

Sainsbury's Bank plc

**Report by the Board of
Directors to the Shareholders
and Financial Statements** for the
year ended 31 December 2011

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Report by the Board of Directors to the Shareholders

The Directors have pleasure in submitting their report and the accounts of Sainsbury's Bank plc ('the Bank') for the year ended 31 December 2011 to the Annual General Meeting to be held on 1st March 2012.

Principal activities

The Bank provides banking services and related financial services wholly within the UK. During the year the Bank continued to develop its customer offer through sales of its core products: personal loans, savings accounts, credit cards, general and life insurance. The Bank is a joint venture between J Sainsbury plc and Bank of Scotland plc with a contractual arrangement in place to govern the sharing of joint control. Bank of Scotland plc is a subsidiary of the Lloyds Banking Group plc. J Sainsbury plc and Bank of Scotland plc are incorporated and domiciled in England and Scotland respectively. Sainsbury's Bank plc is incorporated and domiciled in England.

Developing the business

The Bank has continued to perform strongly for the year ended 31 December 2011, with growth being delivered across a number of key areas leading to a rise in underlying profitability. Active accounts increased by 4.8% versus the prior year and total sales were also 6% higher versus 2010.

As part of the 'Making Shopping More Rewarding' strategy, the Bank has continued to offer rewards to customers when shopping in Sainsbury's supermarkets in conjunction with preferential product pricing for Sainsbury's shoppers. During the year this strategy was further strengthened with the launch of a new Car insurance proposition with RBS Insurance. Wider insurance volumes have continued to grow, with Pet and Home insurance products in particular showing strong new and renewal business performance.

The Bank continues to be active in the credit card and unsecured personal loan market, offering quality products to the Sainsbury's shopper base. The loans market in particular has seen significant competition in the year as well as shrinkage in demand. Despite this, the Bank has continued to grow by maintaining competitive pricing and an attractive overall proposition whilst working within a strict retail credit risk appetite. From a credit risk perspective, the Bank continues to make enhancements to its application and automated credit decisioning techniques.

The ATM network has continued to expand in 2011 and provides a consistently high level of customer service. At the end of the year a total of 1,275 machines were in operation in the Sainsbury's estate (2010: 1,173) and in January 2011 the highest ever level of customer service was achieved.

From an operational perspective the Bank has undertaken a number of changes in the year with minimal customer impact. The ATM estate was successfully migrated to a new IT platform in the first quarter and a number of savings system migrations were also undertaken. There continues to be a focus on constantly improving and delivering excellent customer service. The establishment of the single customer contact centre in 2010 as well as a focus on root cause analysis resulted in a 44% reduction in reportable complaints in 2011. The Bank has a strong risk management framework and this will continue to be strengthened in 2012 as change from regulators and other sources continues.

In the next financial year the Directors anticipate a continued focus on the existing product set as well as ensuring the customer proposition remains relevant and competitive.

Financial performance and position

The Bank's 2011 performance is presented in the income statement on page 12. The Bank's profit before tax has increased by £11m compared to the previous year. The Directors are pleased with the position, delivered through steady income growth and appropriate cost management. The performance is particularly pleasing despite the challenging economic environment as well as a £16.8m loss incurred through the disposal of a number of investment securities. This was undertaken to reduce the overall wholesale credit risk of the Bank. Underlying profit before tax excluding this factor was therefore £56.5m. The Directors remain confident in the long term profitability of the business.

The Directors monitor the financial performance of the Bank and track a variety of key performance measures including Financial, Building the Business, Customer, Risk and People measures, including the following:

	2011	2010
Cost: income ratio	53.83%	52.27%
Net interest margin	2.87%	2.26%
Bad debt asset ratio	2.03%	2.60%
Core Tier 1 capital ratio	9.6%	8.3%
Total capital ratio	14.4%	13.4%

Net operating income increased by £18.7m compared to the prior year. Net interest income increased by £18.0m compared to the prior year (15%) with rates associated with lending products remaining highly competitive in the market place whilst funding costs decreased reflecting a planned reduction in savings balances as well as continued low swap rates linked to the low base rate environment.

Commission income increased marginally by £0.3m compared to the prior year (0.3%). Income from general insurance products increased significantly compared to the prior year, with Home, Car and Pet insurances achieving strong new and renewal volume growth. This was partially offset by a reduction in commission from Credit Cards and Personal Loans.

Costs increased by £13.4m compared to the prior year (12.0%) in line with building business volumes and developing capability in-house.

Impairment losses have fallen by £9.8m in comparison to the prior year despite strong personal loan lending growth. This reflects the continued low risk appetite of the Bank towards customer lending and improvements in credit risk decisioning criteria. The economic environment, whilst challenging, has been broadly stable compared to the prior year. In light of these factors, and the continued development of our credit decisioning and back book management processes the bad debt asset ratio has fallen to 2.03% from 2.60% in the prior year.

Finally the Bank realised a loss on sale of securities in the year of £16.8m (2010: £12.7m) previously accumulated in reserves. A further loss of £7.1m was realised after the balance sheet date as discussed in note 40.

The Bank continues to maintain a predominantly retail funded balance sheet with a high level of liquidity being maintained. Overall savings balances decreased to a level of £2.9bn (-18%) with the Bank tailoring deposit levels to the funding requirements of the business. Throughout the year the Bank successfully moved to a more diversified retail funding base, with fixed rate bond products proving popular with customers and making up an increased percentage of the overall retail deposit position. Despite the greater funding stability stemming from this change as well as lower overall deposits the Bank has maintained a broadly stable holding of highly liquid Treasury bills as well as moving to the use of Money Market Funds. This has resulted in the liquidity position of the Bank being further strengthened in the year. Total loans and advances to customers increased by £52.9m in the year (2.2%).

Risk management approach

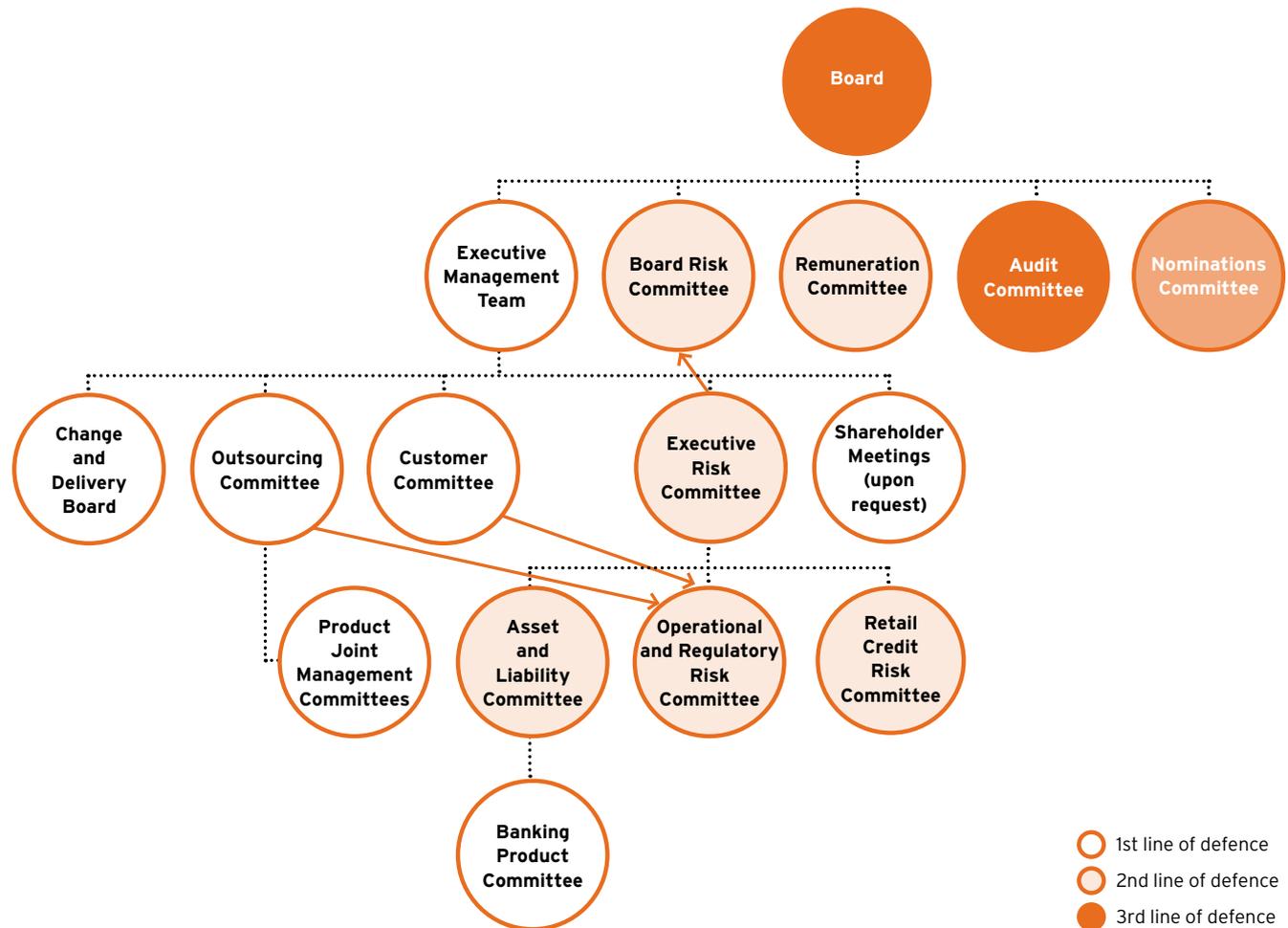
The Bank aims to appropriately manage all risks that arise from its activities. Through its normal operations the principal risks to the Bank are credit risk, liquidity risk, market risk, operational risk and regulatory change.

The Bank has established a risk framework and formal structure to monitor and manage risks across its operations. The Board has agreed statements of risk appetite and these are adhered to via detailed risk

management policies and through reporting to the various governance structures. This is described in more detail on the following page and in note 29.

Risk governance structure

Governance arrangements have remained broadly consistent with the structure in place in the prior year with the exception of the Outsourcing Committee and the Change and Delivery Board which were established to further enhance the risk framework and reflect the growth and development of the business.



• **The Board**

The Board is the key governance body and is responsible for the overall strategy, performance of the business and management of risk. It has delegated responsibility for the day to day running of the business to the Chief Executive and the Executive Management Team through apportionment of responsibility and delegated authorities.

The Board meets at least nine times a year. It comprises key Executive members from the Bank, three Non-Executive Directors from each of the shareholders and two independent Non-Executive Directors. The independent Non-Executive Directors were appointed during the year. A number of Board functions are delegated to four key sub-committees - the Board Risk Committee (BRC), the Audit Committee, Remuneration Committee (RemCo) and the Nominations Committee.

• **Executive Management Team**

The Chief Executive and Executive Management Team (EMT) have been delegated authority from the Board for the day to day running of the business. Responsibilities include general operational management (including oversight of the Change and Delivery Board, Outsourcing Committee, Customer Committee and Executive Risk Committee), delivery of the agreed business plan in line with agreed risk appetite, approval of new business plans or strategic changes prior to submission to the Board and senior management resourcing. The EMT is also responsible for monitoring financial and non-financial performance versus agreed targets on a regular basis.

- **Audit Committee**

The Audit Committee's key responsibility is to advise the Board on the Bank's financial results, both interim and final, including systems and policy issues and relationships with internal and external auditors.

- **Remuneration Committee (RemCo)**

The role of RemCo is to determine and agree with the Board the broad policy for remuneration and for compliance with the FSA Remuneration Code ('the Code') to the extent that the provisions apply to the Bank. RemCo is responsible for recommending, monitoring and noting the level and structure of remuneration for senior management (categorised as 'Code Staff' for the purposes of the Code) and senior risk management and compliance colleagues.

RemCo continually reviews and assesses the impact of remuneration policies on the risk profile of the Bank and employee behaviour. RemCo has oversight over appointment and severance terms for relevant employees (including payments of guaranteed remuneration for appointees and retention terms).

The Bank will publish Pillar 3 remuneration information as required by the Capital Requirements Directive and FSA prudential sourcebook on the J Sainsbury plc external website during June 2012.

- **Nominations Committee**

The Nominations Committee is responsible for reviewing the structure, size and composition of the Board. The committee is also responsible for succession planning into the Board and the Executive Management Team and for ensuring a formal, rigorous and transparent process for recommending appointments to the Board to the Bank's shareholders.

- **Board Risk Committee**

The Board Risk Committee (BRC) is forward looking to anticipate future risks and is responsible for reviewing and reporting its conclusions to the Board on the Bank's risk appetite and the Bank's risk management framework.

- **Executive Risk Committee**

The Executive Risk Committee (ERC) is a sub-committee of the Board Risk Committee. It is responsible for monitoring and exercising compliance of the Bank's activities to approved risk appetite statements and guidelines and limits of authority approved by the Board and Board Risk Committee. The committee also establishes and maintains policies and methodologies for credit risk, market risk, liquidity risk, operational and regulatory risk and oversight of capital adequacy.

- **Change and Delivery Board**

The Change and Delivery Board (CADB) reports to the Executive Management Team. It is responsible for the management and oversight of the Bank change portfolio ensuring appropriate prioritisation of projects and tracking of progress versus plan.

- **Outsourcing Committee**

The Outsourcing Committee (OC) reports to the Executive Management Team. It is responsible for ensuring that outsourcing risk is managed in line with the approved risk appetite and a consistent approach is taken to managing supplier relationships across the Bank.

- **Customer Committee**

The Customer Committee (CC) reports to the Executive Management Team. It is responsible for the management and oversight of all customer matters including complaints and conduct risk considerations. The committee aims to understand and respond to systemic trends and root cause analysis and to ultimately ensure best practice.

- **Operational and Regulatory Risk Committee**

The Operational and Regulatory Risk Committee (ORRC) is a sub-committee of the ERC. It assesses and considers the Bank's current performance in respect of Operational and Regulatory Risk and considers initiatives and actions designed to increase the effectiveness of the control environment in these areas from a 2nd line risk oversight perspective. It is also responsible for overseeing the development and implementation of the Bank's Operational and Regulatory Risk Management Frameworks.

- **Retail Credit Risk Committee**

The Retail Credit Risk Committee (RCRC) is a sub-committee of the ERC. It is responsible for monitoring the performance of the retail lending book. This committee receives regular reports about the performance of all retail credit portfolios. This includes the credit cards and loans application process as well as collections and recoveries and fraud performance.

- **Asset and Liability Committee**

The Asset and Liability Committee (ALCO) is a sub-committee of the ERC. It is responsible for ensuring the Balance Sheet of the Bank is managed effectively with its main areas of responsibility being interest rate risk, wholesale credit risk, liquidity, and capital adequacy.

- **Banking Product Committee**

The Banking Product Committee is a sub-committee of the ALCO. It approves new products, pricing changes to products and all significant feature changes to banking products. The committee also considers transfer pricing impact, capital considerations as well as changes to features that are relevant for interest rate risk.

Risk appetite

The Bank's Board approves the Bank's strategic risk appetite, which defines the level of risk that the Bank is prepared to accept to achieve its strategic objectives. The Board Risk Committee approves the articulation of these risk appetite statements in relation to retail credit risk, wholesale credit risk, market risk (interest rate risk and basis risk), prudential risk, liquidity risk, operational and regulatory risk, and reputational risk.

The Bank has a framework of policies in place, which are a manifestation of its risk appetite statements, to manage key risks. Each policy has an Executive owner who is responsible for maintenance of the policy and ensures it is reviewed at least annually and approved by the relevant governance committees.

Risk model

The Sainsbury's Bank risk model consists of three layers or 'Three lines of defence'. The model is enhanced through access to, and leverage of, its joint venture partners' risk experiences and methodologies. The Board retains ultimate responsibility for risk management in the Bank.

- The first line of defence is responsible for execution of the Bank's strategy, business performance, setting and implementation of policy and management of risks and internal controls. This primarily lies with the Chief Executive, the Executive Management Team (EMT) and the other entities noted on page 2. The Bank's Director of Risk is an integral part of the EMT. On a day-to-day basis, management and control of risk in the business is owned by the individual business units. Escalation procedures exist such that any control failures are reported to the Bank's independent risk team, and to the Executive and relevant governance bodies.
- The second line of defence provides risk oversight, an independent and objective challenge to the first line of defence. The various committees in the risk governance structure challenge the main risk types, ensuring the risks are managed effectively in line with the risk appetite parameters. Representatives from both Joint Venture partners attend relevant risk committees.
- The third line of defence provides independent and objective assurance on the effectiveness of the Bank's risk management, internal control and governance. This is provided by an in-house Head of Internal Audit and audit resource from Lloyds Banking Group (LBG) Internal Audit, J Sainsbury plc Internal Audit or external firms. This is supplemented by the role of the Audit Committee and Board.

As part of the second line of defence, risks are identified and managed by the Bank on an ongoing basis. The Bank's risks were reassessed in 2011 utilising a revised methodology, which is aligned to the three lines of defence model and the Bank's risk management framework.

Controls are implemented in the business to ensure that risks are effectively mitigated in line with the Bank's risk appetite and that a sound control environment is in place. A full Control Self Assessment (CSA) in the Bank is carried out at least annually and challenged by

the ORRC. CSA is a technique whereby managers and colleagues systematically assess the controls within the areas for which they are responsible; to assess the extent to which they succeed in contributing to the achievement of business objectives and guarding against operational risks. The aim of the CSA is to provide positive assurance that management has an adequate level of control of the Bank's material risks, on the basis of both design and operation of controls.

Principal risks and uncertainties

The principal risks to the Bank are retail and wholesale credit risk, liquidity risk, market risk, operational risk and regulatory change. This is consistent with the assessment of top risks arising from the Bank's risk model as described on page 3 and page 29. The table below sets out these risks in more detail and also provides examples of relevant controls and mitigating factors. It should be noted that the strategic risk map goes beyond this assessment and captures less material risks that may still impact the business.

Principal risk	Nature of risk	Key controls and mitigating factors
Economic environment including retail credit risk	The Bank is exposed to UK economic conditions. Adverse changes in unemployment, indebtedness, consumer confidence, and consumer spending would all have the potential to impact the credit quality of the Bank's underlying assets as well as new lending activity.	<ul style="list-style-type: none"> Regular reporting framework in place to identify adverse performance versus forecast and risk appetite. Tracking includes reference to external benchmarking. Dedicated credit risk team who report directly to the Chief Risk Officer. Low risk appetite with better than industry average credit quality being maintained. Impact of severe economic scenarios regularly considered as part of stress testing and capital adequacy assessment process.
Wholesale credit risk	The bank is exposed to losses where institutional counterparties fail or do not meet their contractual cash flow obligations.	<ul style="list-style-type: none"> Credit risk reporting to ALCO, ERC, BRC, Audit Committee and Board including reference to credit default swap (CDS) prices, news and industry consensus. Daily reporting to ALCO on economic environment and any pertinent industry information. Weekly credit risk meetings and weekly summary documents to Board. Regular stress testing and daily monitoring of pricing. Any changes to risk appetite or credit lines approved by ALCO, ERC, BRC and Board.
Liquidity risk	The risk of the Bank being unable to meet its obligations as they fall due.	<ul style="list-style-type: none"> Liquidity crisis management plan in place and subject to regular review and testing. Strong treasury function with daily liquidity risk early indicators and escalation process in place. Robust liquidity position with stock of highly marketable liquid assets that can be utilised to meet liquidity requirements stemming from unexpected events. Internal limits in place to ensure liquid assets are held at a level significantly above regulatory requirements. No reliance on short term wholesale funding and low liquidity risk appetite as evidenced by Individual Liquidity Adequacy Review. FSA oversight of management's assessment of liquidity risk. Increasingly diversified funding base, reducing impact on liquidity in event of unforeseen events.
Market risk	The risk that net interest income is compressed through changes in the external rate environment or unexpected customer behaviour.	<ul style="list-style-type: none"> Detailed market risk policy exists that sets out risk appetite statement with reference to defined interest rate shocks. Regular reporting to ALCO versus limit structure ensuring that earnings and market value sensitivity is within limits. Monthly reporting of prepayment behaviour versus forecast and general product re-pricing assumptions. Rate view committee exists where possible future direction of Bank rate is discussed. All new banking products or amendments to the terms of existing products are reviewed from an interest rate risk perspective to ensure compliance with existing risk appetite.

Principal risk	Nature of risk	Key controls and mitigating factors
Operational risk	Represents the risk of loss stemming from failed processes, human error or fraud.	<ul style="list-style-type: none"> Operational risk team in place reporting directly to the Chief Risk Officer. Annual control self assessment exercise undertaken where adequacy of control framework is considered and action plans agreed. Ongoing maintenance of strategic risk maps and risk registers with appropriate oversight by ORRC, ERC, BRC and Board. Risk registers include quantification of risks following an agreed methodology. Process in place for capturing operational risk 'losses' and ensuring action is taken to mitigate the possibility of reoccurrence. Formal engagement with joint venture partners to understand impact of parent led change. Project lifecycle methodology in place and projects managed according to level of assessed risk.
Regulatory change	The risk of the Bank failing to meet the requirements of legislation, regulatory requirements as defined by the FSA and any other requirements from relevant regulatory bodies.	<ul style="list-style-type: none"> Regulatory risk team in place reporting directly to the Chief Risk Officer. Pro-active monitoring of regulatory change and communication to relevant owners in the business. Tracking of actions required and impact on the business. Regular reporting of regulatory risks to ORRC, ERC, BRC, and Board. Regular and open communication with the FSA on all aspects of Bank activity but with particular focus on regulatory risk. Treating Customer Fairly considerations fully embedded into all relevant Bank activities and employee performance management framework.

Capital and liquidity

The FSA sets and monitors capital requirements for the Bank. In implementing current capital requirements the FSA requires the Bank to maintain a prescribed level of capital with reference to risk weighted assets and the perceived risk management framework. Our submissions to the FSA in the year have shown that the Bank has complied with all externally imposed capital requirements.

The Bank manages its capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of its activities. Note 30 provides information on the capital resources of the Bank at the year end. The Bank's regulatory capital position at 31 December 2011 and 31 December 2010 was as follows:

	31 December 2011 (unaudited) £m	31 December 2010 (unaudited) £m
Risk weighted assets	2,128.3	2,589.6
Core Tier 1 capital ratio	9.6%	8.3%
Total capital ratio	14.4%	13.4%

The Bank will disclose Pillar 3 information as required by the Capital Requirements Directive and FSA prudential sourcebook on the J Sainsbury plc external website during June 2012.

The funding and liquidity position of the Bank remained robust throughout the year. This is described in more detail in note 29. Customer deposits continued to be well in excess of customer lending, such that the Bank was able to reduce the level of customer deposits in line with funding requirements. The Bank has maintained a significant level of highly liquid assets and whilst this was decreased slightly to £451.3m a higher coverage of retail deposits has been maintained versus the prior year at 15.6% (2010: £500.5m, 14.1% of retail deposits).

Going concern and position of the Bank at the end of the financial year

The Directors believe that the Bank is in a stable financial position and is well placed to generate profits in the future as demonstrated through the 2009-2011 financial performance which has occurred against a challenging economic backdrop. In assessing whether the going concern basis continues to be appropriate, the Bank has considered the Financial Reporting Council's (FRC) guidance on assessing going concern and liquidity risk.

The risk management framework is considered adequate in managing liquidity and other key risks in the current environment. During the year the Bank has strengthened both its Capital and Liquidity position and has also been subject to review and challenge by the FSA as part of its remit as lead regulator of the Bank. Further information on the key financial risks of the business can be found in Note 29.

Whilst the Bank outsources many of its operations to other partner providers, including parties within the Lloyds Banking Group plc, the Board does not consider these arrangements to be susceptible to those parties' going concern status. This is due to the likelihood of an orderly rundown in the event of administration, and the ability of the Bank to migrate operations as outlined in the terms of the agreements to alternative providers over a period of 12 months.

The Directors are satisfied that the Bank has adequate resources to continue in business for the foreseeable future taking into account a range of possible operational and legal scenarios. Consequently the going concern basis continues to be appropriate in preparing the accounts.

Issued share capital

The amount of issued share capital was unchanged from the previous year at £170m (Note 24).

Dividends

The profit after tax for the year attributable to the shareholders is £29.9m (2010: £20.6m). The Directors do not recommend payment of a dividend (2010: £nil).

Directors

The Directors at 31 December 2011 were:

Mr Darren Shapland
(Chairman)

Ms Gwyn Burr

Ms Hannah Bernard

Mr Alasdair Lenman

Mr David Fisher
(Chief Executive Officer)

Mr Ian Fox

Mr David Nicholson

Mr John Rogers

Mr John Galloway Appointed 1 April 2011

Mr Richard Keys Appointed 26 July 2011

Mr Alan Cook Appointed 26 July 2011

The Board comprises three Executive Directors and eight Non-Executive Directors. Mr Alasdair Lenman, Mr Ian Fox, Mr David Nicholson and Mr John Galloway are employed and remunerated by Lloyds Banking Group plc. Mr Darren Shapland, Ms Gwyn Burr, Ms Hannah Bernard, Mr David Fisher and Mr John Rogers are employed and remunerated by J Sainsbury plc. Mr Richard Keys and Mr Alan Cook are independent Non-Executive Directors who are not employed by either parent organisation.

With the exception of Mr John Galloway, Mr Richard Keys and Mr Alan Cook, who were appointed during the year, all of the Directors in office at the date of this report served throughout the year.

No other Directors served during the year to 31 December 2011.

Directors' indemnities

The Bank has provided an indemnity for the benefit of all of its current Directors which is a qualifying third party indemnity provision for the purpose of the Companies Act 2006. This was in force throughout the financial year and also at the date of approval of these financial statements.

Charitable and other donations

During the year the Bank made charitable donations in the UK of £10,703 (2010: £11,091). A total of £9,003 was donated to the 2011 Comic Relief event with the remaining amounts supporting various local charities. In the prior year £10,591 was donated to the 2010 Sport Relief event. No political donations were made during the year (2010: £nil).

Employees

The Bank is committed to employment policies, which follow best practice, based on equal opportunities for all employees, irrespective of sex, race, colour, disability or marital status. The Bank gives full and fair consideration to applications for employment from disabled persons, having regard to their particular aptitudes and abilities. Appropriate arrangements are made for the continued employment and training, career development and promotion of disabled persons employed by the Bank. If colleagues become disabled the Bank continues employment, either in the same or an alternative position, with appropriate retraining being given if necessary.

The Bank values the contribution of colleagues and recognises that business objectives cannot be achieved without attracting and developing high quality employees. The Bank is committed to being an equal opportunities employer and has in place a number of processes to ensure colleagues are engaged in the business and are able to develop over time. The Bank maintains a colleague forum, which regularly collates feedback from colleagues on matters of employee interest or concern and engages with management to address issues arising. Employee views on the Bank's performance and as a place of work are also gathered by internet based surveys and through departmental meetings. Information is provided to colleagues through regular newsletters and through the Bank's Intranet Updates on business performance and the financial and economic factors that affect the performance of the Bank are provided through regular newsletters and briefing sessions. Colleague development is important to the Bank and is monitored through individual development plans with access to a wide range of training resources. Employee performance is monitored and encouraged through continuous assessment against set objectives.

Suppliers

The Bank recognises the importance of maintaining good business relationships with its suppliers and is committed to paying all invoices within agreed terms. The average number of days' credit taken at 31 December 2011 was 22 days (2010: 26 days).

Change of auditor

KPMG Audit LLP resigned as auditor of the Bank on 2nd March 2011. PricewaterhouseCoopers LLP was appointed as auditor on 2nd March 2011. PricewaterhouseCoopers LLP have indicated their willingness to remain in office.

Statement as to disclosure of information to auditors

At the date of this report, each of the Directors in office has taken all the steps that he/she ought to have taken as a Director in order to make himself/herself aware of any relevant audit information and to establish that the Bank's auditors are aware of that information. As far as each director is aware, there is no relevant audit information of which the Bank's auditors are unaware.

By order of the Board and signed on its behalf by

Hannah Bernard
Company Secretary
London
1st March 2012

Accounting policies

(a) Statement of compliance

The Bank's financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), and interpretations issued by the International Financial Reporting Interpretations Committee of the IASB as adopted by the European Union. The accounts also comply with those parts of the Companies Act 2006 applicable to companies reporting under IFRS.

(b) Basis of preparation

These financial statements have been prepared under the historical cost convention, as modified by the revaluation of Available for Sale financial assets, and financial assets and liabilities (including derivative instruments) held at fair value through profit and loss.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the company's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed at section(s) below.

The financial statements have been prepared on a going concern basis. This is discussed in the Report by the Board of Directors to the Shareholders on page 5, under the heading 'Going Concern'.

(c) Designation of financial instruments

The Bank has classified its financial instruments in accordance with IAS 39 'Financial Instruments: Recognition and Measurement' as follows:

Non-derivative financial assets where there is no active market and which have fixed or determinable payments are classified as 'loans and receivables'. No assets are held for trading. Derivative instruments are automatically classified as 'at fair value through profit or loss' unless they form part of an effective hedging relationship. No financial assets are designated as 'held to maturity'. All other financial assets are classified as 'available for sale'. All other financial liabilities are classified as 'at amortised cost'.

The resulting treatment of these financial instruments is set out in the accounting policies below.

(d) Loans and advances including impairment

Loans and advances are initially recognised at fair value and subsequently held at amortised cost, using the effective interest method, less provision for impairment and recognised on the balance sheet when cash is advanced.

For the Bank's portfolios of loans, such as credit card lending and personal loans, impairment provisions are calculated for groups of assets, otherwise impairment is identified at a counterparty specific level following objective evidence that a financial asset is impaired. Such evidence may include a missed interest or principal payment or the breach of a banking covenant. The present value of estimated cash flows recoverable is determined after taking into account any security held. The amount of impairment is calculated by comparing the present value of the cash flows discounted at the loan's original effective interest rate with the balance sheet carrying value. If impaired, the carrying value is adjusted and the difference charged to the income statement and a provision recognised in the balance sheet.

The written down value of the impaired loan is compounded back to the net realisable balance over time using an effective interest rate. This is reported through interest receivable within the income statement and represents the unwinding of the discount.

A write-off is made when all or part of a loan or advance is deemed uncollectable or forgiven. Write-offs are charged against previously established provisions for impairment or directly to the income statement. Subsequent recoveries of amounts written off decrease the charge for loan impairment in the income statement.

An allowance for impairment losses is also maintained in respect of assets which are impaired at the balance sheet date but which have not been identified as such, based on historical loss experience and other relevant factors. The methodology and assumptions used are regularly reviewed to reduce any differences between estimates and actual results.

(e) Investment securities including impairment

These comprise debt securities and other fixed interest securities, including treasury and other eligible bills and are recognised on the date the contract is entered into. They are classified as 'available for sale' and carried on the balance sheet at fair value with unrealised gains or losses being recognised through reserves.

Income on available for sale debt securities is recognised on an effective interest rate basis and taken to interest receivable through the income statement. On sale, maturity or impairment deferred gains and losses arising from available for sale securities are recognised in other operating income.

Investment securities classified as available for sale are continually reviewed at the specific investment level for impairment. Impairment is recognised when there is objective evidence that a specific financial asset is impaired. Objective evidence of impairment might include a significant or prolonged decline in market value below the original cost of a financial asset and, in the case of debt securities, non-receipt of due interest or principal repayment, a breach of covenant within the security's terms and conditions or a measurable decrease in the estimated future cash flows since their initial recognition.

The disappearance of active markets, declines in market value and ratings downgrades do not in themselves constitute objective evidence of impairment and, unless a default has occurred on a debt security, the determination of whether or not objective evidence of impairment is present at the balance sheet date requires the exercise of management judgement.

(f) Property, plant and equipment

Property, plant and equipment includes fixtures and fittings, and computer hardware costs and is stated at historical cost less depreciation and impairment losses. Historical cost includes expenditure that is directly attributable to the acquisition of the items. The cost is written off, on a straight-line basis, over the expected lives of the assets, generally between one and ten years.

Property, plant and equipment are assessed for impairment where there is an indication of impairment. Where impairment exists, the carrying amount of the asset is reduced to its recoverable amount and the impairment loss recognised in the income statement. The depreciation charge for the asset is then adjusted to reflect the asset's revised carrying amount.

(g) Intangible assets - software development costs

Computer software and systems

Purchased computer software licenses are capitalised on the basis of the costs incurred to acquire, and bring into use, the specific software. These costs are amortised, on a straight-line basis, over the expected useful lives of the assets (three to five years).

Internally generated computer software and systems including website

Costs directly associated with the production of identifiable and unique software products or systems that are considered likely to generate economic benefits, and are capable of operating in the manner intended by management, are recognised as intangible assets. Such intangible assets arising from development of software and/or systems are amortised, on a straight line basis, over their useful economic lives (not exceeding four years) from the date the product is available for use. Other expenditure, including software research development costs are expensed as incurred.

Capitalised development expenditure and purchased software is stated at cost less accumulated amortisation and impairment losses. Such assets are assessed for impairment where there is an indication of impairment. Where impairment exists, the carrying amount of the asset is reduced to its recoverable amount and the impairment loss recognised in the income statement. The amortisation charge for the asset is then adjusted to reflect the asset's revised carrying amount.

Subsequent expenditure is only capitalised when it increases the future economic benefits embodied in the specific asset to which it relates.

(h) Income recognition

Interest income and expense are recognised in the income statement for all financial instruments measured at amortised cost using the effective interest method. This calculation takes into account all amounts that are integral to the yield as well as incremental transaction costs. The effective interest rate is the rate that discounts the expected future cash flows over the expected life of the financial instrument to the net carrying amount of the financial asset or liability at initial recognition.

Fees and commissions, that are not integral to the effective interest rate calculation, are recognised in the income statement as services are provided. Where in the case of insurance commissions the income comprises an initial commission and profit share both are recognised on completion of the service to the extent reliably measurable. Where there is a risk of potential claw back, an appropriate element of the commission receivable is deferred and amortised over the life of the underlying loan or period of claw back.

(i) Taxation

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 equity. Taxation is determined using tax rates (and laws) enacted or substantially enacted at the balance sheet date. Deferred tax is provided 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.

Deferred tax assets and liabilities are offset against each other when there is a legally enforceable right to set-off current taxation assets against current taxation liabilities and it is the intention to settle these on a net basis.

(j) Nectar points

The costs of Nectar points, awarded as incentives to Sainsbury's Bank customers, are recognised when earned by the customer. For certain insurance products double nectar points are awarded on spend in J Sainsbury's plc stores subject to a cap for 2 years provided there are no claims on the policy and that renewal occurs. The estimated annual cost of the points is recognised at the point of sale for the first year of the offer. The cost of points is recognised within administrative expenses or as a deduction from non-interest income depending on whether the Bank is acting as a principal or agent.

(k) Cash and cash equivalents

Cash and cash equivalents comprise cash in hand, deposits at central banks and money market funds. For the purpose of the Cash Flow Statement cash and cash equivalents omits deposits at central banks and includes Treasury bills and other short term highly liquid investments that are readily convertible to a known amount of cash and are subject to an insignificant risk of changes in value.

(l) Other borrowed funds

Other borrowed funds comprise subordinated liabilities, which consist of dated and undated loan capital. These are initially recognised at fair value and subsequently held at amortised cost and the interest payable is recognised in the income statement through interest payable.

(m) Financial liabilities

Financial liabilities comprise deposits from banks and customer accounts. All financial liabilities are initially recognised at fair value and subsequently measured at amortised cost using the effective interest rate method. A financial liability is derecognised from the balance sheet when the Bank has discharged its obligations, the contract is cancelled or expires.

(n) Foreign currencies

The accounts are presented in sterling which is the Bank's functional and presentation currency.

Foreign currency transactions are translated into sterling at the exchange rate prevailing at the date of the transaction. Monetary assets and liabilities are translated at balance sheet date exchange rates. Exchange differences arising are recognised in the income statement.

(o) Derivative instruments

All derivative instruments are initially measured at fair value on the contract date and are also measured at fair value at subsequent reporting dates. Changes in fair value of any derivative instrument that is not part of a hedging relationship are recognised immediately in the income statement. The Bank designates certain derivatives as either:

1. hedges of the fair value of the particular risks inherent in recognised assets or liabilities (fair value hedges).
2. hedges of highly probable future cash flows attributable to recognised assets or liabilities (cash flow hedges).

These are accounted for as follows:

(a) Cash flow hedging

During the year the Bank used cash flow hedging as a risk management tool for hedging foreign exchange rate risk on on-balance sheet assets.

Cash flow hedge accounting matches the cash flows of hedged items against the corresponding cash flow of the hedging derivative. The effective part of any gain or loss on a hedging instrument is recognised directly in equity in the cash flow hedge reserve and the hedged item is accounted for in accordance with the policy for that financial instrument. Any ineffective portion of the hedging instrument's fair value is recognised immediately in the income statement through net trading income.

The amount deferred in reserves remains until the designated transaction occurs at which time it is released and accounted for in the income statement in line with the treatment of the hedged item. Should circumstances arise where the hedge relationship subsequently proves ineffective, is early settled or is terminated the associated gains and losses that were recognised directly in reserves are reclassified to the income statement through net income.

(b) Portfolio fair value hedging

During the year the Bank used fair value hedging as a risk management tool for hedging interest rate risk on the personal loans portfolio.

Fair value hedging matches the change in value of designated hedged items against the corresponding change in value of the hedging derivative. The designated hedged item can be a recognised asset or liability, a firm commitment or an identified portion of an asset. Portfolio fair value hedging allows the designation of the whole or part of a portfolio of assets or liabilities with similar risk exposures. The hedged item can be designated based on expected maturities to match the hedging derivative maturity. The effective part of any gain or loss on the hedged item adjusts the balance of the item and is recognised through profit or loss offsetting the gain or loss on the hedging derivative.

Should circumstances arise where the hedge relationship subsequently proves ineffective, is early settled or is terminated the adjustment to the balance of the hedged item is reversed and associated gains and losses that were recognised in profit and loss are reversed.

(p) Marketing expenditure

All marketing and expenditure related to the acquisition of customer accounts is written off as incurred.

(q) Provisions

The Bank recognises a provision if there is a present obligation as a consequence of either a legal or a constructive obligation resulting from a past event. To recognise this it should be probable that an outflow of economic resources, that can be reliably measured, will be required to settle the obligation. Provisions are measured as the discounted expected future cash flows taking account of the risks and uncertainties associated with the specific liability where appropriate.

(r) New accounting standards

The following IFRS standards and International Financial Reporting Interpretations Committee ('IFRIC') interpretations have been applied in 2011:

IAS 24 (revised) 'Related Party Disclosures' The revised standard introduces two main changes to related party disclosures. It clarifies and simplifies the definition of a related party, but also enhances the definition such that some entities will be required to make additional disclosures to those given under the previous standard. The revised standard also removes the requirement for government-related entities to disclose details of all transactions with the government and other government-related entities and instead requires more limited disclosures of these transactions. The amendment has had no impact on the financial statements of the Bank.

IAS 32 'Financial Instruments: Presentation'. The standard has been updated to address the accounting for rights issues (rights, options or warrants) that are denominated in a currency other than the functional currency of the issuer. Prior to the amendment, such rights issues were accounted for as derivative liabilities. The amendment states that, if such rights are issued pro rata to an entity's existing shareholders for a fixed amount of any currency, they should be classified as equity, regardless of the currency in which the exercise price is denominated. The amendment has had no impact on the financial statements of the Bank.

IFRS 1 'First Time Adoption'. References to a fixed date of '1 January 2004' have been replaced with 'the date of transition to IFRSs', thus eliminating the need for companies adopting IFRSs for the first time to restate derecognition transactions that occurred before the date of transition to IFRSs. A second amendment provides guidance on how an entity should resume presenting financial statements in accordance with IFRSs after a period when the entity was unable to comply with IFRSs because its functional currency was subject to severe hyperinflation. The amendment has had no impact on the financial statements of the Bank.

IFRIC 14 'Prepayments of a Minimum Funding Requirement'. This update provides guidance on assessing the limit in IAS 19, 'Employee Benefits', on the amount of the surplus that can be recognised as an asset. It also explains how the pension asset or liability may be affected by a statutory or contractual minimum funding requirement. The amendment has had no impact on the financial statements of the Bank.

IFRIC 19 'Extinguishing Financial Liabilities with Equity Instruments'. This interpretation clarifies the accounting when an entity renegotiates the terms of its debt with the result that the liability is extinguished through the debtor issuing its own equity instruments to the creditor. A gain or loss is recognised in the profit and loss account based on the fair value of the equity instruments compared to the carrying amount of the debt. The amendment has had no impact on the financial statements of the Bank.

'Improvements to IFRSs' (April 2010): Several small amendments have been made to a number of standards. None of these amendments have had a significant impact on the financial statements of the Bank. Several changes have been made to IFRS 7 within the 2010 annual improvements project with minor changes to disclosures in the financial statements. In all cases these changes lead to reduced disclosure requirements.

(s) Critical accounting judgements and estimates

The preparation of accounts requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, most critically in respect of impairment losses on loans and advances, effective yield and the valuation of investment securities.

Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. 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.

Critical accounting judgements

The critical accounting judgements made by the Bank that have a material financial impact on the financial statements are as follows:

Impairment of investment securities

Investment securities classified as available for sale are continually reviewed at the specific investment level for impairment. Impairment is recognised when there is objective evidence that a specific financial asset is impaired. Objective evidence of impairment might include a significant or prolonged decline in market value below the original cost of a financial asset and, in the case of debt securities, non-receipt of due interest or principal repayment, a breach of covenant within the security's terms and conditions or a measurable decrease in the estimated future cash flows since their initial recognition.

The disappearance of active markets, declines in market value and ratings downgrades do not in themselves constitute objective evidence of impairment and, unless a default has occurred on a debt security, the determination of whether or not objective evidence of impairment is present at the balance sheet date requires the exercise of management judgement. This judgement is even more important and challenging in the current market conditions when market activity is significantly reduced.

Deferred tax

Deferred tax assets and liabilities require management judgement in determining the amounts to be recognised. In particular, when assessing the extent to which deferred tax assets should be recognised with consideration given to the timing, nature and level of future taxable income. The recognition of deferred tax assets relating to tax losses carried forward relies on profit projections and taxable profit forecasts prepared by management, where a number of assumptions are required based on the levels of growth in profits and the reversal of deferred tax balances.

Critical accounting estimates

The critical accounting estimates made by the Bank are set out below. Disclosures about estimates and the related assumptions are also included in the appropriate Note to the Financial Statements.

Impairment losses on loans and advances

Impairment loss calculations involve the estimation of future cash flows of financial assets, based on observable data at the balance sheet date and historical loss experience for assets with similar credit risk characteristics. This will typically take into account the level of arrears, security, past loss experience and default levels. These calculations are undertaken on a portfolio basis using various statistical modelling techniques. Impairment models are continually reviewed to ensure data and assumptions are appropriate with the most material assumption being around expected loss rates. The accuracy of any such impairment calculation will be affected by unexpected changes to the economic situation, and assumptions which differ from actual outcomes. As such, significant judgement is applied in selecting and updating impairment models.

Effective yield

In calculating the effective interest rate of a financial instrument the Bank takes into account all amounts that are integral to the yield of a financial instrument as well as incremental transaction costs. In the case of loans and advances significant judgement is applied in estimating the effect of various factors on future cash flows. In the case of insurance commissions income comprises an initial commission and profit share both of which are recognised on completion of the service to the extent reliably measurable. Where there is a risk of claw back judgement is applied in deferring an appropriate element of the commission receivable and amortising this over an expected average life.

Determining fair values

The determination of fair value for financial assets and liabilities for which there is no observable market price requires the use of various valuation techniques some of which require significant degrees of judgement.

The main methodologies and assumptions used in estimating the fair values of financial instruments are as follows:

- **Cash and cash equivalents**
Fair value approximates to carrying value because they have minimal credit losses and are either short term in nature or re-price frequently.
- **Loans and advances to customers**
The fair value of loans and advances is estimated by discounting anticipated cash flows, including interest, at a current market rate of interest.
- **Loans and advances to banks and deposits by banks**
The fair value of floating rate placements and overnight deposits is equal to carrying value. The fair value of fixed interest bearing deposits is based on cash flows discounted using current money market interest rates for debts with similar maturity and credit risk characteristics.
- **Customer accounts and other borrowings**
The fair value of customer deposits with no stated maturity date is the amount repayable on demand. The estimated fair value of fixed interest-bearing deposits and other borrowings with no quoted market price is calculated using a cash flow model discounted using interest rates for debts with similar maturity.
- **Investment securities**
Fair value is based on market prices or broker/dealer valuations. Where this information is not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics. In 2011 and 2010 all securities were valued from market prices or broker/dealer valuations.
- **Derivatives**
Fair value is based on valuation techniques including discounted cash flow models using solely observable market data. The most significant inputs into these models are interest rate yield curves which are developed from publicly quoted rates.

Qualifying hedge relationships

In designating financial instruments as qualifying hedge relationships, the Bank has determined that it expects the hedge to be highly effective over the life of the hedging instrument. In accounting for derivatives as cash flow hedges, the Bank has determined that the hedged cash flow exposure relates to highly probable future cash flows.

Provisions and contingent liabilities

The Bank has acted as an introducer to Lloyds Banking Group ('LBG') in relation to the sale of certain past products. In 2009 the Bank recorded a provision to cover estimated costs to LBG in connection with these sales, capped in accordance with the commercial terms agreed. The liability has now fully crystallised.

Commission claw back

Where the Bank receives commission and there is a risk of potential claw back, an appropriate element of the commission receivable is deferred and amortised over the life of the underlying loan or period of claw back. The principal assumptions underlying the level of deferred income relate to the volume of cancellation, write off or early settlement activity as well as the timing of this. Actual levels of claw back are regularly reviewed against model assumptions.

Double nectar points

The Bank offers double nectar points on customer spend in Sainsbury's stores for up to 2 years on purchase of certain savings, personal loan, credit card and insurance products. Points earned in relation to savings, credit card and personal loan products are recognised as incurred as this is the point the customer is entitled to the points. In the case of points earned by customers with insurance products, the Bank provides for the full cost of anticipated nectar points for a year (linked to spend) for each insurance sale. Where a customer renews at the end of the first year, a further provision is recognised. Costs are estimated based on a model of forecast volumes, expected customer profiles, in-store spending levels, and spending caps on the amount of points per month. This model is reassessed at regular intervals.

Financial Services Compensation Scheme (FSCS)

The ultimate liability for levies payable to the FSCS in respect of those financial institutions which collapsed during the 2008 financial year remains uncertain. The amount provided by the Bank is the latest estimate of the contribution required in respect of the period of the initial facility from HM Treasury as well as an assumed extension of the funding arrangements beyond April 2012 as indicated in the document 'FSCS plan and budget: 2012/2013'. This contribution is dependent upon the following factors:

- Future interest rates;
- The Bank's share of industry protected deposits; and
- Finalisation of the principal balance of the HM Treasury loans, including the extent to which the FSCS can recover assets to fund their repayment.

The Bank is aware that further fees, in respect of the final terms associated with extending the period of the initial loan facility or any compensation payments should the FSCS fail to recover sufficient funds to repay its loans, are possible but has not made any provision for them as they cannot be reliably estimated.

The outstanding principal on the loans was originally due to be repaid from April 2012 and the FSCS are currently involved in discussions with HM Treasury regarding refinancing the loan for an extended period. Although the basis of any future levy beyond April 2012 has not been communicated by the FSCS at this stage, the FSCS plan and budget: 2012/2013 has indicated an extension of funding arrangements and the Bank has deemed it prudent to provide for its share of a further levy based on the interest due on the existing facility. The FSCS have historically estimated that a 0.5% increase in LIBOR would result in a £100m increase in the overall annual FSCS levy based on borrowing levels. The Bank share of this based on the 31 December 2011 deposit level would be £0.3m. Further detail of the FSCS and the provision are included in note 21.

(t) IFRS and IFRIC not yet applied

The following standards and interpretations have not yet been adopted by the European Union, are not effective for the year ended 31 December 2011 and have not been applied in preparing the financial statements:

IAS 1 'Financial statement presentation'. This amendment changes the disclosure of items presented in other comprehensive income (OCI) in the statement of comprehensive income on the basis of whether they are potentially recycled to profit or loss. This would have no effect on the financial statements of the Bank.

IAS 12 'Deferred Tax: Recovery of Underlying Assets'. This amendment provides guidance for measuring deferred tax liabilities and deferred tax assets when investment property is measured using the fair value model in IAS 40. This standard is not expected to have a material impact on the financial statements of the Bank.

IAS 19 'Employee Benefits'. This amendment makes significant changes to the recognition and measurement of defined benefit pension expense and termination benefits, and to the disclosures for all employee benefits. This would have no effect on the financial statements of the Bank.

IAS 27 (revised) 'Separate Financial Statements'. This standard includes the provisions on separate financial statements that are left after the control provisions of IAS 27 have been included in the new IFRS 10. This would have no effect on the financial statements of the Bank.

IAS 28 (revised) 'Associates and Joint Ventures'. This standard includes the requirements for joint ventures, as well as associates, to be equity accounted following the issue of IFRS 11. This would have no effect on the financial statements of the Bank.

IFRS 7 (revised) 'Financial Instruments: Disclosures'. Amendments regarding derecognition disclosures of financial assets were introduced as part of the IASBs comprehensive review of off-balance sheet activities. The amendments promote transparency in the reporting of transfer transactions to improve users' understanding of the risk exposures relating to transfers of financial assets and the effect of those risks on an entity's financial position, particularly those involving securitisation of financial assets. The amendment would have no impact on the financial statements of the Bank.

IFRS 9, 'Financial Instruments Part 1: Classification and Measurement'. IFRS 9 was issued in November 2009 and replaces those parts of IAS 39 relating to the classification and measurement of financial assets. Key features are as follows:

- Financial assets are required to be classified into two measurement categories: those to be measured subsequently at fair value, and those to be measured subsequently at amortised cost. The decision is to be made at initial recognition. The classification will depend on the approach taken by the Bank for managing its financial instruments and the contractual cash flow characteristics of the instrument.
- An instrument is subsequently measured at amortised cost only if it is a debt instrument and both the objective of the Bank's business model is to hold the asset to collect the contractual cash flows, and the asset's contractual cash flows represent only payments of principal and interest (that is, it has only 'basic loan features'). All other debt instruments are to be measured at fair value through profit or loss.
- All equity instruments are to be measured subsequently at fair value. Equity instruments that are held for trading will be measured at fair value through profit or loss. For all other equity investments, an irrevocable election can be made at initial recognition, to recognise unrealised and realised fair value gains and losses through other comprehensive income rather than profit or loss. There is to be no recycling of fair value gains and losses to profit or loss. This election may be made on an instrument-by-instrument basis. Dividends are to be presented in profit or loss, as long as they represent a return on investment.

IFRS 9 has not yet been endorsed by the EU. While adoption of IFRS 9 is mandatory from 1 January 2013 (an exposure draft has been released which proposes later mandatory adoption at 1 January 2015), earlier adoption is permitted. During the year the Bank has considered the possible impact of the standard on those instruments currently classified within the Available for Sale category. This will be influenced by the characteristics of financial instruments at the date of adoption and at this stage it is not considered possible to determine the overall impact on the financial statements of this change.

IFRS 9 is the initial stage of the project to replace IAS 39. Further stages exist to deal with changes to the classification and measurement of financial liabilities, impairment of financial assets measured at amortised cost and hedge accounting. As information becomes available the Bank will assess the impact of these changes on the financial statements.

IFRS 10 'Consolidated Financial Statements'. This standard builds on existing principles by identifying the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements, providing additional guidance to assist in determining control where this is difficult to assess. This would have no effect on the financial statements of the Bank.

IFRS 11 'Joint Arrangements'. This standard provides for a more realistic reflection of joint arrangements by focusing on the rights and obligations of the arrangement, rather than its legal form. It discusses two types of joint arrangements: joint operations and joint ventures. Joint operations arise where a joint operator has rights to the assets and obligations relating to the arrangement and hence accounts for its interest in assets, liabilities, revenue and expenses. Joint ventures arise where the joint operator has rights to the net assets of the arrangement and hence equity accounts for its interest. Proportional consolidation of joint ventures is no longer allowed. This would have no effect on the financial statements of the Bank.

IFRS 12 'Disclosures of Interests in Other Entities'. This standard includes the disclosure requirements for all forms of interests in other entities, including joint arrangements, associates, special purpose vehicles and other off-balance sheet vehicles. This would have no effect on the financial statements of the Bank.

IFRS 13 'Fair Value Measurement'. This standard aims to improve consistency and reduce complexity by providing a precise definition of fair value and a single source of fair value measurement and disclosure requirements for use across IFRSs. The requirements, which are largely aligned between IFRSs and US GAAP, do not extend the use of fair value accounting but provide guidance on how it should be applied where its use is already required or permitted by other standards within IFRSs or US GAAP. This is not expected to have a material effect on the financial statements of the Bank.

Income statement

for the year to 31 December 2011

	Note	2011 £m	2010 £m
Interest receivable	3	219.5	218.3
Interest payable	3	(85.3)	(102.1)
Net interest income		134.2	116.2
Fees and commissions receivable		99.0	98.7
Fees and commissions payable		(1.0)	(1.4)
Net operating income		232.2	213.5
Administrative expenses	5	(120.3)	(107.4)
Depreciation and amortisation			
Property, plant and equipment	6	(3.4)	(3.4)
Intangible assets	7	(1.3)	(0.8)
		(125.0)	(111.6)
Impairment losses on financial assets	9	(50.7)	(60.5)
Losses realised on financial instruments	10	(16.8)	(12.7)
Profit before taxation	4	39.7	28.7
Taxation	11	(9.8)	(8.1)
Profit for the year attributable to the owners of the Bank		29.9	20.6

The statement of accounting policies on pages 7 to 11 and the notes on pages 17 to 40 form part of these accounts.

Statement of comprehensive income

For the year to 31 December 2011

	31 December 2011 £m	31 December 2010 £m
Profit for the year	29.9	20.6
Other comprehensive income/(expense):		
Available for sale financial assets fair value movements	0.4	(13.1)
Cash flow hedges effective portion of fair value movements	1.8	2.4
Tax on items recognised directly in equity	(1.4)	3.0
Total other comprehensive income for the year net of tax	0.8	(7.7)
Total comprehensive income for the year	30.7	12.9

All amounts are attributable to the owners of the Bank.

The statement of accounting policies on pages 7 to 11 and the notes on pages 17 to 40 form part of these accounts.

Balance sheet

As at 31 December 2011

	Note	As at 31 December 2011 £m	As at 31 December 2010 £m
Assets			
Cash and cash equivalents	36	248.6	210.5
Financial Investments - Available for Sale			
Treasury bills	12	451.3	500.5
Investment securities	13	88.3	544.8
Loans and advances to banks	15	1,226.6	1,599.0
Loans and advances to customers	16	2,386.1	2,324.5
Property, plant and equipment	6	16.1	15.9
Intangible assets	7	4.7	2.4
Deferred tax asset	11	1.0	1.5
Other assets	17	58.8	90.0
Prepayments and accrued income		23.1	13.2
Total Assets		4,504.6	5,302.3
Liabilities			
Deposits by banks	18	1,171.7	1,277.5
Derivative financial instruments	14	21.7	108.9
Customer accounts	19	2,888.1	3,541.3
Other liabilities	20	27.7	17.6
Current tax liabilities		5.4	0.6
Provisions for liabilities and charges	21	3.6	2.9
Accruals and deferred income	22	28.1	25.9
Other borrowed funds			
Dated loan capital	23	60.0	60.0
Undated loan capital	23	50.0	50.0
Total Liabilities		4,256.3	5,084.7
Equity			
Called up share capital	24	170.0	170.0
Retained earnings	25	98.6	68.7
Other reserves	26	(20.3)	(21.1)
Equity shareholders' funds		248.3	217.6
Total Equity and Liabilities		4,504.6	5,302.3

The financial statements on pages 7 to 40 were approved by the Board of Directors on 1 March 2012 and signed on its behalf by:

Hannah Bernard
Director and Company Secretary
1st March 2012

David Fisher
Director and Chief Executive
1st March 2012

The statement of accounting policies on pages 7 to 11 and the notes on pages 17 to 40 form part of these accounts.

Sainsbury's Bank plc - Company number 3279730

Statement of changes in equity

For the year to 31 December 2011

	Share capital £m	Retained earnings £m	Other reserves £m	Total £m
At 31 December 2011				
At 1 January 2011	170.0	68.7	(21.1)	217.6
Profit for the year	-	29.9	-	29.9
Other comprehensive income/(expense):				
Available for sale financial assets fair value movements (net of tax)	-	-	(0.5)	(0.5)
Cash flow hedges effective portion of fair value movements (net of tax)	-	-	1.3	1.3
Total comprehensive income for the year	-	29.9	0.8	30.7
Additional share capital raised in the year	-	-	-	-
Balance at 31 December 2011	170.0	98.6	(20.3)	248.3

	Share capital £m	Retained earnings £m	Other reserves £m	Total £m
At 31 December 2010				
At 1 January 2010	170.0	48.1	(13.4)	204.7
Profit for the year	-	20.6	-	20.6
Other comprehensive income/(expense):				
Available for sale financial assets fair value movements (net of tax)	-	-	(9.4)	(9.4)
Cash flow hedges effective portion of fair value movements (net of tax)	-	-	1.7	1.7
Total comprehensive income for the year	-	20.6	(7.7)	12.9
Additional share capital raised in the year	-	-	-	-
Balance at 31 December 2010	170.0	68.7	(21.1)	217.6

All amounts are attributable to the owners of the Bank.

The statement of accounting policies on pages 7 to 11 and the notes on pages 17 to 40 form part of these accounts.

Cash flow statement

For the year to 31 December 2011

	Note	31 December 2011 £m	31 December 2010 £m
Cash flows from operating activities	33	(375.4)	62.9
Cash flows from investing activities	34	(5.7)	(5.4)
Cash flows from financing activities	35	(1.8)	(1.6)
Net (decrease) in cash and cash equivalents		(382.9)	55.9
Opening cash and cash equivalents	36	2,306.9	2,251.0
Closing cash and cash equivalents	36	1,924.0	2,306.9

The statement of accounting policies on pages 7 to 11 and the notes on pages 17 to 40 form part of these accounts.

Notes to the accounts

1 Staff

The nature of the joint venture is such that the Bank does not directly employ individuals. The individuals who work for the Bank have contracts of employment with either a member of the J Sainsbury plc group of companies or a member of the Lloyds Banking Group plc (LBG) group of companies. The remuneration cost of these individuals is met by the joint venture. The average weekly number of colleagues working on the Bank's operations during the year is set out below.

		2011 Number	2010 Number
Full time	Seconded colleagues	178	168
	Other colleagues	464	431
		642	599
Part time	Seconded colleagues	20	16
	Other colleagues	15	29
		35	45
		677	644

Secondees are directly seconded from the relevant members of the parent organisations to the Bank. The remaining colleagues are involved in processing activities for Bank products but are not classed as secondees. Colleague costs are disclosed in other administrative expenses in note 5.

The Bank incurs certain costs for colleagues who work for various entities within the LBG plc group of companies in accordance with and subject to certain agreed principles. These entities are participating employers in both a defined contribution pension scheme and a defined benefit pension scheme based upon final pensionable pay, operated by Lloyds Banking Group plc. A total of 61 (2010: 61) employees participate in the defined benefit scheme, the HBOS Final Salary Pension Scheme (HBOS FSPS), which was formed on 3 July 2006 following the merger of various other schemes within the HBOS plc group of companies.

As the Bank is not a participating employer in the HBOS FSPS it does not have a share in the scheme assets and liabilities and as such the pension recharges are treated as a defined contribution charge. The current defined benefit asset on the HBOS FSPS at 31 December 2011, valued on an IAS 19 basis, is £248m (2010: asset of £41m). The latest full actuarial valuation of the HBOS FSPS was carried out as at 31 December 2009 by a qualified independent actuary.

The Bank also incurs certain costs for colleagues who work for members of the J Sainsbury plc group of companies (some of these colleagues are members of a funded defined benefit scheme) in accordance with and subject to certain agreed principles. The scheme, 'Sainsbury's Pension Scheme', was formed during the year by the merger of the two pre-existing schemes ('J Sainsbury Pension and Death Benefit Scheme' and the 'J Sainsbury Executive Pension Scheme') as part of the settlement of the 2009 Triennial Actuarial Valuation for these schemes. A total of 15 (2010: 15) employees participate in the defined benefit scheme which was closed to new employees on 31 January 2002.

As the Bank is not a participating employer in the Sainsbury's Pension Scheme it does not have a share in the scheme assets and liabilities and as such the pension recharges are treated as a defined contribution charge. The defined benefit liability on the Sainsbury's Pension Scheme at March 2011, valued on an IAS 19 basis, was £241m (2010: liability of £303m). The latest full actuarial valuation of the Sainsbury's Pension Scheme was carried out as at March 2009 by a qualified independent actuary.

The pension cost recharge for the year represents contributions payable by the Bank to both types of pension scheme and amounted to £472,710 (2010: £278,803) for the defined contribution schemes and £606,646 (2010: £656,691) for the defined benefit schemes.

2 Directors' emoluments

	2011 £'000	2010 £'000
(i) Aggregate emoluments		
Aggregate emoluments	1,089	669
Aggregate amounts payable under long term incentive schemes	262	115

Retirement benefits have accrued or are accruing to 1 Director under the J Sainsbury plc defined benefit schemes (2010: 1). Benefits are also accruing to 1 Director under the Lloyds Banking Group plc money purchase scheme (2010: 0). In addition to the above, emoluments representing employer's pension contributions of £44k (2010: £30k) were made in the year.

The emoluments set out above include those Executive Directors who held office during the year, all of whom were employed by and paid by either J Sainsbury plc or Lloyds Banking Group plc. The Bank is recharged emolument costs in accordance with and subject to the terms of arrangements agreed with the relevant employer. No recharge is made by either organisation to the Bank in respect of shares in J Sainsbury plc or Lloyds Banking Group plc granted to colleagues. During the year 2 directors (2010: 1) received awards under these schemes reflective of qualifying services. One Director (2010: 1) exercised share options in the year.

Payments were made to independent Non-Executive Directors who served during the year. There was no recharge to the Bank in respect of emoluments for Non-Executive Directors who were employed by J Sainsbury plc or Lloyds Banking Group plc, as their emoluments are deemed to be wholly attributable to services to the respective shareholder companies. Accordingly, the above details include no emoluments in respect of these Non-Executive Directors.

	2011 £'000	2010 £'000
(ii) Highest paid Director		
Aggregate emoluments	603	409
Aggregate amounts payable under long term incentive schemes	-	115

The retirement benefits accruing in relation to the highest paid Director were £nil (2010: £nil).

3 Net interest income

	2011 £m	2010 £m
Interest income:		
Interest income on loans and receivables	215.7	214.0
Interest income from available for sale financial instruments	3.8	4.3
	219.5	218.3
Interest expense:		
Interest expense on loans and receivables	(83.8)	(100.3)
Interest expense on derivative liabilities	(1.5)	(1.8)
	(85.3)	(102.1)
Net interest income	134.2	116.2

Amounts relating to cash flow hedges transferred to profit or loss during the year are reflected as a component of interest income or expense. Net ineffectiveness recognised on cash flow hedges during 2011 was £nil (2010:£nil). Net ineffectiveness recognised on fair value hedges was £1,665 (2010: £nil)

4 Profit before taxation

	2011 £m	2010 £m
Profit before taxation is stated after taking account of the following:		
Income:		
Interest on impaired loan balances	2.1	2.2
Expenses:		
Loss on disposal of property, plant and equipment	-	0.1
Operating lease	0.8	0.6
Auditors' remuneration:		
Statutory audit of the Bank	0.2	0.2

5 Administrative expenses

	2011 £m	2010 £m
Staff costs	16.7	12.8
Marketing costs	25.6	23.8
Other administrative expenses	78.0	70.8
	120.3	107.4

6 Property, plant and equipment

31 December 2011	Equipment £m
Cost:	
At 1 January 2011	45.6
Additions	3.6
Disposals	(0.2)
As at 31 December 2011	49.0
Accumulated depreciation:	
At 1 January 2011	29.7
Charge for the year	3.4
Disposals	(0.2)
As at 31 December 2011	32.9
Net Book Value at 31 December 2011	16.1

31 December 2010	Equipment £m
Cost:	
At 1 January 2010	47.8
Additions	3.5
Disposals	(5.7)
As at 31 December 2010	45.6
Accumulated depreciation:	
At 1 January 2010	31.9
Charge for the year	3.4
Disposals	(5.6)
As at 31 December 2010	29.7
Net Book Value at 31 December 2010	15.9

7 Intangible assets

	Systems and Software Development £m
31 December 2011	
Cost:	
At 1 January 2011	14.4
Additions	3.6
Disposals	(0.1)
As at 31 December 2011	17.9
Accumulated amortisation:	
At 1 January 2011	12.0
Charge for the year	1.3
Disposals	(0.1)
As at 31 December 2011	13.2
Net Book Value at 31 December 2011	4.7

	Systems and Software Development £m
31 December 2010	
Cost:	
At 1 January 2010	14.0
Additions	1.9
Disposals	(1.5)
As at 31 December 2010	14.4
Accumulated amortisation:	
At 1 January 2010	12.7
Charge for the year	0.8
Disposals	(1.5)
As at 31 December 2010	12.0
Net Book Value at 31 December 2010	2.4

8 Capital commitments

	2011 £m	2010 £m
There are commitments in respect of capital expenditure which has been authorised, but not provided for in the accounts, for which contracts have been entered into, on:		
Property, plant and equipment	0.7	0.9
Software development	0.1	-
	0.8	0.9

9 Impairment losses on financial assets

	2011 £m	2010 £m
Loans and advances to customers	50.7	60.5

A reconciliation of impairment losses on loans and advances by class is set out as follows:

	Unsecured lending £m	Secured lending £m	2011 Total £m
12 months to 31 December 2011			
At 1 January 2011	121.9	-	121.9
New impairment provisions less releases (net of recoveries)	50.7	-	50.7
Amounts written off	(57.4)	-	(57.4)
Discount unwind on impaired loans and advances to customers	(2.1)	-	(2.1)
Cumulative impairment provisions as at 31 December 2011	113.3	-	113.3
New impairment provisions less releases	60.3	-	60.3
Recoveries of amounts previously written off	(9.6)	-	(9.6)
Net charge to income statement	50.7	-	50.7
Gross amount of loans individually determined to be impaired, before deducting any individually assessed impairment allowance	138.1	2.6	140.7

	Unsecured lending £m	Secured lending £m	2010 Total £m
12 months to 31 December 2010			
At 1 January 2010	156.9	-	156.9
New impairment provisions less releases (net of recoveries)	60.5	-	60.5
Amounts written off	(93.3)	-	(93.3)
Discount unwind on impaired loans and advances to customers	(2.2)	-	(2.2)
Cumulative impairment provisions as at 31 December 2010	121.9	-	121.9
New impairment provisions less releases	66.0	-	66.0
Recoveries of amounts previously written off	(5.5)	-	(5.5)
Net charge to income statement	60.5	-	60.5
Gross amount of loans individually determined to be impaired, before deducting any individually assessed impairment allowance	158.0	2.8	160.8

Impairment loss calculations involve the estimation of future cash flows of financial assets, based on observable data at the balance sheet date and historical loss experience for assets with similar credit risk characteristics. Impairment models are continually reviewed to ensure data and assumptions are appropriate. However, the accuracy of any such impairment calculation will be affected by unexpected changes to the economic situation, and assumptions which differ from actual outcomes.

10 Losses realised on financial instruments

The Bank sold a number of financial instruments in the year in order to reduce the overall wholesale credit risk of the Bank. This realised a loss of £16.8m (2010: £12.7m) previously accumulated in reserves.

11 Taxation

	2011 £m	2010 £m
(i) Taxation		
UK corporation tax on Profit for the year at 26.5% (2010: 28%)	9.3	7.7
Adjustments in respect of prior years	-	-
Current Tax	9.3	7.7
Deferred tax charge	0.4	0.4
Impact of change in UK corporation tax rate	0.1	-
Deferred Tax	0.5	0.4
Total Tax Charge	9.8	8.1

The taxation charge of £9,776,247 (2010: £8,125,867) represents 24.63% (2010: 28.3%) of pre-tax profits. The taxation charge incorporates a reduction in the deferred tax asset as a result of changes in the main rate of corporation tax from 27% to 25%. The rate change was substantively enacted in March 2011 and takes effect from 1 April 2012. Differences to the UK corporation tax rate for the year of 26.5% are explained below:

	2011 £m	2010 £m
(ii) Reconciliation of effective tax rate		
Profit on ordinary activities before taxation	39.7	28.7
Tax on ordinary activities at 26.5% (2010: 28%)	10.5	8.0
Effects:		
Change in tax rate	0.1	0.1
Impact of rate change on equity items	(0.8)	-
	9.8	8.1

(iii) Deferred taxation

The deferred tax asset, which is not wholly recoverable within one year and which is in respect of timing differences which will reverse and result in a lower tax charge in future years is as follows:

	2011 £m	2010 £m
Deferred tax asset		
At 1 January	1.5	2.0
Movement in deferred tax asset	(0.5)	(0.5)
As at 31 December	1.0	1.5
Tax effect of timing differences due to:		
Accelerated capital allowances	(0.2)	(0.1)
Timing differences on impairment provisions	1.1	1.6
Deferred bonus	0.1	-
Deferred tax asset at 31 December	1.0	1.5

(iv) Other reserves

Tax recognised in equity relating to Available for Sale and Cash Flow reserve movements is as follows:

	2011 £m	2010 £m
Available for Sale reserve - tax (credit)	0.9	(3.7)
Cash Flow reserve - tax (credit)	0.5	0.7
	1.4	(3.0)

12 Treasury bills

	2011 £m	2010 £m
Treasury bills	451.3	500.5
Of which:		
Maturing in three months or less	199.8	229.8
Maturing between three months and one year	251.5	270.7
	451.3	500.5

13 Investment securities

	2011 £m	2010 £m
Investment securities		
Unlisted – issued by banks and building societies	88.3	544.8
Of which:		
Maturing within one year	-	61.2
Between 1 and 5 years	63.2	444.1
After 5 years	25.1	39.5
	88.3	544.8

The fair value movement during the year on investment securities classified as Available for Sale is a gain of £0.4m (2010: a loss of £13.1m).

14 Derivative financial instruments

As part of its asset and liability management the Bank uses derivatives for hedging purposes in order to reduce its exposure to market risks. The Bank uses interest rate swaps to hedge interest rate risk in the personal loan book and currency swaps to hedge foreign exchange risk from cash flows arising from certain available for sale securities.

This is achieved by hedging specific forecast transactions against balance sheet exposures. The table below shows the fair values of derivative financial instruments, recorded as assets or liabilities, together with their notional amounts. The notional amount, recorded gross, is the amount of a derivative's underlying asset, reference rate or index and is the basis upon which changes in the fair value of derivatives are measured. The notional amounts indicate the volume of transactions outstanding at the year end and are indicative of neither the market risk nor the credit risk.

Derivatives held as cash flow hedges

	Notional Amount £m	Assets £m	Liabilities £m
Currency swaps:			
At 31 December 2011	94.0	-	21.6
At 31 December 2010	401.4	-	108.9

Cash flow hedges

The Bank is exposed to foreign exchange risks from cash flows arising on some of its available for sale investment securities. These forecast transactions in foreign currencies are hedged with currency swaps. The cash flows on the currency swaps substantially match the cash flow profile of the hedged investment securities. There were no transactions for which cash flow hedge accounting had to be ceased in 2010 (2009: nil) as a result of the highly probable cash flows no longer being expected to occur. All cash flow hedges are non-current.

Derivatives held as portfolio fair value hedges

	Notional Amount £m	Assets £m	Liabilities £m
Interest rate swaps:			
At 31 December 2011	10.0	-	0.1
At 31 December 2010	-	-	-

Fair value hedges

The Bank is exposed to interest rate risk on the fixed rate interest income from the retail loan portfolio, which is predominantly funded by variable rate savings liabilities. The interest income on a section of the retail loan portfolio has been hedged with 'pay fixed', 'receive floating' interest rate swaps. The cash flows on the interest rate swaps substantially match the cash flow profile of the hedged retail loans. The changes in fair value of the derivatives are hedged against changes in the fair value of the loans, with ineffective movements going to profit or loss.

15 Loans and advances to banks

	Note	2011 £m	2010 £m
Sterling loans and advances to banks		1,226.6	1,599.0
Repayable on demand (included in cash equivalents)	36	11.6	-
Other loans and advances repayable:			
In 3 months or less (included in cash equivalents)	36	1,215.0	1,599.0
Gross advances		1,226.6	1,599.0

16 Loans and advances to customers

	Note	2011 £m	2010 £m
Gross advances		2,499.3	2,446.4
Impairment losses on loans and advances	9	(113.3)	(121.9)
Adjustment in relation to fair value hedging		0.1	-
Loans and advances to customers		2,386.1	2,324.5
Repayable on demand		634.8	718.3
Other loans and advances repayable:			
In 3 months or less		148.2	119.4
Between 3 months and 1 year		419.4	351.1
Between 1 and 5 years		1,185.2	1,109.2
After 5 years		111.7	148.4
Gross advances		2,499.3	2,446.4

The Bank's gross lending exposure before deduction of impairment provisions is analysed below:

	2011 £m	2010 £m
Individuals:		
Home Mortgages	76.0	85.3
Unsecured Personal Lending	2,423.3	2,361.1
Gross loans and advances to customers	2,499.3	2,446.4

17 Other assets

	2011 £m	2010 £m
Customer funds in the course of settlement	14.1	12.5
Bank funds in course of settlement	42.7	47.6
Amounts due from Link network	-	28.8
Other debtors	2.0	1.1
	58.8	90.0

Other assets have no fixed maturities but are expected to be realised within 12 months.

18 Deposits by banks

	2011 £m	2010 £m
Repayable:		
On demand	-	2.7
Within 3 months	80.5	98.4
Between 3 months and 1 year	249.8	292.2
Between 1 and 5 years	825.3	847.2
More than 5 years	16.1	37.0
	1,171.7	1,277.5

19 Customer accounts

Customer accounts comprise sterling interest bearing deposits.

	2011 £m	2010 £m
Repayable:		
On demand	2,299.8	3,375.6
Within 3 months	117.6	-
Between 3 months and 1 year	277.7	61.2
Between 1 and 5 years	193.0	104.5
	2,888.1	3,541.3

20 Other liabilities

All other liabilities are expected to be settled within 3 months.

	2011 £m	2010 £m
Customer funds in course of settlement	19.3	14.5
Bank funds in course of settlement	7.6	0.8
Other liabilities	0.8	2.3
	27.7	17.6

21 Provisions for liabilities and charges

	FSCS £m	Other regulatory provisions £m	Total £m
2011			
At 1 January 2011	2.7	0.2	2.9
Charge to administrative expenses	1.0	1.5	2.5
Utilised in year	(1.2)	(0.6)	(1.8)
At 31 December 2011	2.5	1.1	3.6
2010			
At 1 January 2010	4.2	1.3	5.5
Charge to administrative expenses	(0.1)	-	(0.1)
Utilised in year	(1.4)	(1.1)	(2.5)
At 31 December 2010	2.7	0.2	2.9

Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS) is funded by levies on firms authorised by the FSA, based on their level of deposits taken at 31 December each year. The Bank, as a regulated deposit taker, is subject to levies imposed by the FSCS whose costs are made up of management expenses and compensation payments. As the UK's statutory fund of last resort for customers of domestic financial institutions, the FSCS stepped in during 2008 to provide significant funding in relation to the bail out of a number of banks whose depositors are protected by the scheme. In order to meet its obligations, the FSCS has borrowed funds from HM Treasury on an interest only basis until April 2012 when the first repayment was originally scheduled. These borrowings are anticipated to be repaid wholly or substantially from the realisation of the assets of the institutions assisted. This has resulted in an additional levy being set by the FSCS to cover the interest on this loan. Interest will continue to accrue on the HM Treasury loan to the FSCS until April 2012 and will form part of future FSCS management expenses levies.

Given that the assets of failed institutions are insufficient to repay the entire loan in 2012, the FSCS are currently negotiating with HM Treasury to extend the terms of the loan, or replace it with a new loan. The size of this revised loan, its repayment schedule and the interest conditions have not yet been communicated to the industry, and therefore the extent of any additional levies is currently uncertain. At the date of these financial statements, we have assumed that there will be a levy for the period 2012/2013, based on the interest payable on the remaining existing loan to HM Treasury under current terms.

The impact of this levy in the 2011 financial statements is a net charge of £1.0m (December 2010: release of £0.1m). The closing provision represents the estimated share of levies that will be raised by the FSCS including the interest on the loan in respect of the levy years 2011/2012 and 2012/2013, based on an estimate of the interest that the FSCS will pay on the loan and an estimate of the Bank's market participation in the relevant periods. Note that the 2012/2013 levy represents a provision by the Bank for additional levies, however the basis of this has not yet been communicated by the FSCS. Hence, the provision is based on the interest estimated on the current borrowings from HM Treasury. The net charge of £1.0m comprises a charge of £1.2m for the levy year 2012/2013 and a release of £0.2m in respect of the opening provision held for 2011/2012 due to changes in assumptions in the estimated interest on the loan based on forward LIBOR projections.

21 Provisions for liabilities and charges continued

Other regulatory provisions

Other provisions have been made in prior years in respect of a commercially agreed position between Lloyds Banking Group relating to various customer claims received by them as discussed in critical accounting estimates on page 10. This liability has fully crystallised.

A provision is also recognised for the cost of double nectar points on insurance contracts, which reflects the estimated cost to the Bank over the first year of the contract. This is discussed in critical accounting estimates on page 10.

22 Accruals and deferred income

Included in accruals and deferred income at 31 December 2011 are amounts payable to J Sainsbury plc of £3.4m (December 2010: £2.5m) and amounts payable to Lloyds Banking Group plc of £10.1m (December 2010: £8.3m) in respect of management services and capital expenditure. Accruals and deferred income has no fixed maturity.

23 Other borrowed funds

	2011 £m	2010 £m
Dated loan capital - Repayable between 1 and 5 years		
£60 million Floating Rate subordinated loan 2014	60.0	60.0
Undated loan capital		
£50 million Floating Rate subordinated loan - undated	50.0	50.0

Dated loan capital

The dated subordinated loan is split in proportion to shareholder funding. See note 37 - 'Parent Company'. No repayment, for whatever reason, of dated subordinated debt prior to its stated maturity may be made without the consent of the Financial Services Authority. On a winding up of the Bank, the claims of the holders of dated subordinated debt shall be subordinated in right of payment to the claims of all depositors and creditors of the Bank other than creditors whose claims are expressed to rank pari passu with or junior to the claims of the holders of the dated subordinated debt. Interest on the £60 million Floating Rate subordinated loan dated 2014, is payable three months in arrears at LIBOR plus a margin of 0.60% per annum for the duration of the loan.

Undated loan capital

The undated subordinated loans are split in proportion to shareholder funding. See note 37 - 'Parent Company'. The undated subordinated loan capital shall be repaid on such date as the Financial Services Authority shall agree in writing for such repayment (following a request by either the Lender or Borrower) and in any event not less than five years and one day from the dates of drawdown. On a winding up of the Bank, the claims of the holders of undated subordinated debt shall be subordinated in right of payment to the claims of all depositors and creditors of that company other than creditors whose claims are expressed to rank pari passu with or junior to the claims of the holders of the undated subordinated debt. Interest on the £50 million Floating Rate undated loan capital is payable three months in arrears at LIBOR plus a margin of 1.0% per annum for the duration of the loan.

24 Called up share capital

	'A' Ordinary shares of £1 £m	'B' Ordinary shares of £1 £m	Total Ordinary shares of £1 £m
Allotted, called up and fully paid:			
At 1 January 2011	85.0	85.0	170.0
Issued Ordinary shares	-	-	-
At 31 December 2011	85.0	85.0	170.0

The share capital is divided into class 'A' and class 'B' Ordinary shares which rank pari passu in all respects.

25 Retained earnings

	2011 £m	2010 £m
At 1 January	68.7	48.1
Profit for the year to 31 December	29.9	20.6
At 31 December	98.6	68.7

The shareholders' agreement prescribes that a distribution of profits may not be made if the distribution would result in the Bank being in regulatory test deficit, the distribution would or would be likely to result in a breach of any covenant to any lender, or if a distribution would not be prudent having regard to the future outlook and performance of the Bank.

26 Other reserves

Other reserves comprise the fair value movements for available for sale securities and the effective portion of changes in the fair value of cash flow hedges. Both the available for sale reserve and cash flow reserve will unwind in line with the maturity profile of the underlying investment securities. The maturity profile of the investment securities is highlighted in note 13.

	Available for Sale Reserve £m	Cash Flow Reserve £m	2011 Total £m
At 1 January	(20.3)	(0.8)	(21.1)
Net unrealised losses	(12.0)	(2.6)	(14.6)
Realised losses reclassified to the income statement on disposal	12.4	4.4	16.8
Tax effect of net losses	(0.9)	(0.5)	(1.4)
Balance at 31 December	(20.8)	0.5	(20.3)

	Available for Sale Reserve £m	Cash Flow Reserve £m	2010 Total £m
At 1 January	(10.9)	(2.5)	(13.4)
Net unrealised losses	(27.6)	4.2	(23.4)
Realised losses reclassified to the income statement on disposal	14.5	(1.8)	12.7
Tax effect of net losses	3.7	(0.7)	3.0
Balance at 31 December	(20.3)	(0.8)	(21.1)

These balances include tax of £7.5m in the available for sale reserve (2010: £8.2m) and £0.2m in the cash flow hedge reserve (2010: £0.3m).

Notes to the accounts continued

27 Analysis of financial assets and liabilities by measurement basis

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The principal accounting policies on pages 7 to 11 describe how financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the financial assets and liabilities in the balance sheet by the class of financial instrument to which they are assigned, and therefore by the measurement basis:

	Held for trading £m	Held to maturity securities £m	Loans and receivables £m	Available for sale securities £m	Financial assets and liabilities at amortised cost £m	Derivatives designated as cash flow hedging instruments £m	Derivatives designated as fair value hedging instruments £m	Total £m
At 31 December 2011								
Assets:								
Cash and cash equivalents			248.6					248.6
Financial investments - Available for Sale:								
Treasury bills				451.3				451.3
Investment securities				88.3				88.3
Loans and advances to banks			1,226.6					1,226.6
Loans and advances to customers			2,386.1					2,386.1
Other assets			58.8					58.8
Prepayments and accrued income			22.0					22.0
Total financial assets	-	-	3,942.1	539.6	-	-	-	4,481.7
Total non-financial assets								22.9
Total Assets								4,504.6
Liabilities:								
Deposits by banks					1,171.7			1,171.7
Derivatives						21.6	0.1	21.7
Customer accounts					2,888.1			2,888.1
Other liabilities					27.7			27.7
Accruals and deferred income					28.1			28.1
Other borrowed funds:								
Dated loan capital					60.0			60.0
Undated loan capital					50.0			50.0
Total financial liabilities	-	-	-	-	4,225.6	21.6	0.1	4,247.3
Total non-financial liabilities								9.0
Total Liabilities								4,256.3

	Held for trading £m	Held to maturity securities £m	Loans and receivables £m	Available for sale securities £m	Financial assets and liabilities at amortised cost £m	Derivatives designated as cash flow hedging instruments £m	Total £m
At 31 December 2010							
Assets							
Cash and cash equivalents			210.5				210.5
Financial investments - Available for Sale:							
Treasury bills				500.5			500.5
Investment securities				544.8			544.8
Loans and advances to banks			1,599.0				1,599.0
Loans and advances to customers			2,324.5				2,324.5
Other assets			90.0				90.0
Prepayments and accrued income			12.9				12.9
Total financial assets	-	-	4,236.9	1,045.3	-	-	5,282.2
Total non-financial assets							20.1
Total Assets							5,302.3
Liabilities:							
Deposits by banks					1,277.5		1,277.5
Derivatives designated as cash flow hedging instruments						108.9	108.9
Customer accounts					3,541.3		3,541.3
Other liabilities					17.6		17.6
Accruals and deferred income					25.9		25.9
Other borrowed funds:							
Dated loan capital					60.0		60.0
Undated loan capital					50.0		50.0
Total financial liabilities	-	-	-	-	4,972.3	108.9	5,081.2
Total non-financial liabilities							3.5
Total Liabilities							5,084.7

28 Loan and operating lease commitments**Loan commitments**

The contractual amount of the Bank's off-balance sheet financial instruments that commit it to extend credit to customers is as follows:

	2011 £m	2010 £m
Commitments to extend credit	28.1	30.5

Operating lease commitments

Total commitments under operating leases are as follows:

	2011 £m	2010 £m
Due within one year	0.8	0.6

29 Risk management

Through its normal operations, the Bank is exposed to a number of risks, the most significant of which are credit risk, operational risk, liquidity risk and market risk. The overall risk management framework is described in detail on pages 2 to 5 of the Directors report.

Credit risk

Credit risk is the risk of financial loss arising from the failure of customers or other counterparties to settle their financial obligations to the Bank as they fall due.

Wholesale and derivative credit risk

The Bank lends surplus funds to the inter-bank market. Limits have been established for all counterparties based on their respective financial strength and credit ratings. The limits and proposed counterparties are reviewed and approved by the Assets and Liability Committee and the Executive Risk Committee as required. Derivatives are subject to the same credit risk control procedures as are applied to other wholesale market instruments.

Retail credit risk

Management of credit risk in respect of retail customers makes use of automated credit decisioning techniques (both scorecards and policy rules) for new applications. In addition, behavioural scoring is used to assess the conduct of customers' accounts on an ongoing basis, for e.g. granting extensions to limits. Underwriting is undertaken by specialist teams in operational areas to complement these processes. The Retail Credit Risk Committee ensures that appropriate policies are established and adhered to and this is subject to further oversight from the Executive Risk Committee. Internal Audit teams carry out regular reviews of credit risk processes and policies on an annual basis.

At 31 December 2011, the maximum credit exposure of the Bank in the event of other parties failing to perform their obligations is equal to the sum of loans and advances to banks, loans and advances to customers and credit lines and other commitments to lend. These are set out in notes 15, 16 and 28, respectively. No account is taken of any collateral held and the maximum exposure to loss is considered to be the instrument's balance sheet carrying amount.

The table below shows the maximum exposure to credit risk for the components of the balance sheet, including derivatives. The maximum exposure is shown gross, before the effect of mitigation through the use of collateral agreements.

	2011 £m	2010 £m
Maximum exposure		
Credit risk exposures relating to on-balance sheet		
Cash and cash equivalents	248.6	210.5
Treasury bills	451.3	500.5
Investment securities	88.3	544.8
Loans and advances to banks	1,226.6	1,599.0
Loans and advances to customers:		
Unsecured	2,310.1	2,239.2
Secured	76.0	85.3
Other assets	58.8	90.0
Prepayments and accrued income	23.1	13.2
Credit risk exposures relating to off-balance sheet items		
Loans commitments and other related liabilities	28.1	30.5
Total credit risk exposure	4,510.9	5,313.0

Risk concentrations of the maximum exposure to retail and wholesale credit risk

Concentrations arise when a number of counterparties are engaged in similar business activities, or activities in the geographic region, or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Concentrations indicate the relative sensitivity of the Bank's performance to developments affecting a particular industry or geographical location.

In order to avoid excessive concentrations of risk, the Bank's policies and procedures include specific guidelines to focus on maintaining a diversified portfolio. Identified concentrations of credit risks are controlled and managed according to client or counterparty (and their respective credit qualities). Consideration is also given to geographical sector and in the case of wholesale credit risk the strength of the relevant sovereign.

29 Risk management continued**Geographical sectors**

	2011 £m	2010 £m
Maximum exposure		
United Kingdom	4,422.6	4,768.2
Countries in Europe adopting the Euro	88.3	483.8
Canada	-	61.0
Total	4,510.9	5,313.0

Concentration by location for loans and advances is measured based on the location of the bank's operations, which has a high correlation with the location of the borrower. Concentration by location for investment securities is measured based on the location of the issuer of the security.

Industry sectors

	2011 £m	2010 £m
Maximum exposure		
Corporate	80.0	-
Sovereign:		
UK	453.8	503.6
Non UK	-	-
Bank	1,526.0	2,429.5
Retail	2,451.1	2,379.9
Total	4,510.9	5,313.0

The maximum credit exposure to any client or counterparty as of 31 December 2011 was £1,132.6m (2010: £1,357.8m) before taking into account collateral or other credit enhancements of £340.0m (2010: £642.6m). This exposure was to Lloyds Banking Group plc and represents short term inter-bank deposits and lending under a reverse repo arrangement which is supported by 100% UK gilt collateral. The existence of collateral helps the Bank manage concentration risk and credit risk. Amounts are invested in the repo facility up to a maximum of a year with varying maturities depending on forecast liquidity requirements.

Credit quality per class of financial asset**Loans and advances to customers**

Loans and advances are summarised as follows:

	2011 £m	2010 £m
Impaired	140.7	160.8
Past due but not impaired	21.3	26.4
Neither past due nor impaired	2,337.3	2,259.2
Gross	2,499.3	2,446.4
Less: allowance for impairment	(113.3)	(121.9)
hedging fair value adjustment	0.1	-
Net	2,386.1	2,324.5

Credit quality analysis - 31 December 2011:

	Unsecured lending 2011 £m	Secured lending 2011 £m	2011 £m
Impaired			
Less than 3 months, but impaired	4.4	-	4.4
Past due 3 to 6 months	15.9	0.7	16.6
Past due 6 to 12 months	0.3	0.4	0.7
Past due over 12 months	-	1.4	1.4
Recoveries	117.5	-	117.5
Possession	-	0.1	0.1
Total gross impaired loans	138.1	2.6	140.7
Past due but not impaired			
Past due up to 3 months but not impaired	18.8	2.5	21.3
Total gross past due but not impaired	18.8	2.5	21.3
Neither past due nor impaired*			
Not impaired	2,266.4	70.9	2,337.3
Total gross neither past due nor impaired	2,266.4	70.9	2,337.3
Total gross amount due	2,423.3	76.0	2,499.3
*Includes loans and advances that would have been past due or impaired had their terms not been renegotiated	2.6	-	2.6

29 Risk management continued

Mortgages held over residential properties represent the only collateral held by the Bank for retail exposures. The fair value of collateral held for impaired loans and loans past due but not impaired was £10.4m (2010: £11.1m). The fair value of collateral held against possession cases was £0.1m (2010: £0.2m).

If a customer falls into arrears, the customer will be held in 'collections' where the Bank will work with the customer to try and regularise the position over a period of time. Where the arrears status of a customer deteriorates and there is a failure to respond to correspondence or an acceptable repayment proposal, including notice of default, the customer balance will fall into 'recoveries'. Recoveries will take steps to recover the debt, using their expertise to determine the optimum recovery strategy. Instigation of legal action will depend upon the anticipated recoveries and costs.

Credit quality analysis - 31 December 2010:

	Unsecured lending 2010 £m	Secured lending 2010 £m	2010 £m
Impaired			
Less than 3 months, but impaired	5.9	-	5.9
Past due 3 to 6 months	19.5	0.6	20.1
Past due 6 to 12 months	0.3	0.3	0.6
Past due over 12 months	-	1.7	1.7
Recoveries	132.3	-	132.3
Possession	-	0.2	0.2
Total gross impaired loans	158.0	2.8	160.8
Past due but not impaired			
Past due up to 3 months but not impaired	23.7	2.7	26.4
Total gross past due but not impaired	23.7	2.7	26.4
Neither past due nor impaired*			
Not impaired	2,179.4	79.8	2,259.2
Total gross neither past due nor impaired	2,179.4	79.8	2,259.2
Total gross amount due	2,361.1	85.3	2,446.4
*Includes loans and advances that would have been past due or impaired had their terms not been renegotiated	2.5	-	2.5

Loans and advances to banks

The total gross amount of individually impaired loans and advances to banks as at 31 December 2011 was £nil (2010: £nil). The fair value of collateral held for loans and advances to banks was £340m (2010: £642.6m). Collateral takes the form of security over UK government gilt securities. The table below presents an analysis of lending to banks by rating agency designation, based on Moody's ratings.

	2011 £m	2010 £m
Aaa to A3	1,215.0	1,599.0
Total	1,215.0	1,599.0

29 Risk management continued**Debt securities, cash and equivalents, Treasury bills and other eligible bills**

The total gross amount of individually impaired debt securities, cash and cash equivalents, Treasury bills and other eligible bills as at 31 December 2011 was £nil (2010: £nil). No collateral is held regarding these assets. The tables below present an analysis of the credit quality of money market funds included within cash and cash equivalents. The credit quality of Treasury bills and investment securities by market value is also included. Analysis is by rating agency designation, based on Moody's ratings:

	Cash and cash equivalents £m	Treasury bills £m	Investment securities £m	Total £m
At 31 December 2011				
Aaa to A3	80.0	451.3	73.3	604.6
Baa1 to Baa3	-	-	15.0	15.0
Total	80.0	451.3	88.3	619.6

	Cash and cash equivalents £m	Treasury bills £m	Investment securities £m	Total £m
At 31 December 2010				
Aaa to A3	-	500.5	500.8	1,001.3
Baa1 to Baa3	-	-	44.0	44.0
Total	-	500.5	544.8	1,045.3

Cash and cash equivalents exclude bank balances, cash at central banks and cash at ATMs.

Operational risk

The Bank has adopted the industry standard definition of operational risk from the Basel Committee on Banking Supervision. This is 'the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events'.

As highlighted on page 3, the Bank's risks were reassessed in 2011 utilising a revised methodology which is aligned to the three lines of defence model and the Bank's risk management framework. The key risks assessed were wholesale and retail credit risk, liquidity risk, market risk, regulatory change and operational risk (including outsourcing risk).

In addition to the Control Self Assessment process described on page 3 and regular reporting to the Operational and Regulatory Risk Committee (ORRC), a strategic risk map is also maintained. This provides details of the current impact and likelihood assessments of the key strategic risks of the Bank, along with a forward looking assessment of risks. This is reported to the Board Risk Committee with any significant change in assessments from the last meeting being highlighted and the strategic risk map is also included in the monthly MI pack reviewed by the Board. The Board Risk Committee also considers potential linkages between the key strategic risks in order to identify 'combined risks'.

Internal Audit undertakes reviews across the business throughout the year under a programme agreed with the Bank Audit Committee.

Liquidity risk

Liquidity risk is the risk that the Bank is unable to meet its financial commitments as they fall due without an adverse impact on funding costs or profitability. The Bank's liquidity risk management framework is set to adhere to the standards as set by the FSA in the BIPRU regulations.

As required by the regulations the Bank has completed an Individual Liquidity Adequacy Assessment (ILAA). This allows the Bank to demonstrate that it understands the liquidity risks it is running and has appropriate controls in place to mitigate them. The bank has established a liquidity risk appetite as well as a suite of limits stemming from the ILAA process that has led to a minimum level of liquidity held. Limits are informed by a number of stress scenarios that assess the survival period of the Bank.

In meeting internal limits as well as FSA requirements the Bank maintains a stock of high quality liquid assets that can be readily sold to meet the Bank's obligations to depositors and other creditors. The portfolio of assets is managed on a daily basis and within the framework as outlined in the ILAA and by the FSA.

In addition to this, the Bank prepares both long term and short term forecasts to assess liquidity requirements. Short term forecasting covers a rolling twelve month period and takes into account factors such as ATM cash management, investment maturities and customer deposit patterns and balances. These reports support daily liquidity management and are reviewed daily by senior management along with early warning indicators.

The table below shows the undiscounted cash flows on the Bank's financial assets, liabilities and unrecognised loan commitments on the basis of their earliest possible contractual maturity. The Bank's expected cash flows on these instruments vary significantly from this analysis. The disclosure for derivatives shows a gross inflow and outflow amount. As derivatives have a simultaneous gross settlement it is not considered representative to show only the outflow amount.

Repayments which are subject to notice are treated as if notice were to be given immediately. However, the Bank expects that many customers will not request repayment on the earliest date the Bank could be required to pay and the table does not reflect the expected cash flows indicated by the Bank's deposit retention history.

29 Risk management continued

Residual contractual maturity analysis

At 31 December 2011	Less than 1 month £m	1 to 3 months £m	3 to 12 months £m	1 to 5 years £m	Over 5 years £m	Total 2011 £m
Assets						
Cash and cash equivalents	248.6	-	-	-	-	248.6
Treasury bills	50.1	149.9	251.6	-	-	451.6
Investment securities	-	0.5	1.1	88.2	34.0	123.8
Loans and advances to banks	832.3	395.1	-	-	-	1,227.4
Loans and advances to customers	87.9	177.7	769.5	1,815.3	85.3	2,935.7
Other assets	58.8	-	-	-	-	58.8
Prepayments and accrued income	23.1	-	-	-	-	23.1
Total assets	1,300.8	723.2	1,022.2	1,903.5	119.3	5,069.0
Liabilities						
Non-derivative liabilities						
Deposits by banks	35.0	52.6	267.7	854.6	16.2	1,226.1
Customer accounts	2,351.4	55.1	287.0	199.4	-	2,892.9
Other liabilities	36.7	-	-	-	-	36.7
Accruals	28.1	-	-	-	-	28.1
Other borrowed funds	-	0.4	1.7	65.9	64.4	132.4
	2,451.2	108.1	556.4	1,119.9	80.6	4,316.2
Derivative liabilities						
Cashflow hedges:						
Outflow	-	0.5	1.1	88.2	34.0	123.8
Inflow	-	(0.2)	(0.9)	(71.1)	(27.4)	(99.6)
		0.3	0.2	17.1	6.6	24.2
Fair value hedges:						
Outflow	-	-	1.2	9.4	-	10.6
Inflow	-	-	(1.2)	(9.2)	-	(10.4)
	-	-	-	0.2	-	0.2
Net derivative cashflows	-	0.3	0.2	17.3	6.6	24.4
Unrecognised loan commitments	28.1	-	-	-	-	28.1
Total liabilities	2,479.3	108.4	556.6	1,137.2	87.2	4,368.7
Net liquidity	(1,178.5)	614.8	465.6	766.3	32.1	700.3

29 Risk management continued

At 31 December 2010	Less than 1 month £m	1 to 3 months £m	3 to 12 months £m	1 to 5 years £m	Over 5 years £m	Total 2010 £m
Assets						
Cash and cash equivalents	210.5	-	-	-	-	210.5
Treasury bills	50.1	179.9	270.8	-	-	500.8
Investment securities	20.2	1.0	46.7	421.8	44.1	533.8
Loans and advances to banks	812.9	787.5	-	-	-	1,600.4
Loans and advances to customers	644.8	109.7	567.4	1,332.7	127.0	2,781.6
Other assets	90.0	-	-	-	-	90.0
Prepayments and accrued income	13.2	-	-	-	-	13.2
Total assets	1,841.7	1,078.1	884.9	1,754.5	171.1	5,730.3
Liabilities						
Non-derivative liabilities						
Deposits by banks	36.1	71.3	314.9	888.5	37.6	1,348.4
Customer accounts	3,376.0	0.9	65.1	107.5	-	3,549.5
Other liabilities	20.2	-	-	-	-	20.2
Accruals	25.9	-	-	-	-	25.9
Other borrowed funds	-	0.4	1.3	70.8	62.3	134.8
	3,458.2	72.6	381.3	1,066.8	99.9	5,078.8
Derivative liabilities						
Cashflow hedges:						
Outflow	20.2	0.9	41.4	361.4	44.1	468.0
Inflow	(15.8)	(0.5)	(32.2)	(280.4)	(34.6)	(363.5)
	4.4	0.4	9.2	81.0	9.5	104.5
Unrecognised loan commitments	30.5	-	-	-	-	30.5
Total liabilities	3,493.1	73.0	390.5	1,147.8	109.4	5,213.8
Net liquidity	(1,651.4)	1,005.1	494.4	606.7	61.7	516.5

Market risk

Market risk is the risk that the fair value or future cash flows of financial instruments will fluctuate due to changes in market variables such as interest rates or foreign exchange rates. The Bank does not have a trading book. Non-trading book positions are managed and monitored using sensitivity analysis to minimise earnings volatility, taking into account expected future business flows. Foreign exchange rate risk is fully hedged.

Interest rate risk

The Bank offers lending and savings products with varying interest rate features and maturities which create potential interest rate risk exposures. Interest rate risk is the risk to earnings and capital arising from timing differences on the re-pricing of the Bank's loans and deposits, and unexpected changes to the slope and shape of the yield curve. The Bank assumes interest rate risk through dealings with retail customers as well as through lending in the wholesale market. The Bank's unsecured retail lending (note 16) comprises of fixed rate products with exposure to fair value interest rate risk and variable rate products with exposure to cash flow interest rate risk. The Bank's retail deposits (note 19) comprise of variable rate savings products which are exposed to fair value interest rate risk and cash flow interest rate risk respectively. On the wholesale side, both lending to banks (note 15) and bank deposits (note 18) are exposed to fair value interest rate risk. Sensitivity analysis is used to assess the effect on earnings of interest rate fluctuations and to determine the extent of measures required to mitigate the risk arising from mismatches in the Bank's business.

The systems developed by the Bank enable this risk to be measured and facilitate pro-active management of the interest rate exposures facing the Bank. Where possible, the Bank takes advantage of natural hedging opportunities between fixed rate assets and liabilities with similar re-pricing dates. Net re-pricing gaps are managed within limits set by the Board Risk Committee using fixed rate funding. These exposures are monitored by the Asset and Liability Committee and the Board Risk Committee.

During the year, the Bank entered into several derivative contracts with the objective of managing interest rate risk on the personal loan portfolio (note 15). These 'pay fixed, receive floating' rate interest swap contracts are designed to hedge the re-pricing risk on segments of the personal loan portfolio which earn fixed rate income and hence reduce net interest earnings volatility.

29 Risk management continued

The Bank monitors the sensitivity of financial assets and liabilities to various standard and non-standard interest rate scenarios. Standard scenarios that are considered on a monthly basis include a 50 basis point rise or fall of all yield curves however more extreme scenarios are also considered. The sensitivity of the income statement is the effect of the above changes in basis points on the net interest income for one year, based on the floating rate financial assets and liabilities held at 31 December 2011.

	Sensitivity of net interest income £m	Sensitivity of equity £m
At 31 December 2011		
+ 50 increase in basis points	(2.8)	(4.4)
+ 25 increase in basis points	(1.4)	(2.2)
- 25 decrease in basis points	1.0	2.2
- 50 decrease in basis points	1.3	4.4

	Sensitivity of net interest income £m	Sensitivity of equity £m
At 31 December 2010		
+ 50 increase in basis points	(3.6)	(1.3)
+ 25 increase in basis points	(1.5)	(0.6)
- 25 decrease in basis points	-	0.6
- 50 decrease in basis points	0.2	1.3

The pricing of the retail deposit base is administered and the ability to re-price allows the Bank to actively manage and mitigate basis risk as well as the general sensitivity of net interest income to changes in the yield curve. The Asset and Liability Committee regularly reviews assumptions around pricing changes in response to differing interest rate scenarios.

Currency risk

Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. The Bank is exposed to foreign exchange risks from cash flows arising on some of its available for sale investment securities. These forecast transactions in foreign currencies are hedged with currency swaps. The cash flows on the currency swaps substantially match the cash flow profile of the hedged investment securities. At the end of December 2011 the EUR and USD notional value of the foreign investment securities was €138,960,000 and \$nil respectively (2010: €521,060,000 and \$95,000,000 respectively). This was exactly matched by the EUR and USD notional value of the derivative obligations.

30 Capital resources

The following table analyses the regulatory capital resources of the Bank at 31 December 2011:

	2011 £m	2010 £m
Tier 1 capital:		
Ordinary share capital	170.0	170.0
Reserves	68.6	48.1
Deduction for intangible assets	(4.7)	(2.4)
Total Tier 1 capital	233.9	215.7
Upper Tier 2 capital:		
Undated loan stock	50.0	50.0
Allowable element of provisions	30.5	32.4
Lower Tier 2 capital:		
Dated loan stock	36.0	48.0
Total Tier 2 capital	116.5	130.4
Total capital	350.4	346.1

The Bank's regulatory capital is analysed into two tiers. Tier 1 capital includes ordinary share capital and retained earnings after the deduction of intangible assets. Tier 2 capital includes dated and undated loan capital plus an impairment allowance. Various limits are applied to elements of the capital base. Tier 2 capital cannot exceed Tier 1, and lower Tier 2 capital cannot exceed 50% of Tier 1 capital. The Bank meets both requirements.

Capital management

The Bank manages its capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of its activities. The capital base has not changed materially in the 12 months to 31 December 2011. Capital adequacy is monitored on an ongoing basis by senior management, the Asset and Liability Committee, the Executive Risk Committee and the Board Risk Committee. Our submissions to the FSA in the year have shown that the Bank has complied with all externally imposed capital requirements.

31 Fair value of financial instruments

The fair values of financial instruments are based on market prices where available, or are estimated using other valuation techniques. Where they are short term in nature or re-price frequently, fair value approximates to carrying value. The fair value information presented does not represent the fair value of the Bank as a going concern at 31 December 2011 or 31 December 2010. The classification adopted by the Bank is shown in the following table:

At 31 December 2011	IAS 39 Classification	Carrying Value £m	Fair Value £m
Assets:			
Cash and balances at central banks	Loans and Receivables	248.6	248.6
Treasury bills	Available for Sale	451.3	451.3
Loans and advances to banks	Loans and Receivables	1,226.6	1,226.4
Loans and advances to customers	Loans and Receivables	2,386.1	2,701.7
Investment securities	Available for Sale	88.3	88.3
Liabilities:			
Deposits by banks	Financial Liabilities at amortised cost	1,171.7	1,190.5
Derivative financial instruments	Fair value though profit or loss as modified by effective hedging relationship	21.7	21.7
Customer accounts	Financial Liabilities at amortised cost	2,888.1	2,900.1
Other borrowed funds	Financial Liabilities at amortised cost	110.0	112.4

At 31 December 2010	IAS 39 Classification	Carrying Value £m	Fair Value £m
Assets:			
Cash and balances at central banks	Loans and Receivables	210.5	210.5
Treasury bills	Available for Sale	500.5	500.5
Loans and advances to banks	Loans and Receivables	1,599.0	1,599.0
Loans and advances to customers	Loans and Receivables	2,324.5	2,520.2
Investment securities	Available for Sale	544.8	544.8
Liabilities:			
Deposits by banks	Financial Liabilities at amortised cost	1,277.5	1,300.5
Derivative financial instruments	Fair value though profit or loss as modified by effective hedging relationship	108.9	108.9
Customer accounts	Financial Liabilities at amortised cost	3,541.3	3,545.9
Other borrowed funds	Financial Liabilities at amortised cost	110.0	111.5

Information on how fair values are calculated for the financial assets and liabilities noted above is explained on page 10 of the critical accounting estimates section.

32 Fair value hierarchy

IFRS 7 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources; unobservable inputs reflect the Bank's market assumptions. These two types of inputs have created the following fair value hierarchy:

- Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities. This level includes listed equity securities and debt instruments on exchanges (for example, London Stock Exchange, Frankfurt Stock Exchange, New York Stock Exchange) and exchanges traded derivatives like futures.
- Level 2 - Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices). The sources of input parameters like LIBOR yield curve or counterparty credit risk are Bloomberg and Reuters.
- Level 3 - Inputs for the asset or liability that are not based on observable market data (unobservable inputs). This level includes equity investments and debt instruments with significant unobservable components. This hierarchy requires the use of observable market data when available. The Bank considers relevant and observable market prices in its valuations where possible.

32 Fair value hierarchy continued

The below table provides an analysis of the relevant fair value hierarchy:

At 31 December 2011	Level 1 £m	Level 2 £m	Level 3 £m	Total 2011 £m
Financial Investments - Available for Sale				
Treasury bills	451.3	-	-	451.3
Investment securities	-	88.3	-	88.3
Total assets	451.3	88.3	-	539.6
Derivatives designated as fair value hedging instruments	-	(0.1)	-	(0.1)
Derivatives designated as cash flow hedging instruments	-	(21.6)	-	(21.6)
Total liabilities	-	(21.7)	-	(21.7)

At 31 December 2010	Level 1 £m	Level 2 £m	Level 3 £m	Total 2010 £m
Financial Investments - Available for Sale				
Treasury bills	500.5	-	-	500.5
Investment securities	-	544.8	-	544.8
Total assets	500.5	544.8	-	1045.3
Derivatives designated as cash flow hedging instruments	-	(108.9)	-	(108.9)
Total liabilities	-	(108.9)	-	(108.9)

33 Reconciliation of operating profit to net cash inflow/(outflow) from operating activities

	2011 £m	2010 £m
Profit before taxation	39.7	28.7
Non-cash items included in profit before taxation		
Impairment losses on loans and advances	50.7	60.5
Depreciation on property, plant and equipment	3.4	3.4
Amortisation of intangible assets	1.3	0.8
Loss on disposal of property, plant and equipment	-	0.1
Interest on borrowed funds	1.8	1.6
Change in operating assets and liabilities		
Net (increase) in loans and advances to customers	(112.2)	(229.3)
Net decrease in investment securities	457.0	390.5
Net (decrease) in derivative liabilities	(85.4)	(71.7)
Net decrease in other assets	31.8	(11.0)
Net (increase) in prepayments and accrued income	(9.9)	1.8
Net (decrease) in customer accounts	(653.2)	(159.9)
Net (decrease) in borrowed funds	(105.8)	60.8
Net increase in other liabilities	3.2	(19.6)
Net increase in accruals and deferred income	2.2	6.2
Cash generated from operations	(375.4)	62.9
Income taxes received	-	-
Net cash flows from operating activities	(375.4)	62.9
Operational cash flows from interest		
Interest paid	(78.8)	(92.6)
Interest received	225.4	218.4

34 Analysis of cash flows relating to investing activities

	2011 £m	2010 £m
Purchase of equipment	(3.5)	(3.5)
Purchase of intangibles	(2.2)	(1.9)
	(5.7)	(5.4)

35 Analysis of cash flow in respect of financing

	2011 £m	2010 £m
Interest paid on other borrowed funds	(1.8)	(1.6)

36 Cash and cash equivalents

For the purposes of the cash flow statements, cash and cash equivalents comprise the following:

	Note	2011 £m	2010 £m
Cash and cash equivalents		248.6	210.5
Balances at central banks		(2.5)	(3.1)
Cash and cash equivalents omitting balances at central banks		246.1	207.4
Loans and advances to other banks - repayable on demand	15	11.6	-
Loans and advances to other banks - repayable in less than three months	15	1,215.0	1,599.0
Treasury bills	12	451.3	500.5
		1,924.0	2,306.9

37 Parent company

J Sainsbury plc and Bank of Scotland plc each hold 50% of the issued share capital of the Bank, with a contractual arrangement in place to share joint control. Consequently there is no ultimate parent company.

38 Related party transactions

The Bank is a joint venture between the shareholders, J Sainsbury plc and Bank of Scotland plc (part of the Lloyds Banking Group plc group of companies).

The Bank has identified the following transactions, which fall to be disclosed under the terms of IAS 24:

	2011 £m	2010 £m
Transactions during the year: J Sainsbury plc		
Services and loans provided by J Sainsbury plc:		
Management services	16.1	25.3
Interest expense paid in respect of interest-bearing loans	0.8	0.8
Total loans and advances given during the year	-	-
Balances at 31 December		
Payables:		
Management services	3.4	2.5
Interest payable:		
Subordinated dated loan capital	30.0	30.0
Subordinated undated loan capital	25.0	25.0

In the same period companies within the Lloyds Banking Group plc group provided both management and banking services to the Bank. The Bank also entered into financial transactions with, and earned commission from, companies within the Lloyds Banking Group plc group of companies, all under normal commercial terms.

38 Related party transactions continued

None of the loans and advances to related parties was impaired at the balance sheet date. Furthermore, no expenses were recognised during the year in respect of impairment losses on loans and advances to related parties.

	2011 £m	2010 £m
Transactions during the year: LBG		
Services and loans provided by LBG group of companies:		
Management and banking services	21.3	31.2
Interest expense paid in respect of subordinated loan capital	0.8	0.8
Deposits by banks:		
Fixed term	287.5	470.0
Deposits repaid during the year	(393.3)	(409.2)
Net interest paid in respect of interest rate swaps, loans and advances	34.0	41.4
Loans given to and commission received from LBG group of companies:		
Total loans and advances made during the year	9,351.0	8,824.0
Loans and advances repaid during the year	(9,588.0)	(8,872.0)
Net interest received in respect of interest rate swaps, loans and advances	7.8	9.9
Commission income earned	7.9	10.8
Balances at 31 December		
Receivables:		
Loans and advances	1,131.6	1,357.0
Interest receivable	0.5	0.8
Commission receivable	2.6	3.6
Payables:		
Management and banking services	10.1	8.3
Interest payable	1.4	1.9
Deposits by banks	1,171.7	1,277.5
Subordinated dated loan capital	30.0	30.0
Subordinated undated loan capital	25.0	25.0

The loans and advances figures above are largely collateralised under a reverse repo arrangement which is supported by 100% UK gilt collateral.

39 Transactions with key management personnel

For the purposes of IAS 24 'Related Party Disclosures', key management personnel comprise members of the Sainsbury's Bank Board and the Executive Committee of the Bank, who held office during the year.

Remuneration and other compensation

	2011 £m	2010 £m
Short term employee benefits	2.1	1.8
Post-employment benefits	0.1	0.1
Other long term benefits	0.8	0.1
Share-based payments	0.2	0.1
	3.2	2.1

Short term employee benefits represent salary, bonus and benefits in kind. Post-employment benefits relate to employer's contributions to defined benefit and money purchase pension schemes operated by J Sainsbury's plc and Lloyds Banking Group plc.

Share based payments relates to share schemes operated by the Lloyds Banking Group plc and J Sainsbury's plc. No recharge is made by either organisation to the Bank in respect of shares granted to colleagues. Both schemes are equity-settled in respect of the JV parents.

The Sainsbury's 'Value Builder' long term incentive plan conditionally awards J Sainsbury's shares to senior management. The core award is calculated as a percentage of the employee's salary, scaled according to grade. Awards will vest if the threshold levels of 2 performance related conditions (J Sainsbury's plc return on capital employed and growth in cash flow per share) are met over a three year performance period. The core award can grow by up to 4 times depending on performance. If performance conditions are met, 50% of the award will be released after 3 years and a further 50% after a further year. Dividends will accrue on awards that vest in the form of additional shares.

The Lloyds Banking Group Long Term Incentive Plan (LTIP) is a share-based award available to senior LBG employees. Shares will vest after a 3 year period if performance conditions are met. Performance conditions are based on earnings per share growth and profit growth over the 3 year period.

No termination payments were made during the year (2010: £30k).

39 Transactions with key management personnel continued**Product transactions**

Details of transactions, under terms and conditions available to all colleagues, between the Bank and key management personnel are provided below. For this purpose, key management personnel include Sainsbury's Bank key management personnel and members of their close families. This note does not include key management personnel of J Sainsbury plc or Lloyds Banking Group plc as they are not considered to be key management personnel of Sainsbury's Bank.

Transactions with key management personnel

	Number of key management personnel	Directors £'000	Others £'000
Mortgages, credit cards and term loans:			
At 1 January 2010	4	12	4
Resignations during 2010	(2)	-	(4)
Appointments/ New accounts during 2010	1	-	-
Amounts advanced during the year		75	2
Amounts repaid during the year		(79)	(2)
At 31 December 2010	3	8	-
Resignations during 2011	-	-	-
Appointments/ New accounts during 2011	-	-	-
Amounts advanced during the year		83	1
Amounts repaid during the year		(82)	(1)
At 31 December 2011	3	9	-
Savings and deposit accounts:			
At 1 January 2010	4	70	11
Resignations during 2010	(2)	(33)	(11)
Appointments/ New accounts during 2010	1	38	-
Amounts deposited during the year		37	-
Interest paid		2	-
Amounts withdrawn during the year		(37)	-
At 31 December 2010	3	77	-
Resignations during 2011	-	-	-
Appointments/ New accounts during 2011	2	15	-
Amounts deposited during the year		268	-
Interest paid		3	-
Amounts withdrawn during the year		(88)	-
At 31 December 2011	5	275	-

Based on the Companies Act definition of Loans to Directors, total lending outstanding at 31 December 2011 was £nil (2010: £nil).

40 Events after the balance sheet date

The Bank disposed of an investment security after the balance sheet date realising a loss of £7.1m previously accumulated in reserves. This had no impact on year end valuations or impairment assessments.

41 Approval of accounts and other information

The accounts were approved by the Board of Directors on 1st March 2012. Sainsbury's Bank plc registered office is 33 Holborn, London, EC1N 2HT and its principal executive office is located at Keith House, Redheughs Rigg, South Gyle Crescent, Edinburgh, EH12 9DQ.

Statement of Directors' responsibilities

The directors are responsible for preparing the Report by the Board of Directors to the Shareholders and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the Directors have prepared the financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing these financial statements, the Directors are required to:

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

- maintain the integrity of the website.
 - The maintenance and integrity of the J Sainsbury plc's website is the responsibility of the Directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.
 - Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

By order of the Board and signed on its behalf by

Hannah Bernard
Company Secretary
London
1st March 2012

Independent Auditor's Report to the Shareholders of Sainsbury's Bank plc

We have audited the financial statements of Sainsbury's Bank plc for the year ended 31 December 2011 which comprise the Income Statement, Statement of Comprehensive Income, Balance Sheet, Statement of Changes in Equity, Cash Flow Statement, the Accounting Policies and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

Respective responsibilities of Directors and auditor

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

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Report by the Board of Directors to the Shareholders to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 December 2011 and of its profit and cash flows for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion the information given in the Report by the Board of Directors to the Shareholders for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of Directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit

Lindsay Gardiner (Senior Statutory Auditor)

for and on behalf of PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

Chartered Accountants and Statutory Auditors
Edinburgh
1st March 2012