Sainsbury's Bank plc

Report by the Board of Directors to the Shareholders and Financial Statements for the year ended 31 December 2012

Company number: 3279730

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Report by the Board of Directors to the Shareholders

The Directors have pleasure in submitting the financial statements of Sainsbury's Bank plc ('the Bank') for the year ended 31 December 2012 to the Annual General Meeting to be held on 28 February 2013.

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

Throughout 2012, the Bank has continued to work in partnership with Sainsbury's Supermarkets to provide customers with an alternative to traditional high street banks.

Customers continue to respond positively to our Reward proposition- where the Bank offers rewards to customers when shopping in Sainsbury's Supermarkets in conjunction with preferential product pricing for Sainsbury's shoppers. As Nectar celebrated its tenth birthday, the Bank remains the only financial services provider to have continually awarded Nectar points since its launch, awarding points to more than 1 million collectors. This continued in 2012 with a 50% increase in Nectar points awarded compared with the previous year. This follows the successful launch of a new Nectar based credit card, offering enhanced points on shopping and fuel spend.

The Bank continues to offer competitive credit card and personal loan products aimed primarily at the Sainsbury's shopper. The loans market in particular has seen significant competition in the year. 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 leading to increased underlying profitability.

In 2012, the Bank has grown its customer base with active accounts increasing by 9% versus the prior year and total sales (representing new customers) up by 17% from 2011.

The Bank continues to develop its insurance product suite. During the year the offering was further strengthened with the launch of a new Home Insurance proposition with Direct Line Insurance. Wider insurance volumes have continued to grow, with Car and Home insurance products in particular showing strong new and renewal business performance.

The Bank has continued to develop its Travel Money offering, opening the 126th in-store bureau in November. Performance has continued to grow with year on year increase in sales.

The supermarket based ATM network has continued to expand in 2012 and provides a consistently high level of customer service. At the end of the year a total of 1,368 machines were in operation in the Sainsbury's estate (2011: 1,275) and despite being one of the busiest UK networks, customer service continues to perform well ahead of the industry average.

In the next financial year the Directors anticipate continued development of the existing suite of products to ensure the Bank continues to provide customers with competitive rewarding products.

Financial performance and position

The Bank's 2012 performance is presented in the income statement on page 12. The Bank's profit before tax has increased by £13.2m compared to the previous year. The drivers of this underlying profitability are steady income growth coupled with carefully managed debt management. This performance is particularly pleasing within the backdrop of a challenging competitive environment despite incurring a loss realised through the disposal of a number of investment securities (2012: loss £12.5m; 2011: loss £16.5m), which were undertaken to reduce the overall wholesale credit risk of the Bank. Underlying profit before tax excluding this factor was therefore £65.4m (2011: £56.5m). The Directors remain confident that the business will continue to be profitable in the future.

Net operating income increased by £9.5m compared to the prior year. Net interest income decreased by £5.2m compared to the prior year (3.9%) with rates associated with lending products remaining highly competitive in the market place, whilst funding costs increased reflecting increased average savings balances in 2012. However, this decline was more than offset by favourable improving commission income, which increased by £14.4m compared to the prior year (14.5%). Income from general insurance products increased significantly compared to the prior year, with Home and Car insurances achieving strong new and renewal volume growth. This was partially offset by a reduction in commission from Credit Cards.

Impairment losses have fallen by £18.1m in comparison to the prior year despite strong personal loan lending growth. This reflects continued focus on credit risk decisioning criteria and strong back book management. The bad debt asset ratio has fallen to 1.24% from 2.03% in the prior year.

Costs increased by £18.7m compared to the prior year (15.0%) in line with the Bank's continuing strategy of building business volumes and developing in house capability.

The Directors monitor the financial performance of the Bank and track a variety of key performance measures including the following ratios:

	2012	2011
Cost: income ratio	**59.45%**	53.83%
Net interest margin	**2.79%**	2.87%
Bad debt asset ratio	**1.24%**	2.03%
Core Tier 1 capital ratio	**11.0%**	9.6%
Total capital ratio	**14.3%**	14.4%

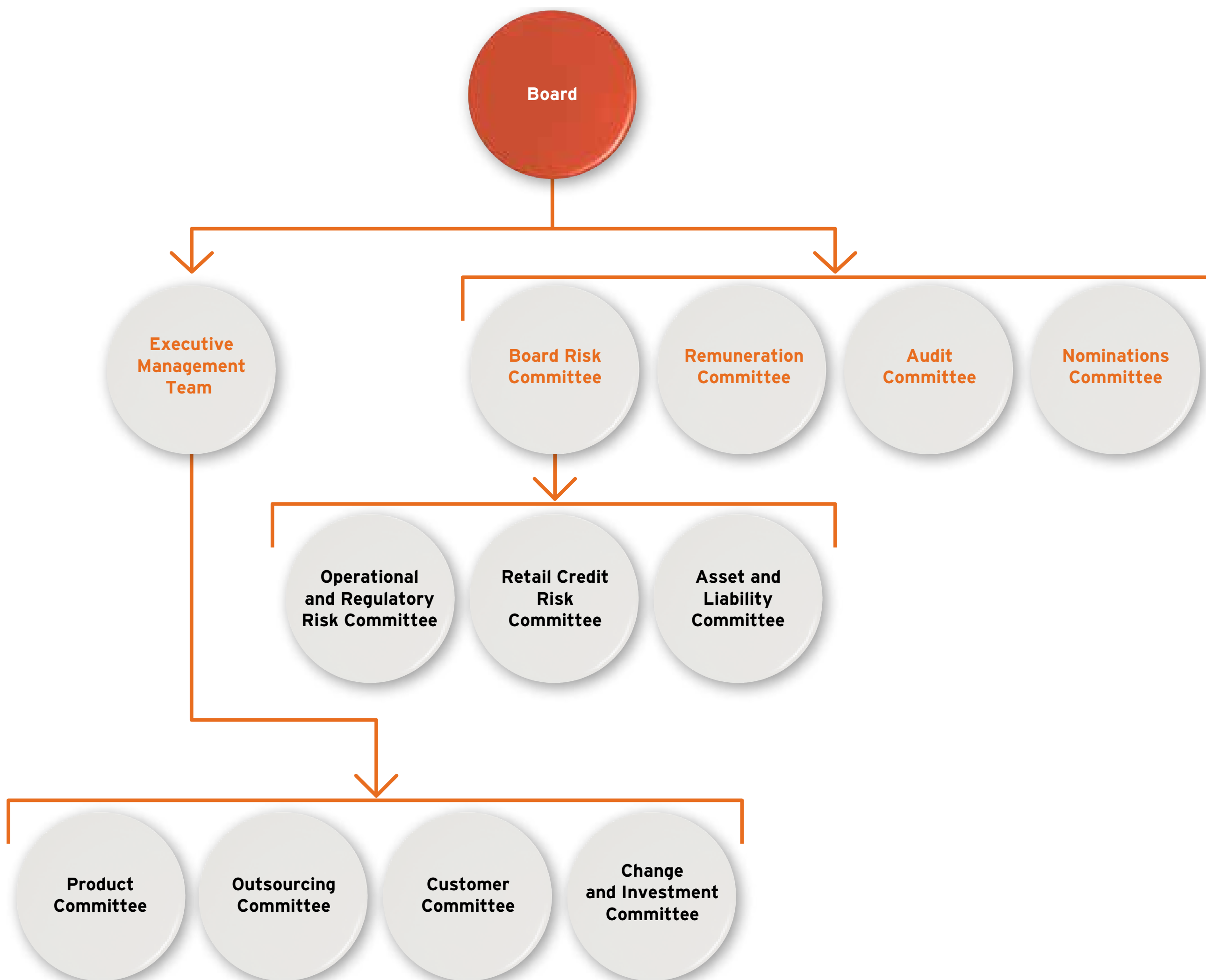
The Bank's funding model is predominantly retail funded with a high level of liquidity being maintained. Overall savings balances increased to a level of £3.3bn (13.2%) with the Bank tailoring deposit levels to the funding requirements of the business. The Bank has maintained a broadly stable holding of highly liquid Treasury Bills and has holdings in very short-term high quality investments. Total gross loans and advances to customers increased by £160.9m in the year (6.7%).

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 that the Retail Credit Risk Committee, Asset and Liability Committee and Operational and Regulatory Risk Committee now report to the Board Risk Committee.



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 Executives members from the Bank, three Non-Executives Directors from each of the shareholders and two independent Non-Executive Directors.

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 Investment Committee,

Outsourcing Committee, Customer Committee and Product 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
The role of the Remuneration Committee (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 2013.

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.

Change and Investment Committee
The Change and Investment Committee (CIC) 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 ultimately to ensure best practice.

The Product Committee
The Product Committee (PC) reports to the Executive Management Team. 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.

Operational and Regulatory Risk Committee
The Operational and Regulatory Risk Committee (ORRC) is a sub-committee of the BRC. 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. It is also responsible for overseeing the development and implementation of the Bank's Operational and Regulatory Risk Management Frameworks.

The Retail Credit Risk Committee
The Retail Credit Risk Committee (RCRC) is a sub-committee of the BRC. 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 performance.

The Asset and Liability Committee
The Asset and Liability Committee (ALCO) is a sub-committee of the BRC. 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.

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 sub-committees noted on this page. 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 internal audit team supplemented by 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.

As part of the second line of defence, risks are identified and managed by the Bank on an ongoing basis. The Bank's risks are assessed utilising a 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.	• 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.	• Credit risk reporting to ALCO, BRC, Audit Committee and Board including reference to 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, BRC and Board.
Liquidity and funding risk	The risk of the Bank being unable to meet its obligations as they fall due.	• 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. • 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.	• 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 sets out the Bank's view on forward-looking base rate. • 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.
Operational risk	Represents the risk of loss stemming from failed processes, human error or fraud.	• 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 risk registers with appropriate oversight by ORRC, 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.	• 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, BRC and the Board. • Regular and open communication with the FSA on all aspects of Bank activity but with particular focus on regulatory risk. • Conduct risk 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. 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 2012 and 31 December 2011 was as follows:

	31 December 2012 (unaudited) £m	31 December 2011 (unaudited) £m
Risk weighted assets	**2,401.0**	2,439.6
Core Tier 1 capital ratio	**11.0%**	9.6%
Total capital ratio	**14.3%**	14.4%

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 2013.

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. The Bank has increased the level of retail funding during 2012 (increased by 13.1%) and maintains a diversified funding base. The Bank maintains a significant level of highly liquid assets, with the holding of Treasury Bills increasing to £474.4m representing 14.5% of deposits (2011: £451.3m, 15.6% of deposits). Whilst not included within the regulatory liquidity buffer, the Bank holds diversified investments in several sterling money market funds (£375m), which are highly liquid in nature.

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 2009-2012 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 continues to maintain its strong 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 financial statements.

Issued share capital

The amount of issued share capital was unchanged from the previous year at £170.0m (Note 24).

Dividends

The profit after tax for the year attributable to the shareholders is £40.3m (2011: £29.9m). The Directors do not recommend payment of a dividend (2011: £nil).

Directors
The Directors at 31 December 2012 were:

Mr Darren Shapland (Chairman)
Ms Gwyn Burr
Ms Hannah Bernard
Mr Ian Fox
Mr John Rogers
Mr John Galloway
Mr Richard Keys
Mr Alan Cook
Mr Peter Griffiths (Chief Executive Officer) Appointed 19 November 2012
Mr Alan Brindley Appointed 3 December 2012

The Board comprises three Executive Directors and seven Non-Executive Directors. Mr Ian Fox, Mr John Galloway and Mr Alan Brindley are employed and remunerated by Lloyds Banking Group plc. Ms Gwyn Burr, Ms Hannah Bernard, Mr John Rogers, and Mr Peter Griffiths are employed and remunerated by J Sainsbury plc. Mr Darren Shapland, 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 Peter Griffiths and Mr Alan Brindley, who were appointed during the year, all of the Directors in office at the date of this report served throughout the year.

Several Directors resigned during the year. Mr David Fisher resigned on 23 March 2012, Mr David Nicolson resigned on 2 March 2012 and Mr Alasdair Lenman resigned on 7 September 2012. Mr David Arden was appointed as Director on 5 April 2012 and resigned as Director on 19 November 2012.

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 £53,694 (2011: £10,703). A total of £15,094 was donated to the 2012 Sport Relief event with the remaining amounts supporting various local charities. In the prior year £9,003 was donated to the 2011 Comic Relief event. No political donations were made during the year (2011: 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 2012 was 17 days (2011: 22 days).

Independent auditors

PricewaterhouseCoopers LLP have indicated their willingness to remain in office as auditor.

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
28 February 2013

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 financial statements 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 principal accounting policies have been applied consistently throughout the year.

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 and Position of the Bank at the end of the financial year'.

(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. Provisioning on unsecured balances identified as being in arrears is calculated based on past experience, with regularly updated assumptions. 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. This includes analysis of the likelihood of a particular balance to move into an arrears status within a defined period of time and application of an appropriate loss rate. The emergence period into an arrears state represents the average time elapsed between the loss trigger event and default. 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 unrealised 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 three 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 licences 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 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 clawback, an appropriate element of the commission receivable is deferred and amortised over the life of the underlying loan or period of clawback. Car insurance initial commission is recognised on completion of the service provided, with an element deferred to reflect cancellation expectation and services yet to be performed in future periods.

(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 or as required by IAS 37 and IFRIC 13. For certain insurance products double Nectar points are awarded on spend in J Sainsbury's plc stores subject to a cap for two 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 financial statements 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:

- hedges of the fair value of the particular risks inherent in recognised assets or liabilities (fair value hedges).
- hedges of highly probable future cash flows attributable to recognised assets are 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) Critical accounting judgements and estimates

The preparation of the financial statements 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.

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.

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.

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.

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 2012 and 2011 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.

Commission clawback
Where the Bank receives commission and there is a risk of potential clawback, an appropriate element of the commission receivable is deferred and amortised over the life of the underlying loan or period of clawback. 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 clawback 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 loans, 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, instore spending levels and spending caps on the amount of points per month. This model is re-assessed at regular intervals.

Financial Services Compensation Scheme
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 interest levied on the renewed loan facility from HM Treasury and further levies representing amounts due from the industry to cover the estimated repayment shortfall due to the non recoverable funds from failed institutions. 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 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 2012 deposit level would be £0.3m. Further details of the FSCS and the provision are included in note 21.

(s) Accounting developments

The following IFRS standards and International Financial Reporting Interpretations Committee (IFRIC) interpretations have been applied in 2012:

IFRS 7 'Financial Instruments: Disclosures'. The revised standard requires additional disclosures for the transfer of assets that are not derecognised in their entirety, or where these assets are derecognised but the entity has a continuing involvement. The amendment has no impact on the financial statements of the Bank. This revision to the standard was effective from 1 July 2011.

IAS 1 'Presentation of Financial Statements'. Effective from 1 July 2011. The revised standard requires additional disclosures from entities that operate in a hyperinflationary environment that elect to measure opening assets and liabilities at fair value and use those valuations as deemed cost within their opening IFRS statement of financial position. This has not yet been endorsed by the EU.

IAS 12 'Income taxes'. Effective from January 2012. This amended guidelines issued regarding determining deferred tax liabilities and deferred tax assets when investment property is measured using the fair value model in IAS 40. This does not impact the Bank as there is currently no Investment Property held on the balance sheet.

The following standards and interpretations have not yet been adopted by the European Union, are not effective for the year ended 31 December 2012 and have not been applied in preparing the financial statements:

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.
- In the June 2012 meeting, the IASB tentatively approved a third classification of Fair Value through the Other Comprehensive Income (OCI). If adopted in the standard, this would allow for fair value fluctuations to be recorded through OCI, however, only impact the profit and loss when realised.

IFRS 9 has not yet been endorsed by the EU. While adoption of IFRS 9 is mandatory from 1 January 2015, earlier adoption is permitted. The Bank has considered the possible impact of the standard on those instruments currently classified within the Available for Sale category if the FV through OCI category is not introduced. 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. These stages have been released as exposure drafts. The Bank has considered the impact of these new draft standards. A revised exposure draft relating to impairment of financial instruments is expected in early 2013. As information becomes available the Bank will assess the impact of these changes on the financial statements.

IAS 1 'Presentation of Financial Statements'. Effective from 1 July 2012, this amended guidelines requiring entities to group items presented in Other Comprehensive Income (OCI) on the basis of whether they are potentially recycled to profit or loss. This will not impact the Bank as all current items in OCI are recycled to profit or loss.

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. Effective from 1 January 2013 (and endorsed by the EU from 1 January 2014). This would have no effect on the financial statements of the Bank.

IFRS 11 'Joint arrangements'. Effective from 1 January 2013 (and EU endorsed from 1 January 2014). 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'. Effective from 1 January 2013 (and EU endorsed from 1 January 2014). 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'. Effective from 1 January 2013. 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. This is not expected to have a material effect 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 is effective from 1 January 2013, but has not yet been endorsed by the EU. 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. Effective from 1 January 2013, this would have no effect on the financial statements of the Bank.

IAS 28 (revised) 'Associates and Joint Ventures'. Effective from 1 January 2013 (and EU endorsed from 1 January 2014). 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 'Financial Instruments: Disclosures'. Effective from 1 January 2013. The revised standard requires additional disclosures on the effect or potential effect of netting arrangements. The Bank will be required to disclose the potential effect of offsetting the assets and liabilities with Lloyds Banking Group.

IFRS 1 'First time adoption of IFRS'. This amendment is effective from 1 January 2013. This relates to disclosure of government grants. There would be no impact on the financial statements of the Bank.

IFRIC 20 'Stripping Costs in the Production Phase of a Surface Mine'. Effective from 1 January 2013. There would be no impact on the financial statements of the Bank.

2011 Annual Improvements. Effective from 1 January 2013. This includes amendments to IFRS 1 on repeated IFRS application and treatment of capitalised borrowing costs. Amendments to IAS 1 clarify requirements on comparative disclosures. Amendments to IAS 16 clarify the classification requirement for servicing equipment. IAS 32 has been updated to clarify tax rules relating to equity instrument distributions shall be accounted for under IAS 12. IAS 34 has been updated to clarify that total assets and liabilities are only required to be disclosed for reportable operating segments under certain circumstances. None of these changes impact the Bank.

Income statement

for the year to 31 December 2012

	Note	2012 £m	2011 £m
Interest receivable	3	**216.9**	219.5
Interest payable	3	**(87.9)**	(85.3)
Net interest income		**129.0**	134.2
Fees and commissions receivable		**113.4**	99.0
Fees and commissions payable		**(0.7)**	(1.0)
Net operating income		**241.7**	232.2
Administrative expenses	5	**(138.4)**	(120.3)
Depreciation and amortisation			
Property, plant and equipment	6	**(3.7)**	(3.4)
Intangible assets	7	**(1.6)**	(1.3)
		(143.7)	(125.0)
Impairment losses on financial assets	9	**(32.6)**	(50.7)
Losses realised on financial instruments	10	**(12.5)**	(16.8)
Profit before taxation	4	**52.9**	39.7
Taxation	11	**(12.6)**	(9.8)
Profit for the year attributable to the owners of the Bank		**40.3**	29.9

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

Statement of comprehensive income

for the year to 31 December 2012

	Note	31 December 2012 £m	31 December 2011 £m
Profit for the year		**40.3**	29.9
Other comprehensive income/(expense):			
Available for sale financial assets fair value movements		**24.5**	0.4
Cash flow hedges effective portion of fair value movements		**(0.7)**	1.8
Tax on items recognised directly in equity	11	**(6.2)**	(1.4)
Total other comprehensive income for the year net of tax		**17.6**	0.8
Total comprehensive income for the year		**57.9**	30.7

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 financial statements.

Balance sheet

As at 31 December 2012

	Note	As at 31 December 2012 £m	As at 31 December 2011 £m
Assets			
Cash and cash equivalents	36	**473.9**	248.6
Financial Investments – Available for Sale			
Treasury bills	12	**474.4**	451.3
Investment securities	13	**29.2**	88.3
Loans and advances to banks	15	**1,377.0**	1,226.6
Loans and advances to customers	16	**2,547.0**	2,386.1
Property, plant and equipment	6	**17.1**	16.1
Intangible assets	7	**4.9**	4.7
Deferred tax asset	11	**0.8**	1.0
Other assets	17	**42.8**	58.8
Prepayments and accrued income		**21.5**	23.1
Total Assets		**4,988.6**	4,504.6
Liabilities			
Deposits by banks	18	**1,234.0**	1,171.7
Derivative financial instruments	14	**5.7**	21.7
Customer accounts	19	**3,268.0**	2,888.1
Other liabilities	20	**12.4**	27.7
Current tax liabilities		**9.5**	5.4
Provisions for liabilities and charges	21	**5.0**	3.6
Accruals and deferred income	22	**37.8**	28.1
Other borrowed funds			
Dated loan capital	23	**60.0**	60.0
Undated loan capital	23	**50.0**	50.0
Total Liabilities		**4,682.4**	4,256.3
Total Equity			
Called up share capital	24	**170.0**	170.0
Retained earnings	25	**138.9**	98.6
Other reserves	26	**(2.7)**	(20.3)
Equity shareholders' funds		**306.2**	248.3
Total Equity and Liabilities		**4,988.6**	4,504.6

The financial statements on pages 7 to 40 were approved by the Board of Directors on 28 February 2013 and signed on its behalf by:

Peter Griffiths
Director and Chief Executive
28 February 2013

Hannah Bernard
Director and Company Secretary
28 February 2013

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

Sainsbury's Bank plc – Company number 3279730

Statement of changes in equity

For the year to 31 December 2012

At 31 December 2012	Called Up Share capital £m	Retained earnings £m	Other reserves £m	Total £m
At 1 January 2012	**170.0**	**98.6**	**(20.3)**	**248.3**
Profit for the year	**-**	**40.3**	**-**	**40.3**
Other comprehensive income/(expense):				
Available for sale financial assets fair value movements (net of tax)	**-**	**-**	**18.1**	**18.1**
Cash flow hedges effective portion of fair value movements (net of tax)	**-**	**-**	**(0.5)**	**(0.5)**
Total comprehensive income for the year	**-**	**40.3**	**17.6**	**57.9**
Additional share capital raised in the year	**-**	**-**	**-**	**-**
Balance at 31 December 2012	**170.0**	**138.9**	**(2.7)**	**306.2**

At 31 December 2011	Called Up Share capital £m	Retained earnings £m	Other reserves £m	Total £m
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

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 financial statements.

Cash flow statement

for the year to 31 December 2012

	Note	31 December 2012 £m	31 December 2011 £m
Cash flows from operating activities	33	**161.9**	(375.4)
Cash flows from investing activities	34	**(6.7)**	(5.7)
Cash flows from financing activities	35	**(1.8)**	(1.8)
Net increase/(decease) in cash and cash equivalents		**153.4**	(382.9)
Opening cash and cash equivalents	36	**1,924.0**	2,306.9
Closing cash and cash equivalents	36	**2,077.4**	1,924.0

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

Notes to the financial statements

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 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.

		2012 Number	2011 Number
Full time	Seconded colleagues	**233**	178
	Other colleagues	**392**	464
		625	642
Part time	Seconded colleagues	**24**	20
	Other colleagues	**18**	15
		42	35
		667	677

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, they are employed by related parties. 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 Lloyds Banking Group (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 73 (2011: 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 2012, valued on an IAS 19 basis, is £681m (2011: asset of £248m). 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 (2011: 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 2012, valued on an IAS 19 basis, was £455m (2011: liability of £243m). The Scheme was subject to a triennial actuarial valuation carried out by Towers Watson, the Scheme's independent actuaries, at March 2012 on the projected unit basis. The results of this valuation are expected to be finalised in June 2013.

The pension cost recharge for the year represents contributions payable by the Bank to both types of pension scheme and amounted to £504,609 (2011: £472,710) for the defined contribution schemes and £628,457 (2011: £606,646) for the defined benefit schemes.

2 Directors' emoluments

(i) Aggregate emoluments	2012 £'000	2011 £'000
Aggregate emoluments	**1,024**	1,089
Aggregate amounts payable under long-term incentive schemes	**146**	262

Retirement benefits have accrued or are accruing to one Director under the J Sainsbury plc defined benefit schemes (2011: 1). Benefits are also accruing to one Director under the Lloyds Banking Group plc money purchase scheme (2011: 1). In addition to the above, emoluments representing employer's pension contributions of £59k (2011: £44k) 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 (2011: 2) received awards under these schemes reflective of qualifying services. No Directors (2011: 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.

(ii) Highest paid Director	2012 £'000	2011 £'000
Aggregate emoluments	**347**	603
Aggregate amounts payable under long-term incentive schemes	**85**	-

The retirement benefits accruing in relation to the highest paid Director were £53,750 (2011: £nil).

3 Net interest income

	2012 £m	2011 £m
Interest income on loans and receivables	**216.4**	215.7
Interest income from available for sale financial instruments	**0.5**	3.8
Interest receivable	**216.9**	219.5
Interest expense on loans and receivables	**(87.9)**	(83.8)
Interest expense on derivative liabilities	**-**	(1.5)
Interest payable	**(87.9)**	(85.3)
Net interest income	**129.0**	134.2

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 2012 was £nil (2011: £nil). Net ineffectiveness recognised on fair value hedges was £1,386 (2011: £1,665).

4 Profit before taxation

	2012 £m	2011 £m
Profit before taxation is stated after taking account of the following:		
Income:		
Interest on impaired loan balances	**2.0**	2.1
Expenses:		
Operating lease	**1.0**	0.8
Auditors' remuneration:		
Statutory audit of the Bank	**0.2**	0.2

5 Administrative expenses

	2012 £m	2011 £m
Staff costs	**18.2**	16.7
Marketing costs	**37.9**	25.6
Other administrative expenses	**82.3**	78.0
	138.4	120.3

6 Property, plant and equipment

31 December 2012	Equipment £m
Cost:	
At 1 January 2012	**49.0**
Additions	**4.7**
Disposals	**-**
As at 31 December 2012	**53.7**
Accumulated depreciation:	
At 1 January 2012	**32.9**
Charge for the year	**3.7**
Disposals	**-**
As at 31 December 2012	**36.6**
Net Book Value at 31 December 2012	**17.1**

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

7 Intangible assets

31 December 2012	Systems and Software Development £m
Cost:	
At 1 January 2012	**17.9**
Additions	**1.8**
Disposals	**-**
As at 31 December 2012	**19.7**
Accumulated amortisation:	
At 1 January 2012	**13.2**
Charge for the year	**1.6**
Disposals	**-**
As at 31 December 2012	**14.8**
Net Book Value at 31 December 2012	**4.9**

31 December 2011	Systems and Software Development £m
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

8 Capital commitments

	2012 £m	2011 £m
There are commitments in respect of capital expenditure which has been authorised, but not provided for in the financial statements, for which contracts have been entered into, on:		
Property, plant and equipment	**0.7**	0.7
Software development	**-**	0.1
	0.7	0.8

9 Impairment losses on financial assets

	2012 £m	2011 £m
Loans and advances to customers	**32.6**	50.7

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

Year ending 31 December 2012	Unsecured lending £m	Secured lending £m	2012 Total £m
At 1 January 2012	**113.3**	**-**	**113.3**
New impairment provisions less releases (net of recoveries)	**32.6**	**-**	**32.6**
Amounts written off	**(51.0)**	**-**	**(51.0)**
Discount unwind on impaired loans and advances to customers	**(2.0)**	**-**	**(2.0)**
Cumulative impairment provisions as at 31 December 2012	**92.9**	**-**	**92.9**
New impairment provisions less releases	**42.3**	**-**	**42.3**
Recoveries of amounts previously written off	**(9.7)**	**-**	**(9.7)**
Net charge to income statement	**32.6**	**-**	**32.6**
Gross amount of loans individually determined to be impaired, before deducting any individually assessed impairment allowance	**112.5**	**2.2**	**114.7**

Year ending 31 December 2011	Unsecured lending £m	Secured lending £m	2011 Total £m
At 1 January 2011	121.9	-	121.9
New impairment provisions less releases (net of recoveries)	50.7	-	50.7
Amounts written off	(57.2)	-	(57.2)
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

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 £12.5m (2011: £16.8m) previously accumulated in reserves.

11 Taxation

(i) Taxation	2012 £m	2011 £m
UK corporation tax on Profit for the year at 24.5% (2011: 26.5%)	**12.4**	9.3
Adjustments in respect of prior years	**-**	-
Current Tax	**12.4**	9.3
Deferred tax charge	**0.1**	0.4
Impact of change in UK corporation tax rate	**0.1**	0.1
Deferred Tax	**0.2**	0.5
Total Tax Charge	**12.6**	9.8

The taxation charge of £12,617,310 (2011: £9,776,247) represents 23.82% (2011: 24.63%) 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 24% to 23%. The rate change was substantively enacted in July 2012 and takes effect from 1 April 2013. Differences to the UK corporation tax rate for the year of 24.5% are explained below:

(ii) Reconciliation of effective tax rate	2012 £m	2011 £m
Profit on ordinary activities before taxation	**52.9**	39.7
Tax on ordinary activities at 24.5% (2011: 26.5%)	**13.0**	10.5
Effects:		
Change in tax rate	**0.1**	0.1
Impact of rate change on equity items	**(0.5)**	(0.8)
	12.6	9.8

(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:

Deferred tax asset	2012 £m	2011 £m
At 1 January	**1.0**	1.5
Movement in deferred tax asset	**(0.2)**	(0.5)
As at 31 December	**0.8**	1.0
Tax effect of timing differences due to:		
Accelerated capital allowances	**(0.2)**	(0.2)
Timing differences on impairment provisions	**0.8**	1.1
Deferred bonus	**0.2**	0.1
Deferred tax asset at 31 December	**0.8**	1.0

Of the above, £0.6m is recoverable after more than 12 months.

(iv) Other reserves

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

	2012 £m	2011 £m
Available for Sale reserve – tax	**6.4**	0.9
Cash Flow reserve – tax (credit)/charge	**(0.2)**	0.5
	6.2	1.4

12 Treasury bills

	2012 £m	2011 £m
Treasury Bills	**474.4**	451.3
Of which:		
Maturing in three months or less	**199.8**	199.8
Maturing between three months and one year	**274.6**	251.5
	474.4	451.3

13 Investment securities

	2012 £m	2011 £m
Investment securities		
Unlisted – issued by banks and building societies	**29.2**	88.3
Of which:		
Maturing within one year	**-**	-
Between 1 and 5 years	**29.2**	63.2
After 5 years	**-**	25.1
	29.2	88.3

The fair value movement during the year on investment securities classified as available for sale is a gain of £4.1m (2011: a gain of £0.4m).

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

Currency swaps:	Notional Amount £m	Assets £m	Liabilities £m
At 31 December 2012	**27.0**	**-**	**5.5**
At 31 December 2011	94.0	-	21.6

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 2012 (2011: 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

Interest rate swaps:	Notional Amount £m	Assets £m	Liabilities £m
At 31 December 2012	**9.0**	**-**	**0.2**
At 31 December 2011	10.0	-	0.1

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	2012 £m	2011 £m
Sterling loans and advances to banks		**1,377.0**	1,226.6
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	**1,132.0**	1,215.0
Other loans and advances repayable:			
More than 3 months	33	**245.0**	-
Gross advances		**1,377.0**	1,226.6

16 Loans and advances to customers

	Note	2012 £m	2011 £m
Gross advances		**2,639.7**	2,499.3
Impairment losses on loans and advances	9	**(92.9)**	(113.3)
Adjustment in relation to fair value hedging		**0.2**	0.1
Loans and advances to customers		**2,547.0**	2,386.1
Repayable on demand		**631.1**	634.8
Other loans and advances repayable			
In 3 months or less		**190.0**	148.2
Between 3 months and 1 year		**489.7**	419.4
Between 1 and 5 years		**1,282.7**	1,185.2
After 5 years		**46.2**	111.7
Gross advances		**2,639.7**	2,499.3

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

	2012 £m	2011 £m
Individuals:		
Home Mortgages	**69.7**	76.0
Unsecured Personal Lending	**2,570.0**	2,423.3
Gross loans and advances to customers	**2,639.7**	2,499.3

17 Other assets

	2012 £m	2011 £m
Customer funds in the course of settlement	**10.0**	14.1
Bank funds in course of settlement	**32.6**	42.7
Other receivables	**0.2**	2.0
	42.8	58.8

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

18 Deposits by banks

	2012 £m	2011 £m
Repayable:		
On demand	**6.1**	-
Within 3 months	**136.3**	80.5
Between 3 months and 1 year	**341.2**	249.8
Between 1 and 5 years	**744.1**	825.3
More than five years	**6.3**	16.1
	1,234.0	1,171.7

19 Customer accounts

Customer accounts comprise sterling interest bearing deposits.

	2012 £m	2011 £m
Repayable:		
On demand	**2,673.6**	2,299.8
Within 3 months	**27.9**	117.6
Between 3 months and 1 year	**274.7**	277.7
Between 1 and 5 years	**291.8**	193.0
	3,268.0	2,888.1

20 Other liabilities

All Other Liabilities are expected to be settled within 3 months.

	2012 £m	2011 £m
Customer funds in course of settlement	**11.1**	19.3
Bank funds in course of settlement	**1.1**	7.6
Other liabilities	**0.2**	0.8
	12.4	27.7

21 Provisions for liabilities and charges

Year ending 31 December 2012	FSCS £m	Other provisions £m	Total £m
At 1 January 2012	**2.5**	**1.1**	**3.6**
Charge to administrative expenses	**2.5**	**2.0**	**4.5**
Utilised in year	**(1.3)**	**(1.8)**	**(3.1)**
At 31 December 2012	**3.7**	**1.3**	**5.0**

Year ending 31 December 2011	FSCS £m	Other provisions £m	Total £m
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

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 borrowed funds from HM Treasury in 2008, which was subsequently refinanced in 2012. These borrowings are anticipated to be repaid substantially from the realisation of the assets of the institutions assisted. This has resulted in a levy being set by the FSCS to cover the interest on this loan and any shortfall in the principal repayment will be borne by levy payers in the form of additional levies. The principal repayment is expected to be divided into three levies from 2013/14 onwards, with the 2013/14 repayment estimated at £363m. The Bank's share of this initial repayment is based on its share of industry protected deposits as at 31 December 2012 and has been provided for in 2012.

The impact of this levy on the 2012 financial statements is a net charge of £2.5m (December 2011: charge of £1.0m). 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 2012/2013 and 2013/2014, and the first principal repayment levy for 2013/2014 and is 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. Hence, the provision is based on the interest estimated on the current borrowings from HM Treasury. The net charge of £2.5m comprises a charge of £2.4m for the levy year 2013/14 and a charge of £0.1m in respect of the opening provision held for 2012/2013 due to changes in assumptions in the estimated interest on the loan based on forward LIBOR projections.

Other provisions

A provision is 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 2012 are amounts payable to J Sainsbury plc of £5.2m (2011: £3.4m) and amounts payable to Lloyds Banking Group plc of £15.1m (2011: £10.1m) in respect of management services and capital expenditure. Accruals and deferred income has no fixed maturity.

23 Other borrowed funds

	2012 £m	2011 £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 2012	85.0	85.0	170.0
Issued Ordinary Shares	–	–	–
At 31 December 2012	**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

	2012 £m	2011 £m
At 1 January	**98.6**	68.7
Profit for the year to 31 December	**40.3**	29.9
At 31 December	**138.9**	98.6

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	2012 Total £m
At 1 January	**(20.8)**	**0.5**	**(20.3)**
Net unrealised losses	**15.6**	**(4.3)**	**11.3**
Realised losses reclassified to the income statement on disposal	**8.9**	**3.6**	**12.5**
Tax effect of net losses	**(6.4)**	**0.2**	**(6.2)**
Balance at 31 December	**(2.7)**	**-**	**(2.7)**

	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)

These balances include tax of £0.9m in the available for sale reserve (2011: £7.5m) and £nil in the cash flow hedge reserve (2011: £0.2m).

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:

At 31 December 2012	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	Non Financial items £m	Total £m
Assets:							
Cash and cash equivalents	473.9						473.9
Financial Investments - Available for Sale:							
Treasury bills		474.4					474.4
Investment securities		29.2					29.2
Loans and advances to banks	1,377.0						1,377.0
Loans and advances to customers	2,547.0						2,547.0
Other assets	42.6					0.2	42.8
Prepayments and accrued income	18.5					3.0	21.5
Tangible, intangible and deferred tax assets						22.8	22.8
Total assets	4,459.0	503.6	-	-	-	26.0	4,988.6
Liabilities:							
Deposits by banks			1,234.0				1,234.0
Derivatives				5.5	0.2		5.7
Customer accounts			3,268.0				3,268.0
Other liabilities			12.4				12.4
Accruals and deferred income			37.8				37.8
Provisions						5.0	5.0
Current tax						9.5	9.5
Other borrowed funds:							
Dated loan capital			60.0				60.0
Undated loan capital			50.0				50.0
Total liabilities	-	-	4,662.2	5.5	0.2	14.5	4,682.4

At 31 December 2011	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	Non Financial items £m	Total £m
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
Tangible, intangible and deferred tax assets						21.8	21.8
Prepayments and accrued income	22.0					1.1	23.1
Total assets	3,942.1	539.6	-	-	-	22.9	4,504.6
Liabilities:							
Deposits by banks			1,171.7				1,171.7
Derivatives designated as cash flow hedging instruments				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
Provisions						3.6	3.6
Current tax						5.4	5.4
Other borrowed funds:							
Dated loan capital			60.0				60.0
Undated loan capital			50.0				50.0
Total liabilities	-	-	4,225.6	21.6	0.1	9.0	4,256.3

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:

	2012 £m	2011 £m
Commitments to extend credit	**30.9**	28.1

Operating Lease Commitments

Total commitments under operating leases are as follows:

	2012 £m	2011 £m
Due within one year	**1.4**	0.8

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 6 of the Report by the Board of Directors to the Shareholders.

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 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 example 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 Board Risk Committee. Internal Audit teams carry out regular reviews of credit risk processes and policies are reviewed and re-approved on an annual basis.

At 31 December 2012, 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.

Maximum exposure	2012 £m	2011 £m
Credit risk exposures relating to on-balance sheet		
Cash and cash equivalents	**473.9**	248.6
Treasury bills	**474.4**	451.3
Investment securities	**29.2**	88.3
Loans and Advances to banks	**1,377.0**	1,226.6
Loans and Advances to customers:		
Unsecured	**2,477.3**	2,310.1
Secured	**69.7**	76.0
Other assets (see note 27)	**42.6**	58.8
Prepayments and accrued income (see note 27)	**18.5**	23.1
Credit risk exposures relating to off-balance sheet items		
Loans commitments and other related liabilities	**30.9**	28.1
Total credit risk exposure	**4,993.5**	4,510.9

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

Maximum exposure	2012 £m	2011 £m
United Kingdom	**4,589.3**	4,422.6
Countries in Europe adopting the euro	**404.2**	88.3
Total	**4,993.5**	4,510.9

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

Maximum exposure	2012 £m	2011 £m
Corporate	**375.0**	80.0
Sovereign:		
UK	**477.3**	453.8
Non UK	**-**	-
Bank	**1,535.0**	1,526.0
Retail	**2,606.2**	2,451.1
Total	**4,993.5**	4,510.9

The maximum credit exposure to any client or counterparty as of 31 December 2012 was £1,267m (2011: £1,132.6m) before taking into account collateral or other credit enhancements of £362m (2011: £340.0m). This exposure was to Lloyd Banking Group plc and represents short-term interbank 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:

	2012 £m	2011 £m
Impaired	**114.7**	140.7
Past due but not impaired	**17.6**	21.3
Neither past due nor impaired	**2,507.4**	2,337.3
Gross	**2,639.7**	2,499.3
Less: allowance for impairment	**(92.9)**	(113.3)
hedging fair value adjustment	**0.2**	0.1
Net	**2,547.0**	2,386.1

Credit quality analysis – 31 December 2012:

	Unsecured lending 2012 £m	Secured lending 2012 £m	2012 £m
Impaired			
Less than 3 months, but impaired	**2.7**	**-**	**2.7**
Past due 3 to 6 months	**7.1**	**0.6**	**7.7**
Past due 6 to 12 months	**-**	**0.4**	**0.4**
Past due over 12 months	**-**	**1.2**	**1.2**
Recoveries	**102.7**	**-**	**102.7**
Possession	**-**	**-**	**-**
Total gross impaired loans	**112.5**	**2.2**	**114.7**
Past due but not impaired			
Past due up to 3 months but not impaired	**14.6**	**3.0**	**17.6**
Total gross past due but not impaired	**14.6**	**3.0**	**17.6**
Neither past due nor impaired*			
Not impaired	**2,442.9**	**64.5**	**2,507.4**
Total gross neither past due nor impaired	**2,442.9**	**64.5**	**2,507.4**
Total gross amount due	**2,570.0**	**69.7**	**2,639.7**
*Includes loans and advances that would have been past due or impaired had their terms not been renegotiated	**2.5**	**-**	**2.5**

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 £8.6m (2011: £10.4m). The fair value of collateral held against possession cases was £nil (2011: £0.1m).

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 agree 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 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

Loans and advances to banks
The total gross amount of individually impaired loans and advances to banks as at 31 December 2012 was £nil (2011: £nil). The fair value of collateral held for loans and advances to banks was £362m (2011: £340.0m). 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.

	2012 £m	2011 £m
Aaa to A3	**1,377.0**	1,215.0
Total	**1,377.0**	1,215.0

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 2012 was £nil (2011: £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:

At 31 December 2012	Cash and cash equivalents £m	Treasury Bills £m	Investment securities £m	Total £m
Aaa to A3	**375.0**	**474.4**	**-**	**849.4**
Baa1 to Baa3	**-**	**-**	**29.2**	**29.2**
Total	**375.0**	**474.4**	**29.2**	**878.6**

At 31 December 2011	Cash and cash equivalents £m	Treasury Bills £m	Investment securities £m	Total £m
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 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'.

The Bank's risks are assessed utilising a risk management framework methodology which is aligned to the Three lines of defence model. 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 and Funding Risk
Liquidity and funding 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 Banks liquidity risk management framework is set to adhere to the standards as set by the FSA in the BIPRU regulations. The Bank seeks to maintain a liquidity and funding profile to ensure that it can meet its financial obligations under stressed market conditions.

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 Financial Services Authority.

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. Early warning indicators include market stress indicators such as the 3m LIBOR and the yield spread on UK bonds and also firm specific indicators such as early signs of withdrawals on the Bank's retail deposits.

The table on page 33 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 2012	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 2012 £m
Assets						
Cash and cash equivalents	473.9	-	-	-	-	473.9
T-bills	50.1	150.0	274.7	-	-	474.8
Investment securities	-	-	0.1	33.7	-	33.8
Loans and advances to banks	503.5	629.5	245.1	-	-	1,378.1
Loans and advances to customers	833.3	143.1	584.9	1,432.3	48.7	3,042.3
Other assets	42.6	-	-	-	-	42.6
Prepayments and accrued income	18.5	-	-	-	-	18.5
Total assets	1,921.9	922.6	1,104.8	1,466.0	48.7	5,464.0
Liabilities						
Non-derivative liabilities						
Deposits by banks	44.8	97.1	354.6	762.8	5.8	1,265.1
Customer accounts	3,259.3	18.5	286.0	300.7	-	3,864.5
Other liabilities	12.4	-	-	-	-	12.4
Accruals	37.8	-	-	-	-	37.8
Other borrowed funds	-	0.5	1.5	64.3	61.4	127.7
	3,354.3	116.1	642.1	1,127.8	67.2	5,307.5
Derivative liabilities						
Cashflow hedges:						
Outflow	-	-	0.1	33.7	-	33.8
Inflow	-	-	(0.1)	(28.2)	-	(28.3)
	-	-	-	5.5	-	5.5
Fair value hedges:						
Outflow	-	-	0.1	0.3	-	0.4
Inflow	-	-	(0.1)	(0.1)	-	(0.2)
	-	-	-	0.2	-	0.2
Net derivative cashflows	-	-	-	5.7	-	5.7
Unrecognised loan commitments	30.9	-	-	-	-	30.9
Total liabilities	3,385.2	116.1	642.1	1,133.5	67.2	5,344.1
Net liquidity	(1,463.3)	806.5	462.7	332.5	(18.5)	119.9

29. Risk management continued

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
T-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

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 2012.

At 31 December 2012	Sensitivity of net interest income £m	Sensitivity of equity £m
+ 50 increase in basis points	**(2.8)**	**(6.2)**
+ 25 increase in basis points	**(1.4)**	**(3.1)**
– 25 decrease in basis points	**1.1**	**3.0**
– 50 decrease in basis points	**2.3**	**6.1**

At 31 December 2011	Sensitivity of net interest income £m	Sensitivity of equity £m
+ 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

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 2012 the EUR notional value of the foreign investment securities was €40,000,000 (2011: €138,960,000). This was exactly matched by the EUR notional value of the derivative obligations.

30 Capital resources

The following table analyses the regulatory capital resources of the Bank at 31 December 2012:

	2012 £m	2011 £m
Tier 1 capital:		
Ordinary share capital	**170.0**	170.0
Reserves	**98.6**	68.6
Deduction for intangible assets	**(4.9)**	(4.7)
Total Tier 1 capital	**263.7**	233.9
Upper Tier 2 capital:		
Undated loan stock	**50.0**	50.0
Allowable element of provisions	**6.9**	30.5
Lower Tier 2 capital:		
Dated loan stock	**24.0**	36.0
Total Tier 2 capital	**80.9**	116.5
Total capital	**344.6**	350.4

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 2012. 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 2012 or 31 December 2011. The classification adopted by the Bank is shown in the following table:

At 31 December 2012	IAS 39 Classification	Carrying Value £m	Fair Value £m
Assets:			
Cash and balances at central banks	Loans and Receivables	**473.9**	**473.9**
Treasury bills	Available for Sale	**474.4**	**474.4**
Loans and advances to banks	Loans and Receivables	**1,377.0**	**1,376.7**
Loans and advances to customers	Loans and Receivables	**2,547.0**	**2,491.0**
Investment securities	Available for Sale	**29.2**	**29.2**
Liabilities:			
Deposits by banks	Financial Liabilities at amortised cost	**1,234.0**	**1,254.3**
Derivative financial instruments	Fair value though profit or loss as modified by effective hedging relationship	**5.7**	**5.7**
Customer accounts	Financial Liabilities at amortised cost	**3,268.0**	**3,276.8**
Other borrowed funds	Financial Liabilities at amortised cost	**110.0**	**85.9**

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

Information on how fair values are calculated for the financial assets and liabilities noted above is explained on pages 9 and 10 of the critical accounting estimates section.

The estimated fair value of loans and advances represents the discounted amount of estimated future cash flows expected to be received. Expected cash flows are discounted at current market rates to determine fair value.

For fixed interest bearing deposits and other borrowings without quoted market price, valuations are based on discounted cash flows using market interest rates for new lending with similar remaining maturity. The estimated fair value of deposits with no stated maturity is the amount repayable on demand. Whilst the calculations are consistent year on year, the applicable assumption as at 31 December 2011 used LIBOR yield curves to determine discount rates for the calculations. Using a comparable market lending rate assumption would have disclosed the above 2011 fair value of Loans and advances to customers at £2,309.7m, Customer accounts at £2,886.1m and Other borrowed funds at £64.5m.

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 2012	Level 1 £m	Level 2 £m	Level 3 £m	Total 2012 £m
Financial Investments - Available for Sale				
Treasury Bills	**474.4**	**-**	**-**	**474.4**
Investment securities	**-**	**29.2**	**-**	**29.2**
Total assets	**474.4**	**29.2**	**-**	**503.6**
Derivatives designated as fair value hedging instruments	**-**	**(0.2)**	**-**	**(0.2)**
Derivatives designated as cash flow hedging instruments	**-**	**(5.5)**	**-**	**(5.5)**
Total liabilities	**-**	**(5.7)**	**-**	**(5.7)**

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)

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

	2012 £m	2011 £m
Profit before taxation	**52.9**	39.7
Non-cash items included in profit before taxation		
Impairment losses on loans and advances	**32.6**	50.7
Depreciation on property, plant and equipment	**3.7**	3.4
Amortisation of intangible assets	**1.6**	1.3
Loss on disposal of property plant and equipment	**-**	-
Interest on borrowed funds	**1.8**	1.8
Change in operating assets and liabilities		
Net (increase) in loans and advances to customers	**(193.5)**	(112.2)
Net (increase) in loans to banks repayable in greater than 3 months	**(245.0)**	-
Net decrease in investment securities	**83.6**	457.0
Net (decrease) in derivative liabilities	**(16.6)**	(85.4)
Net decrease in other assets	**15.6**	31.8
Net decrease/(increase) in prepayments and accrued income	**1.6**	(9.9)
Net increase(decrease) in customer accounts	**379.9**	(653.2)
Net increase/(decrease) in borrowed funds	**62.3**	(105.8)
Net (decrease)/increase in other liabilities	**(13.7)**	9.2
Net increase in accruals and deferred income	**9.7**	2.2
Cash generated from operations	**176.5**	(369.4)
Income taxes paid	**(14.6)**	(6.0)
Net cash flows from operating activities	**161.9**	(375.4)
Operational cash flows from interest		
Interest paid	**(9.6)**	(78.8)
Interest received	**216.9**	225.4

34 Analysis of cash flows relating to investing activities

	2012 £m	2011 £m
Purchase of equipment	**4.7**	3.5
Purchase of intangibles	**2.0**	2.2
	6.7	5.7

35 Analysis of cash flow in respect of financing

	2012 £m	2011 £m
Interest paid on other borrowed funds	**1.8**	1.8

36 Cash and cash equivalents

For the purposes of the cash flow statements, cash and cash equivalents comprise the following (see accounting policy (k)):

	Note	2012 £m	2011 £m
Cash and cash equivalents		**473.9**	248.6
Balances at central banks		**(2.9)**	(2.5)
Cash and cash equivalents omitting balances at central banks		**471.0**	246.1
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	**1,132.0**	1,215.0
Treasury bills	12	**474.4**	451.3
		2,077.4	1,924.0

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:

	2012 £m	2011 £m
Transactions during the year: J Sainsbury plc		
Services and loans provided by J Sainsbury plc:		
Management services	**25.5**	16.1
Interest expense paid in respect of interest bearing loans	**0.9**	0.8
Total loans and advances given during the year	**-**	-
Balances at 31 December		
Payables:		
Management services	**5.7**	3.4
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 (LBG) plc provided both management and banking services to the Bank. The Bank also entered into financial transactions with, and earned commission from, companies within the LBG plc group of companies, all under normal commercial terms.

38 Related party transactions continued

None of the loans and advances to related parties were 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.

	2012 £m	2011 £m
Transactions during the year: LBG		
Services and loans provided by LBG group of companies:		
Management and banking services	**31.7**	21.3
Interest expense paid in respect of subordinated loan capital	**0.9**	0.8
Deposits by banks:		
Fixed term	**386.5**	287.5
Deposits repaid during the year	**(324.2)**	(393.3)
Net interest paid in respect of interest rate swaps, loans and advances	**26.7**	34.0
Loans given to and commission received from LBG group of companies:		
Total loans and advances made during the year	**1,361.5**	9,351.0
Loans and advances repaid during the year	**(1,214.5)**	(9,588.0)
Net interest received in respect of interest rate swaps, loans and advances	**6.8**	7.8
Commission income earned	**6.3**	7.9
Balances at 31 December		
Receivables:		
Loans and advances	**1,267.0**	1,131.6
Interest receivable	**0.7**	0.5
Commission receivable	**0.9**	2.6
Payables:		
Management and banking services	**15.6**	10.1
Interest payable	**1.0**	1.4
Deposits by banks	**1,234.0**	1,171.7
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

	2012 £m	2011 £m
Short-term employee benefits	**2.0**	2.1
Post-employment benefits	**0.1**	0.1
Other long-term benefits	**0.5**	0.8
Share-based payments	**0.3**	0.2
	2.9	3.2

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 joint venture parents.

The Sainsbury's 'Future Builder' and 'Value Builder' long-term incentive plans conditionally award 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 two 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 four times depending on performance. If performance conditions are met, 50% of the award will be released after three 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 three year period if performance conditions are met. Performance conditions are based on earnings per share growth and profit growth over the three year period.

No termination payments were made during the year (2011: £nil).

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 2011	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	-
Resignations during 2012		-	
Appointments/New accounts during 2012	2	-	-
Amounts advanced during the year		93	2
Amounts repaid during the year		(91)	-
At 31 December 2012	**5**	**11**	**2**
Savings and deposit accounts:			
At 1 January 2011	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	-
Resignations during 2012	(1)	(105)	-
Appointments/New accounts during 2012	2	-	1
Amounts deposited during the year		266	-
Interest paid		3	-
Amounts withdrawn during the year		(10)	-
At 31 December 2012	**6**	**429**	**1**

Based on the Companies Act definition of Loans to Directors, total lending outstanding at 31 December 2012 was £nil (2011: £nil).

40 Events after the balance sheet date

There have been no significant events after the balance sheet date.

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
28 February 2013

Independent Auditors' 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 2012 which comprise the Income Statement, Balance Sheet, Statement of Comprehensive Income, 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 Statement of Directors' Responsibilities, 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 and Financial Statements 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 2012 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
28 February 2013