–	–	(18,159)	234	(2,598)	20,523	–
Debt securities in issue	–	(25)	–	(25)	–	–	–
Total liabilities – behavioural	48,268	49,792	8,152	3,346	6,008	28,322	3,964

Notes to the financial statements continued

39. Risk management continued

3. Market risk

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

3.1 Interest rate risk

Interest rate risk policy statements, approved by the RC on behalf of the Banking Group Board, specify the scope of the Banking Group's wholesale market activity, market risk limits and delegated authorities. The policy is managed by ALCO. Its prime task is to assess the interest rate risk inherent in the maturity and repricing characteristics of the Banking Group's assets and liabilities. The Banking Group seeks to minimise the volatility of future earnings from interest rate changes and all interest rate risk exposure is removed from the retail and CABB divisions and consolidated at the centre where it is managed from the core balance sheet within agreed limits. Treasury is responsible for interest rate risk management for the Banking Group. 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 and ALCO reviews the balance sheet risk position and the utilisation of wholesale market risk limits.

3.1.1 Non-treasury interest rate risk

The Banking Group (excluding wholesale) uses a gap report and earnings approach for managing interest rate risk, focusing in detail on the sensitivity of assumed changes in interest rates on net interest income for one year. Higher level analysis is performed for subsequent years.

ALCO monitors the non-trading interest rate risk which is split between certain wholesale portfolios, banking and investment books, and the rest of the Banking Group's balance sheet. The following describes the Banking Group 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 using appropriate transfer pricing rates.

Gap reports are based on defined time periods. ALCO set guidance limits around the gap, principally that the sum of positions maturing in greater than 12 months and non-sensitive balances (includes non-maturity deposits) is no more than a set limit.

Risk limits are formally calculated at each month end. Interest rate risk and effectiveness of hedging is monitored daily using gap positions, incorporating new business requirements. Draw down risk, in particular for fixed rate mortgages, is managed through weekly balance sheet meetings. The Bank's balance sheet 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 reprice with reference to different indices and at different times. This exposes the Banking Group to income volatility if indexes do not move in a ratio of one to one. This risk is managed by performing a future simulation of the Bank's balance sheet to establish what the Banking Group's income volatility would be if the rates do not move in a one for one ratio. Cash placements are then undertaken with the Bank's Treasury markets team to reduce the income volatility. The Bank's Treasury markets team execute external trades as required.

The table below illustrates the sensitivity analysis relating to the Banking Group, a primary measure in the approach to managing interest rate risk. It illustrates the greater than 12 month net gap position at the end of the year on the Banking Group's balances excluding wholesale treasury and customer currency balances, which are managed within the treasury risk framework. The gap is driven by product pricing and product mix. The gap is calculated by placing all assets and liabilities at the earliest of their repricing or maturity date and then summing by time band. The aim is to have assets evenly spread so that the Bank is not exposed to sudden rate movement. The net position shows the amount that the Banking Group is either over or under invested in the month. A £100m gap position would equate to the Banking Group being exposed to income variation of £1m per annum if rates moved by 1%, so the maximum position equates to approximately £8m income exposure if rates moved by 1%.

	Net greater than 12 month position	
	2011 £m	2010 £m
At the year end	**(279)**	(204)
Average for the period	**(330)**	(69)
Maximum sensitivity for the period	**806**	(876)
Minimum sensitivity for the period	**(51)**	56

3.1.2 Treasury interest rate risk

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

3.1.2.1 Value at risk (VaR)

VaR measures the daily maximum potential gain or loss due to market volatility within a statistical confidence level of 95% and a one day holding period. The VaR methodology used is historical simulation using a time series of 1 year to latest day and was £0.35m at 31st December 2011 for the Treasury traded portfolios. The VaR methodology has inherent limitations in that market volatility in the past may not be a reliable predictor of the future, and may not reflect the time required to hedge or dispose of the position. Hence VaR is not used as the sole measure of risk.

3.1.2.2 PV100

This illustrates the change in valuation on a fixed income portfolio experienced, given a 1% increase and decrease in interest rates for treasury, representing treasury banking book and trading book combined. PV100 is the effect on the net present value (NPV) of the treasury portfolio to a parallel shift of 100 basis points upon the base yield curve. The effects of a 1% increase in interest rates are £15m (2010: (£11m) and a 1% decrease £16m (2010: £9m).

39. Risk management continued

3.2 Currency risk

The Bank's treasury foreign exchange activities primarily:

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

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

	2011					2010				
	£	**$**	**€**	**Other**	**Total**	£	$	€	Other	Total
Assets										
Cash and balances at central banks	**6,696**	**–**	**–**	**–**	**6,696**	1,735	–	–	–	1,735
Loans and advances to banks	**1,569**	**60**	**373**	**5**	**2,007**	1,881	35	475	3	2,394
Loans and advances to customers	**33,513**	**55**	**157**	**41**	**33,766**	34,797	50	115	15	34,977
Fair value adjustments for hedged risk	**366**	**–**	**–**	**–**	**366**	167	–	–	–	167
Investment securities – loans and receivables	**657**	**16**	**132**	**–**	**805**	1,500	68	294	55	1,917
Investment securities – available for sale	**3,127**	**125**	**171**	**–**	**3,423**	1,872	380	445	261	2,958
Investment securities – at FV through income or expense	**336**	**–**	**7**	**–**	**343**	29	–	–	–	29
Derivative financial instruments	**975**	**–**	**–**	**–**	**975**	975	–	–	–	975
Equity shares	**6**	**–**	**–**	**–**	**6**	7	–	–	–	7
Investments in Group undertakings	**3**	**–**	**–**	**–**	**3**	2	–	–	–	2
Goodwill	**1**	**–**	**–**	**–**	**1**	1	–	–	–	1
Intangible fixed assets	**41**	**–**	**–**	**–**	**41**	45	–	–	–	45
Investment properties	**173**	**–**	**–**	**–**	**173**	162	–	–	–	162
Property, plant and equipment	**80**	**–**	**–**	**–**	**80**	98	–	–	–	98
Amounts owed by other Co-operative Group undertakings	**179**	**–**	**–**	**–**	**179**	1	–	–	–	1
Other assets	**45**	**–**	**2**	**–**	**47**	4	1	3	2	10
Prepayments and accrued income	**19**	**–**	**–**	**–**	**19**	16	–	–	–	16
Deferred tax assets	**26**	**–**	**–**	**–**	**26**	87	–	–	–	87
Total assets	**47,812**	**256**	**842**	**46**	**48,956**	43,379	534	1,332	336	45,581
Liabilities										
Deposits by banks	**2,567**	**261**	**475**	**–**	**3,303**	1,481	473	840	144	2,938
Customer accounts	**34,899**	**36**	**52**	**4**	**34,991**	32,206	23	89	2	32,320
Customer accounts – capital bonds	**1,430**	**–**	**–**	**–**	**1,430**	1,795	–	–	–	1,795
Debt securities in issue	**4,039**	**–**	**125**	**–**	**4,164**	4,007	–	205	–	4,212
Derivative financial instruments	**1,084**	**1**	**3**	**–**	**1,088**	689	5	7	1	702
Other borrowed funds	**1,230**	**–**	**29**	**–**	**1,259**	975	–	–	–	975
Amounts owed to other Co-operative Group undertakings	**132**	**–**	**–**	**–**	**132**	189	–	–	–	189
Other liabilities	**173**	**–**	**1**	**–**	**174**	141	2	3	1	147
Accruals and deferred income	**40**	**–**	**–**	**–**	**40**	131	–	–	–	131
Provisions for liabilities and charges	**102**	**–**	**–**	**–**	**102**	56	–	–	–	56
Current tax liabilities	**–**	**–**	**–**	**–**	**–**	43	–	–	–	43
Total liabilities	**45,696**	**298**	**685**	**4**	**46,683**	41,713	503	1,144	148	43,508
Net on balance sheet position	**2,116**	**(42)**	**157**	**42**	**2,273**	1,666	31	188	188	2,073

At 31 December 2011 the Banking Group's open position was £0.4m (2010: £0.4m) representing a potential loss of £nil given a 3% depreciation in sterling (2010: £nil). The open position is monitored against limits in addition to limits in place on individual currencies. All figures are in £ sterling equivalent.

Unaudited risk management disclosures

The following risk management disclosures on operational risk do not form part of the audited accounts and are not audited.

Notes to the financial statements continued

39. Risk management continued

4. Operational risk

Operational risk includes internal and external fraud, loss or theft of confidential customer information, loss of key personnel, system capacity issues or programme failure and external events over which the Banking Group has limited controls such as terrorist attack.

In order to meet the Banking Group's appetite for operational risk, it ensures appropriate controls are in place to minimise the chance of any significant disruption and to protect our reputation.

Operational risks are identified, managed and mitigated through ongoing risk management practices including risk assessments, formal control procedures and contingency planning. Operational risks and key controls are formally reviewed on a regular basis. Significant operational risks and the associated capital requirements are regularly reported to the ORC, and the RC. These meet regularly to monitor the suitability of the risk management framework and management of significant risks within the Banking Group.

Business continuity is managed by the Operational Risk function and sets out to minimise the risk of disruption in the event of a sudden, unplanned occurrence that could seriously disrupt business operations. This includes developing and exercising crisis and incident management teams to maintain appropriate preparedness in the event of a major operational disruption.

The Banking Group also has a corporate insurance programme to transfer specific risks to insurers as part of its risk management approach.

The Banking Group has a significant change agenda to transform the business. To support this agenda, a transformation risk category has been created to assure that the management of risks around the design, development and implementation of change is in line with risk appetite.

C) General 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 the actual claims exceed the carrying amount of the insurance liabilities.

In CISGIL, insurance risk is made up of 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).

Principal risks covered

The major classes of general insurance business written are motor and property, together with some liability, pecuniary loss 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 provided 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.

Property cover is 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 (CIS), a fellow subsidiary within the Banking Group, to assume financial responsibility for the run off of general insurance business formerly written by CIS. In return CISGIL received a premium in 2006, settled by transfer of assets, equivalent to the net technical liabilities of this business included in CIS'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 to CISGIL scheduled to be completed in 2012. This transfer will not affect how CISGIL manages the risks in its business.

Frequency and severity of claims

The frequency and severity of property claims can be affected by several factors, the most significant being weather events. In addition, there is a possibility of a very large individual commercial property claim arising from fire and/or consequential loss. 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.

Risk management objectives and strategy

CISGIL's objectives in managing general insurance risk are 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 underwriting strategy attempts to ensure that the underwritten risks are well 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 sets retention levels in accordance with the risk appetite of the business.

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.

Concentration of risk

The bias of the portfolio towards personal contracts reduces the risk of large single losses and there is no significant concentration of risk in any geographical area of the UK. Excess of loss reinsurance cover is used to mitigate losses from individual large claims, particularly large bodily injury.

Statistical modelling with specialised software is used to assess CISGIL's exposure to natural hazards such as windstorm and flood events, including a large east coast flood, which would significantly affect the property portfolio. Weather event catastrophe reinsurance cover is the most important component of the reinsurance programme and is set to restrict losses from a single event.

39. Risk management continued

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.

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.

Financial risk

CISGIL is exposed to financial risk through its financial assets, financial liabilities (including borrowings), reinsurance assets and insurance liabilities. In particular a key financial risk is that the proceeds from financial assets are insufficient to fund the obligations arising under general insurance contracts. CISGIL manages financial risk according to the sub-categories of market risk, credit risk and liquidity risk.

Financial risk management objective and strategy

The principal objective of CISGIL's financial risk management strategy is to manage the return on investments with an acceptable level of financial and insurance risk. Financial risk is managed within an asset and liability management framework (ALM) to ensure this objective is achieved. An over-riding 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 assets 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.

As part of its ALM framework, CISGIL sets a strategic asset allocation range with reference to a suitable benchmark for each asset class taking account of the short term insurance and investment liabilities and the financial 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.

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 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.

Notes to the financial statements continued

39. Risk management continued

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:

	2011	2010
Insurance liabilities	**2.63 years**	2.53 years
Financial assets	**2.69 years**	2.93 years

The mean duration of assets remains within the boundaries of the investment mandate which permits some deviation from the matched position. The mean duration of assets is regularly monitored against 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
Periodical payments		
Insurance liabilities	**26**	15.8 years
Financial assets	**32**	14.3 years
EIROS claims		
Insurance liabilities	**2**	11.0 years
Financial assets	**3**	14.5 years

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; furthermore proceeds from maturing investments are subject to risk over the future return on reinvestment. An increase of 100 basis points in interest yields would reduce the carrying value of CISGIL's assets at the end of the financial year by £27m (2010: £29m). CISGIL invests predominantly in fixed rate securities and has adopted a policy of recognising investment assets on an 'available for sale' basis, therefore the impact upon profit during the period would not be material and would instead be recognised directly in other comprehensive income as a reduction of £20m net of tax (2010: £21m). 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 £21m net of tax (2010: £23m). Our estimate shows that the probability of this interest yield change over one year is modelled as 22%.

The sensitivity analysis above assumes a reasonably possible movement in yield curve with all other variables held constant. The analysis excludes reinvestment risk. 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.

CISGIL has issued £65m (2010: £65m) of subordinated debt at varying margins above three month LIBOR. Additionally CISGIL issued a further £20m of subordinated debt in 2011 with a fixed coupon of 10%. The effect on profit of a 100 basis point movement in three month LIBOR would be £0.5m per annum net of tax (2010: £0.5m).

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; and
- 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 the 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.

39. 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

	AAA £m	AA £m	A £m	BBB and below £m	Not rated £m	Total £m
2010						
Financial assets at fair value through income or expense:						
Deposits with approved credit institutions (fixed rate)	–	1	33	–	–	34
Available for sale assets						
Listed debt (fixed rate)	20	171	527	174	25	917
Listed debt (variable rate)	–	–	25	3	–	28
Unlisted debt (fixed rate)	–	–	–	5	–	5
Reinsurance assets	1	16	6	–	8	31
Insurance receivables and other assets	1	5	17	5	224	252
	22	193	608	187	257	1,267
Assets not subject to credit risk						41
						1,308

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. CISGIL held no collateral as at 31 December 2011. (2010: £nil).

CISGIL makes provisions for the possible impairment of financial assets where there is objective evidence that an impairment loss has been incurred.

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 no 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 are analysed and those which are over exposed are not included in placement of the programme.

Notes to the financial statements continued

39. Risk management continued

The table below shows exposure to European countries as at 31 December 2011:

	Up to 1 year £m	1 to 5 years £m	5 to 10 years £m	Total £m
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**
2010				
Belgium	10	–	–	10
Denmark	–	25	–	25
France	–	22	9	31
Germany	11	–	10	21
Italy	8	–	–	8
Netherlands	–	–	16	16
Norway	5	–	7	12
Spain	5	54	–	59
Sweden	9	10	–	19
Switzerland	–	23	33	56
	48	134	75	257

CISGIL has no exposures to European countries as a result of repo arrangements.

Liquidity 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. This is compared to the cash required as set out in the policy. Cashflow forecasts are produced regularly to predict any area of concern for future liquidity and in support of investment decisions. 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 stressed condition which is assessed 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 cash to cover immediate payments. This is considered reasonable for liquidity, as there is always a delay to payment and CISGIL is to some extent in control of the period to payment. 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 £128m, giving a liquidity requirement of £25.6m against actual near liquid assets of £633m.

CISGIL has access to overnight borrowing facilities with The Co-operative Bank plc (the Bank), a fellow subsidiary. Overnight borrowings are subject to the Bank's regulatory exposure limits for related counterparties. These borrowings are on normal commercial terms and represent an unsecured, uncollateralised obligation of CISGIL. CISGIL is active in the gilt repo market to facilitate liquidity risk management and maintains short term borrowing facilities to enable settlement.

39. Risk management continued

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
2011								
Insurance contract liabilities	**1,064**	**1,064**	**609**	**129**	**98**	**44**	**54**	**130**
Financial liabilities at fair value through income or expense:								
Derivatives	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
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**							

	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
2010								
Insurance contract liabilities	964	964	552	133	96	63	36	84
Financial liabilities at amortised cost:								
Subordinated debt	65	70	1	31	1	1	1	35
Other reinsurance liabilities	8	8	8	–	–	–	–	–
Insurance and other payables	23	23	23	–	–	–	–	–
Cash and cash equivalents	6	6	6	–	–	–	–	–
	1,066	1,071	590	164	97	64	37	119
Other liabilities	6							
Total recognised liabilities	1,072							

D) Life insurance risk

Co-operative Insurance Society Limited (CIS) issues contracts that transfer insurance risk and is exposed to financial risk through the insurance and participating contracts that it issues (and its ceded reinsurance contracts), and through its holdings of financial assets and liabilities. This section summarises these risks and the way the Society manages them.

CIS operates within the Banking Group which has a common board composition for its Banking and Insurance businesses. For more detail regarding the Banking Group's approach to risk management and its governance structure, refer to pages 111 to 112.

Due to the sale of the Life business being highly probable, the credit, liquidity and market risk of the Life business to the Group is perceived to be minimal. The main risks of the Life insurance business are detailed in note 41.

Notes to the financial statements continued

39. Risk management continued

Banking Group Fair Values

The tables below analyse the balance sheet carrying values of financial assets and liabilities by classification.

Balance sheet categories	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
2011							
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	34,018	–	–	–	34,132
Investment securities	–	343	805	3,423	–	–	4,571
Derivative financial instruments	164	594	–	–	–	218	976
Equity shares	–	–	–	6	–	–	6
Amounts owed by 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

39. Risk management continued

Balance sheet categories	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
2010							
Assets							
Cash and balances at central banks	–	–	1,735	–	–	–	1,735
Loans and advances to banks	–	–	2,394	–	–	–	2,394
Loans and advances to customers	–	74	35,070	–	–	–	35,144
Investment securities	–	29	1,917	2,957	–	–	4,903
Derivative financial instruments	67	690	–	–	–	219	976
Equity shares	–	–	–	7	–	–	7
Amounts owed by other Co-operative Group undertakings	–	–	–	–	–	–	–
Total financial assets	67	793	41,117	2,964	–	219	45,160
Non-financial assets							421
Total assets							45,581
Liabilities							
Deposits by banks	–	–	–	–	2,939	–	2,939
Customer accounts	–	–	–	–	32,320	–	32,320
Customer accounts – capital bonds	–	1,795	–	–	–	–	1,795
Debt securities in issue	–	–	–	–	4,212	–	4,212
Derivative financial instruments	53	487	–	–	–	162	702
Other borrowed funds	–	–	–	–	975	–	975
Amounts owed to other Co-operative Group undertakings	–	–	–	–	189	–	189
Total financial liabilities	53	2,282	–	–	40,635	162	43,132
Non-financial liabilities							376
Total liabilities							43,508
Capital and reserves							2,073
Total liabilities and equity							45,581

a) Use of financial instruments

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

Loans and advances to customers and customer accounts

The provision of banking facilities to customers is the prime activity of the Bank and loans and advances to customers and customer accounts are major constituents of the balance sheet. Loans and advances to customers include retail mortgages, corporate loans, credit cards, unsecured retail lending and overdrafts. Customer accounts include retail and corporate current and saving accounts. The Bank has detailed policies and procedures to manage risks. Retail mortgage lending and much of the lending to corporate and business banking customers is secured.

Loans and advances to banks and investment securities

Loans and advances to banks and investment securities underpin the Bank's liquidity requirements and generate incremental net interest and trading income.

Deposits by banks and debt securities in issue

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

Other borrowed funds

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

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.

Notes to the financial statements continued

39. Risk management continued

a) Use of financial instruments continued

Foreign exchange

The Bank undertakes foreign exchange dealing to facilitate customer requirements and to generate incremental income from short term trading in the major currencies. Structured risk and trading related risk are managed formally within position limits approved by the Board.

b) Valuation of financial instruments carried at fair value

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

	Fair value at end of the reporting period using:			
2011	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**	**Total £m**
Non-derivative financial assets				
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

	Fair value at end of the reporting period using:			
2010	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Non-derivative financial assets				
Designated at fair value				
Loans and advances to customers	–	62	12	74
Investment securities	–	29	–	29
Available for sale financial assets				
Investment securities	903	2,054	–	2,957
Equity shares	–	–	7	7
Derivative financial instruments	–	958	18	976
Total assets carried at fair value	903	3,103	37	4,043
Non-derivative financial liabilities				
Designated at fair value				
Customer accounts – capital bonds	–	1,795	–	1,795
Derivative financial instruments	–	675	27	702
Total liabilities carried at fair value	–	2,470	27	2,497

Certain derivative financial instruments have been reclassified between Level 2 and Level 3 in 2010 following a reassessment of the inputs used in the valuation models.

39. Risk management continued

The carrying values of financial instruments measured at fair value are determined in compliance with the accounting policies on pages 85 to 86 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 £102m (2010: £62m) 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.

During 2011 the Bank moved to using Overnight Indexed Swap (OIS) rates to value cash collateralised swaps, resulting in a one-off charge to the income statement of £6m.

Customer accounts – capital bonds

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

Level 3 – Valuation techniques using unobservable inputs

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

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

Loans and advances to customers

Loans and advances to customers include 25 year fixed rate mortgages of £12m (2010: £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 decreased the valuation by £0.5m in 2011 (2010: £0.1m). A reasonable change in the assumptions would not result in any material change in the valuation.

Equity shares

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

Amounts owed to other Co-operative Group undertakings

Deposits from customers includes deposits by The Covered Bond LLP (LLP), Silk Road Finance Number One (Silk Rd 1) and Silk Road Finance Number Two (Silk Rd 2) subsidiaries relating to the legal transfer of loans and advances on issue of the Bank's covered bonds and securitisation. The deposits are fair valued to eliminate an accounting mismatch of the swap derivative as discussed above.

Revaluation of the £4.5bn (2010: £5.9bn) mortgage pool from carrying to fair value is based on assumed timing of future mortgage capital and revenue receipts, discounted to present value using a credit adjusted discount rate.

The amortisation profile is 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.

Derivative financial instruments

Derivative financial instruments including internal interest rate swaps have been entered into between the Bank and the LLP, the Bank and Silk Rd 1 and the Bank and Silk Rd 2.

The purpose of the swap is to convert the fixed and base rate linked revenue receipts of the pool of mortgage assets to the same LIBOR linked basis as the intercompany loan. Under this swap arrangement the LLP or Silk Rd 1 or Silk Rd 2 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.

Notes to the financial statements continued

39. Risk management continued

Level 3 – Valuation techniques using unobservable inputs continued

The swap is 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 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.

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

2011	Fair value at the beginning of the year £m	Purchases £m	Sales £m	Profit or loss including impairment £m	Fair value at the end of the year £m
Loans and advances to customers	**12**	**–**	**–**	**1**	**13**
Derivative assets	**17**	**–**	**–**	**8**	**25**
Equity shares	**7**	**–**	**–**	**(2)**	**5**
Derivative liabilities	**(27)**	**–**	**–**	**14**	**(13)**
	9	**–**	**–**	**21**	**30**

2010	Fair value at the beginning of the year £m	Purchases £m	Sales £m	Profit or loss including impairment £m	Fair value at the end of the year £m
Loans and advances to customers	12	–	–	–	12
Derivative assets	–	–	–	17	17
Equity shares	7	–	–	–	7
Derivative liabilities	–	–	–	(27)	(27)
	19	–	–	(10)	9

The carrying values of financial instruments measured at amortised cost are determined in compliance with the accounting policies on page 85.

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.

2011 Financial assets		Carrying value £m	Fair value £m
Loans and receivables			
	Loans and advances to banks	**2,007**	**2,004**
	Loans and advances to customers	**34,018**	**34,236**
	Investment securities	**805**	**799**
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**

2010 Financial assets		Carrying value £m	Fair value £m
Loans and receivables			
	Loans and advances to banks	2,394	2,392
	Loans and advances to customers	35,070	35,697
	Investment securities	1,917	2,036
Financial liabilities			
Financial liabilities at amortised cost	Deposits by banks	2,939	2,971
	Customer accounts	32,320	32,401
	Debt securities in issue	4,212	4,832
	Other borrowed funds	975	1,107

39. Risk management continued

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

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

The fair value of floating rate placements and overnight deposits is their carrying amount. The estimated fair value of fixed interest bearing deposits is based on discounted cash flows using prevailing money market interest rates for debts with similar credit risk and remaining maturity. A credit loss adjustment has been applied based on expected loss amounts derived from the Bank's regulatory capital calculations.

Loans and advances to customers
Fixed rate loans and advances to customers are revalued to fair value based on future interest cash flows (at funding rates) and principal cash flows discounted using the zero coupon rate. Forecast principal repayments are based on redemption at the earlier of maturity or repricing date with some overlay for historic behavioural experience where relevant. The eventual timing of future cash flows may be different from the forecast due to unpredictable customer behaviour. It is assumed there is no fair value adjustment required in respect of interest rate movement on variable rate assets. A credit loss adjustment has been applied based on expected loss amounts derived from the Bank's regulatory capital calculations.

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

Customer accounts
The estimated fair value of deposits with no stated maturity, which includes non-interest bearing deposits, is the amount repayable on demand. The estimated fair value of fixed interest bearing deposits and other borrowings without quoted market price is based on discounted cash flows using interest rates for new debts with similar remaining maturity.

Debt securities in issue and other borrowed funds
The aggregate fair values are calculated based on quoted market prices. For those notes where quoted market prices are not available, a discounted cashflow model is used based on a current yield curve appropriate for the remaining term to maturity.

Fair values of CISGIL financial assets and liabilities
The following summarises the major methods and assumptions used in estimating the fair values of financial instruments reflected in the financial statements:

(a) 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 their carrying amount.

(b) 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.

Fair value of 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 similar maturity including an appropriate allowance for credit risk.

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.

(c) Borrowed funds
Fair value measurement is based on a discounted cashflow basis using prevailing market interest rates.

(d) 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.

The table below shows a comparison of the carrying value and fair values of financial instruments where the value is significantly different. In all other instances fair values are not materially different from carrying values.

Notes to the financial statements continued

39. Risk management continued

Financial liabilities	2011 Carrying value £m	2011 Fair value £m	2010 Carrying value £m	2010 Fair value £m
Other borrowed funds	85	70	65	56

Financial asset and liability classification

The table below analyses financial instruments by measurement basis as detailed by IAS 39.

Balance sheet categories 2011	Designated at fair value £m	Loans and receivables £m	Available for sale £m	Other amortised cost £m	Total £m
Assets					
Financial assets at fair value through income or expense	64	–	–	–	64
Available for sale assets	–	–	969	–	969
Other assets	–	191	–	–	191
Total financial assets	64	191	969	–	1,224
Non-financial assets					199
Total assets					1,423
Liabilities					
Derivative financial instruments	–	–	–	–	–
Other borrowed funds	–	–	–	85	85
Overdrafts	–	–	–	9	9
Other liabilities	–	–	–	24	24
Total financial liabilities	–	–	–	118	118
Non-financial liabilities					1,059
Total liabilities					1,177
Capital and reserves					246
Total liabilities and equity					1,423

2010	Designated at fair value £m	Loans and receivables £m	Available for sale £m	Other amortised cost £m	Total £m
Assets					
Financial assets at fair value through income or expense	34	–	–	–	34
Available for sale assets	–	–	950	–	950
Other assets	–	206	–	–	206
Total financial assets	34	206	950	–	1,190
Non-financial assets					118
Total assets					1,308
Liabilities					
Other borrowed funds	–	–	–	65	65
Overdrafts	–	–	–	6	6
Other liabilities	–	–	–	23	23
Total financial liabilities	–	–	–	94	94
Non-financial liabilities					955
Total liabilities					1,049
Capital and reserves					259
Total liabilities and equity					1,308

39. Risk management continued

The following table provides an analysis of financial instruments that are measured subsequent to initial recognition at fair value, grouped into Levels 1 to 3 based on the degree to which the fair value is observable.

- 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).

Based upon guidance issued by the Committee of European Securities Regulators (CESR), CISGIL classifies debt 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).

Valuation of financial instruments

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

Valuation of financial instruments

2010	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Assets				
Financial assets at fair value through income or expense	–	34	–	34
Available for sale assets	–	950	–	950
Total financial assets at fair value	–	984	–	984

The valuation techniques using observable inputs primarily relate to debt securities that would otherwise be fair valued using quoted market prices.

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).

	Carrying amount £m	2011 Fair value £m	Amortised cost £m
Investments in debt securities as:			
Available for sale financial assets	969	969	988

	Carrying amount £m	2010 Fair value £m	Amortised cost £m
Investments in debt securities as:			
Available for sale financial assets	950	950	918

Notes to the financial statements continued

40. 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:

Premiums

	2011 £m	2010 £m
Gross premiums:		
Non-participation contracts	**33**	38
Participation contracts	**375**	446
Outward reinsurance premiums:		
Non-participation contracts	**(15)**	(17)
	393	467
Analysis of gross written premiums:		
Premiums under individual contracts	**403**	479
Premiums under group contracts	**5**	5
	408	484

	2011 £m	2010 £m
Life contracts:		
Premiums from life assurance business	**310**	372
Premiums from pensions business	**96**	109
Premiums from permanent health business	**2**	3
	408	484

Investment income

	2011 £m	2010 £m
Interest income from debt securities at fair value through profit or loss	**342**	366
Dividend income from equities at fair value through profit or loss	**163**	126
Interest income from loans at amortised cost	**–**	1
Rental income from investment properties	**108**	108
Cash and cash equivalents interest income	**12**	7
Interest income from derivative financial instruments	**11**	5
	636	613

Net gains/(losses) on remeasurement of financial and other assets at fair value through income or expense

	2011 £m	2010 £m
Listed equities	**(458)**	541
Unlisted equities	**1**	88
Listed debt securities	**860**	254
Unlisted debt securities	**458**	213
Derivatives	**614**	(42)
Investment properties	**36**	102
Net losses on remeasurement of financial liabilities at fair value through profit or loss	**(458)**	(212)
Other investments	**2**	–
	1,055	944

40. Detailed analysis of loss on discontinued operations, net of tax continued

Claims paid

	2011 £m	2010 £m
Gross claims paid		
Long term insurance contracts:		
– Death benefits	**137**	127
– Surrender benefits	**474**	392
– Maturity claims	**344**	321
– Annuity and other benefits	**190**	207
Less recovered from reinsurers		
Long term business:		
– Death benefits	**(11)**	(10)
– Annuity and other benefits	**(137)**	(140)
Net claims paid	**997**	897

41. 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

	2011 £m	2010 £m
Derivative financial assets at FVTPL – held for trading:		
Financial future contracts	**1**	–
Interest rate swaptions	**264**	–
Interest rate swaps	**871**	–
FTSE options	**159**	–
Forwards	**4**	–
Total return swaps	**188**	–
	1,487	–

Derivatives – liabilities classified as held for sale

	2011 £m	2010 £m
Financial future contracts	**18**	–
Interest rate swaps	**1,066**	–
Total return swaps	**92**	–
Forwards	**21**	–
	1,197	–

Notes to the financial statements continued

41. Detailed analysis of assets and liabilities held for sale continued

Other investments

	2011 £m	2010 £m
Listed equities	4,583	–
Unlisted equities	998	–
Listed debt securities – fixed rate	7,637	–
Listed debt securities – floating rate	134	–
Unlisted debt securities – fixed rate	4	–
Unlisted debt securities – floating rate	2,550	–
Deposits with credit institutions – fixed rate	1,569	–
Investment properties	1,574	
	19,049	–

Government guaranteed securities with a market value of £817m (2010: £870m), which were the subject of repurchase contracts, are included in debt securities in the analysis above. A liability of £755m (2010: £871m) is included within financial liabilities in respect of the associated repurchase liability.

Analysis of insurance and participating contract liabilities

	2011 £m	2010 £m
Gross		
Long term insurance contracts:		
– Insurance contracts	3,177	–
– Insurance participating contracts	14,256	–
– Investment participating contracts	627	–
– Adjustment for funeral bonds	(381)	–
	17,679	–
Recoverable from reinsurers		
Long term insurance contracts:		
– Insurance contracts	(2,019)	–
– Insurance participating contracts	(1,468)	–
	(3,487)	–
Net		
Long term insurance contracts:		
– Insurance contracts	1,158	–
– Insurance participating contracts	12,788	–
– Investment participating contracts	627	–
Net insurance liabilities	14,573	–

41. Detailed analysis of assets and liabilities held for sale continued

Capital position statement 2011 (for Co-operative Insurance Society only)

	Long term business (excluding 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

Capital position statement 2010 (for Co-operative Insurance Society only)

	Long term business (excluding 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	1,011	–	–	1,011
– Adjustments to assets	(60)	–	–	(60)
Total available capital resources	951	–	200	1,151
With profits liabilities on realistic basis:				
– Options and guarantees	1,113	–	–	1,113
– Other policyholder obligations	11,462	228	–	11,690
Total participating contract liabilities	12,575	228	–	12,803
– Non-participating life assurance	818	–	–	818
Insurance and participating contract liabilities per capital position statement	13,393	228	–	13,621

Notes to the financial statements continued

41. Detailed analysis of assets and liabilities held for sale continued

Reconciliation to insurance and participating contracts liability

	2011 £m	2010 £m
Insurance and participating contract liabilities as per capital position statement	**14,458**	–
Add back reinsurance	**3,487**	–
Outstanding claims reserves	**115**	–
Less funeral bonds	**(381)**	–
Insurance and participating contract liabilities	**17,679**	–

a) Long term life insurance contracts – assumptions, changes in assumptions and sensitivity

i) Capital management policies and objectives

The liabilities of the long term business fund shown in the capital position statement are calculated following FSA rules and guidance. CIS has a general reserve of £200m which is a separate shareholder-owned fund held outside the long term business which, if available, may be used in exceptional circumstances to help meet the long term business fund's solvency requirements.

The whole of the profits of the long term business are 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 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.

ii) 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 2011. At 31 December 2011, provisions amounting to £897m (2010: £559m) 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 2010. At 31 December 2011, provisions amounting to £67m (2010: £49m) 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 2011. At 31 December 2011, provisions amounting to £781m (2010: £552m) have been made to cover the future cost of meeting guarantees of this type.

iii) 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 move the capital and reserving requirements of non-profit business to a more realistic basis. CIS adopted the changes under this policy statement at 12 January 2008, and continues to do so at 31 December 2011.

41. Detailed analysis of assets and liabilities held for sale continued

iv) 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.

v) 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 onerous contracts of £4m (2010: £3m) for insurance contracts and £5m (2010: £4m) for investment contracts to provide for the excess of expenses over anticipated charges are 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.

vi) Assumptions used in valuing the realistic liabilities

The overall objective of the CIS 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 CIS 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; and
- tax.

vii) Interest rates used in valuing the realistic liabilities

A risk free future interest rate of 2.48% (2010: 3.99%) is assumed when calculating prospective asset shares and the value of in-force business on non-participating contracts in compliance with the requirements of the Prudential Sourcebook of Insurers (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.

viii) 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.

ix) Expenses and expense inflation

Expense assumptions for prospective asset shares and value for 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 5.1% per annum (2010: 5.1% per annum).

Notes to the financial statements continued

41. Detailed analysis of assets and liabilities held for sale continued

x) 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 2011 experience investigations and new CMIB models for future assumed annuitant mortality improvements, but these changes have not had a major impact on the insurance contract liabilities.

xi) 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% (2010: 20%).

xii) 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 as described in section ii). 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 and the sensitivity of the working capital to each test are as follows:

RCM stress tests

	Reduction in working capital £m
20% fall in equity values and 12.5% fall in property values	80
17.5% reduction in long term gilt yields	35
32.5% improvement in persistency rates	125
Increase of 113 basis points in bond yields for credit risk test	90
Total RCM before management actions	330

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 £330m (2010: £215m). The excess working capital of the fund after the RCM is therefore £674m (2010: £735m). The RCM is covered 3.0 times (2010: 4.4 times) by working capital.

Other stress tests

	Reduction in working capital £m
5% fall in assurance mortality rates	2
5% fall in annuitant mortality rates	52
10% increase in renewal expenses	65
1% increase in renewal expense inflation	126

b) Change in long term insurance liabilities and reinsurance assets

	2011			
	Non-participating insurance contracts £m	**Participating insurance contracts £m**	**Reinsurance £m**	**Net £m**
At beginning of the year	**2,676**	**13,981**	**(3,036)**	**13,621**
New liabilities	**165**	**138**	**–**	**303**
Changes in liabilities during the year	**(10)**	**(974)**	**–**	**(984)**
Effect of changes in non-economic assumptions	**–**	**1**	**–**	**1**
Effect of changes in asset shares	**–**	**648**	**–**	**648**
Effect of changes in economic conditions	**174**	**681**	**–**	**855**
Other	**172**	**281**	**(439)**	**14**
At end of the year	**3,177**	**14,756**	**(3,475)**	**14,458**
Outstanding claims	**–**	**127**	**(12)**	**115**
Insurance contract liabilities	**3,177**	**14,883**	**(3,487)**	**14,573**

41. Detailed analysis of assets and liabilities held for sale continued

c) Movement in working capital of the long term business fund

	2011 £m	2010 £m
At beginning of the year	951	–
Opening adjustments	71	–
Changes to insurance assumptions	(1)	–
Economic variances	34	–
Insurance variances	(46)	–
Other factors	(34)	–
At end of the year	**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 pensions persistency and annuity take up rate assumptions to reflect the latest experience investigations.

Economic variances
Economic variances arise from the following:

- investment returns in the current calendar year more than (2010: more than) the assumed risk free rate helping to reduce (2010: reduce) the cost of meeting policy guarantees;
- a decrease (2010: decrease) in assumed future risk free rates which has increased (2010: increased) the cost of policy guarantees; and
- assumed future volatility of equity and fixed interest assets has increased (2010: decreased) which has increased (2010: decreased) 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; and
- 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.

- the impact of changes to the short term assumed asset mix reflecting current asset holdings

Risk Management
Due to the sale of the life business being classed as discontinued, the main risks of the life business are disclosed in this note.

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 CIS 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. CIS 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 CIS General Insurance Society Limited (CISGIL), a fellow subsidiary society within the Banking Group, under the terms of an indemnification agreement. This business is currently pending a Part VII transfer to CISGIL under the Financial Services and Markets Act 2000, scheduled to be completed in 2012.

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.

Notes to the financial statements continued

41. Detailed analysis of assets and liabilities held for sale continued

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

CIS'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. CIS 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.

Financial risk

CIS is exposed to risk through the insurance and participating contracts that it issues (and its ceded reinsurance contracts) and through its holdings of financial assets and liabilities (including investment contracts, borrowings and derivatives). In particular a key financial risk is that the proceeds from financial assets and property are insufficient to fund the obligations arising under long term insurance, investment contracts and general insurance business in run off. CIS manages this risk separately for general insurance business in run off and long term business and then according to the categories of market risk, credit risk and liquidity risk. The general insurance business in run off is currently pending a Part VII transfer to CISGIL under the Financial Services and Markets Act 2000, scheduled to be completed in 2012.

Financial risk management objective and strategy

The principal objective of CIS's financial risk management strategy is to optimise the return on investments commensurate with an acceptable level of financial and insurance risk. Financial risk is managed within an asset and liability management framework (ALM) to ensure that this objective is achieved. An overriding constraint on the fund's investment strategy is to ensure that at all times the fund has sufficient assets to meet its solvency and capital requirements.

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, which require risks and capital to be regularly monitored and reported, and decisions made according to delegated authorities. Actions to control risk and manage the working capital of the fund include the use of reinsurance, matching assets and liabilities (including using derivatives) and setting discretionary benefits at appropriate levels, as described in the Principles and Practices of Financial Management (PPFM).

The Risk Committee specifically monitors ALM exposures and controls the effectiveness of the market and credit policies. Exposures to market and credit risk are managed through diversifying investments across asset classes, issuers and markets.

The principal ALM technique of CIS'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.

As part of its ALM framework, CIS sets a strategic asset allocation range with reference to a suitable benchmark for each asset class taking account, separately, of the shareholder and long term insurance and investment liabilities, long term investment performance and the financial risks. Controls and limits are set for each risk and sub-risk type and managed within the risk management procedures accordingly. CIS considers capital adequacy and solvency when establishing and controlling the assets and risk limits.

41. Detailed analysis of assets and liabilities held for sale continued

Market risk

Market risk is the risk that the fair value 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 where a significant proportion of assets is held in equities, property and alternative investments such as hedge funds.

Financial risk within the long term business fund is managed as follows:

- long term insurance liabilities in respect of 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 on the non-participating business;
- financial assets held to meet expected participating policy guarantee costs and the working capital of the fund, are invested in fixed interest securities to reduce cashflow 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 backing guaranteed benefits on participating contracts with equities;
- a portfolio of gilt total return swaps and interest rate swaps are held to hedge the risk of adverse movements in swaps 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 and alternatives; and
- for unit linked investment contracts, assets are directly matched with liabilities.

CIS manages its cashflow interest rate risk by using interest rate swaps and deposits. CIS enters into interest rate swaps and gilt repurchasing arrangements to manage borrowing requirements.

Sensitivity analysis

At the end of 2011 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 largely liquidated its equity and derivative holdings during 2011; formerly the fund was exposed to equity price risk arising from the fluctuation in equity market values although the risk was significantly reduced by selling equity futures. 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 pa. We consider that the probability of a change in base rate of this magnitude over the coming year would be less than 10%.

At the end of 2010 when the other than long term fund was still invested in equities it was estimated that a 10% increase in equity values would have increased the balance sheet carrying value of equities by £28m. This would have largely been offset by an increase in the value of financial liabilities in respect of financial futures contracts. However, the futures did not provide a perfect hedge against changes in value of the equities portfolio, and the change in the liability was expected to lie within the range £32m to £24m giving a net profit impact, pre-tax, of between +£5m and –£4m.

A 10% reduction in equity values would have produced the reverse impact on pre-tax profit, being between +£4m and –£5m, as the movement would have been offset by a movement in equity futures. This sensitivity analysis is based upon a change in one assumption while holding all other assumptions constant.

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.

Credit risk

CIS's principal credit risk exposure arises in connection with default of debt securities and reinsurance counterparties, as a result of either 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.

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. CIS structures the levels of counterparty risk and asset concentration risk it accepts by placing limits and controls over the 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. Counterparty exposures are subject to review at least annually and, where concern exists over counterparty credit quality, the exposure is monitored and actively managed.

Where reinsurance is used to manage insurance risk, a risk is created 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, CIS 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 CIS in run off has been passed to CISGIL, a fellow society within the Banking Group, via an indemnification agreement. If CISGIL were unable to fulfill its contractual obligations, financial responsibility for these claims would revert to CIS.

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.

Notes to the financial statements continued

41. Detailed analysis of assets and liabilities held for sale continued

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
As at 31 December 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 gilt edged securities.

	AAA £m	AA £m	A £m	BBB and below £m	Not rated £m	Total £m
As at 1 January 2011						
Reinsurance assets	–	19	3,052	–	–	3,071
Financial assets at fair value through income or expense:						
Listed debt (fixed rate)*	3,220	614	1,627	1,028	17	6,506
Unlisted debt (fixed rate)	4	–	–	–	–	4
Unlisted debt (floating rate)	–	2,150	–	–	–	2,150
Deposits with approved credit institutions (fixed rate)	–	808	695	–	6	1,509
Derivatives	1	485	311	–	–	797
Loans and receivables at amortised cost:						
Loans	–	–	–	–	6	6
Insurance receivables and other assets	29	49	49	24	82	233
Cash and cash equivalents	–	10	49	–	–	59
	3,254	4,135	5,783	1,052	111	14,335
Assets not subject to credit risk						8,038
						22,373

* Includes £2,625m of gilt edged securities

The maximum exposure to credit risk is best represented by the carrying value of each financial asset in the table. Collateral is held as security for reverse repo balances of £425m (2010: £688m) reported within deposits with approved credit institutions, the unlisted floating rate debt of £2,550m (2010: £2,150m), and derivative positions of the long term business fund.

41. Detailed analysis of assets and liabilities held for sale continued

Eurozone risk

CIS has no direct credit exposure to sovereign debt or financial institutions in Greece, Portugal, Ireland, Italy or Belgium. CIS has no direct exposure to sovereign debt in Spain and credit exposure to financial institutions in Spain is closely monitored and currently represents 0.5% 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.

	Certificates of deposit £m	Bonds £m	Total Exposure £m
As at 31 December 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 to15 years £m	15 to 20 years £m	20 to 25 years £m	More than 25 years £m	Total £m
As at 31 December 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**

	Certificates of deposit £m	Bonds £m	Total Exposure £m
As at 31 December 2010			
Belgium	–	16	16
Denmark	–	37	37
France	150	171	321
Germany	275	150	425
Italy	150	–	150
Netherlands	100	77	177
Norway	–	11	11
Spain	50	26	76
Supranational	–	401	401
Sweden	–	15	15
Switzerland	–	30	30
	725	934	1,659

Notes to the financial statements continued

41. Detailed analysis of assets and liabilities held for sale continued

	Up to 5 years £m	5 to 10 years £m	10 to15 years £m	15 to 20 years £m	20 to 25 years £m	More than 25 years £m	Total £m
As at 31 December 2010							
Belgium	–	16	–	–	–	–	16
Denmark	–	–	–	–	–	37	37
France	150	10	–	67	75	20	322
Germany	304	–	21	36	25	38	424
Italy	150	–	–	–	–	–	150
Netherlands	100	12	–	–	–	65	177
Norway	11	–	–	–	–	–	11
Spain	73	–	–	4	–	–	77
Supranational	43	72	98	91	49	47	400
Sweden	–	–	–	–	–	15	15
Switzerland	–	30	–	–	–	–	30
	831	140	119	198	149	222	1,659

Holdings in Certificate of Deposits (CD's) are all short dated and, at the end of 2011, all were repayable within six months of the end of the financial year (2010: all CD's repayable within three months of the end of the financial year).

Additionally CIS holds currency futures and currency forward contracts denominated in Euro. At the end of 2011, the net exposure was an asset position of £1m (2010: £4m).

Liquidity risk
Liquidity risk is the risk that cash may not be available at a reasonable cost to pay obligations when due. CIS is exposed to calls on its available cash resources mainly from claims arising, collateral arrangements on derivatives and reinsurance contracts.

A liquidity risk policy has been established and risk is managed through the 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 13% of the long term business fund. This is determined using the Society'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 new business premiums income received;
- no reinsurance recoveries received; and
- contractual payments occurring at the earliest possible date.

In addition, a minimum of £700m of gilts are held to meet extreme collateral payments on derivative contracts.

Based on the latest internal assessment, the liquidity requirement is £2.0bn (2010: £1.6bn) against actual available liquid assets of £8.7bn (2010: £7.4bn).

CIS is active in the gilt repo market as part of its cash management activities and maintains short term borrowing facilities to enable settlement.

41. 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 out flow £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
As at 31 December 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**	**1,200**	**1,200**	**–**	**–**	**–**	**–**
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	**25,026**	**4,592**	**4,861**	**4,607**	**3,780**	**7,186**
Other liabilities	**1,175**						
Total recognised liabilities	**24,327**						

	Carrying Value £m	Gross nominal out flow £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
As at 31 December 2010							
Insurance and participating contract liabilities	16,943	16,944	1,848	4,639	3,819	2,733	3,905
Financial liabilities at fair value through income or expense (held for trading):							
Derivatives	535	535	535	–	–	–	–
Financial liabilities designated at fair value through income or expense:							
Investment contract liabilities	316	316	316	–	–	–	–
Other reinsurance liabilities	2,150	4,643	58	362	500	497	3,226
Financial liabilities at amortised cost:							
Amounts owed to credit institutions (fixed rate)	871	871	871	–	–	–	–
Insurance and other payables	139	139	122	17	–	–	–
Other reinsurance liabilities	1	1	1	–	–	–	–
Net asset value attributable to unit holders	30	30	30	–	–	–	–
	20,985	23,479	3,781	5,018	4,319	3,230	7,131
Other liabilities	1,148						
Total recognised liabilities	22,133						

Currency risk

Currency risk is the risk that cash flows or fair values fluctuate as a result of changes in foreign exchange rates. CIS writes contracts of insurance in the UK and insurance and investment liabilities are denominated in sterling. The shareholder funds are invested solely in assets denominated in sterling. 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.

Objectives when managing capital

Co-operative Insurance Society Limited's (CIS) primary objective in respect of capital management is to ensure that it has sufficient capital now and in the future to support all the risks in the business to the required level of confidence, thus ensuring policyholder protection as well as meeting its regulatory solvency requirements.

Capital within the other than long term business fund consists of the excess of assets over and above the accumulated reserves necessary to support the run-off of the existing general insurance business.

Capital within the long term business fund (LTBF) consists of the excess of assets over the amount needed to meet its liabilities (including those that arise from the regulatory duty to treat customers fairly when setting discretionary benefits). In exceptional circumstances, assets outside the LTBF (share capital and general reserve), if available, may be used to meet the LTBF's solvency requirements.

CIS has not changed the manner in which it defines capital to meet regulatory solvency during either the current or prior financial periods.

Notes to the financial statements continued

41. Detailed analysis of assets and liabilities held for sale continued

Required capital

CIS is required to hold regulatory capital for both its long term business and its general insurance business in run-off in compliance with the rules issued by the FSA.

(a) Regulatory required capital

The regulatory requirement is defined in rules issued by the FSA. To summarise, firms must hold the higher of:

- Pillar 1, which is the maximum of the:
  - MCR (Minimum Capital Requirement); and
  - ECR (Enhanced Capital Requirement); and
- Pillar 2, which is the ICG (Individual Capital Guidance) determined from CIS's ICA (Individual Capital Assessment) plus any add-ons imposed by the FSA.

For the long term business fund the Pillar 1 requirement is calculated as the higher of two prescribed tests – Peak 1 and Peak 2 and are outlined as follows:

- Peak 1 – a prudent valuation of the guarantees of the fund.
- Peak 2 – a realistic market consistent valuation of the expected future cash flows of the fund.

Pillar 2 considers an internal view of risks faced by the long term business fund on a realistic basis similar to Peak 2.

CIS, in accordance with FSA requirements, calculates its ICA to be the capital required to be 99.5% confident of meeting liabilities as they fall due over a one year time horizon.

(b) Internal required capital

The CIS Board has responsibility for deciding the risk appetite that is appropriate for the business. This risk appetite is designed to ensure that CIS will hold a capital margin in excess of the regulatory requirements, as described in (a), that the Board deems sufficient to manage the risks of falling below the regulatory capital requirement.

The risk appetite statement influences the strategic direction of the organisation via the strategic planning process.

Submissions to the FSA in the year have shown that CIS has complied with all externally imposed solvency requirements throughout the period.

(c) Capital composition

CIS capital comprises total shareholders' equity, excluding inadmissible assets and equalisation provisions recognised in equity. Long term business figures also include unallocated divisible surplus (UDS) amounts.

	Long term business 2011 £m	**Other than long term business 2011 £m**	Long term business 2010 £m	Other than long term business 2010 £m
Capital and reserves per the financial statements	**–**	**239**	–	370
UDS (Society)	**1,032**	**–**	1,011	–
Capital hypothecated to long term business	**200**	**(200)**	200	(200)
Valuation differences	**2,106**	**–**	1,654	–
Deduction for inadmissible and other assets	**(58)**	**(28)**	(72)	(11)
Proposed dividend	**–**	**–**	–	(34)
Total available capital resources	**3,280**	**11**	2,793	125
Capital hypothecated to long term business	**(200)**		(200)	
Total capital resources on a Peak 1 basis	**3,080**		2,593	
Peak 2 adjustments	**(2,105)**		(1,643)	
Excess working capital	**975**		950	
Risk capital margin	**(330)**		(215)	
Total capital resources on a Peak 2 basis	**645**		735	

The UDS reported above is based on the Society only position. Group capital includes the consolidated UDS of £1,053m, the difference of £20m representing consolidation adjustments for investments in subsidiaries.

Long term business capital is managed on a Banking Group basis, taking into consideration the capital requirements of two regulated subsidiaries of the life fund, CIS Unit Managers Ltd and CIS Policyholder Services Ltd. These subsidiaries are not considered material to the long term business fund overall.

Long term business regulatory capital

For the long term business fund, within Pillar 1 calculations Peak 2 is significantly higher than Peak 1 resulting in a negative adjustment to capital of £2,106m (2010: £1,642m).

41. Detailed analysis of assets and liabilities held for sale continued

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:

(a) Financial investments at fair value through income or expense

Background

CIS 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 year end date, is valued at £2,550m (2010: £2,150m). 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.

CIS derives the fair value of certain holdings based primarily upon net asset values (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. CIS considers this approach to be materially representative of fair value for these investments as it reflects CIS's share of rights and obligations under the investment, because:

- the most significant of these investments have 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 CIS 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 the Society'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.

(b) 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.

(c) 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.

(d) 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.

(e) 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 section (a) above.

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.

Notes to the financial statements continued

41. Detailed analysis of assets and liabilities held for sale continued

	2011 Carrying value £m	2011 Fair value £m	2010 Carrying value £m	2010 Fair value £m
Financial assets				
Loans at amortised cost	**2**	**2**	6	6

The tables below analyse financial instruments by measurement basis as detailed by IAS 39 (Financial Instruments: Recognition and Measurement).

Balance sheet categories

2011	Designated at fair value £m	Loans and receivables £m	Other amortised cost £m	Total £m
Assets				
Financial assets at fair value through income or expense	**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	**19,091**	**293**	**–**	**19,384**
Non-financial assets				**5,102**
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	**2,550**	**–**	**1**	**2,551**
Total financial liabilities	**4,819**	**–**	**171**	**4,990**
Non-financial liabilities				**19,256**
Total liabilities				**24,246**
Capital and reserves				**240**
Total equity and liabilities				**24,486**

2010	Designated at fair value £m	Loans and receivables £m	Other amortised cost £m	Total £m
Assets				
Financial assets at fair value through income or expense	16,640	–	–	16,640
Loans at amortised cost	–	6	–	6
Derivative financial instruments	797	–	–	797
Insurance receivables and other assets	–	233	–	233
Cash and cash equivalents	–	59	–	59
Total financial assets	17,437	298	–	17,735
Non-financial assets				4,638
Total assets				22,373
Liabilities				
Investment contract liabilities	316	–	–	316
Derivative financial instruments	535	–	–	535
Amounts owed to credit institutions	871	–	–	871
Insurance and other payables	–	–	139	139
Other reinsurance liabilities	2,150	–	1	2,151
Total financial liabilities	3,872	–	140	4,012
Non-financial liabilities				17,991
Total liabilities				22,003
Capital and reserves				370
Total equity and liabilities				22,373

41. Detailed analysis of assets and liabilities held for sale continued

The following table details financial assets held by the Group and Society 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), CIS 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 cashflow 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.

Valuation of financial instruments

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	–	2,550	–	2,550
Total financial liabilities at fair value	18	4,801	–	4,819

Notes to the financial statements continued

41. Detailed analysis of assets and liabilities held for sale continued

2010	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial assets				
Financial instruments at fair value through income or expense:				
Listed equities	5,501	–	–	5,501
Unlisted equities	280	458	232	970
Listed debt:				
Fixed rate	2,625	3,882	–	6,507
Unlisted debt:				
Fixed rate	–	3	–	3
Floating rate	–	2,150	–	2,150
Deposits with credit institutions	–	1,509	–	1,509
Total financial instruments at fair value through income or expense	8,406	8,002	232	16,640
Derivative financial instruments	10	787	–	797
Total financial assets at fair value	8,416	8,789	232	17,437
Financial liabilities				
Investment contract liabilities:				
Unit linked	–	316	–	316
Derivative financial instruments	10	525	–	535
Other financial liabilities:				
Gilt repos	–	871	–	871
Reinsurance liability	–	2,150	–	2,150
Total financial liabilities at fair value	10	3,862	–	3,872

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 the Group and Society 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 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:

Assets	**Level 3 financial instruments at fair value through income or expense 2011**	Level 3 financial instruments at fair value through income or expense 2010
Opening balance	**233**	185
Gains/(losses) in income or expense	**30**	24
Gains/(losses) in other comprehensive income	**–**	–
Purchases	**70**	50
Issues	**–**	–
Settlements	**(48)**	(26)
Transfers in	**–**	–
Transfers out	**–**	–
Closing balance	**285**	233

Assets	**Level 3 financial instruments at fair value through income or expense 2011**	Level 3 financial instruments at fair value through income or expense 2010
Total gains for the period included in income or expense for Level 3 assets held at the end of the reporting period	**31**	24

42. Capital resources

	2011 £m	2010 £m
Share capital	**70**	70
General reserve	**200**	317
Retained earnings and other reserves	**4,751**	4,419
	5,021	4,806
Perpetual non-cumulative preference share	**60**	60
Subordinated debt	**1,084**	885
Total capital resources	**6,165**	5,751

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 nature of 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. In 2011, the Group made record member payments of £142m (2010: £104m) to its stakeholders, invested in future growth by implementing record capital expenditure of £595m (2010: £492m) whilst still keeping total member funds up by £215m (2010: up by £318m).

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 £72m (2010: gain of £53m) and cumulative gains on available for sale assets of £5m (2010: gain of £10m).

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.

The following are also included in the calculation of total Banking Group 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 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 CBG (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.

43. 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:

	2011 £m	2010 £m
Reclaim fund assets – cash	**315**	–
Provision for reclaims of dormant account balances	**(146)**	–
Provision for future distributions to Big Lottery Fund	**(95)**	–
Reclaim fund liabilities	**(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.

44. Prior year adjustment – Change in Funeral Bond accounting policy

The Group has changed its accounting policy on funeral bonds for 2011 such that the bonds are now accounted for in line with IAS 18 instead of IFRS 4 as was applied in previous years. The level of insurance risk is not considered to be significant and as the nature of the Group's funeral bond portfolio becomes increasingly diverse and the range of sales channels and bonds within the business changes, it is considered that IAS 18 has become a more appropriate basis of accounting than IFRS 4 allowing the Group to recognise income over the life of a bond in a way that better reflects the commercial and financial nature of the transaction.

The impact of the prior year adjustment is shown below.

	Note	**2011 £m**	2010 as reported £m	Prior year adjustment £m	2010 restated £m	2009 as reported £m	Prior year adjustment £m	2009 restated £m
Deferred tax asset – Trading Group	16	**133**	134	2	136	284	(1)	283
Trade and other receivables	18							
Prepayments and accrued income		**153**	174	(20)	154	268	(10)	258
Other receivables		**164**	553	(188)	365	342	(96)	246
Trade and other payables	26							
Accruals and deferred income		**(419)**	(564)	(29)	(593)	(542)	(18)	(560)
Funeral bonds		**(508)**	(622)	221	(401)	(476)	125	(351)
Provisions	27							
Regulatory/other		**(53)**	(102)	8	(94)	(111)	4	(107)
Retained earnings		**4,703**	4,582	(6)	4,576	4,237	4	4,241

The impact of the prior year adjustment on 2010 profits was a £12m reduction to reported profit before tax and a £10m reduction to post tax profits. Had the Group not made the accounting policy change, profit before tax in 2011 would have been £18m higher.

45. Events after the reporting period

There were no reportable events after the reporting period.

Analysis of profits from regional business activities (unaudited)

	2011		2010 (restated)	
	Sales £m	**Profit £m**	Sales £m	Profit £m
Central and Eastern	**1,284**	**80**	1,368	91
North	**1,618**	**102**	1,661	117
North West and North Midlands	**1,256**	**79**	1,342	98
Scotland and Northern Ireland	**1,125**	**92**	1,197	90
South East	**1,370**	**92**	1,381	96
South and West	**1,380**	**92**	1,436	107
Wales/Cymru	**588**	**46**	631	53
Sales and contribution from regional business activities	**8,621**	**583**	9,016	652
Sales and profit from non-regional businesses and regional business overhead	**2,238**	**(140)**	2,258	(174)
Co-operative Banking Group	**2,214**	**201**	2,030	202
Discontinued items	**(643)**	**(68)**	(895)	(35)
Intercompany eliminations and group operating costs	**(22)**	**(50)**	(21)	(43)
Net revenue and underlying segment operating profit before significant items	**12,408**	**526**	12,388	602

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.

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